

September/October 2010

planner

Newsletter of the AICPA Personal Financial Planning Community

Impact of the Dodd-Frank Act on CPA Financial Planners

By Wesley G. Nissen, CPA

CPA financial planners can expect more than a few changes from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), signed into law by President Obama on July 21, 2010.

CPAs are exempt from direct oversight by the new Bureau of Consumer Financial Protection (bureau), created by the Dodd-Frank Act and set up to promote consistent regulatory treatment of consumer, financial, and investment products and services. Substantial financial reforms included in the Dodd-Frank Act include the following:

- Increasing the power of the Federal Reserve, the SEC, and the Commodity Futures Trade Commission
- Creating the new bureau to monitor consumer-lending rules
- Creating a new Financial Stability Oversight Council
- Granting the government the power to break up failing companies
- Increasing federal regulations on derivative instruments, the insurance industry, and other financial products and services

Thanks, in part, to education efforts by the AICPA Congressional Affairs team about the role CPAs play and the regulations they are already subject to, CPAs providing “customary and usual” accounting services are not subject to oversight by the new bureau. This includes accounting, tax, advisory, other services that are subject to the regulatory authority of a state board of accountancy or a federal authority, or other services that are incidental to these customary and usual accounting activities. This exemption also generally includes CPA firms and anyone employed by, or a partner in, a CPA firm.

Here is a summary of the most important pieces of the Dodd-Frank Act potentially affecting CPA financial planners.

Registration of Investment Advisers

Financial planners will want to know that the Dodd-Frank Act does not, in any manner, change the definition of an investment adviser, and it does not change certain existing historical exemptions, including the “solely incidental” exemption.

According to the Investment Advisers Act of 1940, an investment adviser is subject to regulation by the securities regulator in the appropriate state where it maintains a place of business, or where, during the preceding 12 months, it had more than 5 clients. Advisers generally must register with the applicable state(s) unless a state-based exemption from registration

What's Inside

5. Using Psychometrics to Assess Risk Tolerance

One way to know more about a client's risk tolerance is to measure risk through psychometrics. Author Geoff Davey provides his insight and observations for improvement.

7. Five Things You Must Do Now to Grow Your CPA Wealth Advisory Practice

The key to survival in the new economy is based on developing mutually beneficial relationships designed to increase referrals. John J. Bowen Jr. examines five ways to take relationship marketing to a higher level.

About the Author

Wesley G. Nissen, CPA, a partner with the Chicago office of Winston & Strawn, LLP, heads the firm's financial services practice group. He is an attorney who represents asset managers and proprietary trading firms of all types. Contact him at wnissen@winston.com.

is available. If, however, an adviser has at least \$25 million in assets under management (AUM), the adviser currently may choose to register with the SEC. Advisers with \$30 million or more AUM were required to register with the SEC unless an exemption was available.

Although certain rules under the Investment Advisers Act of 1940 likely will need to be revised to reconcile those rules with the changes mandated by the Dodd-Frank Act, it would seem that the Dodd-Frank Act effectively substitutes a \$100 million threshold for the \$30 million threshold. Accordingly, advisers managing \$100 million or more will be required to register with the SEC.

Advisers managing less than \$100 million, but more than \$25 million, generally will be prohibited from registering with the SEC unless the investment adviser is an adviser to a registered investment company or otherwise would be required to register with 15 or more states. Advisers who are not required to be registered as an investment adviser with the securities commissioner of the state in which the adviser maintains its principal office—or, if registered, would not be subject to examination as an investment adviser by any such commission—also may be permitted, but not required, to register with the SEC. Advisers who will need to transition from SEC to state registration as a result of the Dodd-Frank Act will need to do so within one year of enactment of the Act.

The Dodd-Frank Act also provides some additional clarity regarding the SEC's rulemaking authority and will eliminate the "Private Adviser Exemption" from investment adviser registration with the SEC. The U.S. Comptroller General, for example, will be required to study and evaluate the effectiveness of regulations to protect investors from persons who misleadingly hold themselves out as financial planners, as well as the oversight structure and regulations for financial planners, and legal or regulatory gaps regarding financial planners.

Exemptions From Registration

The Investment Advisers Act of 1940 provides an exemption from SEC registration for advisers with fewer than 15 clients and who neither held themselves out generally to the public as an investment adviser, nor acted as an adviser to a registered investment company. Many advisers were able to rely upon the private adviser exemption due to a 2006 U.S. Court of Appeals decision, which ruled that certain funds could each be counted as a single client and that the adviser of such funds did not need to count the fund's underlying investors as clients.

The Dodd-Frank Act essentially replaces the private adviser exemption with a number of more limited exemptions, including relatively narrow exemptions for foreign private advisers and private fund advisers. In the latter exemption, advisers who act solely as

PLANNER: September/October 2010, Volume 25, Number 5. Publication and editorial office: 220 Leigh Farm Road, Durham, NC 27707. Copyright © 2010 AICPA. Opinions of the authors and the AICPA staff are their own and do not necessarily reflect policies of the AICPA, the Personal Financial Planning Team, or the Editorial Advisory Board.

EDITOR: **Scott H. Cytron**, ABC, scott@cytronandcompany.com. For questions or assistance with your PFP Section membership, please contact pfp@aicpa.org or call (888) 777-7077. If you need assistance with the log in process to the PFP Section's website, contact the AICPA Service Center through service@aicpa.org or call (888) 777-7077 (option #3, then option #3).

EDITORIAL ADVISORY BOARD: **Kelly Allen**, CPA, Kelly Allen & Associates, Inc., San Bernardino, CA; **Lyle K. Benson, Jr.**, CPA/PFS, CFP®, L.K. Benson & Company, Baltimore, MD; **Clark M. Blackman II**, MA, CPA/PFS, CFA, CFP®, Alpha Wealth Strategies, Kingwood, TX; **Randi K. Grant**, CPA/PFS, CFP®, Berkowitz Dick Pollack & Brant Certified Public Accountants & Consultants, LLP, Miami, FL; **Deena B. Katz**, CFP®, Associate Professor, Texas Tech University, Lubbock, TX; **Marsha G. LePew**, CPA/PFS, CFP®, ChFC, LePew Financial Services, Inc., Rock Hill, SC; **Michael McConnell**, CPA/PFS, CFP®, LarsonAllen LLP, Minneapolis, MN; **Lawrence W. McKoy**, CPA/PFS, CFP®, Goodman & Company, LLP, Glen Allen, VA; **Leslie D. Michael**, CPA/PFS, CFP®, Michael Associates, LLC, Indianapolis, IN; **Andrea R. Millar**, CPA/PFS, AICPA, Durham, NC; **Theodore J. Sarenski**, CPA/PFS, CFP®, DB&B Financial Services, LLC, Syracuse, NY; **Michele L. Schaff**, CPA/PFS, MPA, AIFA, Ardor Financial Group, Northfield, IL; **Kenneth J. Strauss**, CPA/PFS, CFP®, Berkowitz Dick Pollack & Brant Certified Public Accountants & Consultants, LLP, Fort Lauderdale, FL; **Dale Walters**, CPA/PFS, CFP®, Keats, Connelly & Associates, Phoenix, AZ; **James D. Warring**, CPA/PFS, CFP®, EagleStone Wealth Advisors, Inc., Rockville, MD; **Jimmy J. Williams**, CPA/PFS, MTAX, BVAL, Jimmy J. Williams & Co., PC, McAlester, OK.

Dodd-Frank Internet Seminar

Wesley G. Nissen presented, “The Dodd-Frank Wall Street Reform and Consumer Protection Act: What CPA Financial Planners Need to Know,” on Aug. 12, 2010, to PFP Section members. Visit the *CPE and Events* archive for a full set of all materials.

advisers to private funds and have AUM in the United States of less than \$150 million also are exempt from SEC registration. However, exempt private fund investors will be required to maintain records and provide reports to the SEC that an agency deems necessary or appropriate in the public interest or for the protection of investors.

Also exempt from SEC investment advisers’ registration under the Dodd-Frank Act are advisers to venture capital funds and advisers who are a family office. The term *venture capital fund* must be defined by the SEC prior to July 21, 2011. However, no time period is specified by which the SEC must define *family office*.

Investor Suitability Standards

The Dodd-Frank Act also amends the “accredited investor” suitability standard as defined in the Securities Act of 1933 by excluding the value of a person’s primary residence from the net worth threshold (currently set at \$1 million, either individually or jointly with the person’s spouse). The Dodd-Frank Act also directs the SEC to maintain the current net worth threshold of \$1 million as modified by the exclusion of the primary residence for four years after enactment and directs the SEC to review the definition at least once every four years.

Although the Investment Advisers Act of 1940 generally prohibits registered investment advisers from charging performance fees, it does provide an exemption that enables registered advisers to charge such fees to *qualified clients*, defined as persons or companies with at least \$750,000 in AUM with the adviser immediately after entering into the advisory relationship, or persons with a net worth exceeding \$1.5 million (including assets held jointly with a spouse). The Dodd-Frank Act also will adjust for inflation the \$750,000 AUM and \$1.5 million net worth thresholds in multiples of \$100,000 one year after its enactment and every five years thereafter.

Obligations of Brokers, Dealers, and Investment Advisers

By no later than January 21, 2011, the Dodd-Frank Act requires the SEC to study, evaluate, and report the effectiveness of existing standards of care for brokers, dealers, investment advisers, and persons associated with investment advisers when providing investment advice and recommendations about securities to retail customers. The SEC also must examine whether there are legal or regulatory gaps, shortcomings, or overlaps in the protection of retail customers. In conducting the study, the SEC will have to consider whether retail customers understand that there are currently different standards of care applicable to brokers, dealers, and investment advisers in the provision of investment advice about securities to retail customers. The AICPA PFP Executive Committee is in favor of a fiduciary standard for those providing investment advice. The result of this study will not impact the standard for CPA financial planners given that they are held to a standard of care at least as strong as the fiduciary standard via the AICPA Code of Professional Conduct.

Data, Reports, Exams, and Disclosures

The Dodd-Frank Act authorizes the SEC to require SEC-registered advisers to private funds to maintain records of, and file with, the SEC reports regarding such funds as are “necessary and appropriate in the public interest and for the protection of investors,” or to provide the Financial Stability Oversight Council with the data necessary to assess and monitor systemic risk.

Records and reports must include the amount of AUM, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, valuation policies and practices of the fund, types of assets held, side arrangements or side letters, trading practices, and other information the SEC determines

Regulatory Reform Resources

The PFP Division has been communicating developments in regulatory reform since late 2008 via the weekly electronic PFP News. Any new developments will continue to be communicated in PFP News and will also be posted to the PFP site at www.aicpa.org/PFP/advocacy.

We encourage you to contact us at regulatoryreform@aicpa.org with any questions or concerns.

necessary. Confidentiality applies to information obtained by the SEC, and restrictions apply to the SEC's ability to make public proprietary information of an investment adviser obtained from any filed report (subject to certain exceptions) such as what may be necessary for purposes of assessing potential systemic risk. The Investment Advisers Act of 1940 also is amended to provide the SEC with somewhat greater authority to require advisers to disclose the identity, investments, or affairs of any clients to assess systemic risk.

Reports Required on Planners' Roles and Exams

The Comptroller General of the United States, who must submit a report to Congress within 180 days of July 21, 2010 (the date of the Dodd-Frank Act's enactment), will have to consider the role of financial planners in providing advice, whether current regulations provide adequate standards for planners, risks to investors, investors' understanding of licensing requirements, and possible benefits to investors of oversight of financial planners, among other considerations. The Dodd-Frank Act also would require certain studies about whether financial planners should be subject to increased oversight and whether a fiduciary status should be imposed on broker-dealers who render investment advice.

As it relates to the study on regulation of financial planning, the AICPA Congressional Affairs and PFP Division staff have met with the GAO to explain the role of CPA financial planners and the oversight they are subject to. AICPA believes:

- ◆ Additional oversight of financial planning would be duplicative since the bureau has oversight over financial planning that is not currently regulated, thereby eliminating any gaps in regulation.
- ◆ Because CPAs are subject to regulation by their state boards of accountancy in any advice that they provide and further, by the SEC or states when providing investment advice, additional regulation of the profession of financial planning is duplicative for CPA financial planners. The goal, first and foremost, is to protect the public's best interest, while also recognizing the regulatory framework that currently exists for CPAs.
- ◆ All financial planners should be held to a minimum standard of care, which includes acting with integrity, objectivity, due care, competence, providing full disclosure of any conflicts of interest, attaining client consent if a conflict exists, maintaining the confidentiality of all client information, disclosing to the client of any commission or referral fees, and serving the public interest when providing any of these financial services.

Adviser examinations also will be studied. The SEC will have to bear in mind the number and frequency of advisers' exams over the five years preceding enactment; the extent to which Congress authorizes the SEC to designate one or more supplemental, self-regulatory organizations, such as the Financial Industry Regulatory Authority and current and potential approaches to examining the advisory activities of dually registered broker-dealers and investment advisers. ■

Using Psychometrics to Assess Risk Tolerance

By Geoff Davey

Financial planners have a professional, ethical, and legal obligation to assess their clients' risk tolerance; yet, when we seek advice on how to measure risk tolerance, the answers are almost always drawn from finance and economics instead of psychology.

Psychologists have investigated risk tolerance for more than 50 years. Based on a large body of knowledge and many studies, psychology tells us that risk tolerance is an aspect of personality. It is a psychological trait, or a relatively enduring way one person differs from another.

An individual's risk tolerance influences the amount of risk he or she wants to take, something CPA financial planners need to know to guide and counsel their clients. However, assessing a psychological trait such as risk tolerance is not easy. Fortunately, a scientific discipline known as "psychometrics" can help us do this.

Psychometrics and Trials

Psychometrics, a blend of psychology and statistics, provides a discipline for developing valid and reliable tests and standards against which the bona fides of a test can be evaluated.

To meet psychometric standards, a test must go through rigorous development. In *usability trials*, questions are created and tested on representative samples of the intended population to see if the audience can understand and answer the questions.

Industry-standard risk questionnaires typically include questions that would fail usability trials. For example, in questions about rates of return, the more informed will want to know if the rates are before or after inflation, and any mention of "after inflation" in a returns' question is too difficult for most respondents.

The goal is to have a valid questionnaire. Having questions with high usability means the planner does not need to be involved in explaining the questions. The questionnaire also can be completed at the client's convenience. In fact, the planner should not be involved at all in explaining questions in order to avoid biasing the results.

Next, in *norming trials*, the questions are tested on further representative samples using statistical criteria. The results are examined to determine if the statistical characteristics of the questions and the scoring algorithm make sense. Questions that, at first, appear insightful are often revealed to have little or no statistical value in differentiating one respondent from another. Typically, question development requires multiple loops through both trial processes.

Tests Must Be Valid and Reliable

In psychometric terms, a *valid test* measures what it claims to measure and a *reliable test* measures consistently with known accuracy. The critical aspects of validity are content validity and criterion-related validity.

If a test's content is valid, the questions are seen to be very relevant by those with expertise in the field. In a risk tolerance test, the questions address attitudes, values, preferences, and decisions involving financial risk. In addition to questions that would fail usability trials, industry-standard risk questionnaires also include irrelevant questions relating to time horizon, stage of life, investment experience, and other areas. Although

About the Author

Geoff Davey is co-founder of FinaMetrica, a company focusing on the psychological factors relevant to financial decision-making in terms that are meaningful to individuals and their advisers. Contact him at geoff.davey@finametrica.com.

Risk Tolerance Resources

This article is the second in a series of articles on risk tolerance. The first article appeared in the *July/August Planner* and covered the interaction between risk required, risk capacity, and risk tolerance.

Geoff Davey has several examples of a valid risk tolerance questionnaire on www.riskprofiling.com. In addition, a recording of his spring seminar, *Best Practice Risk Profiling* is available to PFP Section members, along with presentation materials. Section members may register for a *free 30-day trial* of the FinaMetrica system and are eligible for a 10% discount.

these are matters a planner should explore, they are not germane to risk tolerance and including them in a risk tolerance questionnaire will cause an invalid result.

For criterion-related validity, respondents' behavior must be consistent with the strength of the psychological trait. With risk tolerance, the criterion would be actual behavior reflecting risk-taking propensity, for example, the percentage of stocks owned within a portfolio. If the criterion is collected at the same time the test is administered, it is called *concurrent* validity. If it does not materialize until some later time, it is called *predictive* validity.

Let's now look at reliability. The score on any test consists of two parts, a true score and an error (test score = true score \pm error of measurement). All tests have some margin of error, so it is a matter of degree. Reliability can be considered as the correlation of the true score to the test score. In other words, reliability tells us what percentage of the test is nonerror.

If the error component is large, then the test is unreliable and will fail to give consistent results from one testing to the next, even if the client's risk tolerance has not changed. The error generally comes from sources in the test itself, such as ambiguous wording. With everything else being equal, the more questions asked, the more reliable the test becomes. For satisfactory reliability, the correlation should be .8 or greater. For industry-standard risk questionnaires, the correlation is typically $\sim .4$, which leads to gross errors.

Psychologists divide behavior into cognitive (intellectual) and affective (emotional) domains. Risk tolerance falls into the affective domain. Years of research shows it takes typically more than 20 questions to reliably assess affective traits than cognitive ones.

What Will Clients Think?

Although clients need no persuading that it is important for planners to have an accurate understanding of their risk tolerance, they may need some encouragement:

- Surveys of respondents show they consider it a worthwhile exercise, which leads to a better understanding of themselves (and, in couples, to one another) in relation to financial risk.
- A valid, reliable, 20-question psychometrically designed test will really only take about 15 minutes to complete.
- A psychometric risk tolerance test should be a bright spot in the otherwise somewhat burdensome initial fact-finding experience.

"Know the client" has always been a cornerstone of financial planning. Knowing the client's risk tolerance is an essential component of that obligation, and even more so in a fiduciary environment. Although it might seem unconventional, a psychometric test ensures that a valid, reliable, and accurate assessment is made, allowing the planner to provide more informed advice and service.

In the next article in this series, the shortcomings of industry-standard approaches to assessing risk tolerance will be examined. For the present, independent studies show planners who use an industry-standard approach make disturbingly inaccurate estimates of their clients' risk tolerance. The errors are so large that planners would be more accurate if they made no attempt at all to assess a client's risk tolerance and simply assumed everyone was average. ■

Five Things You Must Do Now to Grow Your CPA Wealth Advisory Practice

By John J. Bowen Jr.

We are living through a time of almost unprecedented market volatility and disruption. Many financial advisers are content with simply waiting out the storm, believing they will do well to just survive. These advisers couldn't be more wrong.

Today, our clients need us more than ever. Financial advisers who do not communicate in a meaningful way to address client concerns will find those clients looking elsewhere for what they need. In fact, according to a survey conducted by Prince and Associates, Inc., four out of five affluent investors plan to take assets away from their current advisers due to dissatisfaction with inadequate advisor service.

As a client-centered wealth adviser, you have a once-in-a-lifetime opportunity to capture a share of those dissatisfied clients by working in an extremely systematic way. Empirical research on adviser best practices conducted by CEG Worldwide, LLC, with elite wealth managers identified five steps you can take right now to substantially grow your business through this volatile period.

1. Maintain a Positive Focus

Maintaining a positive focus is about being successful and focusing on exactly the right things that will make a significant difference for your practice and clients.

Your overarching aim should be to build a simple wealth advisory business in which you, as an elite adviser to affluent individuals, become indispensable to your clients. You want your practice to run smoothly and provide a world-class experience to your clients. As a result, you will be recognized as an expert at serving your target market, making it far easier to attract new clients from that market.

Don't confuse activity with effectiveness. Think of yourself as an entrepreneur. This will force you to focus solely on the actions that directly contribute to building your business.

2. Conduct Rediscovery Meetings to Get Immediate Results

During these times of market turmoil, some financial advisers avoid contacting their clients. Advisers don't want to face uncomfortable questions about portfolio performance.

You should do the exact opposite.

Now is the time to reach out to your clients to reconnect and schedule rediscovery meetings. At these meetings, work with each client to create a "total client profile," one page that provides key details in seven important areas of the client's life and finances:

- *Values.* What is important to the client about money?
- *Goals.* What are the client's most important goals and dreams?
- *Relationships.* Who does the client care about?
- *Assets.* What are the client's assets?
- *Advisers.* Who are the client's other professional advisers?

PFP Center Website Log In Instructions: pfp.aicpa.org

1. Visit aicpa.org/pfp.
2. Click on "sign in" at the top of the page.
3. You'll be prompted for your username & password. If you have forgotten either one, there are links for you to reset. A "remember me" button prevents you from having to log in each time you visit the site.

Online Resources

John J. Bowen Jr. addresses the steps advisers should take to build a world-class wealth management practice in his three-part Internet seminar series. Complete recordings and presentation materials may be found in the PFP CPE and Event archives.

- *Process.* How does the client like to work with his or her advisers?
- *Interests.* What does the client enjoy doing?

More than likely, this rediscovery will uncover new ways in which you can assist your clients. This process will reassure your clients that you fully understand them as people and are addressing their financial lives, which is just as important during this uncertain period.

3. Provide a Second Opinion Service

Let your clients know you will provide any of their business associates, friends, and family members with a complimentary second opinion on their finances. Ask for those individuals' names and contact information, and then follow up directly with them to schedule an introductory discovery meeting.

This service is not magic, but it is one of the most effective ways we know for bringing in qualified clients. Even though many clients today are dissatisfied with their financial advisers, they don't always know where to go for a second opinion. When these individuals receive your advice, they get the opportunity to experience your discovery process and client-centered approach. CEG Worldwide, LLC, research indicates this type of experience is something most affluent investors have never experienced. As a result, this approach makes it very comfortable for prospects to transfer assets to you.

Many financial advisers hesitate to ask clients for referrals. Advisers think they are somehow asking clients for something the clients would rather not give. Actually, just the opposite is true! Just as you like sharing with friends the names of books or movies you enjoyed, your clients will want to share with their friends the top-notch wealth advisory experience they are receiving from you.

However, you need to position this correctly. You are not requesting referrals, but rather providing a valuable service that will help their friends and colleagues ensure they are making smart financial decisions in today's climate.

4. Create New Opportunities Through Centers of Influence Interviews

If you want to move up market to serve more affluent clients, reaching out in a systematic way to key individuals in your target market is one of the best methods.

Identify 10 individuals who have a high degree of influence in the target market—the movers and shakers who know all the key people and whom others look to for leadership. If your practice focuses on executives in high tech industries, for example, centers of influence might include industry association leaders, CEOs of the leading companies, and editors of industry publications.

Set up meetings with these individuals to interview them. Ask about the top concerns and challenges of their communities and opportunities to address them. These interviews will give you insights on your target market you never had before. This information will help you to devise new marketing approaches, identify new organizations, and gain new access to highly qualified prospects.

Many financial advisers waver on taking this step because they wrongly assume the centers of influence are unwilling to spend their time talking with them. However, make your goal clear to the center of influence. You want to gather key information about their community that will allow you to assist members of that community. Once understood, we find that most centers of influence are more than willing to help.

5. Develop Powerful Strategic Alliances

According to CEG Worldwide, LLC, research, more than 50% of referrals for affluent individuals—those with more than \$1 million in investable assets—come from other professionals. This makes building strategic relationships with other professional advisers one of the most effective actions you can take to grow your business.

These strategic alliances can be with any professional adviser who serves your target market, including estate planning attorneys, high end insurance specialists, or business brokers.

Within your own accounting firm, leverage the relationships you have to better serve the firm's clients. You want the key accounting partners to fully embrace what you do to send qualified clients your way. By far, the best way to do this is to get these partners to go through your wealth advisory process themselves so they experience your service first hand.

Assuming both you and the managing partner agree that a strategic alliance would support your common goals, meet with all the key partners for a brainstorming meeting to obtain their buy-in and create a strategic action plan to work on together. Try these three steps:

1. Conduct a pilot program in which the accounting partners refer 10 qualified clients to your service.
2. Create a campaign to offer your second opinion service to tax clients during tax season.
3. Conduct a series of exclusive educational client events where you and other experts in your target market make presentations on the financial challenges of greatest concern to clients.

Through these five actions, you not only will enjoy a significant boost in practice growth, you will further ensure your clients are getting the assistance they need right now to have financial peace of mind. ■