INSTITUTE FOR
THE FIDUCIARY STANDARD

NEWS RELEASE

Thursday, January 29, 2014 **<u>EMBARGOED UNTIL 4.30PM ET 1.29.15</u>**
Information: Knut Rostad, 301-509-6468

Institute Proposes *Best Practices* for Advisers and Brokers Seeking to Meet True Fiduciary Standard

Product Sellers or Advice Givers? *Best Practices* Put this Question First

Vanguard Founder John C. (Jack) Bogle: "The time has come to return to traditional values of fiduciary duty. The 'Best Practices' proposal … is an important first step"

San Diego, January 29 -- The Institute for the Fiduciary Standard today proposed eleven *Best Practices* fiduciaries should meet to serve the best interest of their clients. The *Best Practices* are released today for public and industry comment due March 9 and are available at www.thefiduciaryinstitute.org.

Knut A. Rostad, president of the Institute for the Fiduciary Standard, said in a statement, "Fiduciary duties have defined relationships of trust and confidence in investment advice for generations. Yet, in recent years the meaning of *fiduciary* has been transformed, so many investors today are confused or skeptical or downright distrustful of financial professionals – even fiduciaries. Investor misconceptions about who's selling products and who's offering advice, and what they pay, are pervasive."

"This 'Made in Washington' confusion parallels a 'new view' of fiduciary, seen in statements of regulators, policymakers and brokerage lobbyists. This 'new view' suggests a true fiduciary standard is unnecessary or outright harmful and must be altered to better accommodate conflicted sales practices. This 'new view' is profoundly 'anti fiduciary' and deeply troubling."

"*Best Practices* are designed to help investors identify true fiduciaries committed to objectivity, transparency, and plain English communications. Crafted to be concrete, verifiable and understandable – Best Practices communicate to investors how true fiduciary advisers and brokers are a breed apart," Rostad concluded.

Vanguard Founder Jack Bogle on the Best Practices

Vanguard founder John C. (Jack) Bogle, who co-chairs the Council of Advisors on the Best Practices initiative, notes: *"America's bloated financial system has earned the distrust of our nation's investors. Far too often, the interests of asset managers and registered investment advisors overwhelm the interests of investors. As it is said in holy writ, "No man can serve two masters." In short, salesmanship has trumped steward-ship in our nation's financial system. The time has come for the field of investment advice to return to its traditional values of fiduciary duty and trust. The "Best Practices" proposal of the Institute for the Fiduciary Standard is an important first step."*

Tamar Frankel on Investor Mistrust , "Not since the 1930's …..

Boston University fiduciary law scholar, Tamar Frankel, who also co-chairs the Council of Advisors for the Best Practices initiative, underscored the relevance of investor distrust, *"Not since the 1930s have investors so mistrusted their advisers. Advisers must take this mistrust seriously. The time has come for advisers to publicly explain how they are committed to fiduciary principles in the service of their clients."*

NAPFA, Institute Best Practices Partner

The National Association of Personal Financial Advisers (NAPFA) partners with the Institute on the Best Practices Initiative. NAPFA CEO, Geoffrey Brown, states, *"The development of advisor best practices supports NAPFA's goals of advancing fiduciary principles to protect consumers and elevate the ethical and educational standards for financial planning professionals. We look forward to hearing the feedback garnered through the public comment period."*

Best Practices Board

The *Best Practices* were drafted by the Best Practices Board over the past ten months. The Best Practices Board members are:

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, Firstrust
William C. Prewitt, M.S., CFP ® Charleston Financial Advisors, LLC
Knut A. Rostad, MBA, AIF®, Institute for the Fiduciary Standard

Institute Developing Protocols and Procedures to Verify Compliance with Practices

The Institute is working with outside experts to develop procedures to verify that an adviser or broker meets the Best Practices. Brian Hamburger, Chief Counsel to the Best Practices Board notes, *"We can create the greatest set of standards for the industry, but this initiative seeks to go beyond that. If a firm's achievement against these practices is not measureable then they will have little value and no merit."*

Public Comment

The Institute seeks public and industry comments on the Best Practices, and asks that these comments be emailed to the Institute by Monday March 9, 2015 at: info@thefiduciaryinstitite.org

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Sources for Comment on Best Practices

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Council of Advisors

The Council of Advisors formed to advise the Best Practices Board in crafting best practices for fiduciary advisors.

The Council of Advisors is co-chaired by John C. (Jack) Bogle. Founder, The Vanguard Group and Tamar Frankel, Michaels Faculty Research Scholar at Boston University School of Law. Council members include: Steven G. Blum, The Wharton School, Deborah S. Bosley, The Plain Language Group, Robert G. Kennedy, University of St. Thomas Opus College of Business, Woodrow W. Leake, retired university professor, and Edward J. Waitzer, Osgoode Hall Law School and Schulich School of Business, York University

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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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BEST PRACTICES BOARD

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. [2]

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. [3]

Duty: Act in Utmost Good Faith

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

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 underling 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. Forth, 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.

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

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5. <u>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.</u>

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. <u>Abstain from principal trading unless a client initiates an order to purchase the security on an unsolicited basis.</u>

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.” [4]

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.

10. <u>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</u>.

Duty: Control Investment Expenses

11. <u>Consider peer group rankings in ensuring compensation and expenses are reasonable.</u>

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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