Compliance Lessons from the Past
Preparing Representatives for the Future.

# hindsight 20/20

Securities America

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**Hindsight 20/20: Compliance Lessons from the Past Preparing Representatives for the Future.**
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## EXECUTIVE SUMMARY

The financial services industry, from banking to insurance to financial advice and investments, is heavily regulated and has high expectations of its professionals and representatives. Investment counsel and financial advice is so very important to the well-being of clients, particularly retirees, that it's no wonder substantial regulatory attention is focused on retirement planning. This paper discusses key compliance best practices from which representatives can enhance their businesses. The paper discusses compliance lessons from the past that can help prepare representatives for the future. The paper does not, however, cover compliance rules and regulations in their entirety, nor is the paper a de facto compliance manual. Compliance best practices can be found from many sources in the industry, and we hope to encourage representatives to spend time talking with their own firms' compliance departments, attending regulatory seminars, networking with peers, reviewing historical case studies and regularly seeking FINRA guidance, as well as other regulatory guidance in order to expand and enhance the best practices introduced in this paper.

## INTRODUCTION

In addition to the unknown nature of the future and working with the diversity of clients' wants and needs, **hindsight** is one of the biggest challenges facing today's financial representatives.

> ***Hindsight*** – Noun; recognition of the realities, possibilities, or requirements of a situation, event, decision etc., after its occurrence.

It is said that hindsight is 20/20. From clients to regulators to representatives, we all think we know what should have been advised or done when looking at the realities, possibilities or requirements of a situation after its occurrence. Now more than ever it's critical that financial representatives anticipate the various combinations and permutations of uncertain future events that may have an effect on the plans, advice and recommendations they're giving their clients.

It is incumbent upon today's financial representatives to find better ways to ensure that their clients are educated about the recommendations, plans and actions that are being implemented. Further, meticulous documentation of that clear understanding by clients about the decisions they are making can help financial representatives give context to the services they provide. This education and documentation can be invaluable when a representative's services are being viewed or judged in the unforgiving clarity of retrospective analysis.

In contrast, the concept of hindsight can be a very powerful ally for representatives. All financial representatives can learn lessons from the historical circumstances of others. By examining decisions and advice in the context of the time that they were given AND in a clear retrospective framework, representatives can learn to better serve their clients, their businesses and themselves in the here and now. Indeed, compliance lessons from the past should be leveraged to prepare representatives for a better, more effective future as a financial representative.

This paper analyzes the circumstances of financial representatives and provides some insight and direction to representatives across the industry on how to better serve their clients, their advisory businesses and themselves. The paper is not meant to supplant any supervisory or regulatory authority, because each representative has his or her own obligations, policies, procedures and processes to follow. Rather, this paper is simply one building block in the larger subject of regulatory and compliance best practices.

## AN OVERVIEW OF THE RETIREMENT PLANNING PROCESS

The mechanics of retirement planning are well known and a staple in industry education of representatives. Nevertheless, a review of financial representatives' cases and circumstances in recent history suggests a need for more thoughtful analysis of the ramifications of advice, plans and recommendations presented in light of unpredictable factors in clients' lives and the markets. Inputs into the process of retirement planning could be better evaluated, including representatives' sources of clients, their financial plans and the products used in plans and recommendations. Additionally, compliance best practices suggest that the inner-workings of products and their specific characteristics and peculiarities should be more thoroughly examined in order to best serve and protect clients' interests.

### CLIENT SUITABILITY

***Appropriate care*** – Regulators have always emphasized the need for financial representatives to exhibit appropriate care when working with all of their clients, but it seems that particularly close attention has been paid recently to clients in their retirement years. Consider that in 2004, 80% of a person's retirement income was up to him or her to provide *(Income of the Aged Chartbook 2004, released by the Social Security Administration in Sept. 2006)*, and many believe that this percentage of personal retirement responsibility is only going to get higher in the foreseeable future. As such, advice, investment recommendations and plans that financial representatives provide to retirees are critically important, and regulators are emphasizing this fact.

***Considering the right time*** – The right time for a client to retire has been a hot topic in the industry. In 2004 it was estimated that as many as 40% of retirees could be forced back into the workforce in the following 10 years because they didn't save enough for retirement *(Newstream.com, 2004)*. This figure is only exacerbated by early retirements. The prospect of an early retirement, powerfully alluring to many clients, has prompted clients and representatives to search for creative solutions to reach the goal of early retirement.

The ever increasing ability of healthcare to prolong lives in the United States has made retirement planning even more challenging. According to the Social Security Administration's Period Life Table updated through June 7, 2006, a 55-year-old male's life expectancy is nearly 24 years and a female's is just over 27 years. For 65-year-olds, the expectancies are approximately 16 and 19 years respectively. And for 75-year-olds, the expectancies are nearly 10 and 12 years respectively. In all cases, those are long retirement periods for which financial plans need to provide, and this fact emphasizes the care and forethought that should go into planning.

***Assessing preparedness*** – A representative with a client wanting to retire should be thoughtful and deliberate in how he or she approaches the retirement planning process. Perhaps the most scrutinized element of a representative's assessment of a client's preparedness to retire is the client's depth of understanding of pertinent issues. Only 42% of Americans know how much money to save for retirement *(2005 Retirement Confidence Survey, EBRI)*. That being the case, it's a fair statement that many clients don't know if they have enough money to retire at any given time.

Representatives should strive to have a full understanding of a client's total financial situation at the point the client wants to retire. Best practices suggest that representatives devote ample time with clients to get their total financial picture, a holistic perspective from which representatives can best determine the suitability of retirement, be it earlier or later in a given client's life.

Historically, many financial representatives have failed to fully consider life changes that are on the horizon. From a compliance best practices viewpoint, representatives who have not diligently considered and explored either probable or possible changes to a client's life circumstances may have fallen short with regard to their responsibilities. Moreover, compliance best practices suggest representatives give a concerted effort to educate and discuss possibilities and outcomes with clients, and then document these discussions, the clients' levels of understanding and the clients' subsequent final decisions.

***Realizing uncertainty and ensuring a margin for error*** – As stated, hindsight is 20/20. So how can representatives be somewhat insulated from future uncertainty? First, one should realize that uncertainty is, in fact, a certainty. The economy, the markets and life circumstances are all dynamic. As such, one key way to help clients understand potential long-term effects of their decisions is analysis and discussion of hypothetical scenarios. Consider the following scenario.

### Looking at "Uncertainty"

In 1998, Sarah Client, a 55-year-old mid-manager at a major corporation, was being prompted by her company to consider retiring early and taking advantage of her long-held company-sponsored retirement plan, which held approximately $750,000 in assets.

Unsure whether she should take a lump-sum distribution or a lifetime monthly pension, Sarah decided to attend a retirement planning seminar held at her company by a local financial advisor, Jonathan Counsel. After the seminar, having piqued Sarah's interest with his retirement knowledge, Sarah scheduled a detailed personal meeting to discuss her options for retirement with Jonathan. At the meeting, Jonathan and Sarah determined that keeping her company-sponsored retirement plan and taking its lifetime annuity payment would not provide enough income to maintain Sarah's standard of living. Other strategies needed consideration.

Through detailed conversations, Sarah and Jonathan decided that in order to retire early Sarah would take a 72(t) distribution and roll her company-based retirement plan assets into an income distribution program managed by Jonathan. They also determined that Sarah needed to withdraw 9%, or $67,500, from her retirement nest egg annually to maintain her standard of living. With the historical rate of return for the stock market at 10.4%* (assuming dividend reinvestment) and seemingly stable, growing market conditions, they decided at the time that it was reasonable to move forward with their plan as long as they took steps to maintain some cash reserves to compensate for potential market instability.

At the meeting's conclusion Sarah was happy with her decisions and confident in her plan. It was the start of a successful business relationship. *Had Sarah and Jonathan thoroughly explored the impact of uncertainty in their planning? Were decisions made from which representatives can learn and apply to future cases?*

### In Hindsight

In the 20/20 perspective of hindsight, Sarah and Jonathan may not have planned thoroughly enough. It's true that 10.4%* is the historic stock market return, but that does not mean that every year has that same rate of return. That figure is an average. Over the past 80 years, there have been many short-term periods that produced returns well below the historical average. Understand that mathematically an average is by definition an equilibrium point of gains and losses. There is no way to definitively predict either side of the equation.

In 1998, markets were solid and from a client's perspective it seemed like growth could go on indefinitely. However, we now know that during 2000, a prolonged bear market began, compounded and deepened by unforeseen circumstances (the terrorist attacks of September 11, 2001). These unforeseen circumstances posed tragic consequences for retirees like Sarah who were locked into distribution plans with little to no flexibility to change withdrawals. With only a bare minimum of retirement assets and a withdrawal rate of 9%, Sarah was losing principal fast. Even though Jonathan advised clearly and repeatedly that Sarah needed to alter her lifestyle and begin saving distributions for re-investment to battle the damage the bear market was inflicting, Sarah chose to continue her lifestyle and ultimately depleted so much of her retirement assets that no matter how good the next few years became after the market turned around, she could never recover.

### What Can Representatives Learn?

This story suggests that a more conservative approach to Sarah's case would have been prudent. Although a potential for down markets was considered, Sarah's plans did not take into account the potential for a long bear market with large losses. Additionally, we can see by the story that Sarah did not really consider potential risks of the plan even though her financial representative advised her on ways to better manage the bear market's effects on her retirement. In 1998, many in the industry believed that a 9% withdrawal was reasonable, but in 2006 many now believe that no more than 4% to 5% should have been withdrawn. For financial representatives, this begs the question, what will the future's opinions hold as reasonable withdrawal percentages? This story suggests that potential future opinions and the judgment of hindsight be considered when planning for current circumstances.

**FINRA Investor Alert "Look Before You Leave" September 14, 2006.*

*This story is for illustrative purposes only and does not advocate specific advice.*

It's a common phrase in the financial services industry that past performance does not guarantee future results. This is true with regard to more than just product performance. The saying is relevant to nearly everything that may happen in one's life! Hindsight and compliance best practices propose working closely with clients to understand best-case, worst-case and average-case scenarios. In the story just highlighted, Sarah and Jonathan could have taken more time to consider and analyze the various possibilities: What if the market does poorly? Will Sarah be positioned to protect her retirement nest egg? What if the market takes off? Being young, will Sarah sacrifice an opportunity to grow her assets by retiring early and fixing distributions at a certain rate? In this illustration, it seems that they did not take enough time to explore the different possible outcomes of the decisions that they were making. Through honest, thoughtful evaluations of the outcomes on both sides, representatives and clients have a better chance to arrive at the best decisions considering all factors. The use of hypothetical scenarios through systems like Monte Carlo Simulation, which randomly generates values for uncertain variables over and over to simulate a model, may have provided more insight into the dangers of unpredictable variables. Monte Carlo simulations have been around for more than 50 years, but only with advances in low-cost computing power have they expanded beyond the scientific community into other industries like financial planning and market analysis.

Another point to cover regarding this illustration is the issue of advice, recall and documentation. The representative Jonathan had discussions with Sarah regarding managing the bear market, educational meetings regarding the risks involved and multiple conversations about managing the potential downside of her plans. Sarah, excited about the prospects of the best-case scenario, was somewhat blinded by the rewards and failed to recall covering and understanding the risks. Her representative was in fact advising and recommending appropriately, but insufficient documentation and an inherent unpredictability of human memory and recall can work together to the detriment of the representative.

***Suitability is a triple-stage assessment with evolutionary components*** – Suitability is commonly discussed in terms of "is it right for the client," which is an over-simplification. There are really three levels of suitability to consider in order to best serve clients. First and most often covered with clients by representatives are **investment objectives and risk tolerances**. As the ever-present and important foundation of the suitability process, the area of investment objectives and risk tolerances is probably the most commonly discussed, presented and taught about suitability topic in the industry. Best practices suggest that this first, foundational level of suitability be addressed frequently and regularly. The second level, **portfolio suitability**, is perhaps less often the focus of representatives' attention, but is no less important. Are a representative's strategies or portfolio of products in line with the objectives and risk tolerances of the client? The third level is **product suitability**. Are the products inside the portfolio in line with the client's overall investment objectives, risk tolerances, and portfolio strategies?

In a healthy, open and honest client-representative relationship, these suitability measures are fairly easy to assess and implement. Compliance best practices dictate that representatives consistently monitor the evolution of their clients' lives, their strategies and needs, and the markets to help ensure that suitability remains in line at all three levels. For instance, if the markets turn bearish, does that affect the suitability assessments of clients? Does it affect all three levels? If so, can a representative stray from the original suitability assessments to compensate for market performance? These are all good questions with less-than-clear answers. Working closely with clients to help ensure representatives are up-to-date with their clients' suitability evolution is the only prescription for actively managing and maintaining a proper suitability balance.

## DIVERSIFICATION IN MANY FORMS

Financial representatives are very familiar with the terms "product mix" and "diversification," and generally have a solid grasp of the value of these as they relate to product selection and investment selection. However, it's still important to touch on the topic briefly before elaborating on other, less recognized uses of diversification that are critical to a representative's success.

***Populating client plans with a variety of products with similar objectives*** – Compliance best practices suggest that representatives should have a full understanding of the products they recommend. Representatives should work hard to know and understand competing products that offer the same general benefits as their preferred products if substituted in their recommendations and plans.

### The Sense and Non-Sense of Variable Annuities

Variable annuity products have changed significantly since their inception and have been in the industry spotlight in recent years necessitating a more detailed discussion. Once used primarily for tax-deferral and a guaranteed death value, today's variable annuities are much more complex and include features that are designed to provide protection against investment loss and guaranteed living benefits in addition to traditional features.

The attention in the industry on variable annuities has focused particularly on investment strategies that move IRA funds and other tax-deferred funds into variable annuities since those IRA funds were already growing tax deferred in their original investment vehicle. Costs may well outweigh benefits in some situations. As such, it is important that the different variable annuities in the marketplace, and the features within those variable annuities, are well understood. When considering variable annuities for clients, it's important representatives remember that "one size does not fit all." According to the September 14, 2006, FINRA Investor Alert *Look Before You Leave*, "[If a representative's recommended] strategy involves variable annuities, be aware that most variable annuities have sales charges, including asset-based sales charges or surrender charges. In addition, variable annuities may impose a variety of fees and expenses, including mortality and expense fees, administrative costs, and investment advisory fees. Some products offer, for an extra fee, enhanced benefits that go beyond standard contract features, such as living benefits – which are designed to protect a client's future income stream – as well as death benefits – which are designed to protect a client's death benefit payable to a beneficiary." The bottom line: variable annuities are complex and <u>may</u> be expensive relative to other investments.

Variable annuities are very different from each other and have varying components that may or may not be advantageous to any given client. When deciding if a variable annuity is right for a client, be sure to consider the annuity in light of the client's stage in life, overall financial goals, current and foreseeable financial circumstances, insurance needs, credit protection requirements, time-frame of product effectiveness and liquidity needs. In contrast to the many benefits of variable annuities, the product may be expensive, have insurance coverage limits, invest in a limited selection of sub-accounts, provide investment growth taxed at ordinary income tax rates on withdrawal, and may be a liquidity challenge.

Most variable annuities offer a form of death benefit as a part of their base contract. There are then a wide variety of optional death benefits typically divided into the three categories of minimum anniversary value, rising floor and earnings enhancement. There are, however, other combinations and permutations of death benefits in the market, along with a popular spousal continuation feature. Living benefits of variable annuities come in three broad categories including guaranteed minimum withdrawal, guaranteed minimum income and guaranteed minimum accumulation. Compliance best practices suggest that representatives study the tradeoffs among benefits carefully to find which best fit each client's individual needs.

<u>Generally</u> speaking, if a client meets the conditions listed below, then a variable annuity may be an appropriate product choice and needs further detailed consideration. Does a representative's client:

**(1)** Have the ability to wait for annuity proceeds until age 59½?
**(2)** Prefer investing in diversified investment pools rather than individual securities?
**(3)** Want income payments for life during his or her retirement?
**(4)** Currently have a 28% or higher income tax bracket, but expects to be in a lower income tax bracket during retirement?
**(5)** Contribute the maximum to their 401(k) plans and IRAs and need more tax deferral on investment gains?
**(6)** Have no concerns about heirs paying ordinary income taxes on appreciation?
**(7)** Plan to keep an annuity for 8 to 12 years or more?

If a client doesn't fit this profile, then it's critically important that additional careful consideration and product investigation is pursued to ensure the best choices and riders are selected to meet the client's needs. Like all products, particularly complex products, a full understanding of the products by the representatives recommending them is vital. Then, compliance best practices suggests that representatives give every effort to ensure their clients understand the rewards and the risks and costs that are inherent in any given product, particularly complex and potentially expensive products.

***Assessing a representative's recommendations*** – Finding a niche and then specializing in meeting that niche's shared needs is a valuable marketing strategy. Many representatives base their business models on niche marketing. Still, the lack of diversification of a representative's prospect and client sources suggests that special care be given to risk management regarding those sources.

Niche business models do present some challenges for representatives. Regulators have focused on the fact that no single investment product or individual plan is suitable for everyone who comes through a business' doors. As such, representatives need to be careful that they are not recommending the same thing for every client, regardless of the possibility that a business' niche-focus dictates similar strategies or products because only a certain type of client is prospected. Niche-based business models are really about understanding the circumstances common to a group of clients so that representatives can spend more time, thought and energy on the individual needs of each client within that group.

If a representative's business is weighted heavily on using one strategy for retirement planning and that strategy uses a limited variety of products such as variable annuities, there may well be added scrutiny from supervisors and regulators. Compliance best practices dictate that representatives consider thinking in terms of result, not product. If a niche strategy requires product "A" that delivers a specific objective and result, then the representative may be able to better serve clients by having a battery of different products that all provide similar objectives and results, and can be used somewhat interchangeably in similar situations. Then, when populating each client's plan with products, the products used can vary while still serving the same purpose in the plan. This allows the flexibility to build portfolios designed to meet the unique circumstances and needs of each individual client.

Compliance best practices also suggest that using a broad mix of different products that deliver the same objectives and results can help keep representatives from falling into a pattern and becoming overly specialized.

***Think about the security of your client sources*** – Client sources is one area of diversification about which many representatives don't give a lot of thought. Let's look at an example.

**Looking at Client Source Diversification and Risk Management**

Financial representative Jane Doe discovered that a local Fortune-100 corporation in her market had an aging work force that needed retirement advice. Dutifully working the lunchrooms and educational circuit, Jane struck a vein of gold – more than 50% of the workers were interested in using her services. Jane began landing clients left and right, but also started to neglect her other tried-and-true sources of clients. Over time, more and more of Jane's business was coming from this one corporation's retiring employees. Jane realized that her client-base was heavy with this corporation's clients, but she only had so much time in the day and these clients did seem satisfied, although she didn't have a system in place to know for sure. Unknown to Jane, a group of clients from this corporation started to become increasingly unhappy with the performance of their accounts due to a bear market that had been deepened by unforeseeable socio-economic events. At a critical point, the group began interacting and comparing notes on performance and advice. The group realized that Jane had them in very similar strategies and had even been using the same form letters for communication to different clients. Because the group felt that their finances had been mismanaged, and that Jane had given them all the same advice that was performing poorly, they began making formal complaints and ultimately taking legal action.

News of the complaints and legal actions filtered throughout Jane's retirees from this corporation, as well as pre-retirees still at the corporation. Jane began losing clients rapidly as they moved their business, and she wasn't able to land any new clients from the corporation due to a bad perception of her business and her advice. *What could Jane have done differently to mitigate the business' risk of client loss?*

This example represents how having too many eggs in one basket is applicable to many sources of risk management, even a representative's sources of clients. In this example, Jane is losing and losing fast. She neglected other client sources due to focusing on the "goose that laid the golden egg" while at the same time she was not working hard enough to manage the risk of losing that "golden egg." Does that mean Jane should have taken a pass on this valuable source of clients she found at this corporation? *Definitely not!* Many representatives have built thriving businesses from a single source of clients. What this does mean is that Jane should have implemented more systematic service and satisfaction measures based on individual client needs. By doing so, she could have preemptively managed any dissatisfaction, saving her current client relationships and maintaining her primary source of clients. Leveraging better and more consistent client satisfaction monitoring, Jane may have been able to mitigate the risks of losing her primary source of clients.

Much like investment product risk, it's important that every representative consider the diversity of his or her client base, and then better manage client satisfaction within key sources or more fully diversify client sources. Only then can some measure of business security be realized. Whether representatives rely upon a niche source or diversified sources of clients, managing the risk of losing those client sources is a best practice that can heavily influence business success.

Another key point related to this story is the importance of portfolio and product diversification. In cases where representatives have groups of similar clients with apparently similar needs, it's very important that each individual client receives a strategy and products that are meant to meet his or her specific needs, not the aggregate needs of the group of similar clients.

## MARKETING IN EQUILIBRIUM

Marketing as an industry historically highlights the rewards and benefits of whatever product or service is being promoted, giving little attention to inherent weaknesses or potential negatives with said products and services. The financial industry's rules and regulations stress a more balanced approach. As such, much care should be given by representatives to delivering balanced and honest representations of themselves and the products and services they represent. Compliance best practices suggest that representatives should market on factors that can be controlled, unlike performance, and that in all marketing materials and messages, rewards cannot be represented without due attention being paid to the associated risks.

***Provocative messages and your marketing*** – Regardless of the United States' history of free speech, one still cannot yell "fire" in a crowded theater. From a compliance perspective, the same concept is true of a representative's marketing messages. Eliciting undue fear of taxes or risk of loss will be a red flag to supervisors and regulators, as will playing (or preying) on strong emotions like fear of death or fear of becoming indigent.

Emotional solicitations may work well, but at what price? Generally it's a good idea to steer clear of these provocative, emotionally extreme sorts of marketing messages. As with so much in the financial services industry, balance is the key. Marketing messages need to be powerful to help representatives prospect, but the messages must also be honest and avoid hyperbole.

***Promissory versus realistic methods of persuasion*** – On the flip side of the "provocative messages" coin are promissory messages. Most everyone in America has seen the "You May Have Already Won a Million Dollars" direct mail piece in their post office box. Marketing tactics focus heavily on making a big splash with all of the rewards the reader or listener might receive. Unlike messages seen in general consumer marketing, the financial industry's regulators will notice promissory messages and representatives need to beware! The simple fact is that potential rewards cannot be emphasized without a balanced representation of the risks involved. Absolute statements of reward will get noticed by more than just the prospects you want to see them. Competitors, regulators and colleagues will all get wind of unbalanced marketing messages and the representatives soliciting with them will most likely have to defend the use of the messages.

***Professional designations as a marketing tool*** – Compliance best practices offer that great care should be taken in how representatives represent industry designations to prospects and clients. That's a lesson learned from somewhat recent bad PR about "senior specialist" designations.

Consider the following short example of using a designation as a marketing tool.

**Designations as a Marketing Tool**

Ben Studious, a financial representative, recently earned a CFP® designation. In addition, Ben has a Juris Doctorate (JD) from a local university but has not passed the Bar Exam and is not licensed to practice law. Ben is anxious to use his credentials to enhance credibility with prospective clients. He has business cards and letterhead printed that use his new CFP® designation as well as "Attorney at Law" below his name. *Is Ben acting appropriately?*

In this case, Ben is misleading his prospective clients. Ben is not an attorney because he has not passed the Bar and is not licensed to practice law. Ben could use his JD designation, but cannot hold himself out as a practicing attorney.

A designation, or title in the example above, should not be used for any reason if not up-to-date and accurate. Representatives should work to represent themselves accurately and clearly. If a designation is not yet fully attained, has lapsed for any reason or is questionable in source, it should not be used.

If representatives are interested in obtaining a designation, best practices encourage them to consider carefully the how and why of getting it. If motivations are for marketing only, then regulatory issues may arise. Consider from where the designation originates. Is the organization real and credible? Is there a track record for the designation? "Given how complex [the financial industry] has become, studying for designations is great; it makes you a better advisor. But using designations to create false impressions and to steer prospects into unsuitable products is [clearly unethical and potentially illegal]." *(June 2006 National Ethics Bureau newsletter, "Red Flag Reminders")*

***Using testimonials as a marketing tool*** – According to the SEC website, "Restrictions on the Use of Testimonials – FINRA rules prohibit exaggerated and misleading endorsements of investments or of investment returns (FINRA Rule 2210(d)(1))." Testimonials must also include certain information: "advertisements or sales literature providing any testimonial concerning the investment advice or investment performance of a member or its products must prominently disclose the following: (1) the fact that the testimonial may not be representative of the experience of other clients; (2) the fact that the testimonial is not indicative of future performance or success; and (3) if more than a nominal sum is paid, the fact that it is a paid testimonial" *(FINRA Rule 2210(d)(2)(A)*.

*On the other hand, regulatory rules regarding the use of testimonials are much stricter for Registered Investment Advisers and essentially prohibit any registered advisor – or an advisor required to be registered – from circulating or distributing advertisements that refer directly or indirectly to a testimonial of any kind regarding its advice and other services.* The Advisers Act Rule 206(4)-1(a)(1) states that the prohibition on testimonials is much broader than the way testimonials are treated under other federal securities laws and other regulatory requirements, which generally permit testimonials that are not misleading.

Best practices offer that financial representatives who want to leverage the strength of testimonials while promoting themselves and their businesses need to work with their supervisors and broker/dealers to make sure that all of the rules and regulations of testimonials are being followed. Consider the short example on the following page.

### Testimonials as a Marketing Tool

John Adman is a registered representative with a major broker/dealer on the East Coast. As a long-time representative with a history of superior client service, John decided to use a testimonial from client Shelly Eggerson in a newspaper advertisement. Shelly's testimonial talks of the attention and professionalism she receives from John, and the advertisement includes all of the appropriate compliance disclosures. John's response from the advertisement is very strong, and he starts seeing a solid stream of prospects calling and setting appointments.

One day at lunch with a colleague from across town, John expounds on the success he's had using Shelly's testimonial in his advertising. John's colleague Don Advisor is a Registered Investment Advisor Representative, knows that as an advisor his level of client service and support is top-notch and believes that a testimonial about him would also bring in a new stream of prospects. After lunch, Don schedules a meeting with his branch supervisor and manager to discuss this exciting marketing idea and is energized to begin the new campaign.

Unfortunately, Don is out of luck. The Investment Advisors Act rules are clear. Investment advisors are strictly prohibited from using any testimonials with clients or prospects in any way. Don simply is not allowed to do what he wants to do and must find another way to promote his services, abilities and offerings.

***Seminar marketing is a powerful tool, but be careful!*** – Seminar marketing is a powerful marketing tool for financial representatives, and high on the list of scrutiny by compliance staff and regulators. With seminar program vendors touting 50% to 70% attendee appointment rates and groups as large as 50 to 100 per seminar, many representatives are using seminars as their marketing foundation. How can representatives help ensure they'll pass the added scrutiny of seminars?

It's really not too difficult to prepare a seminar that will pass close examination. First, be sure that all of the slides and the script are compliance reviewed together, along with any supporting materials like invitations and handouts to be used at the seminar. Then, once these materials are approved, you should never add any additional slides, script or handouts to the presentation unless they're reviewed once again. Next, always take great care to avoid provocative or promissory language as discussed earlier in this section on marketing, as well as maintain an appropriate risk-reward balance. Too many seminars highlight benefits with representatives believing they'll cover risks in upcoming appointments. However, if those risks aren't covered in subsequent meetings, or if the discussions aren't sufficiently documented, then the client-representative relationship may be perceived by regulators to be based upon inappropriate or inaccurate information.

Also note that with seminar marketing, regulators may pay special attention to product oriented seminars that offer meals or "free lunch" seminars. Giveaways and meals used to lure prospects to product-pitch seminars are a recipe for trouble with supervisors and regulators. Compliance best practices offer that giveaways and meals only be used with educational seminars where product pitches are not the key message or component.

## FOCAL POINTS

### AN OVERVIEW OF THE RETIREMENT PLANNING PROCESS

- The inputs into the process of retirement planning should be carefully evaluated, including a representative's sources of clients, subsequent strategies and plans, and the products used in those plans and recommendations.

#### Client Suitability

- All clients should be given appropriate care.
- With the decline in defined benefit pension plans and an increase in defined contribution plans, there is an added burden of appropriate care to be given to retirees.
- Early retirement planning requires additional planning and in-depth consideration by both representatives and clients. *Is it really the right time to retire?*
- Clients wanting to retire should be educated to help them understand whether they are truly ready. *Are they prepared financially? Are they prepared emotionally?*
- Suitability can be thought of as having three levels: investment objectives and risk tolerance suitability, portfolio suitability and product suitability. All three levels need to remain aligned as client needs and markets evolve.
- Representatives need to realize that the future is uncertain for nearly every aspect of their retiring clients' lives. The best representatives try to anticipate unforeseen circumstances and plan accordingly.
- Hypothetical scenarios using worst-case, best-case and average-case examples will help representatives educate clients while helping protect clients' and representatives' interests.

#### Diversification in Many Forms

- Representatives should have a full understanding of the products they recommend and some knowledge of competing products that provide the same general benefits.
- Variable Annuities can be complex and expensive compared to other products. As such, due care should be taken to ensure suitability is appropriate.
- Representatives should work to educate their clients regarding the risks and rewards of variable annuities such that the clients can explain these products in their own words.
- Representatives should consider a mixture of strategies and recommendations to attain the same purposes in a plan to better avoid "one size fits all" scrutiny.
- Representatives should be careful to manage risk with regard to their client sources, be they a diversified strategy or a niche-focused strategy. The niche business model is a good one, but it can come with a higher standard for care and other potential risks.

#### Marketing in Equilibrium

- Avoid heavily emotional and provocative marketing messages, as well as promissory marketing messages. Rewards of a product or strategy should not be touted without providing a balanced discussion of the associated risks.
- Consider how professional designations are used. Avoid using them as marketing tools, and be sure designations are substantive and offered through credible sources.
- Seminar marketing is a target of scrutiny by compliance staff and regulators, particularly if the seminars are mostly a product pitch and not educational in substance.
- Representatives should be very careful to only present reviewed and approved materials. Additionally, free meals and give-aways may receive special attention by regulators when coupled with product pitch oriented presentations.
- Representatives should not alter approved presentations in any way without having the presentation re-reviewed.
- Balanced representation of risks and rewards is critical in all marketing efforts.
- Testimonials are a sensitive subject and care must be taken to have approval before use.

## THE CHALLENGES OF RETIREMENT INCOME DISTRIBUTION PLANNING

What are the challenges of retirement income distribution planning? Consider these points. Few retirees can know exactly what their income needs will be beyond the short term. No retiree really knows when he or she will pass away. The future of tax rates can never be known for certain. Strategies for successfully distributing retirement income are different than those for successfully accumulating retirement wealth. The kicker, the largest population in history is about to transition into retirement (the wealth distribution years), so there will be approximately 76 million clients controlling an estimated $12-$15 trillion dollars. The Baby Boomers expect to maintain their historically active and vibrant lifestyles, meaning their finances need to be managed to provide a lifetime of comfortable and consistent income. It's quite clear that there are many challenges faced by financial representatives when dealing with retirement income distribution planning.

### UNDERSTANDING DISTRIBUTION REGULATIONS

Rather than talk of specific regulations here, it's more important to cover the issue of knowing and keeping up-to-date on the various regulations effecting retirement planning and distributions management. There have been changes in recent years that have provided some flexibility when working with varying retirement plan distribution strategies, but there are still substantial issues to be weighed and analyzed by clients and representatives both. Best practices indicate that it's imperative that representatives work diligently to know as best they can the differing rules and regulations. These same best practices suggest a few ways to help representatives keep up-to-date, including closely working with their firm's compliance staff, frequently visiting regulatory websites and keeping current with continuing education requirements. These are by no means the only ways to keep sharp on rules and regulations, so continuing efforts to learn and grow are always encouraged.

### 72(t) DISTRIBUTIONS AND EARLY RETIREMENT

Internal Revenue Code §72(t) provides several exceptions to the 10% tax penalty that is normally applied to pre-59½ distributions from qualified retirement plans. §72(t)(2)(A)(iv) provides that no penalty will be applied to "Distributions which are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or joint lives (or joint life expectancies) of such employee and his designated beneficiary."

***Substantially Equal Periodic Payments (SEPP)*** – The rules for §72(t)/(q) distributions require clients to receive Substantially Equal Periodic Payments (SEPP) based on their life expectancy to avoid a 10% premature distribution penalty on withdrawals. §72(t) payments must last the longer of five years or the age of 59½. Also, the SEPP amount must be calculated using an IRS approved method including the Required Minimum Distribution method, the Fixed Amortization method or the Fixed Annuitization method.

The ***Required Minimum Distribution*** method is the simplest for calculating a SEPP, but it also tends to produce the lowest payment. The ***Fixed Amortization*** method amortizes the client's account balance over a single life expectancy, the uniform life expectancy table or a joint life expectancy based on the oldest named beneficiary. The ***Fixed Annuitization*** method is one of the more complex methods and uses an annuity factor to calculate the SEPP. It's important to note that the annuitized SEPP is based on the client's life expectancy only, and is not based on beneficiary age.

In 2002, the IRS ruled that the distribution type could be changed one time without penalty from the Annuitized or Amortized methods to the Required Minimum Distribution method. This allows clients the option to move from a fixed payment distribution method to a payment method that fluctuates annually with the value of their account. This exception exists largely to allow individuals who have suffered substantial losses the option to reduce the distribution to prevent the retirement account from being prematurely depleted. To learn more about this important exception, please visit www.treasury.gov and review Revenue Ruling 2002-62.

If clients want to change payments for any reason other than disability or death prior to the required distribution period end date, distributions may be subject to a retroactive Premature Distribution penalty. That penalty would be 10% (plus interest) for all years beginning the year payments started and ending the year of the change. It's important to note that §72(t) does not exempt withdrawals from other applicable taxes. Further, early distributions from a retirement account reduce the money available later during retirement. If clients experience a higher rate of return, the value of the account can actually grow, even with distributions. However, if the clients suffer losses, their account balances may end up shrinking faster than expected, causing a depletion of principal. It's evident that anticipation of market fluctuations and planning to manage such changes are vital to properly planning retirement distributions.

## PRE-PACKAGED DISTRIBUTION PLANNING PROGRAMS

One way that representatives can serve their clients well, provide balance in product and planning, and decrease the time and effort needed to provide retirement income distribution planning is through the use of pre-packaged planning programs. There are a number of proven, regulator-reviewed and compliance-approved systems in the marketplace that can help representatives with retirement distribution planning. Many of the systems provide a well-balanced marketing message for representatives to use when prospecting and advising clients, along with methods that help representatives develop scenarios for educating clients on the risks and rewards of a given plan.

These programs essentially allocate a client's retirement nest-egg into groups or segments that hold assets ranging from very conservative to aggressive. One segment is always the most conservative and tends to receive the largest portion of a client's retirement funds. Successive groupings receive varying lesser percentages that total 100% of the funds. Segments receiving the smallest amounts of money are those which hold progressively more aggressive assets. These groupings are typically held for the longest periods of time in order to achieve the best possible chance of growth.

Initially, using a guaranteed product for a short period of time provides a guaranteed income stream. For each subsequent time period, additional segments will be successively converted into a guaranteed income strategy with the shorter-term payouts, essentially re-loading the guaranteed income stream segment. Should projected rates of return be realized throughout the different groupings, sufficient money will be available to implement guaranteed income distributions with increasing amounts to compensate for inflation and to maintain a desired level of retirement income cash flow. Then, upon the client's passing away, any remaining assets are available to transfer to the client's beneficiaries.

A frequent question representatives may have regarding these sort of programs is whether they can work with 72(t) distributions and associated restrictions. IRS Notice 89-25 and Rev. Ruling 2002-62[1] both refer to only one IRA account balance for purposes of calculating the SEPP indicating at first blush that these segmented, rolling-money programs would not work. However, three previous Private Letter Rulings from the IRS concluded that 72(t) distributions can be figured upon assets held in two or more IRAs (i.e. segments). These rulings also explain that the payments can come from one or any combination of IRAs used to calculate the distributions. However, all assets held within the designated 72(t) IRAs must be used to calculate the distributions. These letter rulings are significant for clients who want to calculate their 72(t) distributions on assets held in two or more IRAs. It also provides an additional measure of planning flexibility for those who don't want to touch assets held in certain accounts.

## FOCAL POINTS

### THE CHALLENGES OF RETIREMENT INCOME DISTRIBUTION PLANNING

- The future is uncertain, thus complicating income distribution planning.
- The Baby Boomers are coming and they're bringing wealth and a desire for a full, vibrant retirement with them. Demands on retirement planning may become more complex, and satisfying clients may become more difficult.

#### Understanding Distribution Regulations

- To better a representative's understanding of various distribution regulations, it's important they work closely with their firm's compliance staff, take time to visit regulatory websites and work to keep current with continuing education requirements.

#### 72(t) Distributions and Early Retirement

- Largely thanks to 72(t), early retirement is possible, but careful and serious planning for the uncertainty of the future must be done.
- 72(t) requires Substantially Equal Periodic Payments (SEPP) based on client life expectancy.
- 72(t) payments are calculated using one of three IRS-approved methods: Required Minimum Distribution method, the Fixed Amortization method and the Fixed Annuitization method.
- Regulators are scrutinizing early retirement plans and marketing pitches. Representatives should work diligently to ensure they have educated their clients thoroughly on the risks of retiring early.

#### Pre-Packaged Distribution Planning Programs

- The marketplace has a variety of packaged income distribution planning tools to help representatives serve their clients' best interests.
- The distribution planning programs available frequently provide balanced marketing materials, helping representatives present the options in a fair and honest manner.
- Many of the packaged programs provide robust hypothetical scenario analysis tools to help representatives educate their clients.
- The best distribution strategies essentially divide assets into segments with varying investment philosophies. There is always a short-term segment that provides current income distributions while the other segments grow at differing rates. The segments then roll from higher return groupings to lower return groupings that flow into a constant short-term income distribution segment.
- These programs tend to provide enhanced flexibility during the retirement income distribution planning and execution stages of the retirees' lives.
- These programs will work with 72(t) distribution rules and can be used to help with early retirement income distribution planning.

## THE IMPORTANCE OF BALANCE WHEN ADVISING CLIENTS

There is a precarious balancing act of time management in the financial services industry. Representatives are faced with finding equilibrium between running business operations and maintaining their expertise in a changing industry, between growing their businesses and still providing current clients superior service, between protecting their clients' interests financially and trying to provide service and support that meets their needs emotionally. If any element of a financial representative's business becomes out of balance, other areas may suffer to the detriment of clients, the business and the representative. As such, compliance best practices suggest that in all things representatives should strive for balance, particularly when counseling clients and making recommendations and plans.

### DUE DILIGENCE IN PRODUCT SELECTION

The interpretation of due diligence is vague at best, and the use of subjective phrases like "reasonable person" and "not necessarily exhaustive" doesn't lend itself to making representatives feel very secure that they are being thorough enough in all aspects of their advisory businesses.

> ***Due Diligence*** – Such diligence as a reasonable person under the same circumstances would use. Use of reasonable but not necessarily exhaustive efforts called also reasonable diligence.

Nevertheless, it is a best practice for financial representatives to be detailed in their investigation and understanding of the strategies, advice and products they offer, and to take every effort to help ensure that their clients clearly understand what is involved in their strategies, planning, recommendations and product selection.

***Do you fully understand the products*** – How can representatives be confident that they are sufficiently knowledgeable about the various products in the market? Well, there's no easy answer to this. Compliance best practices suggest that representatives consistently spend a portion of their time researching, reading and reviewing materials provided by product providers, industry experts, regulatory agencies and their broker/dealer and firm management. The key to fully understanding the products being used to populate strategies and financial plans is time management and committed scheduling. Planning when and how a representative and his or her staff will be conducting due diligence activities, and being consistent and committed to this plan, can mean the difference between being effective with recommendations and disappointing clients or getting in trouble with regulators.

***Do your clients really understand the products*** – A current, and in some ways perennial, hot topic in the industry is the concept of client understanding. If representatives want to be confident that their clients understand the strategies, advice and products being offered and used, then representatives need to ask themselves after every meeting, "Could this client explain to me in his or her own words what his or her wants or needs are? Can he or she tell me what services, advice and products I offered, and how his or her needs may be met by the solutions I gave?" If representatives waver in answering these questions, then they may not be fulfilling their responsibility in the eyes of the regulators. Clients should be able to express in their own words what they want or need and how the actions to be taken are designed to meet those goals. Additionally, clients should be able to explain the potential risks they are assuming as a result of taking the actions that are planned.

One of the easiest ways that representatives can protect themselves is through consistent and detailed documentation. It's frequently said in the financial services industry that if it's not documented, it didn't happen. In rare circumstances will any amount of rationale, logic or emotion change this perception during findings of fact or judicial processes.

Best practices suggest that if representatives want to survive a highly regulated industry like financial services, then consistency and detail are the defenses to employ, and 95% is not good enough. Historically there have been a number of disagreements between clients and representatives where the financial advisor was actually hurt by documentation that was largely consistent but not systematized nor complete, and was thus perceived as flawed. Consider the following example.

**Looking at "systematic documentation"**

Representative Stephen Counsel was committed to superior customer service and was very systematic in his office. Over the past three years, Stephen met with Allen Client in person 18 times, corresponded by postal letter 12 times, sent 24 e-mails and had 12 intermittent personal meetings or phone calls. As a critical client with substantial wealth, Stephen and Allen had a total of 66 contacts over this three-year period. At a 95% accuracy rate of documentation, Stephen was confident that he had "covered his bases" with regard to official record of the client relationship and the meetings. There had only been three or four contacts that were undocumented.

At the three-year point of their relationship, as market conditions eroded, Allen Client filed a complaint that he did not fully understand the risks of a specific investment strategy that was recommended, and that Stephen Counsel's office had talked him into trying the strategy against his better judgment. Allen had lost 20% of his retirement principal due to recent poor market conditions.

Stephen found that two of the four contacts that were not documented happened to be when the risks of the new strategy were discussed. However, he felt sure that the fact that he was a systematic and diligent record keeper would act to prove that he did discuss the risks with Allen Client and that Allen knew what he was doing. *Is Stephen right? Has his meticulous record keeping given him protection?*

It's important to remember, many believe that if there isn't documentation, it didn't happen. In this case it's even worse. Fictional representative Stephen Counsel had record keeping systems in place and a high rate of accuracy and consistency in documentation. By having such a high documentation rate, regulators, arbitrators and judges in this hypothetical case may have been even more convinced that the contacts not recorded did not happen. After all, Stephen was very detailed in all of the other contacts, why would these critical contacts that confirmed his actions be missing? Compliance best practices suggest that consistency and detail when representatives are working with a client can mean the difference between being a trusted financial advisor and being in trouble with compliance supervisors and regulators.

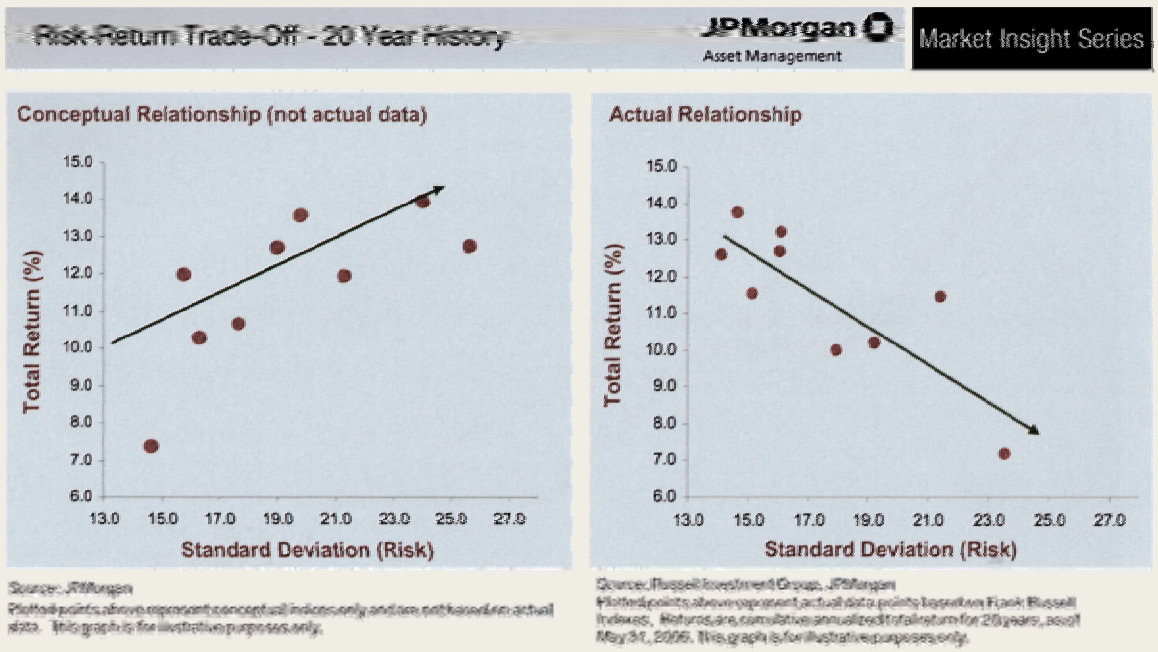
How does due diligence fit into the balance equation? As commented in the introduction to this section, representatives are faced with finding equilibrium between many facets of their businesses. When looking at documentation and record keeping, it seems clear that it can weigh heavily on time management systems. Every meeting, contact, recommendation and explanation should have appropriate follow-up and systematic documentation. Representatives may want to consider the best ways to accomplish this task and be 100% consistent in their processes. If not, all of the client education and advice may be for naught. The balance between doing the right thing and making sure representatives can prove they did the right thing is a critical equation that is a prerequisite to protecting clients' best interests and representatives' best interests. Additionally, by being systematic in follow-up documentation, representatives are receiving consistent reminders and feedback from their own systems, helping them to ensure they're fulfilling their obligations to clients.

## BALANCING YOUR CONVERSATIONS

Another hot issue in the industry at this time is the concept of balance as seen in conversations and presentations. Although the idea of rewards being counter-weighted with associated risks is not a new concept for financial representatives, it's easy for representatives to fall into a pattern of extolling the virtues of strategies and products while simultaneously ignoring potential pitfalls and shortcomings. Yes, representatives should be enthusiastic about the help they are providing clients, but they should also have an even keel so that clients are hearing and understanding all points of their conversations.

***Explaining the ramifications of different potential market environments*** – A proven way to protect clients is to talk with them in lay terms so that they understand both how and why certain market conditions may affect their financial plans, the recommendations related to those plans and the types of products populating the plans. Having clients then explain in their own terms what might happen if the markets drop precipitously or soar to record heights will give representatives confidence that their clients understand the unpredictable nature of the future and the impact that uncertainty can have on their financial plans.

***The truth about the risk versus reward relationship*** – To representatives, few client discussions are as critical as the concept of the risk versus reward tradeoff. What's rarely discussed is that the relationship is not as direct as a simple tradeoff. In fact, at a certain point, as risk increases only the potential for a reward increases. As risk continues to rise, there comes a point where there are more "losses" than "wins" and the rewards begin decreasing. This concept is illustrated below.




*Courtesy of JPMorgan Asset Management's "Guide to the Markets, 4Q06" Market Insight Series.*

Compliance best practices indicate that oversimplifying the risk-reward relationship may lead clients to take unsuitable risks. It's important that representatives work diligently to help clients understand the concept of "diminishing returns" and that the risk-reward equation is not a one-to-one, straight-line relationship.

***The use of scenarios to help client understanding*** – Scenario analysis, an example of which was reviewed in the "Overview of the Retirement Planning Process" section of this paper, is one of the most powerful tools representatives can use to illustrate the possible outcomes of any strategy or

market position. By showing clients a best-case scenario, a worst-case scenario and an average-case scenario, representatives can offer a better lay understanding of the consequences of each of these clients' plans and decisions. Compliance best practices suggest that with hypothetical- or scenario-analysis it's important that the inputs of the examples are fair and balanced. The old saying "garbage in, garbage out" is very true in this situation. An analysis that uses skewed or overly optimistic returns may appear plausible at first blush, but with a more in-depth review can be a source of regulatory trouble. Representatives need to work hard to ensure that the inputs being used to construct a scenario are verifiable to help protect their clients' best interests as well as themselves.

Be sure that any analysis that is used to help clients make decisions has been reviewed and approved by your firm's compliance and supervisory staff. Only then can representatives feel confident that they are dealing fairly and honestly while advising clients.

***The critical importance of documentation in discussions of balance*** – It's said by experts in the industry that a meaningful percentage of historical legal proceedings and arbitrations between clients and representatives could have been avoided had the representatives simply followed each and every meeting or contact where planning decisions were made, strategies discussed or education delivered with a letter reiterating what was discussed, why certain choices were made and how those choices were meant to meet the needs discussed. It may seem redundant in ways and busy-work at times, but in reality a follow-up letter that recaps meetings and contacts reduces ambiguity as to how circumstances unfolded, why decisions were made and how they were acted upon. These letters, when coupled with consistent notes and other systematic documentation, provide an ongoing context for the circumstances in which representatives' counsel and recommendations were given. This then gives anyone judging with 20/20 hindsight the services rendered a more fair perspective of the services rendered.

Another supporting best practice is leveraging debriefings through the use of transcription services. There are a number of services in the marketplace that provide recording and transcription of meetings. Representatives can then use these services to provide documentation of the discussions and decisions. Examples of dictation services include Elance.com, idictate.com and copytalk.com.

## FOCAL POINTS

### THE IMPORTANCE OF BALANCE WHEN ADVISING CLIENTS

- There is a precarious balancing act of time management in the industry, and representatives are faced with finding equilibrium among facets of their businesses. If an element becomes over-weighted, other areas may suffer. Care should be given to maintain a healthy balance focused on serving client interests.

#### Due Diligence

- Due Diligence is defined as such diligence as a reasonable person under the same circumstances would use. Use of reasonable but not necessarily exhaustive efforts called also reasonable diligence.
- Financial representatives should be detailed in their investigation and understanding of the strategies, advice and products they offer.
- Every effort should be given to ensure clients understand what is involved in planning, recommendations and product selection.
- Representatives should consistently spend a portion of their time researching, reading and reviewing materials provided by product providers, industry experts, regulatory agencies and firm management.
- Clients should be able to express in their own words what they want or need, and how the actions to be taken are designed to meet those goals, as well as the potential risks they are assuming by taking the actions that are planned.
- It's frequently said that if it's not documented, it did not happen.
- Meetings, contacts, recommendations and explanations should have appropriate follow-up and systematic documentation.

#### Balancing Your Conversations

- Representatives should not extol the virtues of strategies and products while simultaneously ignoring potential pitfalls and shortcomings.
- Talk with clients in lay terms so that they understand how and why market conditions may affect their financial plans, the recommendations related to those plans and the types of products populating the plans.
- Work to ensure clients understand that the risk-reward ratio is not one-to-one and in fact risky behavior tends to have diminishing returns.
- Show clients a best-case scenario, a worst-case scenario and an average-case scenario to offer a better lay understanding of the consequences of any of a client's plans and decisions.
- Scenarios that use skewed or overly optimistic returns can be a source of regulatory trouble. Inputs being used to construct a scenario must be verifiable to protect representatives' and their clients' best interests.
- Follow-up letters, when coupled with consistent notes and other systematic documentation, provide an ongoing context for the circumstances in which representatives' counsel and recommendations were given. This then gives anyone judging the services rendered a better perspective than hindsight alone.
- Another source of documentation can come through the use of transcription services that record meetings and then provide written transcripts for record keeping.

## POLICY AND PROCEDURE AWARENESS HAS NO SUBSTITUTE

There is an old saying, "ignorance of the law is no excuse." Perhaps nowhere is this saying more true than in the self-regulated and government-surveyed financial services industry that is teeming with rules, regulations and laws. Representatives have a Herculean task in maintaining appropriate levels of knowledge and expertise regarding regulations and law.

### THE EXPECTATIONS OF SUPERVISORS AND REGULATORS

Compliance supervisors and regulatory agencies expect an extremely high level of professionalism in all areas of financial representatives' businesses, interactions with their clients and standing in the industry and community. In essence, today's financial representatives are expected to be consummate representatives in all they do, with particular attention being paid to protecting clients and serving the clients' best interests. Whether faced with FINRA regulations, SEC law, state law or broker/dealer and firm rules, compliance best practices suggest that representatives devote substantive time and energy to maintaining a currency with industry happenings and the evolution of regulatory mandates.

### THE DUTY OF A PROFESSIONAL TO CLIENTS

In all things, the consummate financial representative will put client interests and the protection of a client's accumulated wealth first and foremost, act in good faith, provide full disclosure of all material facts and conflicts of interest, and will never mislead clients. Representatives have a duty hierarchy that puts primacy on the welfare of the clients, followed by the good standing and professionalism of their businesses and finally their own personal interests. At no time should this hierarchy be inverted or mixed. Strong penalties can and frequently do ensue if priorities are confused and clients' best interests are not the focal point of the advisory relationship.

### THE IMPORTANCE OF AWARENESS

Much like the level of due diligence needed to properly advise and plan for clients, having an appropriate knowledge-base and an ongoing awareness of rules, regulations and laws in the financial industry can help representatives stay clear of legal trouble. Compliance best practices suggest representatives take time daily or weekly, consistently and systematically, to keep up-to-date with legislation, addendums to currently regulatory rules and any hot topics in the regulatory environment. Likewise, representatives must stay current on the policies and procedures of his or her broker dealer. By doing so, representatives can avoid having to fall back on the ineffective "I didn't know" excuse.

Best practices indicate that representatives should always routinely keep their continuing education requirements up-to-date, frequently visit the regulatory websites to keep current with issues of importance and work closely with their firm's compliance and supervisory staff to help ensure they are meeting the requirements of each level of oversight, be it FINRA, SEC, state, broker/dealer or direct supervisors.

## FOCAL POINTS

### POLICY AND PROCEDURE AWARENESS HAS NO SUBSTITUTE

- Ignorance of the law is no excuse.
- Persons have presumed knowledge of the law.

#### The Expectations of Supervisors and Regulators

- Representatives are expected to protect clients and serve the clients' best interests in all they do at all times.
- Time and energy should be devoted to staying abreast of industry happenings and the evolution of regulatory mandates.

#### The Duty of a Professional to Clients

- In all things, a consummate financial representative will put client interests and the protection of a client's accumulated wealth first and foremost, act in good faith, provide full disclosure of all material facts and conflicts of interest, and will never mislead clients.
- At no time should the hierarchy of a representative's duties to clients be inverted or mixed.

#### The Importance of Awareness

- Take time daily or weekly, consistently and systematically, to keep up-to-date with legislation, addendums to currently regulatory rules and any hot topics in the regulatory environment.
- Routinely keep continuing education requirements up to date.
- Routinely visit regulatory websites to keep current with issues of importance.
- Work closely with their firm's compliance and supervisory staff to ensure requirements at each level of oversight, be it FINRA, SEC, state, broker/dealer or direct supervisors, are being met.

## CONCLUSION

Hindsight is indeed 20/20. Representatives, whether or not they have experienced compliance problems or legal issues, should study the history of their businesses. They should ask themselves, what can be seen in retrospect that wasn't evident at the time? What can be learned from these lessons from the past? Instances where representatives have "dodged a bullet" through sheer luck or the good fortune of fate can provide very valuable lessons to be applied to representatives' current business and personal practices. And what of the lessons learned by others in the financial industry? The circumstances of others can be very enlightening to representatives who take the time to research different cases, circumstances and outcomes. Through introspection and retrospection, representatives can modify their own businesses for optimal client service, enhanced representative confidence and security, and better overall business practices.

Additionally, by examining financial decisions and advice in the context of the time they were given and in an invariably clear retrospective framework, representatives can learn to better serve their clients, their businesses and themselves. Indeed, compliance lessons from the past should be leveraged to prepare representatives for a better future.

**"Those who cannot remember the past are condemned to repeat it."**
**George Santayana, American poet and philosopher**

*Life of Reason, "Reason in Common Sense," chapter 12 (1905-6);*
*According to The Columbia World of Quotations (1996).*

## END NOTES

[1] Private Letter Rulings are neither law nor policy, and apply only to the recipient of the letter.

Financial Representative Compliance Best Practices

# resources & tools

Securities America

For Broker/Dealer Use Only.

## BEST PRACTICES RESOURCES AND TOOLS LIST

The following pages highlight a few of the tools and resources available to help representatives implement compliance best practices in their offices. The list below includes websites and companies that provide products and services representatives may find useful. The following pages include pre-written letters and a ghost-written article that representatives may use at the discretion of their own firms' compliance approval processes. *This resource list is just a starting point and should not be considered exhaustive or complete.*

### WEBSITES, ONLINE RESOURCES AND COMPANIES OF NOTE

► **Regulatory Bodies & Government Agencies**

- Financial Industry Regulatory Authority (formerly NASD) => http://www.FINRA.org
- Securities Exchange Commission => http://www.SEC.gov
- North American Securities Administrators Administration => http://www.NASAA.org
- Securities Investor Protection Corporation => http://www.SIPC.org
- Internal Revenue Service => http://www.IRS.gov
- United States Department of Treasury => http://www.Treasury.gov
- Municipal Securities Rulemaking Board => http://www.msrb.org

► **Industry Organizations**

- NYSE Group, Inc. => http://www.nyse.com
- NASDAQ => http://www.nasdaq.com
- Chicago Board Options Exchange (CBOE) => http://www.cboe.com
- Financial Services Institute (FSI) => http://www.FinancialServices.org
- Financial Planning Association => http://www.FPAnet.org
- National Association of Insurance & Financial Advisors (NAIFA) => http://www.naifa.org
- National Association for Variable Annuities (NAVA) => http://www.navanet.org
- National Society of Compliance Professionals (NSCP) => http://www.nscp.org
- National Association of Real Estate Investment Trusts => http://www.nareit.com

► **Compliance Support, Systems and Training**

- National Regulatory Services (NRS) => http://www.nrs-inc.com
- Bisys Regulatory Services => http://www.bisysregulatory.com
- RegEd => http://www.reged.com
- ComplianceMAX => http://www.compliancemax.com
- Dearborn Financial Publishing Group => http://www.dearborn.com
- Kaplan Financial => http://www.kaplanfinancial.com

► **Hypothetical Scenario / Monte Carlo Analysis**

- Emerging Information Systems Inc. => http://www.Naviplan.com
- Emerging Information Systems Inc. => http://www.profiles.com
- Sungard => http://www.Sungard.com
- MoneyGuide Pro => http://www.Moneyguidepro.com

► **Pre-Packaged Income Distribution Programs**

- The Income for Life Model => http://wealth2k.com/TheIncomeForLifeModel/index.html
- The Grangaard Strategy => http://www.thegrangaardstrategy.com
- Buckets of Money => http://www.BucketsOfMoney.com

► **Dictation and Transcription Services**

- Elance => elance.com
- iDictate.com => idictate.com
- Copytalk => copytalk.com

## “72(t) INCOME DISTRIBUTIONS” SAMPLE LETTER

*This letter can be used for clients who have opted to use the 72(t) exception to withdraw funds from qualified plans before age 59½.*

Dear <<client>>:

Thank you for meeting with me on <<date>> to discuss your retirement plan. I’d like to reiterate an important point from our conversation regarding early distributions from your qualified retirement plan account.

You have chosen to begin monthly distributions from your qualified retirement plan account(s) held at <<company>> through <<broker-dealer name>> as the broker-dealer. Because you are under age 59½, the distributions have been initiated under IRS rule 72(t) and incorporate one of the exclusions to the 10 percent tax penalty that normally applies to qualified retirement plan withdrawals before age 59½.

The exclusion states that such distributions must be taken as part of a series of substantially equal period payments (not less frequently than annually) based on your life expectancy. These payments must continue for the longer of five years or until you are age 59½.

The exception is generally subject to the following rules:

1. The method of payments can be modified only one time in the first five years of the distribution period and prior to the account owner reaching age 59½ (both conditions must be met), or in the event of death or disability.
2. You have selected the <<annuitization/amortization/variable>> method, one of the three calculation methods outlined in rule 72(t) for determining the equal periodic payments. You are, or will be, receiving your distributions <<monthly/quarterly/annually>>.

Income distribution issues relating to your qualified retirement plan accounts can be complicated. It is always recommended that they be reviewed and understood by your accountant or tax advisor.

While we’ve recommended a distribution percentage that we believe to be achievable in today’s market environment, your preferred distribution percentage is typically not changeable and the future is always uncertain. As such, please be aware that to a greater or lesser extent, market performance will affect the value of your accounts. <<*This is an area of the letter where you can explain and clarify the chosen distribution percentage as it relates to both your advice and your client’s wishes.* AS AN EXAMPLE ONLY: According to the amount of your income request, you are receiving a distribution near the upper end of the allowed limit. As a result, prolonged periods of unfavorable market performance may put undue pressure on your portfolios from which you are receiving current income. In turn, this pressure may cause you to have to reduce spending or adapt your lifestyle so you can re-invest part of your distributions to offset erosion of principal. *Please work carefully with your firm’s compliance department to ensure this section of the letter is appropriate for your firm’s rules and regulations.*>>

We will continue to work with you to review your accounts and look forward to a continued, successful and professional relationship. If you have any questions, please call me at <<phone>>.

Sincerely,

# “RETIREMENT INCOME DISTRIBUTIONS” SAMPLE LETTER

*This letter can be used for clients who have opted to begin retirement plan income distribution age 59½ or later.*

Dear <<client>>:

Thank you for meeting with me on <<date>> to discuss your retirement plan. I’d like to reiterate an important point from our conversation regarding distributions from your qualified retirement plan account.

You have chosen to begin monthly distributions from your qualified retirement plan account(s) held at <<company>> through <<broker-dealer name>> as the broker-dealer.

Income distribution issues relating to your qualified retirement plan accounts can be complicated. It is always recommended that they be reviewed and understood by your accountant or tax advisor.

As you know, your preferred distribution percentage should be monitored closely because the future is always uncertain. Be aware that to a greater or lesser extent, market performance will affect the assets you have placed into your income distribution plan. <<*This is an area of the letter where you can explain and clarify the chosen distribution percentage as it relates to both your advice and your client’s wishes.* AS AN EXAMPLE ONLY: According to the amount of your income request, you are receiving a distribution percentage near the upper end of the allowed limit. As a result, prolonged periods of unfavorable market performance may put undue pressure on your portfolios from which you are receiving current income. In turn, this pressure may cause you to have to reduce spending or adapt your lifestyle so you can re-invest part of your distributions to offset erosion of principal. *Please work carefully with your firm’s compliance department to ensure this section of the letter is appropriate for your firm’s rules and regulations.*>>

We will continue to work with you to review your accounts and look forward to a continued, successful and professional relationship. If you have any questions, please call me at <<phone>>.

Sincerely,

## "HELPING TO EASE BEAR MARKET CONCERNS" SAMPLE LETTER

*This letter can be used to help ease the general investor concerns over a bear market.*

Dear <<client>>:

It is understandable that many investors may be unsettled by the poor performance of the stock markets, especially after extended periods of positive performance. One can get quite comfortable with a scenario consisting of bull markets and rising portfolio values. Much less comforting is the prospect of seeing the value of your investments drop, as a bear market unfolds. A bear market is defined as a prolonged period of falling prices, generally measured by a loss of 20% or more from previous highs.

Some investors' natural instinct during a period of falling prices is to pull out of the market. This same instinct might make buying into a rising market seem attractive. A problem is inherent with this mode of thinking. This creates the possibility for buying investments at a high price and selling investments at a low price, which is contrary to the popular investing credo "buy low and sell high." Of course hindsight is always 20/20, and it is impossible to know when the perfect time to buy or sell is; however, periods of falling prices might actually create buying opportunities for savvy investors[1].

One source of calm for investors may be found when examining the history of bear markets. They have occurred before. They have been a regular occurrence in the stock market, and are familiar to those who have many years of investing experience. There have been numerous bear markets since World War II, as measured by the S&P 500[2], with recovery periods ranging from 5 months to 70 months. As you can see, sometimes the recovery periods are long, but historically recovery does happen[3].

This should help to ease your worries about market downturns, if you're a long-term investor or if you're a retiree and have a portion of your assets in more growth-oriented investments for conversion to income in the future. Of course, each individual's situation may vary, but for those with a longer time horizon for all or a substantial portion of their assets, I suggest looking at a struggling market with a sense of calm. We try to choose investments that are well positioned for the long-term. That being our strategy, we do not recommend making any rash decisions to get into or out of the market based solely on the performance of the stock market. We do monitor your investments for those that may no longer exhibit long-term potential or may no longer be suitable to your needs, and will let you know if we feel changes are necessary. If you have any questions or concerns, please call us. Remember that investing for your future is not a sprint but a marathon.

Sincerely,

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(1) Investing in securities involves risks. Investments seeking a higher degree of return also involve a higher degree of risk. Investment will fluctuate with the prevailing market conditions and may be worth more or less than original cost upon liquidation.

(2) The S&P 500 is an unmanaged group of securities considered to be representative of the stock market in general. An investment cannot be made directly into an index.

(3) Past performance does not guarantee future results.

# 401(k) Distribution Dilemmas

*How you will take your 401(k) distributions when you retire can be an important consideration in executing your post-retirement plan.*

We all look forward to the day when we can finally kick back, relax and collect our carefully-planned and hard-earned retirement savings. But rushing into withdrawing your retirement funds could cost you a great deal of money in taxes. That’s why planning now for that day is so important.

If your employer requires distribution of your 401(k) plan funds when you leave employment, rolling it over to an IRA may be your only option for avoiding unnecessary taxes. A lump-sum distribution directly to you will probably bump you into a higher tax bracket.

Some employers, however, allow retirees to leave those funds in the company’s 401(k) plan. Given the option – leaving your money in the plan or rolling it into an IRA – which do you choose?

By leaving the money in the 401(k), you can continue to let it grow tax-deferred. You remain subject to the rules of the plan and the investment options offered, and to any changes the employer makes to the plan after you retire. Money in your 401(k) account is protected from creditors in a personal bankruptcy or lawsuit. If you die, your beneficiaries have to take a lump-sum distribution.

Despite the ease and attraction of leaving your money in your 401(k) plan, if the plan has limited or poor investment choices, you may want to opt for the rollover.

Rolling your 401(k) savings into an IRA allows you to continue investing and growing your assets tax deferred. It also gives you more control over when and how to invest your money and, to some extent, when you take distributions. If you have multiple qualified plans (for example, accounts at several different employers), consolidating them into an IRA can make them easier to manage, and may help you qualify for break points or sales charge discounts in mutual funds. If you die, distribution of IRA funds to your beneficiaries may be spread over several years. Legislation in 2005 increased and simplified creditor protection for funds in retirement accounts and, depending on your given situation, may apply to your assets.

You should note that rollovers to an IRA from other qualified plan accounts are best made directly to avoid incurring any penalties or additional taxes. You will be subject to a 20% automatic withholding for income tax plus a 10% penalty, if you are under age 59½. Withdrawn funds must be in the new account within 60 days, or the amount you received will be taxable.

You are not required to take distributions from a qualified plan – 401(k) or traditional IRA – until age 70½. The benefits of tax-deferred compounding usually make it advantageous to access these accounts after using funds from other accounts. Required minimum distributions – the amount the government makes you take out of qualified plans after age 70½ – cannot be used as contributions to another qualified plan.

No matter which method you choose for taking distributions from your 401(k) during retirement, the key is stick to your investment plan and make sure that you’re choosing the most appropriate method of withdrawal. Your financial representative can be an important resource for helping you make those decisions.

# Understanding Retirement Planning for Clients

# education & tools

Securities America

## UNDERSTANDING RETIREMENT PLANNING – CLIENT EDUCATION TOOLS

Retirement and all of the wonderful events and experiences that come with it is a culmination of a lifetime of hard work, careful planning, and diligent saving. But while the act of retirement exists in many shapes and forms, your financial journey during retirement starts with one simple step: withdrawing money from retirement savings.

Taking your first withdrawal is a crucial moment in your retirement and shouldn't be taken lightly. In conjunction with a financial representative, you should ask yourself five key questions before you take that first step.

**(1) When should I begin withdrawing?**
The question of when to begin withdrawals is one of the most important choices you can make. Oftentimes you may have a withdrawal date already planned, but sometimes life doesn't always cooperate with your plans. Taking withdrawal too early can make it more difficult to stick by your retirement plan and may increase your chances of having fewer resources as you get older. Make sure you and your financial representative have a contingency plan prepared. Don't rely on just one withdrawal date.

**(2) Do I have a solid plan?**
Taking all of the market and tax considerations into account when withdrawing from your accounts is vital to keeping a solid financial balance in retirement. Your financial representative probably knows which accounts you'll withdraw from first, but do you? Are you informed about the strategy involving which accounts you'll withdraw from and when? And is your spouse involved?

**(3) Am I ever really going to stop working?**
Let's face it, you've worked hard your entire life. Many people who retire after a long career, but don't have adequate hobbies or activities, eventually get bored and end up returning to work. And some don't stop working at all, or they just work a bit less. Making sure that your financial representative is aware of your plans, or even the possibility of a return to work, is important to your withdrawal plan. Any extra income can make a difference in what accounts you withdraw from and when you do so.

**(4) How will my withdrawals interact with my lifestyle and leisure?**
Are your withdrawals going to provide you with enough income to travel? And what about your other hobbies and plans? Making sure your withdrawals allow you to continue living the same lifestyle in retirement is vitally important. Do you feel like your income will be adequate for you to enjoy life? And if not, have you discussed it with your financial representative?

**(5) What about unexpected medical costs?**
It's no secret that the cost of healthcare in America has skyrocketed. Being prepared for the increasing costs and the possibility of emergency care are two more key factors to consider before withdrawing from your nest egg. Health insurance is often not enough, and long-term care insurance should be considered as an added way to protect you from financial loss relating to healthcare.

These are just five basic questions to ask yourself before you tap your retirement savings. Many of them may have already been covered by your financial representative, but it's always helpful to be informed and prepared on your own as well. The sooner you're prepared for retirement, the sooner you can decide what you want to do for the rest of your life.

## IS EARLY RETIREMENT FOR YOU? CONSIDER YOUR OPTIONS WISELY.

If you're thinking of retiring early, make sure that you consider your various options carefully and plan thoughtfully with your financial representative to help ensure your income lasts as long as your lifetime. Listed below are some points to consider.

**(1)** IRS Section 72(t) can help you retire early and avoid a 10% penalty tax. However, there's more to a successful early retirement than avoiding a 10% tax penalty. In depth discussions, planning and care should be taken to help protect your retirement income while providing for a more secure and comfortable retirement.

**(2)** Some company pensions may offer steady and predictable payments for your entire life, but the payments may be smaller than you want for a comfortable retirement. In that case, you may have to continue working, or return to work, to make ends meet. A lump-sum distribution from the company retirement plan may allow for a larger income stream through re-investing the lump-sum, but there will be added uncertainty due to investments whose values fluctuate. It's not always a black-and-white decision. Be sure you understand all of the possibilities and risks before you choose regular pension payments or a lump-sum distribution.

**(3)** Employers often allow former employees to leave 401(k) assets in the company's plan. It is by no means always the best choice, and careful consideration should be given to your current and future financial needs.

**(4)** Before quitting and cashing in your 401(k), do your math and talk to a tax professional. Whether retiring early or at the typical age, you may have tax consequences that should be investigated, whether in your favor or to your detriment.

**(5)** It's also wise to talk with your attorney about possible unintended consequences of moving retirement assets or retiring early, especially if you're in debt or owe child support or alimony. There may be issues you should consider depending on the laws of your state.

**(6)** If your retirement plans involve mutual fund investing, keep in mind that Class A mutual fund shares may be the best choice if the investment amount is large enough to qualify for a discount on front-end sales loads. These discounts may be offered for larger mutual fund investments, usually start at $50,000 and sometimes can be as low as $25,000. Be sure to ask your financial counsel if and how this might apply to you.

**(7)** If a strategy involves variable annuities, be aware that most variable annuities have sales charges, including asset-based sales charges or surrender charges. In addition, variable annuities may impose a variety of fees and expenses when you invest in them, including mortality and expense fees, administrative costs, and investment advisory fees. Some products offer, for an extra fee, enhanced benefits that go beyond standard contract features, such as living benefits—which are designed to protect a client's future income stream—as well as death benefits—which are designed to protect a client's death benefit payable to a beneficiary. The bottom line: variable annuities can be complex and sometimes more expensive relative to other investments, so be careful and be sure to ask your financial counsel if and how this might apply to you.

**(8)** Lastly, take time to ask your financial representative about any ideas, plans, strategies or concepts with which you're unclear. Don't be embarrassed if you don't understand something. Ask for detailed, clear explanations. Your financial representative is there to help you understand the options available to you for retiring.

Keep in mind that your retired life may be as long as, or longer, than your working life. Take the time to research your retirement options carefully before you leave the working world behind and enter the retirement lifestyle you deserve.