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THE FIDUCIARY STANDARD

BEST PRACTICES BOARD

Best Practices: Professional Conduct Standards Guidance

March 15, 2017

Introduction

The Best Practices Fiduciary Advisor Affirmation Program, announced in September 2016, has been well received by advisors. This paper seeks to provide additional guidance regarding specific issues raised by advisors seeking to adopt the Best Practices.

The 'Best Practices' are designed to reflect professional conduct of fiduciary advisors and to assist investors in evaluating and selecting advisors and wealth managers. Investors seek professional guidance which is competent, objective, transparent, and understandable. The Best Practices aim to assist investors, by being concrete and verifiable and crafted in plain language.

Fiduciary principles that apply to advisors broadly include two sets of competence criteria. "Technical" criteria or knowledge is evidenced by education, expertise and experience. Ethical criteria rooted in the fiduciary duty of loyalty is evidenced by honesty, integrity and transparency. Each set of competences is vital. The Best Practices Board believes strengthening practices to demonstrate *loyalty*, particularly regarding conflicts of interest, opaque fees and expenses, and incomplete or vague communications can go far to address these concerns.[1]

Unfortunately, given the regular stream of reports of advisors engaged in conflicts and self-dealing, many investors have come to doubt the integrity of their financial service providers. In today's distrustful climate the need for advisors to demonstrate their integrity in more important than ever. The Best Practices are offered to help advisors do so.

The Best Practices are intended to reflect how conscientious and competent advisors can serve clients today, mindful of the wide variety of risks, costs and strategies and varying client needs, profiles and investment sophistication levels. Best Practices reflect the principles-based nature of fiduciary law which is anchored by core values and norms. It is these values and norms which must remain steadfast because, as law professor Tamar Frankel notes, "Without them no society can survive." [2]

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Best Practices are professional conduct standards that outline what the Board believes fiduciary advisors should do for their clients. Here, each Best Practice is listed and described in *italics* below it. The practices seek to uphold a high standard of transparent and objective advice. Also, guidance is provided to enhance understanding of what they mean.

General Practices

1. Affirm the fiduciary standard under the Advisers Act of 1940, common law, and if applicable, ERISA and DOL's COI rule, govern all professional advisory client relationships at all times.

Fiduciary status, as required in law, applies at all times in all client engagements, and this affirmation is stated in writing.

2. Establish and document a "reasonable basis" for advice in the best interest of the client.

Advice is given on a reasonable basis, and a summary of this reasonable basis will be provided by your advisor in writing upon request.

Guidance. A "reasonable basis" forms the underlying rationale for the advice. The documentation for the advice includes relevant facts, analysis and circumstances. The scope and nature of the client engagement and a client's goals and overall circumstances are pertinent to the breadth of analysis. A "reasonable basis" is a well-established obligation of the Investment Advisers Act of 1940. [3] On a clients' request, the advisor should provide at minimum a brief written summary for any recommendation. The summary may be brief.

Duty: Act in Utmost Good Faith

3. Communicate clearly and truthfully, both orally and in writing. Do not mislead. Make all disclosures and important agreements in writing.

All important client agreements and disclosures are put in writing and no written or verbal statements are misleading. [4]

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4. <u>Provide a written statement of total fees and underlying investment expenses paid by the client. Include any payments to the advisor or the firm or related parties from any third party resulting from the advisor's recommendations.</u>

Your advisor provides a good faith estimate of fees and expenses in writing during the starting phase of the engagement when the investment policy is agreed to. Thereafter, your advisor will offer to all clients to provide, upon request, an annual good faith estimate in writing of total fees and expenses incurred by each client and paid to the firm or related parties because of my advice.

Guidance. This practice is meant to increase investor awareness of fees and expenses. A "good faith estimate" is intended to be a statement that describes the fees and expenses that the advisor reasonably anticipates that the client will pay, indirectly or directly, in conjunction with their investments that are being advised or managed by the advisor. It should include the fees that will likely to be paid to the advisor, third parties, and the underlying investment products. Good faith estimates are based on information available and circumstances known at the time they are made. Further, good faith estimates only include expenses that are associated with investments recommended by or under the control of the advisor and advisor affiliates.

E*xample*. Here is one example to provide a good faith estimate of fees and expenses. This is just one example and does not represent other methods to achieve the same goal. In preparing an estimate an advisor may use alternative reasonable methods as long as the rationale and process is disclosed.

As part of an account opening process, a best efforts assessment of the 'costs to implement' is provided, based on (a client's) most recent statements as the basis for assessments.

- Cost to sell current holdings through the custodian. The typical charge for most securities is between $___ and $___ . "Based on the information client provided, our best effort estimate to sell your current holdings is $ ___."

- Costs to implement new strategies. Mutual funds and ETFs have underlying expenses including administrative and investment management costs. Those costs are represented as the "expense ratio." In Addition, the custodian, ___,may include a charge to buy / sell or hold certain securities. Our best effort estimate to implement our strategies as we have discussed is: Average weighted expense ratio: ___. This means $. _____. Custodian charges: $ ___.

- Our firm does not use any products that carry a sales charge or pay a commission. Our firm does not accept or receive 12b-1 fees or any other compensation outside our AUM agreement with you. For more information please see our ADV.

**Duty: Loyalty - Avoid Conflicts of Interest;
Disclose and Manage Unavoidable Conflicts**

5. Avoid conflicts and potential conflicts. Disclose all unavoidable conflicts. Manage or mitigate material conflicts. Acknowledge that material conflicts of interest are incompatible with objective advice.

Your advisor seeks to avoid conflicts of interest. For unavoidable conflicts, your advisor 1) affirmatively discloses the conflict with 'sufficiently specific facts' to allow client understanding, and 2) manages the conflict to preserve the client's best interests. For material conflicts your advisor 3) obtains informed written client consent. Also, 4) your advisor affirms the transaction remains consistent with the client's best interests. Further, he or she provides clients and prospective clients a written description of conflicts and steps to manage them.

Guidance. A conflict of interest occurs when the interests of the adviser or his/her firm "interferes with" the adviser's duties to clients. A material conflict occurs when such interference could reasonably be deemed to affect how a client decides to act. [5]

Disclosure of conflicts of interest is a well-established obligation of the Investment Advisers Act of 1940 and a central requirement of Form ADV. [6]

Mitigating material conflicts involves several steps. First, there must be clear, complete and timely disclosure. Second, fiduciaries must have a reasonable basis for believing that clients fully understand the implications of the conflict to the advisor and client. Implications may include the relative merits and risks of options not chosen by the advisor, and the additional fees earned by the advisor (whether paid out of client funds or not) and any additional client paid expenses incurred. Third, the client must provide "informed, intelligent, and independent" consent before the transaction is completed. Finally, after receiving client consent, the advisor must also be able to demonstrate that the transaction remains reasonable and fair and consistent with the client's best interest.

6. Abstain from principal trading unless a client initiates an order to purchase the security on an unsolicited basis.

Your advisor abstains from principal trading – unless specifically requested by a client without your advisor's urgings.

Guidance. This practice applies to the individual fiduciary, not to the firm. The adviser or broker may purchase the security on a 'best execution' basis.

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7. Avoid compensation in association with client transactions. If such compensation is unavoidable, demonstrate how the conflict is managed and overcome and the product recommendation and compensation serves the client's best interest.

(Choose either "A" or "B".) A) Your advisor does not receive compensation in association with a client transaction. B) If your advisor does receive compensation in association with a transaction, your advisor 1) affirmatively discloses the conflict with 'sufficiently specific facts' to allow client understanding, and 2) manages the conflict to preserve the client's best interests. For material conflicts your advisor 3) obtains informed written client consent. Also, 4) your advisor affirms the transaction remains consistent with the client's best interests. Further, he or she provides clients and prospective clients a written description of conflicts and steps to manage them

Guidance. Financial product sales typically involve transactional fees or commissions. Payments directed to the advisor or his/her firm associated with product sales, may include commissions, shelf space payments, and 12b-1 fees. Because the transaction fee is tied to the completion of the product sale, it raises the question of whether the fee paid to the advisor rather than the client's best interest is the basis for the recommendation. The centrality of this question in investment adviser regulation cannot be overlooked. This question occupied the authors of the Investment Advisers Act of 1940.[7]

Consequently, the advisor's burden is to demonstrate that the transactional fee associated with the recommendation does not impair objectivity, or is not duplicative and is commensurate with the services provided and serves the best interest of the client. Advisors (or whose firms) who receive such third – party compensation have an obligation to follow the steps noted in practice 5 and demonstrate the client's best interest is served.

8. Avoid gifts or entertainment that are not minimal and not occasional. Avoid third party payments, "benefits" and indirect payments that do not generally benefit the firm's clients and may reasonably be perceived to impair objectivity.

Gifts and entertainment received are minimal and occasional. Any third-party compensation or benefits received by the firm do not impair the advisor's objectivity. The firm's complete policy on gifts and entertainment and "soft dollars" is available on request.

Duty: Act Prudently -- With the Care, Skill and Judgment of a Professional

9. Ensure baseline knowledge, competence and ongoing education appropriate for the engagement.

Your advisor's education, professional certifications and ongoing education are appropriate for client engagements, and, at minimum, include an undergraduate degree and either a relevant post graduate education or a specialized designation or certification requiring significant additional education.

Guidance. Baseline knowledge can be demonstrated by holding a recognized industry designation which requires significant study and knowledge and ongoing CE requirements such as demonstrated by a CPA/PFS, CFA, CFP, ChFC. (This list is not intended to be exhaustive, but as representative.) Also, a graduate degree in finance, in financial planning or a related master's degree with a concentration in finance or accounting meets the criteria. Alternatively, a verified record of no fewer than eighteen years full-time financial advisory work and no fewer than five years of attaining CEs meets baseline knowledge.

10. Institute an investment policy statement (IPS) or an investment policy process (IPP) that is appropriate to the engagement and describes the investment strategy. Have access to a representative universe of investment vehicles that provide ample options to meet the desired asset allocation and in consideration of generally accepted criteria.

The IPS or IPP may be of varying lengths, but it should express, at minimum, assumptions regarding objectives, risk and performance. Follow and document a prudent process of due diligence to research and analyze investment vehicles. On request, document the prudent process applicable to any recommendation and the investment program is implemented consistent with the IPS or IPP.

Duty: Control Investment Expenses

11. Consider peer group rankings or apply specific procedures in ensuring underlying investment expenses are reasonable.

Your advisor benchmarks the fees and costs clients incur with reliable services or surveys other resources or has procedures to determine that client expenses are reasonable.

Guidance. Controlling investment expenses that the advisor recommends or selects should not interfere with the fiduciary being able to recommend from a broad array of securities and other investment vehicles consistent with the client's risk tolerance, time horizon and sophistication. Having discretion imposes a responsibility on the advisor to reasonably avoid unnecessary investment expenses. This is particularly true if expenses significantly exceed peer group averages or typical expenses for products with similar complexity or risk. Controlling investment expenses does not require the least expensive alternative; it does require a reasonable basis for selecting a more expensive alternative.

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Duty: Affirm Compliance with Best Practices

12. The advisor affirms in writing adherence to Best Practices, and attains written affirmation from the firm that these practices may be met by the advisor**.**

Your advisor affirms adherence to Best Practices and that no firm policy interferes with your advisor's adherence.

Guidance. The Best Practices apply at either the individual advisor level or the firm level. If an advisor seeks to subscribe on his / her individual behalf, the advisor should notify their firm that the Best Practices will be followed by the advisor at all times, in all dealings with clients. The advisor shall provide the firm with a copy of the Best Practices.

End Notes

(NOTE: The end notes here are not part of the interpretive guidance for Best Practices and are for information purposes only.)

1. Three Institute white papers precede Best Practices. The first paper, "Six Core Fiduciary Duties for Financial Advisors," September 9 2013, discusses these duties in practical contexts. http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/09/InstituteSixCoreFiduciaryDuties.pdf

   The second paper, "Fiduciary Advisors Must Craft, Uphold and Advocate for Fiduciary Best Practices," May 13, 2014, makes the case for why advisors must lead in the public square and urge the industry to not wait for regulators and to voluntarily uphold Best Practices. http://www.thefiduciaryinstitute.org/wp-content/uploads/2014/05/BestPracticesPaperMay13.pdf.

   The third paper, "Key Principles for Fiduciary Best Practices and an Emerging Profession," September 10, 2014, sets out the rationale for focusing Best Practices on ethical criteria and avoiding conflicts of interest, the reasonableness of fees and expenses, and communications that are clear, complete and truthful. http://www.thefiduciaryinstitute.org/wp-content/uploads/2014/09/BPPSeptember102014Final.pdf

2. Frankel, Tamar. *Fiduciary Law in the Twenty-First Century" Boston University Law Review (BU School of Law) Vol 91 May 2011 Number 3*

3. Securities attorney Lorna Schnase offers a brief summary. “Generally, reasonable basis for an investment recommendation usually starts with knowing the client, which would typically contemplate documentation of the client’s circumstances and goals (client intake questionnaires, for example). For investment advice recommending specific investments, documentation would typically include disclosure documents for the investment (prospectus, offering memorandum, etc.). Of course, more extensive documentation of due diligence could be expected (for example, notes of interviews with issuer executives, market analyses, internal or external broker research reports, etc.) for investments that are alternative, riskier, or contain unusual features. There is usually a wide variety of documentation that could support a claim of “reasonable basis,” from the investor’s standpoint, the standpoint of the particular investment, and everything that could connect the two.” (Email to K Rostad, 11-18-16.)

   Also see Plaze, Robert E., "Regulation of Investment Advisers by the U.S. Securities and Exchange Commission,” Sept. 2016, page 35: http://www.stroock.com/siteFiles/PAFile120.pdf and SEC cases cited in footnote 198; i.e.: Including, *In the Matter of Alfred C. Rizzo,* Investment Advisers Act Release No. 897 (Jan. 11, 1984) (investment adviser lacked a reasonable basis for advice and could not rely on "incredible claims" of issuer)

   Furthermore, from FINRA, “The following frequently asked questions (FAQs) provide guidance on FINRA Rule 2111 (Suitability). This document consolidates the questions and answers in Regulatory Notices 12-55, 12-25 and 11-25, organized by topic.”

   Q5.1. Can a broker who does not understand the risks associated with a recommendation violate the reasonable-basis obligation even if the recommendation is suitable for *some* investors? [Notice 12-25 (FAQ 22)]

   A5.1. Yes. The reasonable-basis obligation has two components: a broker must (1) perform reasonable diligence to understand the nature of the recommended security or investment strategy involving a security or securities, as well as the potential risks and rewards, and (2) determine whether the recommendation is suitable for at least some investors based on that understanding.[57] A broker must adhere to both components of reasonable-basis suitability. A broker could violate the obligation if he or she did not understand the recommended security or investment strategy, even if the security or investment strategy is suitable for at least some investors. A broker must understand the securities and investment strategies involving a security or securities that he or she recommends to customers.[58]

   Also, see “Statement on Standards in Personal Financial Planning Services, AICPA, Personal Financial Planning Division.” p. 16.
   https://www.aicpa.org/InterestAreas/PersonalFinancialPlanning/Resources/PracticeCenter/ProfessionalResponsibilities/Pages/PFPexposuredraft.aspx

4. See "Regulation of Investment Advisers…" supra in note 3 at page 33 and footnote 187.

5. "What are the Specific Fiduciary Duties of Those Who Provide Investment Advice to Retail Clients," Ron A Rhoades. 2011. See discussion, pages 70 – 82.

6. Form ADV, General Instructions for Part 2 of Form ADV. 3) "… As a fiduciary, you must also seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. This obligation requires that you provide the client with specific facts so that the clients is able to understand the conflicts of interest you have and the business practices in which you engage and can give informed consent to such conflicts or practices or reject them."

7. Investor harms of product sales portrayed as unbiased advice were believed widespread in the 1920s and 1930s. In 1940 many investment counsellors and policy makers were deeply concerned with conflicted advice. This concern animated their thinking and significantly shaped the Advisers Act of 1940. See SEC v Capital Gains Research Bureau, https://www.sec.gov/divisions/investment/capitalgains1963.pdf

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