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CPAs Broaching New Territory as Financial Service Professionals

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Abstract: *The entrance of CPAs into the financial services marketplace will create ripples of change that will be felt by advisers and consumers alike. Traditional CPAs, insurers who contract with CPAs, and other financial services professionals who might be considering a partnership with CPAs will be closely watching the evolution of the CPA practice and finding ways to network more effectively with CPAs who are now offering full-service financial advice.*

However, before these changes begin to permanently alter the shape of the financial services landscape, CPAs must address a series of challenges in the form of stringent requirements imposed by state boards of accountancy. This article examines these challenges as well as the significant regulatory, business, and structural issues that CPA firms must address as they enter the financial services arena.

Introduction

As financial services enter the 21st century, one of the most profound changes will be the entrance of CPA firms as “full-service” financial advisers. In almost every major study, affluent clients turn to their CPA as their most desired and trusted adviser. This trust, when combined with client confidence in their rigorous training and access to financial information, makes CPAs the 800-pound gorilla of the financial services world.

The Blurring of Financial Service Providers

With the rapid deregulation and dismantling of New Deal barriers, all financial service providers are offering a wider range of products and services to their clients. The surprise is not that CPAs have decided to offer the full range of financial services, but that they are so late to enter this expansion. While there has been much discussion about banks entering the investment and insurance arenas, comparatively little has been written about the impact CPAs make on this powerful trend (Figure 1).

This article will review briefly the events that have brought us this watershed change, as well as examine the requirements still imposed by the state boards of accountancy. Finally, it will look forward by analyzing the significant regulatory, business, and structural issues that CPA firms must address as they enter the business of fee-based money management, investments, and insurance products.

Events Leading to Change

Since the turn of the 20th century, state boards of accountancy had banned CPAs from receiving commissions. This ban was also incorporated in the American Institute of Certified Public Accountants (AICPA) position.

The ban on commissions was first challenged at a national level in the late '80s when the Federal Trade Commission (FTC) brought suit against the AICPA. The FTC contended that the association's ban on commissions was an illegal restraint on trade. This suit was settled in 1990 with the result that the AICPA adopted Rules 503 and 302, which permitted CPAs to receive commissions from the sale of financial service products. Since then, the change has worked its way through the states with legislators or associations lifting or modifying the ban. At this time, 42 states have either initiated legislation or modified regulations to lift the ban on commissions.

Current Issues Affecting CPAs Receiving Commissions

As accounting firms outline strategic business plans for the 21st century, most are anticipating an expanded offering of financial services. However, the lifting of the ban on commissions has created a whole series of new questions that firms must answer as they enter several new businesses simultaneously. Not only must they conduct this new business in a way that complies with state boards of accountancy, but they also find themselves regulated by a host of complex new state, fed-

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eral, and industry regulatory bodies. The entrance of a firm into securities, insurance, and fee-based investment advice will require new licenses, continuing education, and procedures.

This expansion will present major opportunities for CPA firms to expand their practices and increase their revenue, but there are significant traps for the unwary. Firms should welcome this opportunity, but at the same time, it is crucial to have a cogent strategy for determining the consequences of this move and managing the risks. In order to best serve their clients and maintain their objectivity, CPAs will have to choose affiliations and associations carefully.

Regulation by State Associations

Most accountancy boards have written their regulations or codes of ethics in a way that defines engagements that cannot involve a receipt of commissions or a contingent fee. The professional must then look for the exceptions to this rule. For example, the Mississippi State Board of Public Accountancy states:

d. Commissions

- (1) A CPA shall not for a commission recommend or refer to a client any product or service or for a commission recommend or refer any product or service to be supplied by a client, or receive a commission when the CPA or the CPA's firm also performs for that client:
 - (a) An audit or review of a financial statement;
 - (b) A compilation of a financial statement when the CPA expects or reasonably might expect that a third party will use the financial statement and the CPA's compilation report does not disclose a lack of independence or
 - (c) An examination of prospective financial information...
- (2) A CPA who is not prohibited by

this section from performing services for or receiving a commission and who is paid or expects to be paid a commission shall disclose that fact to any person or entity to whom the CPA recommends or refers a product or service to which the commission relates.

Some states also prohibit the receipt of a commission if the client is a governmental entity.

Requirement of Written Disclosure. While statutes like the ones in Mississippi and Ohio do not specifically provide that the disclosure be in writing, other states such as Florida, Massachusetts, and West Virginia specifically mandate that the disclosure must be in writing and prior to the engagement. Prudent practice seems to recommend that this disclosure be in writing even if not specifically mandated.

This written disclosure not only documents that the statutory requirement has been met, but it also informs the clients that they may be dealing with either a different entity or one of the affiliated CPA professionals in a different capacity. If properly drafted, the disclosure also will clarify the extent of the engagement, the services to be performed, the method of compen-

sation, and any potential conflicts of interest. If the CPA or CPA firm is involved with the sale or recommendation of a security, the disclosure must also satisfy requirements of NASD Conduct Rule 2210 dealing with the identification of the broker-dealer and a number of separate disclosure requirements of the 1940 Registered Investment Adviser Act.

Requirement of Independence and Objectivity. While some industry pundits have claimed that the lifting of the ban will end the objectivity that has made CPAs the most trusted advisers, others are quick to point out that the requirement of absolute objectivity remains one of the cornerstone tenants in their code of ethics and professional conduct. Firms choosing to enter the commission-based arena will need to demonstrate to the state associations and to their clients that they still meet the standard of objectivity. This requirement may be very difficult for a firm to meet should it choose to partner or merge with a firm that places heavy emphasis on its own proprietary products or a distribution system dominated by captive agents or representatives.

Even the contractual language and terms in some insurance and securities brokerage contracts will create a

FIGURE 1
Comparison of Services Offered by Financial Advisers

	Insurance Products	Investment Products	Banking Services	Fee-based Planning	Legal Services
Attorneys	?	?	?	X	X
Insurance Agents	X	X	X	X	
Stock Brokers	X	X	X	X	
Bankers	X	X	X	X	X
Accountants	?	?	?	X	

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direct conflict with this required objectivity. One major insurance company's program for CPAs has the following wording in its contract:

While this contract is in effect, the CPA shall not solicit, obtain or submit any application to any other company for any form of insurance policy or annuity contract, or agree to do so, nor shall the CPA in any other way act or assist in obtaining or providing any such insurance or annuity from any such other company, unless specifically authorized in writing by the company.

This contract also seems to compromise the CPA's independence by requiring annual production quotas of the company's proprietary product line for a minimum of 12 years. Failure to meet annual mandated commission levels results in harsh consequences for the CPA, including forfeiture of all renewal commissions.

Other investment and securities firms, while not so explicitly requiring sales of their proprietary products, may do so through compensation systems. Many firms purporting to have multiple products available offer significantly higher commissions on their own proprietary products. For example, another major insurance company promoting a program for CPAs pays both its captive agents working on the case and the accounting firms with which they are partnered a 75 percent commission on their proprietary products and only 37 percent to 45 percent on any other company's products. While multiple products may be available, the practical effect of this would be a perception that the CPAs are just an extension of the captive general agency system.

Requirement of Competency for the Engagement. Most codes also require that the CPA not undertake any engagement that he or she or his or her firm cannot reasonably expect to complete with professional competence. If firms wish to offer their

clients a wide array of financial service products on a commission basis, they will have to demonstrate professional competence in these areas. Large firms will be able to assign areas of expertise within the firm. Smaller firms will only be able to demonstrate this competence by creating a team that provides the specific competence required by the engagement.

This requirement of competence is problematic for some firms that are broadly licensing solo practitioners. Those one-person shops choosing to add these additional lines will now need to demonstrate expertise in not only current tax law and accounting standards but also investment and portfolio theory, group benefits, and insurance—a heavy burden by any definition. Failure to provide this expertise not only will risk violation of this standard, but also will not give the clients of the firm a compelling reason to switch from their current providers.

Why Are Licenses Required?

Many CPAs wrongly assume that the lifting of the ban on commissions will allow them immediately to share in commission-based products. The lifting of the ban merely permits individuals or firms to attempt to obtain the licenses necessary to participate in this business. The basic requirement to participate in both the investment and insurance businesses involves testing and licenses. Both investment and insurance regulations explicitly prohibit sharing of commissions with nonlicensed persons or entities. Although commonly violated, it is usually illegal for an insurance and securities licensed CPA to share commissions with other, nonlicensed members of the CPA firm. Besides the legal requirement of having licenses to participate in these businesses, there are several other important reasons why members of the firms should obtain additional licenses:

1. To obtain errors and omissions

insurance to protect the firm and its clients in the event that a problem occurs with these activities.

2. To insure continued receipt of revenues. By having the product sponsor or broker-dealer pay the firm directly, the firm is protected from someone "forgetting" to send a check.

3. To insure that they have continued access to their clients' information as the agent or registered representative of the transaction. This can be particularly important if the licensed CPA decides to leave the CPA firm and take the investment and insurance clients with him or her.

4. To prevent even the appearance of taking money "under the table."

5. To avoid the "Catch 22" created by the convergence of state accountancy board rules and NASD conduct rules. Since accountants are required to disclose the source of commissions, fees, and "referrals," this disclosure must, in most states, be in writing. The documentation of this payment, "if illegal," would create written, prima facie evidence that could be the basis for revocation of a securities license. At a minimum, it could be the basis for NASD or broker-dealer discipline.

What Licenses Are Required?

The answer to that question is dependent on the types of products and services that the CPA or firm wishes to offer. The licensing can be broken into three broad categories: commission-based investment products, fee-based investment products and insurance-based products. Increasingly, there is an overlap in the regulation of these areas (Figure 2).

Regulation of Investment Products

The 1933 and 1934 Securities Acts created a broad framework for the registration and regulation of securities products. One of the results of this regulation was the creation of the Securities and Exchange Commission (SEC). The SEC has chosen to dele-

gate the direct supervision and licensing of investment professionals to the National Association of Securities Dealers (NASD). Those wishing to offer securities-based products, i.e., stocks, bonds, mutual funds, limited partnerships, variable life, and variable annuities, must become registered. This involves sponsorship by a member firm (broker-dealer) and passing an exam (Series 6 or 7). Depending on the nature of the activities conducted and the state of client domicile, addi-

tional licenses may be required.

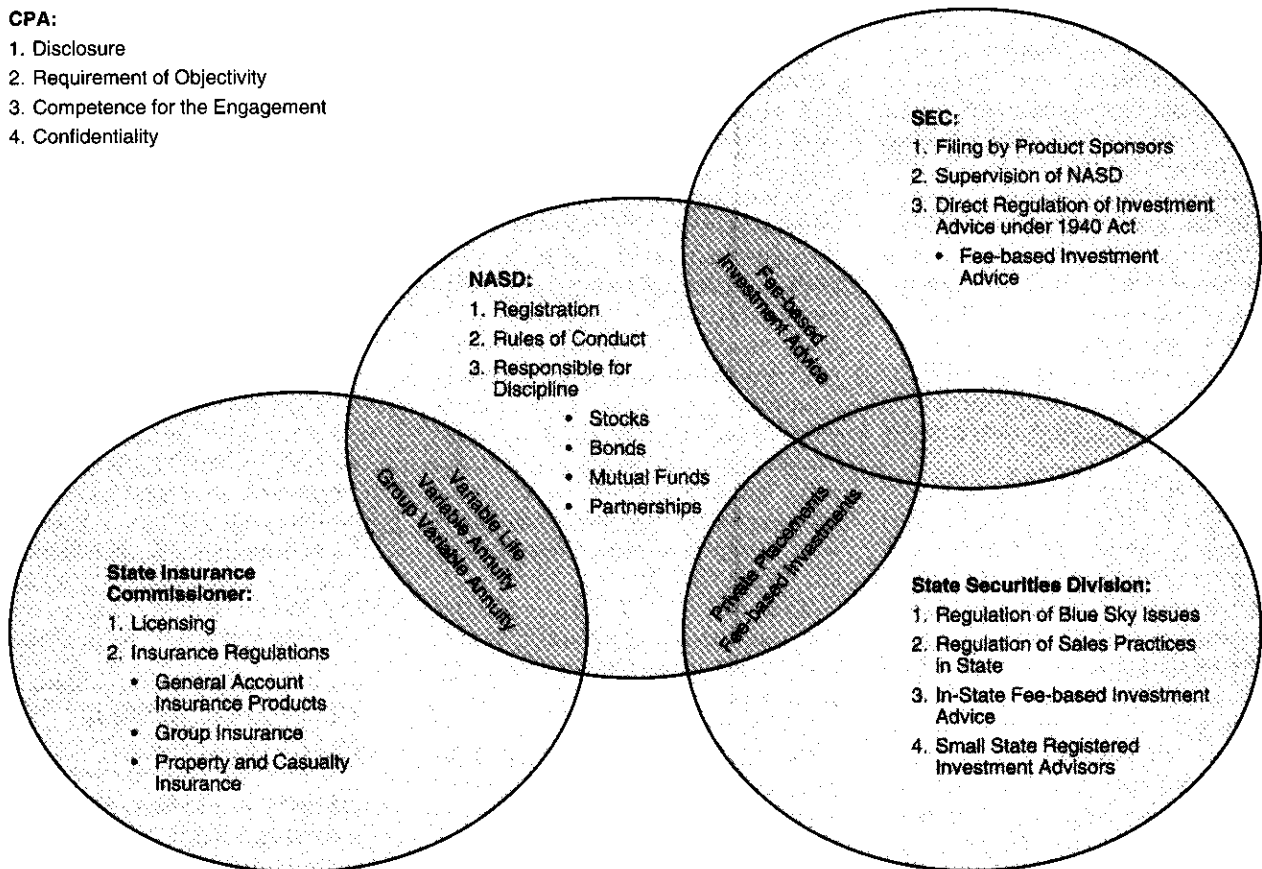
Some national CPA firms have contemplated either building or buying their own broker-dealer that would be a NASD member firm. The heavy upfront cost and staffing make this an option for only the largest firms. Therefore, most firms will choose to affiliate with an established broker-dealer. The broker-dealer universe is comprised of three types of firms—a wire house firm (e.g., Merrill Lynch, Legg Mason, McDonald & Com-

pany), a life insurance company broker-dealer (e.g., Equitable Securities, Lincoln Advisers), or an independent broker-dealer (e.g., HD Vest, Royal Alliance, ValMark Securities).

The choice of broker-dealer is one of the most significant ones a CPA can make for several reasons:

1. With limited exceptions, the broker-dealer is a monogamous relationship. Registered representatives can only be registered with one broker-dealer.

FIGURE 2
Governing Regulatory Bodies



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2. Registered representatives are prohibited from sharing commissions with members of another firm (NASD Conduct Rule 3040).

3. Increasingly, broker-dealers have acquired supervision responsibilities over a broad array of financial service products, so the broker-dealer determines the availability and selection of

- variable life and annuity products
- activities of a registered investment adviser (NASD Notice to Members 94-44)
- group annuities

4. The broker-dealer must enter into a selling agreement for a product before it can be offered to a client. Therefore, it controls which products are sold and what commission rates are paid.

5. The broker-dealer is responsible for monitoring client correspondence and record keeping. Some broker-dealers' client correspondence procedures would make it difficult to conduct business in the way to which CPA firms have become accustomed.

6. Broker-dealers are also charged with supervising financial planning activities. Some firms will allow financial planning to be conducted through a CPA's own registered investment adviser (RIA), while others require financial planning to be processed through the broker-dealer's own RIA.

Regulation of Fee-based Investment Advice

Fee-based investment advice is regulated both by the SEC (under the 1940 Investment Advisers Act) and by every state securities administrator. The 1940 Act requires that any person or entity providing advice about securities for compensation must register with the SEC or the state securities administrator. The adviser must also provide potential investors with a detailed disclosure of the firm's affiliations, background, and financial proformas. The exact computation of

how these fees will be determined must also be specified. This disclosure is part of the filing with the SEC and called an ADV Part II.

There has always been an exception in the 1940 Act for accountants and attorneys who give investment advice that is incidental to their practice of accounting or law. There is no question that this exception would not cover CPAs who provide financial planning services or fee-based money management. SEC cases have held that this advice is no longer incidental to the practice of law or accounting and is a separate business that must be registered.

Although many accounting firms have ignored this ruling, it is foolhardy to do so. The 1940 statute makes it a felony to offer this advice without being registered and includes fines up to \$10,000 and five years in jail per case.

Record Keeping and Communication Requirements. In addition to registration, the SEC requires strict compliance with record keeping and communication. The SEC is one of the most active of the regulatory bodies conducting surprise on-site examinations of registered investment advisory firms on a periodic basis. At that time, they will perform a thorough inspection of all required records and communications. These examinations can take anywhere from a few hours to an entire week. Of the six independent RIA firms associated with ValMark Securities, four had on-site inspections in 1998.

State versus Federal Regulation. The confusing state of affairs with conflicting state and federal regulation was clarified with the National Securities Markets Improvement Act of 1996. This federal legislation delegated to the states responsibility for investment advisers with less than \$25 million in assets. The SEC retained direct regulation of larger advisers and those in states without regulation. The

states that did not previously regulate investment advisers have all begun the process of creating new statutes to provide this supervision.

Regulation of Insurance Products

The states have traditionally been the sole regulators of both insurance companies and the licensing of agents and agencies. The lax regulation by many state insurance commissioners of this industry has drawn calls for federal intervention. It appears that for the foreseeable future accounting firms will need to either establish a corporate agency or individually license with the state to participate in the sale of these products. Most states have separate exams and licenses for life, health, and property/casualty insurance. While the same insurance commissioner regulates both life and property/casualty insurance, there are different requirements for each of these lines. Most states have instituted both a prelicensing training and a continuing education requirement. In most states a life and health license will also allow the sale of group insurance.

The dominance of variable life insurance and variable annuity products in recent years has, in many ways, caused a de facto control of the insurance business by broker-dealers.

In addition to filing with the state insurance commissioner, these products require registration with the SEC. Therefore, in order to offer these products, the CPA must have a securities license and be registered with a NASD member firm. Again, the broker-dealer is key to product availability, objectivity and compensation.

CPA Participation in Financial Services

Options Available to CPAs Entering Financial Services

Given this complex background with many layers of regulation, CPA

firms have several options:

1. *Limit activities to only fee-based services provided by accountants.* This would involve continued referral of product sales to insurance agents, stockbrokers, benefit consultants, and investment advisers. However, the firm would need to affiliate with a RIA or establish its own.

2. *Refer business to a person or firm with special expertise to share revenue.* This requires becoming both insurance and securities licensed and forming a commission-sharing arrangement with one or several firms. It also requires giving up substantial control over the CPA's clients.

3. *Build or buy expertise in house to offer both planning and implementation of a broad array of financial service products.* This requires hiring people with the requisite experience to run the expanded service offering. It will also require acquisitions of appropriate entities or licenses. Disadvantages of this option are both the huge up-front investment in time and resources and the need to constantly monitor the increased compliance responsibilities.

4. *Merger or joint venture with a firm providing the desired services.* This option allows quick entry into the business with high added value for the client but may limit ongoing flexibility to change the structure of the arrangement. It will also require the necessary licenses.

5. *Preferred-provider model.* By choosing to partner with several independent financial service organizations, the CPA firm can "subcontract" various components of its financial services strategy. This would include affiliations with a broker-dealer and its RIA. It would allow the flexibility to "fire" experts who do not perform to standard or break the protocol established by the accounting firm. This model also allows the accounting firm to choose experts based on the job required. Key to this model is a

central organization through which members can network and share common licenses. The broker-dealer affiliation is key.

6. *Sell the firm to a large financial services concern such as IDS or Century Business.* Because financial services firms recognize the tremendous long-term financial rewards of capturing the clients of a CPA firm, they are currently paying much higher multiples for practices than was the case before product sales were possible. This option is very attractive to equity partners waiting to retire. The option allows them to partially capitalize the value of the potential future financial business.

A word of caution must be noted. If the proceeds are either wholly or in part paid in stock, the partners of the CPA firm must have confidence in the acquiring firm's future.

Key Factors for Determining an Effective Financial Services Strategy

The strategy that will be most effective is dependent on each firm's situation. Key factors in determining a strategy should include:

- the accounting firm's size
- the degree of sophistication of the local market
- the nature of the practice and the clients
- the level of expertise inside the firm
- the budget for establishing the financial services entity
- the firm's relationships with other service providers
- the range of services and products to be offered
- the level of involvement the firm wants to have in its new businesses
- the importance of continued control and independence
- the desire of equity partners to stay in the business or retire

Each of these factors will lead a CPA firm to one of these broad options, depending on the firm's unique circumstances and personalities. The terms and conditions of the attendant contractual relationship should be customized accordingly. Each has distinct risks and rewards, but some of the same issues run through each alternative. Firms must also take great care to think through the long-term strategic implications of product providers and partners. They must structure contracts carefully to protect their clients, their independence, their objectivity, and their own financial interest.

Looking Ahead

There are a limited number of firms that have served as pioneers in this field. The successful firms have shown us that they have the potential to remake the financial services landscape. For those innovative firms that think about how this expansion can benefit their clients, the barriers between product and service will blur.

Advantages to CPA Firms and Their Clients

In providing tax planning, accounting professionals will be better able to advise their clients on which securities to sell because they will have access to the clients' statements over the Internet. Clients will no longer need to collect 1099s for their investments at tax time and send them to the CPA. Instead, the accountant will electronically download this information. When advising the client on what form of qualified or nonqualified plan provides the most benefit to the owner, the accountant will not have to call a benefits consultant, but instead will be able to model assumptions because the firm will have direct access to the client's data.

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Impact on the Financial Planning Process

The entire process of financial planning will conceivably change because planning no longer will be a static paper plan that was created at a single point in time. There will no longer be the artificial barriers between advice, implementation, and compliance work. The new model will be based on an ongoing relationship where the adviser and the team of experts will have access to live data and can adjust the plan and its implementation on a regular basis.

Client-driven Factors to Consider

With this type of future possible, the choices made at the beginning of the process will have a profound impact on the potential future success of the firm.

Regardless of the model chosen, clients will ask several basic questions.

- What value-added proposition does your firm add to my purchase of these products and services?
- Can I still trust your firm to be independent and objective in your recommendations?
- Does your firm bring me world-class expertise?
- Whom does your firm represent first in this transaction? Are you still acting as my adviser? Or are you an extension of a company's proprietary product marketing force?
- Does the technology your firm employs allow you to do a better job as both my accountant and financial adviser?

By asking themselves these questions first, CPA firms will be able to make the correct choices in deciding which of the six models is most appropriate for their needs. These basic questions provide the framework to answer the hundreds of questions that must be considered on the journey to the continued development of the accounting profession in the next century. **J**

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