

## BEST PRACTICES BOARD

### Proposed Best Practices January 2015

#### Introduction

Today, a wide range of financial professionals serve investors in a dynamic and complex market place. ‘Best Practices’ are designed to assist investors in evaluating and selecting investment advisers and wealth managers from among these diverse professionals. Investors seek guidance which is objective, transparent, and understandable. Best Practices, crafted to be concrete, verifiable and understandable, exist to assist them in doing so.

Fiduciary principles include two sets of competence criteria. “Technical” criteria such as education, expertise and experience, and “ethical” criteria such as character, honesty and transparency. Both are important, particularly so when both investor and regulatory shortcomings are ubiquitous. (See Institute white paper, <http://www.thefiduciaryinstitute.org/wp-content/uploads/2014/05/BestPracticesPaperMay13.pdf>. ) Yet, today, ethical criteria need greater strengthening and present significant risks to investors. They are the focus of Best Practices. (See Institute whitepaper, <http://www.thefiduciaryinstitute.org/wp-content/uploads/2014/09/BPPSeptember102014.pdf>

Investor misconceptions about what advisers or brokers do and how they are compensated, and how much investors themselves pay for these services are all well-documented. The Best Practices Board believes strengthening practices regarding conflicts of interest, opaque and unreasonable fees and expenses, and incomplete or incomprehensible communications can address these concerns.

Codes of ethics and practice standards are generally developed and administered in four phases: i.e.: discussion and analysis, recommended practices, required practices and verification or enforcement. Each phase serves a purpose. Yet, the central question is what practices are required *and* verified or enforced. *Best Practices* are written to be understood by Main Street investors and to be concrete and verifiable as opposed to *aspirational*. (This ‘Plain English and verifiable’ attribute is especially important today where, fairly or not, investor distrust of Wall Street and financial services has seeped into investors’ views of advisers and brokers and is pervasive.)

*Best Practices* follow on the Institute whitepaper, <http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/09/InstituteSixCoreFiduciaryDuties.pdf>. They are also informed by the good work of others in the professional standards arena; i.e.: fi360, CFP Board, AICPA/ PFS, CFA Institute. Also, writings that include, *The New Fiduciary Standard* (Hatton), *The Management of Investment Decisions* (Trone, et al.) and *The New Wealth Management* (Evensky, at. al.) 1

*Best Practices* strive to reflect the best legal scholarship and current practices; i. e.: as evident in how conscientious fiduciaries serve clients’ best interests today. This entails assessing risks and costs and the wide variety of strategies in differing facts and circumstances. This requires both prudence and flexibility to meet diverse client risk profiles and levels of client sophistication. This we have strived for. On this and the particulars of the eleven *Best Practices* we seek industry and public comment.

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*Fiduciary duty requires that advisers,  
and brokers giving advice,  
put their client's best interests first.  
Fiduciary practices spell out how  
advisers and brokers should serve their clients.*

### **General Practices**

*1. Affirm that the fiduciary standard under the Advisers Act of 1940 governs the professional Relationship at all times.*

This language is placed in the engagement agreement.

*2. Provide a “reasonable basis” for advice in the best interest of the client.*

The “reasonable basis” documentation includes relevant facts, analysis and circumstances. The scope and nature of the client engagement and a client’s goals and overall circumstances are central to the breadth of analysis. The relevant facts should include key assumptions, the universe of data considered, and the analysis applied. <sup>2</sup>

Further, more prescriptive documentation regarding the selection of investment vehicles, may include a more detailed group of factors which include: “liquidity, marketability, minimum required investments ...” and risk. <sup>3</sup>

### **Duty: Act in Utmost Good Faith**

*3. Communicate clearly and truthfully, both orally and in writing. Make all disclosures and agreements in writing.*

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4. Provide, at least annually, a written statement of total fees and underlying expenses paid by the client. Include an accounting or good faith estimate of any payments to the advisor or the firm or related parties from any third party resulting from the advisor's recommendations.

The purpose of this practice is to increase transparency and understanding of investment expenses. An increased understanding requires including the costs of the underlying investments investors pay with the advisory fee in calculating total fees and expenses. In the case of mutual funds, this typically includes the expense ratio and transaction costs. To be complete, the annual statement of fees and expenses must include these underlying investment expenses.

While improvements have been made, the industry remains too opaque about underlying investments' fees and expenses. Expense transparency may fall into four categories. Some expenses (mutual fund expense ratios) are readily available. Other expenses are not available but can be calculated. Still other expenses cannot be calculated but may be reliably estimated. Finally, there are some expenses that may not be either calculated or reliably estimated. Consequently, any client's annual underlying expenses may include expenses that are simply reported, those which are easily calculated, those which must be estimated and those which cannot be reliably estimated.

Thus, calculating or estimating underlying expenses can be met in a variety of ways. Here are four. First, it may be met through an accounting of the actual expenses associated with the investments. Second it may be met through a good faith estimate of the underlying expenses. A brief overview explanation of the basis of this good faith estimate should be included. Third, it may be met through a combination of these two approaches. Fourth, this practice may be met through an accounting and / or estimation of a typical firm portfolio with allocations that resemble, but most assuredly are not the same as, the client's.

Additional disclosure on a quarterly basis reminding clients of fees and expenses is beneficial. However, it should not substitute for an annual fees and expense report.

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

5. Avoid all conflicts and potential conflicts. Disclose all unavoidable potential and actual conflicts. Manage or mitigate material conflicts. Acknowledge that conflicts of interest can corrode objective advice.

A conflict of interest disclosure document is created as an addendum with the engagement agreement.

Managing 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.

Additional care should be taken with the highest risk transactions that, for example, may carry material conflicts as well as high commissions. Two examples of such transactions, in certain situations, are indexed annuities and proprietary products. For these transactions, additional care should include:

- Duplicative compensation is credited back to the client or, if this is not possible, at minimum, is not accepted by the firm or individual fiduciary and donated to a charity.
- Further, prior to proceeding with the transaction, the client may review the terms of the proposed transaction in writing for seven days.

Regarding indexed annuities, while the underlying concept may be attractive, the conflicts associated with the high commissions in the current distribution channels – such as a 6% upfront commission – are very difficult to overcome.

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

Principal trading “Occurs when a brokerage buys securities in the secondary markets, holds these securities for a period of time and then sells them. The purpose behind principal trading is for firms to create profits for their own portfolios through price appreciations.”<sup>4</sup>

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This practice applies to the individual fiduciary, not to the firm. The adviser or broker may purchase the security on a 'best execution' basis. The fiduciary must disclose that the firm's analysts have determined that the firm's best interest is to sell this security from its inventory.

7. *Avoid significant gifts, third party payments, sales commissions, or compensation in association with client transactions that cannot be directly credited back to the client or managed as a fee offset.*

This includes payments directed to the adviser or broker and includes soft dollars, subsidies, shelf space payments, 12b-1 fees paid to the firm.

This practice seeks to avoid compensation that is duplicative or can impair objectivity. Some commissions will not, per se, be covered by this practice. An example of a commission that is not covered by this requirement would be one consistent with the adviser's other fee arrangements with existing advisory clients, such as C-class shares when handling small accounts, and is provided to the adviser when he or she is not otherwise compensated for the service.

It is important to avoid compensation, gifts, or remuneration that are not inconsequential or whose value exceeds \$100 and that may impair objective advice or may be reasonably perceived to do so.

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

8. *Ensure baseline knowledge, competence, experience and ongoing education appropriate for the engagement.*

Baseline knowledge and experience as demonstrated by holding industry accepted designations, which include: AICPA/PFS, CFA, CFP, ChFC, Masters in Financial Planning

9. *Institute an investment policy statement (IPS) or an investment policy process (IPP) that is appropriate to the engagement and describes the investment strategy. Consistently 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.*

The IPS or IPP may be of varying lengths, but it should express, at minimum, assumptions regarding objectives, risk and expectations regarding performance.

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*10. Have access to a broad universe of investment vehicles that provide ample options to meet the desired asset allocation and in consideration of widely accepted criteria.*

### **Duty: Control Investment Expenses**

*11. Consider peer group rankings in ensuring compensation and expenses are reasonable.*

Controlling investment expense 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. Similarly, broad discretion does not free the fiduciary from the duty to avoid unnecessary expenses and the duty to justify investment costs, particularly if they exceed peer group averages or typical expenses for the risk assumed. Similar to the working definition of "best execution," controlling investment expenses does not require the least expensive alternative; it does require a reasonable basis and full explanation for higher than "average" expenses.

Data sources for peer group expenses may include Yahoo Finance, Bloomberg, fi360 and Morningstar.

### **End Notes**

1. This reference to the good work of other fiduciary experts does not imply their endorsement of the *Best Practices*; the reference acknowledges their contributions to the field.
2. Statement on Standards in Personal Financial Planning Services, AICPA, Personal Financial Planning Division.
3. Prudent Practices for Investment Advisors, fi360, 2013. See Practice 3.3.
4. Investopedia.

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Clark M. Blackman II, CFA, CPA/PFS, AIF ®, Alpha Wealth Strategies LLC

Bryan D. Beatty, CFP ®, AIF ®, Egan, Berger & Weiner LLC

Christopher W. Cannon, CFA, Firsttrust

William C. Prewitt, M.S., CFP ®, Charleston Financial Advisors, LLC

Knut A. Rostad, MBA, AIF ®, Institute for the Fiduciary Standard