

The Age of Independent Advice

The Remarkable History of the Independent Registered Investment Adviser Industry



Chapter Three: Stirrings Beneath the Surface

This is the third of six chapters excerpted from Schwab Institutional’s book on the history of the RIA industry. World War II was a beneficial stimulus that put an end to the Great Depression. But for investors and advisers, the war years and the three decades that followed, little changed as the stock market remained the province of the very wealthy.

Chapter Three covers the 1940s to 1960s when the formation of a regulatory structure and the early seeds of the financial planning profession were taking root.

For the U.S. economy as a whole, World War II was a beneficial stimulus that put an end to the Great Depression. For investors and their advisers, however, the war years and the three decades that followed were stagnant. “On balance,” writes Charles Geisst in his comprehensive history of Wall Street, “the situation in 1940 was as bad as at any time during the early years of the Depression.”¹ To support the war effort, Americans enthusiastically bought bonds, but not stocks. There were few new stock offerings and few investment advisers around to recommend them: like other Americans of conscription age, they had joined the armed services in droves. Even New York Stock Exchange president William McChesney Martin, discouraged by the slow pace of business and increasing pressure from the Securities and Exchange Commission, answered a draft call early in the war. The sudden shortage of men in the investment adviser community opened the doors—at least temporarily—to talented women such as Scudder’s Margaret Ogden, who’d begun her career as a librarian and who rose during the war to become the firm’s first female research analyst.

The end of the war ushered in an unprecedented boom of rising incomes, record consumer spending, increased factory output, and a sustained bull market. Yet between 1940 and 1970 the financial services industry itself, and the makeup and perspective of investors, changed very little from the early years of the century. With employers almost universally taking care of workers’ retirement

funding through pensions, average Americans preferred to plow their hard-earned cash into real estate and life insurance rather than “speculate” in stocks. The stock market remained, as it had for decades, the province of the very wealthy.

But that’s not to say the years between 1940 and 1970 were an uneventful lull for the investment adviser community. On the contrary, the fledgling industry was being dynamically molded by two forces: one external, the other internal.

From the outside, the SEC increased its regulatory power over the financial services industry in general and, increasingly, over investment advisers. The process began with the passage of the Investment Advisers Act of 1940 and took a full three decades to assume its modern form.

And from the inside, investment advisers began to create the means to regulate and educate themselves. The result would be a new profession that emerged in the early 1970s: financial planning.

AN INDUSTRY REVEALS ITSELF

The Investment Advisers Act of 1940 required advisers to register with the Securities and Exchange Commission for the first time in history. But the act didn’t tell the SEC what to do with those registrations. True, the new law gave SEC lawyer David Schenker, who had led the agency’s 1936–39 investigations into the activities of investment companies and investment advisers, a mandate to clean up the

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scandal-ridden investment companies, known today as mutual funds. But his authority over advisers was less specific and involved mostly information gathering—itself an important first step toward regulation. During the previous decade’s investigations, Schenker and his SEC colleagues had been frustrated by their inability to gather information about investment advisers, almost all of them small, independent organizations. Now that information began arriving in Washington.

But if Schenker had expected a torrent, he was soon disappointed. In 1937, *Newsweek* magazine estimated there were five thousand investment advisers nationwide. Schenker and others had testified in congressional hearings that the number was at least six thousand. Both estimates turned out to be wildly inflated. Late in 1940, Schenker told a meeting of the Investment Counsel Association of America (ICAA), the leading trade association for advisers, that only 895 applications had been received for adviser registration.

In his talk, Schenker entertained the audience by describing some of the rejected registrants. One claimed on his registration form to have had years of experience in the oil and gold-mining industries. His clients, he declared, benefited significantly from his expertise in the stock and bond markets. “Every known [sic] in the investment field is considered in order to insure the client the maximum profit and the maximum safety,” the applicant wrote. When the SEC followed up on these bold claims, it located the man in a Wisconsin prison where he was serving time for assault. The convict’s objective, Schenker said, had been “to show the parole board he had a business to go to as soon as he was released.”² Needless to say, this self-described expert was not among the advisers granted registration in 1940. In fact, the total number of registrations came to only seven hundred, which meant the agency rejected roughly 20 percent of the registration forms it received. Clearly, the adviser industry was much smaller and less influential than the SEC had envisioned. Developing a formal regulatory scheme hardly seemed worth the effort.

Besides, the new regulators lacked the tools to monitor the dealings between investment adviser firms and their clients. The registration form, though long, provided only a general picture of each advisory firm. For example, of the 895 firms filing applications for registration, 367 were sole

proprietorships. Schenker found this large proportion grounds for concern. In his remarks to the ICAA, he worried that these one-man shops might be fly-by-night operations without even an established place of business. Yet the SEC had no authority to conduct even routine examinations. And even if it had had the authority, because the law contained no provision requiring advisers to keep books and records, there might be nothing to examine. If it suspected outright fraud, the SEC had the power to act. But its lack of oversight power greatly limited its effectiveness.

It would take a couple of decades for investment advisers to become numerous and influential enough to attract serious regulatory attention. The industry was growing, but very slowly. Each year between 1940 and 1970 fewer than a hundred firms joined the ranks of registered advisers. In 1950 there were barely a thousand investment adviser firms. In 1970 that number had increased to just thirty-five hundred. The majority of investment advisers continued to cater to the financial elite; the most prominent styled themselves as investment counsel, typically providing fee-based advice to wealthy, sophisticated individuals and institutions that was not subject to the same conflicts as commission-based advice provided by broker-dealers. Not until the 1980s, when investment markets opened to working- and middle-class Americans and technological innovation and entrepreneurial wealth dramatically changed the financial landscape, would the community of investment advisers experience significant growth—and change.

BUILDING A MODERN REGULATORY STRUCTURE

As World War II drew to a close, the SEC pressed Congress to grant the agency the expanded powers it needed. First on the list was the ability to require advisers to keep books and records and the authority to routinely examine them. In a special report to Congress in 1945, the agency proposed those measures and others to beef up the original 1940 legislation. But Congress’s attention lay elsewhere, and the proposals languished for years. They were reintroduced in 1957 and again in 1959, when the House Special Subcommittee on Legislative Oversight pronounced: “It is time in view of the increasing public reliance upon investment advisers, to strengthen the Act and make it more than a mere census of persons in the investment advisory business.”

In addition to the record-keeping and examination provisions, new amendments authorized the agency to require the reporting of securities transactions by advisory personnel and to regulate advertising by advisers. The SEC now could deny registration to advisers convicted of financial crimes, embezzlement, or violations of securities laws. The agency was empowered to suspend the registration of advisers for up to twelve months; previously the only legal sanction was revocation of the adviser's registration. The SEC could promulgate rules aimed at preventing fraud, even among advisers who were not registered with the SEC because they were exempt or had failed to comply with the registration requirements. The amendments also helped eliminate potential conflicts with state regulation of advisers and endorsed the concept of concurrent state and federal jurisdiction over them. At last, the SEC had additional tools to enforce the provisions of the Advisers Act. In 1963, more than two decades after the law's passage, the agency started conducting routine examinations of investment adviser firms.

All along, though, the SEC had been fighting adviser fraud through rule making, interpretive orders, and enforcement actions, with mixed results. The most famous enforcement action was its 1963 case against Capital Gains Research Bureau, the name of both a registered adviser and of that adviser's investment newsletter publisher. The firm had secretly bought shares of stocks it was about to recommend to its five thousand newsletter subscribers and to a much larger mailing list of prospective customers. Stock prices rose after the newsletters were mailed, and the company sold out at a quick profit.

The SEC brought an action in federal district court in New York for an injunction to force the company to disclose or discontinue the practice, which it alleged to be a fraud on investors. As one observer reported, "To the amazement of the financial community, the District Court of the Southern District of New York refused to grant the injunction, and to its greater astonishment the Circuit Court of Appeals for the Second Circuit in its turn sustained the lower court."³ In 1963 the SEC appealed the case to the U.S. Supreme Court, which reversed the previous decisions. The high court ruled that the publisher's actions constituted fraud under the Advisers Act. It backed the SEC's bid to require disclosure of such activities to clients, and even called that remedy "mild." Most important, it affirmed that the

original statute held investment advisers to strict fiduciary standards in their dealings with clients.⁴ It was a landmark victory for the SEC that greatly strengthened the Commission's legal powers. Advisers celebrated, too: the entire industry benefited from the tougher stance on fraud.

On the legislative front, Congress in 1963 received the report of a special commission, chaired by Chicago lawyer Milton H. Cohen, which had been created to come up with securities reform recommendations. Among those recommendations: the creation of a self-regulatory organization, or SRO, for investment advisers. It was the first of many times when that idea would be floated—so far unsuccessfully because of strong industry opposition. (Not that the concept is without precedent. For some time, broker-dealers have been subject to oversight by self-regulatory organizations such as the New York Stock Exchange and the National Association of Securities Dealers, which in turn are subject to SEC oversight.) The commission also wanted the SEC to set professional standards for advisory firm personnel and suggested that a national board of securities examiners administer licensing programs. The SEC was receptive to an SRO for advisers; the investment adviser industry was not. As a result, Congress shelved the SRO proposal and the commission's other reforms.

The reformers won the next round in 1970, when Congress approved a new set of amendments to the Advisers Act. These amendments strengthened the SEC's authority to discipline advisers and advisory firm personnel and expanded the agency's ability to grant exemptions from the act's provisions. The amendments also allowed advisers to charge high-net-worth clients performance fees—known as "fulcrum fees"—in certain circumstances, generally when portfolio performance exceeded an index or other benchmark.

Throughout the 1950s, 1960s, and 1970s, the SEC's interest in strengthening its control over investment advisers ebbed and flowed. Periods of relatively little regulatory activity were followed by intervals of crackdowns to address particular industry problems. When it wanted to fill gaps in its regulatory authority, the agency often had to wait years for Congress to address the issues; sometimes no new authority was granted. And when a reform package did pass, the next one was unlikely to succeed until a good deal of time had elapsed. Thus, a reform plan proposed in

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1976, just six years after the previous set of amendments, probably would have faced an uphill struggle in any event. The proposals would have dramatically expanded the SEC's authority over advisers establishing professional qualification standards for advisers and requiring them to meet minimum financial responsibility standards. Hugh F. Owens, an SEC commissioner, had pushed for both measures. "As much or more than the clients of broker-dealers," he said, "the clients of investment advisers seem to rely on the professional competence of their advisers, and the absence of qualification requirements for investment advisers and persons associated with them constitutes an undesirable gap in the pattern of federal securities regulation."⁵

But critics said the SEC was unable to justify its case. "No evidence of need was developed at the hearings or presented to the committee by the SEC," said Sen. Jesse Helms, R-North Carolina.⁶ A subsequent attempt in 1989 to establish an SRO for investment advisers met a similar fate.

Another major change to the Advisers Act came in 1996 with the passage of the Investment Advisers Supervision Coordination Act, part of a larger measure known as the National Securities Markets Improvement Act. It reduced the SEC's workload by giving the states jurisdiction over advisers with \$25 million or less in assets under management. As a result, the SEC's resources were freed up to concentrate on regulating larger advisory firms, while the states focused on smaller ones. The change was intended to boost the overall effectiveness of federal and state supervisory efforts and ease burdens on firms operating in more than one state.

"The Coordination Act represents a grand experiment in new federalism," David G. Tittsworth, executive director of the Investment Advisers Association, testified after the law had taken effect. "By and large we believe the results have been successful in achieving the objectives of the legislation."⁷

Other new SEC rules in recent years have strengthened or streamlined adviser regulation. Among them were changes to the registration Form ADV filed each year by advisers, the introduction of electronic ADV filing, and the subsequent launch of the online Form ADV database in 2000.⁸ The Commission also required advisers to

establish policies and procedures regarding the voting of proxies and to provide information to clients about how proxies are voted,⁹ and it modernized rules regarding the custody of client assets in order to combat fraud.¹⁰ More recently, the 2004 mutual fund trading scandals prompted new requirements that advisory firms adopt procedures designed to prevent violations of the federal securities laws, designate chief compliance officers, and adopt codes of ethics.¹¹

In retrospect, the unsuccessful 1976 amendments represented the SEC's most vigorous efforts to expand its regulatory mandate over investment advisers. Today's regulatory landscape for investment advisers was shaped almost entirely by the 1940 act, the amendments of 1960 and 1970, subsequent SEC rules resulting from those legislative acts, and related court decisions.

"THE WORLD WAS RIPE FOR FINANCIAL PLANNING"

Although independent advisers resisted external pressures to form a self-regulatory organization, that didn't mean they were indifferent to professional standards. On the contrary, by the late 1960s they showed a mounting interest in education and certification. J. Chandler Peterson, an industry pioneer and early president of the International Association for Financial Planning, later described it as a kind of collective awakening. "All across the country, in the late 1960s and early 1970s, people were arriving at the same ideas independently but simultaneously," he said. "It just took something to flush the ideas out."¹²

That "something" took place in Chicago on December 12 and 13, 1969. Loren Dunton, a Colorado financial consultant, and James R. Johnston, a life-insurance salesman, had persuaded eleven colleagues from the securities, mutual fund, and insurance industries to meet at a hotel near O'Hare Airport to talk about dramatically improving the level of professionalism in retail financial services and replacing salesmanship with "financial counseling" as the industry's driving force. The attendees included salesmen of mutual funds and securities and life insurance; one was a financial counselor, one was a publicist. They came from Florida, New York, Ohio, and Pennsylvania; most paid their own expenses. When they left Chicago the following day, the foundation had been laid for two organizations: the International Association for Financial Planning and its educational wing, the College for

Financial Planning. In addition, Dunton soon conceived the idea of a certification program for financial counselors, the Certified Financial Planner™ (CFP®) designation.

Why did the financial planning movement emerge at this time? The best way to answer the question is to look at what had come before. Here's how industry veterans E. Denby Brandon Jr., and H. Oliver Welch, writing in 2003, set the scene:

Between 1945 and 1970, the mainstream of the financial services field generally continued to serve clients in a fragmented way. As a result, many clients had financial programs characterized by lack of balance and adequate diversification. They were largely determined by the professional training and compensation of the person who had the most influence with the client. For example, if a good life insurance salesman had the most impact on the client's financial life, more attention would usually be given to estate or death planning and the purchase of whole life insurance. A good securities salesman would direct the client's attention to life-time or investment planning and the purchase of securities recommended by his firm. Real estate, tax shelter or hard-assets salespeople would all tend to impose their products on the client's financial activities. In many cases, a turf-protection mentality would prevent the various salespeople from seeking more appropriate solutions to their clients' financial problems.¹³

Clearly, financial planners believed that product sales was not an appropriate driver for client advice. Someone who had no interest in promoting specific products was needed to take a chair on the client's side of the table and offer objective advice. This adviser would make recommendations based on the client's goals and circumstances, not the level of product commissions.

Some key concepts of financial planning—but not the term “financial planning”—were used by investment counsel firms as early as the 1920s. Those firms made an effort to understand a client's circumstances and financial goals in order to recommend an appropriate course of action. They also monitored the client's investment portfolio. These practices—which were fully consonant with what emerged in the 1960s and 1970s as financial planning—were codified to some extent in the Investment Advisers Act of 1940, the regulatory regime that applied most closely to the emerging financial planning industry.

Nevertheless, whatever its debt to early investment-counsel firms, financial planning evolved most directly from the life insurance industry. “As late as 1960, life insurance was the substance of financial planning,” said Rich White, an early chronicler of the profession. At that time, “By definition, a financial planner was an insurance man who offered the public more than money-if-you-die. Financial planners ... estimated estate tax payments for wealthy customers and sold insurance to fund those payments. They formed clinics in which they analyzed financial goals and sold packages of life insurance, disability insurance and annuities.”¹⁴

The term for this methodology was “needs-based selling.” To figure the amount of life insurance or disability insurance required by a client, the agent analyzed the family's financial objectives and future spending needs, then subtracted existing financial resources. The present value of the shortfall was the amount of insurance recommended by the agent.¹⁵ This now much evolved capital needs analysis approach, often using sophisticated sensitivity analyses and Monte Carlo simulation, is routinely used by financial planners to explore client financial goals. “The approach of looking at the client's needs was clearly derived from the life insurance industry,” said Dr. William L. Anthes, retired president of the College for Financial Planning. “But the life insurance people tried to solve every problem through life insurance. Although some founders of the financial planning industry came out of the life insurance business, they were saying there's got to be another way to solve a person's problem.”

Dunton had already reached this conclusion. “Dunton knew from his experience in sales training that the world was ripe for financial planning,” wrote one observer a decade after the Chicago meeting. “The concept would simply sell itself once he, the promoter, got the ball rolling.”¹⁶

And Dunton was the best kind of promoter: one who believed fervently in what he was offering. “Many pressures are being exerted on the consumer to spend, but there had been no effort on the part of the financial services industry to counteract these forces. People weren't compelled to save or allocate their monies wisely,” he later observed. The Society for Financial Counseling Ethics, which Dunton had founded in mid-1969, “was formed in large part to compete with advertisers and

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marketers who were urging people to spend,” he added. “Its mission was to educate Americans as to why they should save, insure, invest their money, and plan for retirement.”¹⁷

Like many entrepreneurs, Dunton—who is credited with coining the term *certified financial planner*—was more successful launching projects than sustaining them. The early rush of enthusiasm with which his ideas were greeted was soon replaced by a torrent of challenges. “None of [the participants in the Chicago area] had the financial clout to reach into the deep pockets of the many wealthy corporations in the financial services field,” wrote Brandon and Welch. “To begin these two organizations they had a totally inadequate amount of current capital, only a vague action plan, and no one with real organizational experience to undertake projects of this magnitude. There were no outstanding educators or educational institutions represented. It is difficult to imagine a major movement in the financial services field with the odds so heavily stacked against its success.”¹⁸

The shining exception to this bleak picture was the College for Financial Planning, which controlled the CFP mark and set educational standards for its attainment. In charge of the college’s planning was Lewis G. Kearns, director of financial planning for Wellington Management Company, a money management firm located in Boston and known for its flagship Wellington Fund. He recruited the Chicago meeting’s co-organizer, James R. Johnston, who had a background in life insurance and a burning interest in education. Both men were inspired leadership choices. By the time the college opened its doors in Denver in 1972, dozens of students had enrolled in its first class.

But the college faced a serious problem: financial planning was virtually virgin territory. There were few targeted textbooks or course materials for the new discipline. It was not taught anywhere else. In fact no one had formally defined the scope or methodology of financial planning. The creation of the college’s curriculum would represent the creation of the new profession’s intellectual capital.

Johnston, who later became the college’s president, took on this Herculean task with zeal. With long-distance advice from Kearns, he planned and wrote the seventeen chapters of “Counseling the Individual,” the first course that the first class of students would take. Johnston

researched and wrote feverishly, keeping one step ahead of the students as their coursework progressed. The college would later use the motto “We wrote the book on financial planning.” It’s more accurate to say that James R. Johnston wrote the book on financial planning.¹⁹

The College for Financial Planning became independent of the Society for Financial Counseling Ethics in 1972 and obtained nonprofit status in 1973. That year, forty-two students graduated as the industry’s first CFP professionals. By the end of the decade, there were approximately twenty-one hundred CFP professionals. “The emergence of the CFP designation,” wrote Gail Quint in her history of the college, “began to chip away at the public perception that all financial representatives were salespeople interested chiefly in the accumulation of sales commissions in a product-oriented industry versus a view of professionals interested in a consumer-service and planning function.”²⁰

Among those who took note of the new professional designation was the National Association of Securities Dealers, and its former president, Gordon S. Macklin. In October 1972, the NASD issued a notice to all member firms warning about broker-dealer representatives using terms such as *financial planning*, *financial counseling*, or *financial consultant*. The notice cited an SEC action in which a broker-dealer had been found in violation of antifraud rules because employees represented themselves as “financial planning experts” when they were not. An attorney at the SEC, Ezra Weiss, reviewed the NASD Notice to Members and convinced his boss, SEC chairman William Casey (later to become director of the Central Intelligence Agency), that the CFP mark was deceptive and had to be abolished. He proposed Certified Financial Representative (CFR) as an appropriate replacement. Casey happened to be a friend of Ferdinand Nauheim, chairman of the board of trustees of the College for Financial Planning; he asked Nauheim to change the mark. “The day I learned of the problem I called him,” Nauheim said later. “He said, ‘Ferd, I’m having a sardine sandwich and a glass of milk on my desk. Get yourself a sandwich and join me.’” Nauheim hurried over.²¹

Eventually Nauheim relented. He persuaded the college’s trustees to change the CFP mark to CFR—and started a firestorm of protest. Though still tiny, the financial planning community had become attached to the CFP mark and

didn't want to see it polluted or watered down. (The episode foreshadowed a similar controversy over a proposal three decades later to create an Associate CFP designation, dubbed CFP Lite by detractors.) But before push could come to shove, Nauheim, Weiss, and Casey all left their respective jobs, and the issue was dropped.

The CFP mark may have been safe, but the College for Financial Planning remained intermittently short of funds for some time, its future continually precarious. Johnston, now the college president, fought to keep the new institution alive. "We were always flying by the seat of our pants, struggling to meet great challenges," he recalled later. "There was a lot of skepticism on the part of outsiders who said it couldn't be done. But people kept enrolling—or returning after they'd dropped out." The bottom came at the end of 1974, when it appeared the college would be unable to meet its year-end payroll. On Christmas Eve, a desperate Johnston began calling contacts at large organizations that sponsored groups of students for the CFP designation. He got through to Jay Hines, an executive at IDS Corporation, a financial services firm with a financial planning–based marketing approach. (IDS was later purchased by American Express.) IDS had fifty-one students enrolled. Could he help? Hines immediately offered to prepay his students' tuition, which solved the college's short-term cash crisis. "After that, I knew it all had to work out," Johnston said later.²²

The tide had turned, although success did not occur overnight. By 1979, when William Anthes became the College's third president—a post he held through 1992—the institution still "had a number of problems," in Anthes's words. "But I also witnessed the commitment of the students who wanted to become CFP professionals and enter that new field of financial planning." Under Anthes, the college would experience dynamic growth, greatly improve the quality of its offerings, and become accredited.

Even bigger changes were on the horizon in the second half of the 1970s and throughout the 1980s, not just for the CFP mark and financial planners but for the entire independent adviser profession. On the negative side: out-of-control inflation and roller-coastering boom-and-bust markets. On the positive side: revolutionary changes in retirement regulation. Together, these forces were about to transform the way in which middle-class Americans looked

at investing and retirement planning—and the way in which they got help with the increasingly difficult choices they were forced to make.

Loren Dunton, the Father of Personal Financial Planning

Central Casting couldn't have found a more apt or colorful candidate than Loren Dunton to play the role of industry pioneer. Dunton was born in 1918 in the small mining town of Trail, British Columbia, near the Washington State border and very far from Wall Street. According to one biographical note, "he enjoyed an exciting bachelor life in Seattle, Alaska, and San Francisco" before marrying his first wife at twenty-nine. He took up parachuting at age forty-five, the same year he published his first book, *Self-Discipline*; twelve more books—including *How to Sell to Women*, *Your Book of Financial Planning*, and *Prime Time: How to Enjoy the Best Years of Your Life*—would follow.

Above all, Dunton was a salesman and a promoter with a strong streak of idealism. He sold vacuum cleaners and encyclopedias before settling in Colorado, where he sold mutual funds and started a consulting firm whose clients were financial service providers. While working with them, Dunton came to see the need for higher standards of professionalism in retail financial services. He formed the Society for Financial Counseling Ethics and began looking for a way to bring his ideas to a larger audience. He found his messenger in a local life insurance salesman, James R. Johnston, who had long enjoyed listening to motivational speakers but felt frustrated by their lack of follow-through. Johnston recognized Dunton's motivational talents and offered himself as the educator who would take up where Dunton left off.

Together, the two men planned a national summit to create a professional organization for financial advisers that would offer education and certification. Yet despite his considerable skills as a connector, Dunton was able to persuade only eleven financial professionals to come to Chicago on December 12, 1969, and participate in what is now considered a signal event in financial planning history.

The International Association for Financial Planning and its educational wing, the College for Financial Planning, struggled for several years under Dunton's leadership before eventually becoming important contributors to the financial planning industry. Dunton gave up the helm of the IAFP in 1974 and eventually moved to San Francisco, where he continued his public-speaking and writing careers. He founded several nonprofit groups, including the National Center for Financial Education, which taught consumers how to have a secure financial future. Dunton died in 1997 at age 79.

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