A Lawyers Guide To Life Insurance Securities and Financial Products

by Benjamin Blakeman[1]

Within the past ten years, the financial services industry has undergone some of the most dramatic changes in its history. On November 12, 1999, President Clinton signed into law the repeal of the Glass-Steagall Act, which since 1933 had separated banks from other financial firms, and other laws separating banking and insurance, to "permit the creation of new, more efficient financial holding companies, which can offer banking, insurance, securities, and other financial products to consumers"[2]

The banking, accounting and insurance industries had been pushing for the repeal of this "antiquated" act for years prior to its repeal. Banks did not want to be restricted from selling life insurance and securities, life insurance companies did not want to be prevented from owning banks or mutual fund companies or selling stocks, and the accounting industry wanted in on the amazing growth of financial services that had taken place with the incredible bull market of the 1990's. Most of all, everyone wanted to acquire everyone else in the financial free-for-all which culminated with the acquisition of America Online by Time Warner, signaling the end of the bull market in 2000. Since the repeal of Glass-Steagall, life agents are permitted to sell securities and banking services, bankers can sell life insurance and securities, and CPA's can sell securities and life insurance, as long as they possess the proper licenses. This opened the virtual floodgates on financial services products sales and marketing.

The myriad of potential conflicts of interest on this new landscape could fill an encyclopedia. The preferred marketing of certain products by life insurance agents and securities brokers has already spawned numerous investigations and prosecutions, resulting in the payment of hundreds of millions of dollars in fines by some of the largest mutual fund companies. But that is only the tip of the iceberg, as we will discuss at a later point.

Soon after the fall of the market and the accounting scandals of 2000 and 2001, the Sarbanes-Oxley Act and many other laws and regulations were enacted to protect

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[2] White House press release, "Fact Sheet on Financial Services Modernization", Nov. 12, 1999.

consumers from the excesses of Corporate America. These laws and regulations require insurance agencies that sell securities products to have agency compliance officers, to maintain compliance manuals, correspondence logs, complaint logs, to pre-approve advertising (roughly defined under NASD Rule 2210 as any communication to more than one client), annual auditing, suitability rules, and a host of other requirements designed to prevent fraud.

On the insurance side, there is no direct federal regulation (except for Variable Life Insurance, which is classified as a security). The individual states have to approve any product offered, and while there are no specific self-auditing rules, there are important rules regarding replacement of policies (including annuities) and marketing to seniors.

If your client consults you for advice considering the purchase of such products, it may be useful to be aware of some of the basic issues of concern. The following discussion will highlight some of the more common situations where you may want to caution your client.

1. Deferred Annuities

Annuities are one of the most commonly sold and least well-understood products available in the financial marketplace today. Sales of deferred annuities have skyrocketed in recent years. They come in three basic flavors: fixed, variable and equity-indexed. A fixed annuity pays a guaranteed amount of interest for a certain period, and may or may not be renewable for an additional term. Variable annuities offer the owner a choice of separate accounts, similar to mutual funds and run by the same fund managers that manage such funds, with the ability to switch investments without penalty. Equity indexed annuities offer a percentage of participation in market returns, with a guaranteed minimum return (usually 0, but sometimes as high as 2 - 3%).

All deferred annuities are tax-deferral vehicles primarily for retirement purposes. Annuities sold by brokers almost invariably have declining surrender charges, which means that if the annuity is surrendered within a certain period (usually 10 to 15 years), the owner will pay a surrender charge. These charges can range up to 15 percent or more of the value. If your client is using a deferred annuity as a retirement vehicle, he should be aware of the following:

A. The administrative charges usually are from 70 to 150 basis points per year for the life of the contract. If the expected gross rate of return is 8 percent, for example, the net rate realized could be as low as 6.5 percent. This differential compounds over time inversely to the effect of compounding of interest. Thus, over a 20 year period, a $100,000 investment that would be worth $492,680.28 (at 8 percent)

will be worth only $365,644.67, a difference of $127,035.61. This represents an erosion of 25.78% of the total return due to administrative charges. So there should be a darn good reason for buying the annuity.

B. Withdrawals are limited. Any money withdrawn from an annuity prior to the owner/annuitant's age 59 ½ is subject to a penalty tax of 10% of the amount withdrawn.[3] This is in addition to any surrender charges that may apply. Surrender charges will usually not apply to withdrawals that do not exceed 10% of the account balance, but make sure your client reads the fine print before making a withdrawal. Guarantees can also be affected by early withdrawals.

C. If the annuity is purchased within a retirement plan, the advantage of deferring taxes is already present within the plan, and the annuity is unnecessary for that purpose. The only reason for purchasing an annuity within a retirement plan is to obtain the unique benefits present within the contract. Generally, those benefits consist of: a) in variable annuities, the ability to switch investments from one to another without penalty within the contract, which includes offerings from different fund managers, b) contractual guarantees, such as death benefits and "living benefits". However, these guarantees often cost more than they are really worth.

For example, a so-called "guaranteed minimum income benefit" may imply that for purposes of generating income, the account value is guaranteed to be at least twice the original investment after 10 years, and cost an additional 50 basis points (½ of 1%) per year. But you will find, comparing the actual guaranteed income is substantially less than your client would receive if he purchased an immediate annuity for the same principal amount as the so-called "guarantee" amount. In addition, of course this guarantee will further reduce the returns on the contract. There are a myriad of other guarantees available, and some may be beneficial in your client's particular case, but he needs to understand what he is buying beforehand.

D. If the annuity is purchased with after-tax dollars (i.e. outside of a retirement plan), your client must understand that he is trading capital gains taxes paid as you go (in the case of individual stocks or mutual funds) for ordinary income taxes paid upon withdrawal. All annuity withdrawals are taxed on a last in, first out basis, so the gains in the contract are taken out first, and are taxed as ordinary income. If your client is in a 30% tax bracket, his taxes could be twice what they would have been in a mutual fund. This can substantially impact the ultimate return on investment. The client can avoid this type of taxation only if he annuitizes, i.e. accepts a permanent stream of income in exchange for the principal value of the annuity. However, most people just don't want

[3] There can be exceptions, such as first time home purchases or medical expenses, where the penalty will not apply, but you will have to fight the IRS to get the money back.

to trade their nest egg for a stream of income.

E. Higher commissions create a conflict for the broker. Most of the annuities offered by brokers to the general public have commissions that are much higher than mutual funds. Average mutual fund commissions range from 3 to 5% (less charges the broker has to pay to his broker-dealer, which can range as high as 65% of the total commission on the sale. Annuities can pay up to 15%, often without any charges to the broker dealer. Which would you rather sell? While there are annuities that pay lower commissions (as low as 3%), that have lower surrender charges, shorter surrender periods, and lower administrative fees, few brokers will offer them unless they are in a competitive situation.

F. One of the worst deals your client can get for himself is the so-called "bonus annuity". The bonus option available on many products works like this: Your account gets credited with a 5% bonus upon purchase, but the surrender charge starts at 10% and declines to 0 after ten years. He pays 50 basis points for the bonus per year, so the entire 5% gets eaten up in additional fees by the time you can use it. The purpose of the bonus is to compensate for the surrender charge your client is paying in real dollars when he surrenders his old annuity to buy the new one. In other words, he has given up a perfectly good contract and paid a surrender charge to get nothing of real value in return.

2. "Free" Life Insurance

Let's say your 70 year old client casually mentioned to you that he was contacted by an insurance agent offering him a one million dollar life insurance policy with no up front cost and no obligation ever to pay premiums. Sounds like a great deal, doesn't it? Here's how it works. The client applies for a life insurance policy he may or may not need, with the assurance that a financing entity will advance the premiums for two years on a non-recourse loan. At the end of the two year period, the client may keep the policy and repay the loan, or sell the policy (on the secondary market), possibly at a profit.

Why not take advantage of this opportunity? First, you should understand that there is a two year "period of contestability" during which the insurance company may challenge the policy for fraud or material misrepresentations. The basis of such a challenge could be, for example, that the client misstated the basis of his need for life insurance (such as exaggerating income to be replaced or overestimating debts), misrepresented his intention regarding ownership of the policy (said he did not intend to sell it to a third party when he really did so intend), fails to disclose the true "premium payor" or says he is a non tobacco user when he really smokes "every now and then". In these cases, the death benefit could be illusory because the company

may refuse to pay. If the insured elects to keep the policy, he must pay the premiums in addition to repaying the loan plus interest. Thus, the cost will be higher than it would have been if the policy had been purchased outright.

The first question to ask is whether the client needs the insurance. If so, he or she would be better off shopping for the best policy and ignoring the "free" offer. If not, he may want to consider whether he wants to file a fraudulent insurance application.

Various bills are currently in the works to seriously hinder or eliminate this practice, including one draconian measure that would levy a 50% tax on the proceeds from the sale.

3. The Magic Vanishing Premium (The policy will pay for itself)

Insurance agents often make the representation that a cash value policy will "pay for itself" after a certain period of time, usually 15 years or more. While limited pay policies do exist, they have high premiums, and most insurance policies sold with this representation are not guaranteed to pay for themselves. A careful reading of the policy illustration provided to the applicant will show that if the insured fails to pay the contractual premiums, the policy may lapse. A policy illustration will always contain a ledger showing the worst case scenario in the left column and the projected performance in the right column.

Needless to say, when an agent does not give his client the illustration, or does not give him all of the pages, there is good reason to be suspicious. When he does, the customer is typically told to ignore the left column because it is "unlikely" that that particular scenario will occur. The right column is a "best case" scenario, and is not guaranteed. Historically, very few insurance policies have lived up to the projected performance. Your client would be well advised to check the performance of the policy on an annual basis, and to make whatever adjustments are necessary.

4. Mutual funds Issues

A mutual fund is an investment company that invests in a basket of securities to achieve diversification and superior returns. They are governed by the Investment Company Act of 1940. There are two basic types of mutual funds, open end and closed end. Open end fund shares are sold directly by the fund company and are redeemable directly from the fund company. They are priced once daily at the end of the trading day, and cannot be sold on the secondary market (i.e. the stock market). The price is the net asset value of the shares, less commissions or surrender charges if any. Closed end funds are sold on the secondary market, and are priced by the

market. Their prices may be higher or lower than the net asset value, and they cannot be purchased from or sold to the fund company itself (except under very limited circumstances).

Most fund shares are sold by brokers, and they are usually open end shares. There are two types of open end funds: load and no load. A load is a commission. No load funds are rarely sold by brokers. However, brokers who are Investment Advisors may charge a management fee in lieu of a commission will sell these funds, or they can be purchased directly from the fund company. The most famous of these is the Vanguard family of funds. The inherent conflict, of course, is that in order for the broker to stay in business, he has to sell a load fund, and the load reduces the return to the investor.

All open end funds <u>must</u> be sold with a prospectus. <u>SEC Rule 10b-5(b)</u>. The prospectus will <u>always</u> detail the effect of the commissions and administrative charges the customer pays. These disclosures are prominent and eye-opening, but as a practical matter almost no one ever bothers to read them. It is the responsibility of the broker to deliver the prospectus at the time of sale or before, and if he or she fails to do this, the investment may be rescindable.

Providing a prospectus at the time of sale does not, however, foreclose other claims. <u>Benzon v. Morgan Stanley Distribs., Inc.</u>, 420 F.3d 598, 611 (6th Cir. 2005); <u>Bruschi v. Brown</u>, 876 F.2d 1526, 1531 (11th Cir. 1989) (recognizing the existence of a claim when an investor's loss results from the risky nature of an investment that a broker induced the investor to purchase by representing that the investment was safe). Providing a client with a prospectus may not be a complete defense, as a matter of law, to state claims that the stock broker or investment advisor misrepresented facts or failed to disclose facts material to his or her client's investment decisions. Of course, clients asserting claims based on fraudulent or negligent misrepresentations must prove that they relied reasonably on the broker's or financial advisor's representations regarding the investment. <u>Robinson v. Omer</u>, 952 S.W.2d 423, 427 (Tenn. 1997); <u>Hardcastle v. Harris</u>, 170 S.W.3d 67, 83 n.25 (Tenn. Ct. App. 2004). The fact that an investor was furnished a prospectus disclosing detailed information regarding the investment will play a significant role in determining whether the investor's reliance on the representations of the broker or financial advisor was reasonable.

Closed-end funds may only be sold by Series 7 licensees. They include the popular Exchange-Traded Funds (ETFs) that can be bought or sold as often as the owner likes, at any time during the day. These funds are traded only on the secondary market, and the shares are generally not redeemable by the fund company. Many ETFs are passively managed to mimic an index of one kind or another, and they often have much lower management fees than their open end cousins. There are also

actively managed closed end funds. These also have their advantages and disadvantages, which are too complex to discuss in this article.

5. Licensing Restrictions and Some Implications

Most financial services professionals who work for insurance agencies do not have a Series 7 license (general securities) and are not Registered Investment Advisors (or Investment Advisory Representatives). Many insurance professionals do not even have a Series 6 license (to sell mutual funds). This state of affairs has several important implications.

One important thing to realize is that if the agent who approached your client has no securities license, he is not even allowed to discuss securities. That means that any comment or advice he offers on any security the client may have or be thinking about purchasing is illegal advice. Many non-securities licensed folks don't even know this, because they haven't had the securities training to realize it. Nevertheless, if an insurance licensee urges your client to sell his mutual funds or stocks and buy an annuity or a life insurance policy, he is out of bounds by definition.

Series 6 licensees also are limited in what they can say or do. Since they are not licensed to sell general securities, they cannot sell, talk about or render advice concerning individual stocks. They also cannot discuss Exchange Traded Funds (ETFs), which contrary to what their name implies are general securities instruments that require a Series 7 license. So if your client was advised to sell his stock portfolio and invest in mutual funds for diversification, he may have a claim.

6. Policy Exchanges (Churning or Twisting)

The two most common types of insurance agents are career agents and brokers. The primary difference between them is that career agents are usually required to sell a certain amount of the products of the company by whom he or she is employed. If he or she fails to sell the required amount of the company's products, he or she will be terminated. It is therefore quite common in the insurance industry for agents to switch companies. When they do, they lose the continuing commissions they receive from permanent life insurance policies they have sold, and may lose the client as well.

Once they change jobs, some agents will contact their clients and attempt to sell them a new policy with the new company. This will not only generate a large new commission (the bulk of which is paid in the first year of the policy), but will maintain the relationship with the client.

When a new policy is applied for, the application will always require the applicant to state whether another policy is being replaced. The company that issued the original policy will be sent a notice, and will usually attempt to "conserve" the policy. However, given the relationship of trust between the insured and the agent, this attempt will often fail. Less scrupulous agents will encourage clients to deny that the original policy is being replaced at all, thus avoiding the required notification. Once the new policy is issued, the insured will simply call the first company and surrender the old policy.

There are several things to be wary of in such a situation. First, the issuance of a new policy will commence a new two year contestability period. Thus, if the insured dies within that time, the application will be gone over with a fine-toothed comb for any possible misrepresentations, and there is a risk the death benefit will be denied, or at least delayed. Second, the insured will likely be paying higher premiums for the insurance, because he will be older than he was when the first policy was issued. Third, if the insured's health is not as good as it was when the first policy was issued, he will pay a higher premium for that reason. Fourth, since life insurance policy administrative charges and fees are "front-loaded", the insured will always lose money he invested in the original policy.

In recent years, many companies have discontinued selling whole life policies entirely, and have encouraged their agents to sell universal life products which are more profitable to the company and which have a greater likelihood of lapsing without the company having to pay a death benefit.

As a result, it is common practice to replace a whole life policy with a universal life policy. This can occur either within the same company, or more commonly, by another company's product. The usual justification for the exchange is that the insured can purchase a higher death benefit for the same "cost". The problem with this type of exchange is that although the annual premium may be lower for the universal life policy, the guarantees are entirely different.

With universal life, there is a risk that the policy could lapse despite timely payment of all premiums, whereas with a whole life policy, there is no such risk. In addition, most whole life policies increase in value over time, whereas universal life policies usually do not. Thus, if the insured lives long enough, he or his family may suffer a substantial loss by the conversion.

Within the past several years, companies have come out with "secondary guarantees", that guarantee the universal life policy will not lapse as long as the premiums are paid, even if the cash value goes to zero. The advantage to such policies over whole life is that the premiums are lower. The disadvantage is that they

are designed never to accumulate substantial cash value, and will virtually never reach the point where the owner could stop paying the premium prior to the full term of the policy. This means that the money invested in the policy can never be used for any other purpose, eliminating two of the primary advantages of permanent life insurance–tax free growth of the cash values, and unrestricted use of that cash during the insured's lifetime.

If your client wants to increase his death benefit, he would be better off in most cases to either purchase an additional term policy or a new cash value policy without replacement.

7. Special Issues Concerning Variable Universal Life Policies

Variable universal life, or variable life policies allow the owner of the policy to invest money in subaccounts to earn tax free returns. These policies make possible a much greater return than would be possible with a whole life or ordinary universal life policy (which simply pays interest like a CD). The most significant disadvantage of these policies is that they can lose money if the investments don't perform according to plan. The management and administrative fees are substantial, and there are no guarantees. Since their introduction, they have been sold using an illustrations showing returns as high as 10 percent or even 12 percent gross return[4] before policy charges. The rate of return shown is at the discretion of the agent up to that limit. The effect on the policy if it does not achieve the projected result can be devastating. All illustrations are required to show what will happen if the return is 0%, and they are also required to show projections based on the projected rate at maximum contract charges. In virtually all cases, these projections will show the ultimate account value to be $0, which in most cases will cause the policy to lapse.

It is particularly important, therefore, that the investment performance of such policies be monitored on an annual basis, something that rarely happens. Policyholders do not usually want to spend the time reviewing their portfolios, especially when they are underperforming expectations or losing money, and they will rarely want to put more money into a policy than they originally committed in premiums. Once again, as with all universal life policies, there is no guaranteed cash accumulation value, and the money that had been projected to be there may not be there when it is needed. In addition, many agents who sell such policies may not stay at the same company or even stay in the business, so the policyholder will often be on his own in this investment.

[4] The maximum return allowed by NASD.

8. A broker is not automatically a fiduciary

The obligation of an insurance agent or securities representative is to present suitable investment or insurance products given the client's needs, financial situation, risk tolerance, and investment time horizon.

Securities brokerage accounts are usually non-discretionary. A non-discretionary account is an account where the customer places orders to purchase securities products, and the securities representative places the orders through his broker-dealer. The customer receives a confirmation from the broker-dealer or the clearing firm. If there is a dispute, the customer has an obligation to make that dispute known right away or he is bound by it. The duties associated with a non-discretionary account are:

1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price, and financial prognosis;

(2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests;

(3) the duty to inform the customer of the risks involved in purchasing or selling a particular security;

(4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security;

(5) the duty not to misrepresent any fact material to the transaction; and

(6) the duty to transact business only after receiving prior authorization from the customer.

Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978). As long as the representative does not exercise discretion with regard to the trades, he is not acting as a fiduciary. [5]

Here the lines get fuzzy. Orders to purchase securities in a client's account must be marked "solicited" or "unsolicited". This has to do with whether the representative recommended or sought the trade. If he did, the trade should be marked as "solicited". Broker-dealers have pretty strict rules about solicited and unsolicited trades. Many, especially on the insurance side of the business, have absolute prohibitions against solicited trades unless the representative is also an investment advisory representative (which most are not).

When a trade is actually solicited, but the order is marked "unsolicited" (as most are), several additional issues can be raised: 1) whether the representative improperly rendered financial advice, either without proper licensing authority or in violation of the rules of the broker-dealer or NASD; 2) whether the representative violated the terms of the contract (which may specify that such trades may not be solicited); and 3) whether a

[5] Discretion in this context usually means deciding which security to purchase or when to purchase it.

new relationship was created

It is common if not typical for a customer to ask the advice of the representative as to what security should be purchased or sold. Representatives often either recommend a purchase or sale of a particular security or provide a list of several securities from which the client can choose. The client places an order based on the recommendation or list, and the trade is done. MANY REPRESENTATIVES EITHER DO NOT REALIZE OR IGNORE THE FACT THAT THESE ARE SOLICITED TRADES. As a result, they often incorrectly mark the orders as "unsolicited".

When a stock broker or financial advisor provides financial or investment advice, he or she may become a fiduciary, and as such, is required to exercise the utmost good faith, loyalty, and honesty toward the client. The broker or advisor implicitly represents to the client that he or she has an adequate basis for the opinions or advice being provided. Hanly v. S.E.C., 415 F.2d 589, 596-97 (2d Cir. 1969); Univ. Hill Found. v. Goldman, 422 F. Supp. 879, 893 (S.D.N.Y. 1976). He or she also is required to disclose facts that are material to the client's decision-making. See Marshall v. Sevier County, 639 S.W.2d 440, 446 (Tenn. Ct. App. 1982); Heard v. Miles, 32 Tenn. App. 410, 418-21, 222 S.W.2d 848, 851-852 (1949). These requirements create additional duties that may give rise to a valid claim.

Discretionary accounts permit the rendering of advice, solicited trades, and in many cases, the placing of trades without the client's knowledge or specific permission. However, the representative that exercises control over the account is held to a particularly high standard of knowledge, and is also, of course, a fiduciary.

In the case of Insurance agents, it is far less clear when a fiduciary duty exists. Most cases have held that an insurance broker only needs to use reasonable care to represent his or her client." (Kotlar v. Hartford Fire Ins. Co., supra, 83 Cal.App.4th at p. 1123). But in Eddy v. Sharp (1988) 199 Cal. App. 3d 858 [245 Cal. Rptr. 211], the court commented in dicta that "[i]f an insurance agent is the agent for several companies and selects the company with which to place the insurance or insures with one of them according to directions, the insurance agent is the agent of the insured. ... Where the agency relationship exists there is not only a fiduciary duty but an obligation to use due care." (Id. at p. 865, citations omitted.)

Whether or not the broker-insured relationship is a fiduciary one, a broker still has certain fiduciary duties. For example, "[a]ll funds received by any person acting as an insurance agent [or] broker ... as premium or return premium on or under any policy of insurance ... are received and held by that person in his or her fiduciary capacity. Any such person who diverts or appropriates those fiduciary funds to his or her own use is guilty of theft and punishable for theft as provided by law." (Ins. Code, § 1733).

However, in Westrec Marina Management, Inc. v. Jardine Ins. Brokers Orange County, Inc. (2000) 85 Cal.App.4th 1042 [102 Cal. Rptr. 2d 673, brokers found liable for breach of fiduciary duty where they failed to obtain insurance at best available price.

As one leading treatise has observed: "It is not clear in what respect the 'fiduciary duty' owed by an independent insurance agent differs from the duty of due (reasonable) care. As used in respect to an independent agent, 'fiduciary duty' may refer merely to avoidance of conflict of interest, self-dealing, excessive compensation, etc." (Croskey et al., Cal. Practice Guide: Insurance Litigation, P 11:166, p. 11-34 (rev. # 1, 2003).)

The three best pieces of advice your client could receive are: 1) do not act on impulse, 2) try to make sure the seller is someone that can be trusted, and 3) read all of the literature (boring as it may be).

9. False promises

Salespeople, if they are to be successful, cannot emphasize the disadvantages of the product they are trying to sell. If they did, they would lose sales. Thus, what most of them do is to emphasize the upside, and de-emphasize the downside. Since these conversations are almost never in writing (except sometimes by email), your client will rarely be able to prove that false statements were made in the sale. For this reason, it is essential that the literature be examined before the purchase (although most insurance products contain a free-look period). If there is a discrepancy between what the client was told and what the literature says, you need to be especially careful to advise the client that it is only the representations in the literature that are enforceable, not the promises of the sales agent or broker.

10. Suitability issues

Probably the most common area where litigation against financial institutions has succeeded is in the area of suitability. The unsuitability of a portfolio of growth stocks for retired investors living on fixed income is the paradigm example of an unsuitable transaction. There are many others. An annuity with a ten year surrender period should usually not be sold to someone planning to retire in less than ten years unless it is not going to be used for retirement income or will be annuitized. One should not borrow the cash value from a life insurance policy to buy mutual funds, or borrow from their home to buy life insurance or mutual funds. Term insurance is unsuitable if the need for life insurance is permanent, unless it is all the applicant can afford. Stocks are unsuitable if they do not fit the risk profile and time horizons of the investor. Deferred annuities are not appropriate within a retirement plan unless they

have specific features or guarantees valuable to the investor. Mutual funds or stocks should not be sold to buy variable annuities, for tax reasons.

There are many rules such as these, and they are too numerous to catalog here. The most important question to ask is whether the product fits the needs of the client.

11. Conflicts of Interest and Other Ethical Conundra

This topic could be the subject of a treatise. However, it may be useful to summarize some of the major problems in this area. One of the most glaring examples of a conflict of interest is that of a CPA selling life insurance, annuities, or mutual funds for a commission while getting paid for the advice he is rendering as a financial consultant. In this situation, not only is the client is paying twice for the same thing, but the CPA may have a fiduciary relationship with the client which gives rise to duties likely to be violated in any number of ways.

Financial services agencies that recruit CPA's to refer business to them usually offer a lucrative commission split arrangement that requires the CPA to do little but refer the client. The financial services representative that works with the CPA does the actual selling of the products. These products may or may not be the best in their category. The financial services person usually works primarily with one insurance company or several mutual funds companies, and is most interested in doing business with those companies. He is not concerned about fiduciary issues because he is not acting in a fiduciary capacity.

However, because the CPA is arguably acting as a fiduciary, he or she has the obligation to advise the client of such things as the financial relationship he has with the financial services representative and the company he or she represents, the disadvantages of the product sold, or the type of product being sold, and a host of other matters. It is easy to imagine situations where a client, having been approached to purchase a life insurance policy, consults his CPA, only to find out that the CPA also sells life insurance, and the CPA recommends the client to another broker, who sells a policy that is not as good (or suitable) as the one the client was originally offered. In this situation, the CPA could be liable under a couple of different theories. Lawyers, obviously, could have similar problems if they made such a referral.

There are also conflicts between the rules of ethics in different industries. The ethical rules for lawyers, CPA's, insurance agents, registered representatives, bank employees, and others who could be involved in a financial product sale are all different. In any given situation, those differences could result in conflicting requirements of disclosure or different requirements as to the advice rendered. The area is ripe for creative theories of litigation.

12. Summary and Conclusion

It is apparent that the recent changes in the financial services industry have given rise to a great number of new issues. This article is not intended to be exhaustive or definitive, but only to highlight various ways in which lawyers can be of service to clients who purchase or are considering the purchase of various financial products.