INSTITUTE FOR
THE FIDUCIARY STANDARD

BEST PRACTICES BOARD

Introduction to the June 23, 2015 Draft
Proposed Best Practices

Please Provide Comments by July 13, 2015

Over the past four months the Institute for the Fiduciary Standard Best Practices Board has received many thoughtful comments from numerous practitioners and organizations. Some of these comments are on the Institute website. www.thefiduciaryinstitute.org Other commenters requested their views be offered without being publicized and their requests have been honored.

The Best Practices Board has learned much from these comments. Among other lessons, that there are as many views as viewers. Major themes that stand out include: the cost of meeting the Best Practices must be reasonable and related to their benefits. Fair enough. Certain practices, such as affirming the advisor's fiduciary status (Practice 1) and being prepared to offer a "reasonable basis" for a recommendation (Practice 2) are fairly straight forward or already part of federal regulatory regime.

Other practices present more challenges. The requirement to provide a report of annual fees and expenses (Practice 4) or to avoid conflicts of interest in compensation arrangements (Practice 7) present business model, technical, logistical or practical challenges. Some of these challenges may not be overcome easily or immediately and may take time to address.

The Best Practices Board has tried to balance the importance to require certain conduct that may be reasonably expected by investors who, almost always, consider their advisor trustworthy -- against the costs challenges of complying. In this effort we have sought to streamline and specify more clearly how these practices may be met and / or offer examples of doing so.

As we review prior comments from practitioners, we see that additional input, especially from practitioners, would be helpful. Input that sheds light on the most effective ways to fulfill the practices' requirements -- .what you would do to comply. We seek comments on all the practices, but especially emphasize practices 4, 5, 7, and 11.

Thank you in advance for your interest and contribution to developing Best Practices.

Please provide your comments by July 13 to info@thefiduciarystandard.org.

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Proposed Best Practices . June 23, 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 advisors and wealth managers from among these professionals. Investors seek guidance which is competent, objective, transparent, and understandable. Best Practices are crafted to be concrete, verifiable and understandable to assist investors to do so.

Fiduciary principles broadly include two sets of competence criteria. "Technical" criteria such as education, expertise and experience, and "ethical" criteria such as character, honesty and transparency. Each set of competences is vital.

Yet, lapses in ethical criteria present significant risks to investors and need strengthening. Investor misconceptions about what advisors do and how they are compensated, and how much investors themselves pay for these services are 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. [1]

Developing practice standards may be thought of in four parts: i.e.: discussion and analysis, and then recommending, requiring and verifying practices. Each part serves a purpose. In today's distrustful climate the key is practices that are required *and* verifiable. *Best Practices* are written to be concrete and verifiable and understood by Main Street investors. They are written to help investors assess and evaluate advisors

Best Practices strive to reflect what conscientious and competent advisors do today, mindful of the wide variety of risks and costs and strategies and different client needs, profiles and investment sophistication levels. *Best Practices* reflect the open-ended 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, so pertinently, "Without which no society can survive." [2]

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Fiduciary duty requires advisors serve client's best interests first.
Fiduciary Best Practices spell out what this means.

General Practices

1. *Affirm that the fiduciary standard under the Advisers Act of 1940 and common law principles govern the professional relationship at all times.*

This language is placed in the engagement agreement.

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

A "reasonable basis" is the justification for the advice (not the standard of conduct applied to 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. Relevant facts should include key assumptions, the universe of data considered, and the analysis applied. [3] On request, the advisor should show this documentation to the client and explain how the recommendation was developed and why it is appropriate.

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.*

Clear and truthful communications are accurate and are understandable to ordinary investors. They do not mislead. Misleading communications either omit important facts or information or include facts and information that imply something that is either not true or not accurate. Misleading communications are prohibited. [4]

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4. *Provide, or instruct clients how to obtain, 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.*

While improvements have come about, the industry remains too opaque about underlying investment fees and expenses. The purpose of this practice is to increase transparency and investor awareness of investment expenses which are sometimes not readily apparent. Increased transparency and investor awareness requires tallying or estimating underlying investments.

Increasing expense transparency is challenging. Certain expenses (mutual fund expense ratios) are readily available. Other expenses are not so available but can be calculated, while other expenses will be difficult to calculate but may be estimated. Finally, there are some expenses that may not be either calculated or reliably estimated. Consequently, an annual investment expense report may include expenses that are simply reported, those that are calculated and those which are estimated.

Advisor fees include asset management fees and, if applicable, separate financial planning fees. Underlying investment expenses, in the case of mutual funds, typically include the expense ratio and management fees, transaction fees and custody fees. Also, depending on the share class, commissions, front end or back end loads, 12 b 1 fees, and wrap fees may be included

Underling investment expenses can be reported in a variety of ways. First, through an accounting of the actual expenses associated with the investments. Second, a good faith estimate of the underlying expenses may be used. A brief explanation of the basis of this good faith estimate should be included. Third, if neither of these methods are feasible, 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. (See attachment 1, Best Practice 4, Guidance for Advisors.)

Alternatively, the advisor may fulfill this practice by assisting the client in obtaining the underlying investment expenses through a third-party vendor such as Morningstar or FeeX, for example. or by otherwise helping the client calculate the investment expenses. In either case, the advisor's duty is to take reasonable care to assist the client in obtaining the necessary information for the annual report.

The written statement of fees and expenses should be compiled no less often than annually.

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

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

A conflict of interest disclosure document is created as an addendum with the engagement agreement. The document includes a sufficiently detailed description of each conflict – a description that communicates the harm of the conflict so as understandable to the ordinary investor. It also describes how unavoidable conflicts are managed or mitigated to the client's benefit.

A material conflict of interest is any factor "which might affect" a client's decision regarding a recommendation. 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.

Question for commenters.

- Is it reasonable to require client "comprehension" or "informed, intelligent and independent" consent as a prerequisite for proceeding with a transaction when a material conflict exists?

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."[5]

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 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."

Product sales depend on 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 recommendation and fee paid to the advisor is conflicted advice or whether the conflict has been managed and the recommendation serves the client's best interest. The centrality of this question in investment adviser regulation should not be overlooked. This question occupied the authors of the Advisers Act of 1940. [6]

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 demonstrate the client's best interest is served.

Examples where such transactional fees or commissions may be effectively managed include:

A commission consistent with the advisor's other fee arrangements with existing advisory clients, such as C-class shares when handling small accounts, and is provided to the advisor when he or she is not otherwise compensated for the service.

A fee-offset commission arrangement.

A level fee compensation agreement that requires third party payments exceeding the compensation cap be rebated or otherwise not accepted by the advisor.

Questions to commenters.

- What other circumstances around a product recommendation indicate that a transaction fee associated with the sale of a products is managed and the conflict does not impair the advisor's objectivity? Please provide examples.
- Likewise, what circumstances would indicate that a fixed, hourly, or AUM fee, would present greater conflicts than would a transaction fee associated with the sale of a product would present?

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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 or entertainment must be inconsequential and not exceed $100 in value for each instance. Payments or benefits directed to the advisor or firm and that includes soft dollars should be minimal, deemed reasonable and related to serving clients' best interest.

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

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

Baseline knowledge can be demonstrated by holding industry accepted designations, which include: AICPA/PFS, CFA, CFP, ChFC. (This list is not intended to be exhaustive. It is representative.) As an alternative to an industry designation, a graduate degree in finance, in financial planning or a related finance degree, or an MBA.

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 in ensuring underlying investment 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. This is particularly true if expenses exceed peer group averages or typical expenses for the product complexity or risk assumed.

For example, a discussion of the advantages of active management should include the "reasonable basis" for the additional costs of active management as compared to passive investing and using indexes or ETFs. Likewise, a discussion of either active or passive management should include a discussion of the range of costs within the recommended management strategy. 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 explanation for higher than "average" expenses.

Questions to commenters.

- How important are investment expenses? How should this importance be expressed in "Best Practices?" Should, as an example, Morningstar's opinion – or the opinion of other independent research organizations -- regarding the importance of investment expenses be considered?
- How should the divergent range of underlying expenses in some asset classes be addressed in "Best Practices?" Should "Best Practices" include a "point / counterpoint" discussion as to the respective cases for both passive and active management?

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 business practices have been reviewed**.**

The Best Practices apply at the individual advisor level. The advisor should notify their firm (via their immediate supervisor) that the Best Practices will be followed by the advisor at all times, in all dealings with clients; and said supervisor will be provided with a copy of the Best Practices.

End Notes

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. See “Statement on Standards in Personal Financial Planning Services, AICPA, Personal Financial Planning Division.” p. 16.

   Also see "Regulation of Investment Advisers by the U.S. Securities and Exchange Commission" dated March 2013, page 24: *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) As the SEC stated:

   As a registered investment adviser, Rizzo was required to have a reasonable basis for his investment advice. This duty follows from the "delicate fiduciary nature of an investment advisory relationship," a relationship that requires the investment adviser to "furnish to clients on a personal basis competent . . . advice regarding the sound management of their investments." Securities and Exchange Commission v. Capital Gains Research Bureau, Inc, 375 U.S. 180, 191 and 187 (1963). Rizzo had no such reasonable basis, but rather, despite Major's incredible claims, relied almost solely on Major's management for his information. In the words of the court in Securities and Exchange Commission v. Blavin, 557 F. Supp. 1304, 1314 (E.D. Mich. 1983), "a reader of an investment newsletter has a right to expect the investment adviser to do more than merely reprint . . . glowing financial news gleaned from financial reports or conversations with companies or officers." While a company serves as a

valuable source of information in connection with providing investment advice to clients, in situations such as Major's, where the company is small, speculative and relatively unknown, an investment adviser is obligated to corroborate such information from independent sources in connection with providing investment advice. See Securities Act Release No. 5168 (July 7, 1971) ("information received from little known companies or their officials . . . must be treated with great caution as these are the very parties that may be seeking to deceive.")

4. See "Regulation of Investment Advisers…" in note 3 at page 23.

5. Prudent Practices for Investment Advisors, fi360, 2013. See Practice 3.3.

6. The investor harms when product sales was portrayed as unbiased advice was 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

Best Practices Board

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Attachment 1.

Best Practices 4
Guidance for Advisors

A written statement: The "in writing" requirement can be met by email. Whether by paper or email, for easy retrieval and if available, the notice and statement should be stored in firm-wide software systems by customer/client. The statement shall report on all information for all transactions in a 12 month period. This means that information shall not be delivered in a piecemeal fashion.

Fees and underlying expenses paid by the client. Include fees and expenses received by the advisor, the firm or related parties from any third party: The statement shall include the following categories of fees and expenses:

a) Advisory fees (e.g. Investment management fees, wrap fees, separate account fees, financial planning fee, consulting, tax preparation, etc.)
b) Investment and Insurance product costs (fund expense ratio costs, pooled vehicle management expenses, contract management and mortality costs, etc.)
c) Sales charges (commissions, realized surrender charges, referral fees, realized front-end and back-end loads, sales transaction fees, etc.)

Total fees and expenses: The statement shall only provide TOTALS for a 12-month period. Totals shall be provided in both dollar and percentage terms (to one decimal place) and be based on the (advised on) account value. It is only necessary to provide a 12-month total. Do not provide on a per transaction basis unless complete data for all transactions in the 12-month period is provided.

Resulting from the advisor's recommendations: Applies to investments and insurance products that:
a) the advisor (or advisory firm) recommends and
b) are implemented (i.e. purchased, sold, surrendered, etc.) by the customer/client.
Do not include transactions when the client/customer initiates or solicits the purchase or sale of the product.

Computation of fees: Underling investment expenses can be computed and reported in one or more of these three ways:

a) Known expenses and fees – Such as from a contract with the client/customer, a firm's internal reports, or from a third-party analysis (e.g. Morningstar report or other on-line provider of fee and expense analysis). The source of the data shall be noted.
b) Good Faith estimate of the underlying expenses and fees – Such an estimate shall include a brief explanation of the basis for the estimate.
c) Proxy estimate – An estimate based on a portfolio that resembles or is typical of the customer's portfolio. Such an estimate shall in include an explanation of the basis for the estimate.

In the report it shall be noted which fees and expenses are based on each of the above computations.

Example 1:

In the 12-month period ending 11/30/2014, fees and expenses on your account(s) were:

Advisory Fees[1]: $10,980
Account value as of 11/30/2014 $1,112,030
Fees and expenses as a percent of account value: 1.0%

Investment and Insurance Product costs[2]: $4,670
Account value as of 11/30/2014 $1,112,030
Fees and expenses as a percent of account value: 0.42%

Sales Charges[3]: $500
Account value as of 11/30/2014 $1,112,030
Fees and expenses as a percent of account value: 0.05%

TOTAL Fees, Expenses $16,150
Account value as of 11/30/2014 $1,112,030
Fees and expenses as a percent of account value: 1.5%

Example 2:

In the 12-month period ending 11/30/2014, fees and expenses on your account(s) were:

Advisory Fees[4]: $0
Account value as of 11/30/2014 $1,112,030
Fees and expenses as a percent of account value: 0%

Investment and Insurance Product costs[5]: $10,008
Account value as of 11/30/2014 $1,112,030
Fees and expenses as a percent of account value: 0.9%

Sales Charges[6]: $6,450
Account value as of 11/30/2014 $1,112,030
Fees and expenses as a percent of account value: 0.6%

TOTAL Fees Expenses $16,458
Account value as of 11/30/2014 $1,112,030
Fees and expenses as a percent of account value: 1.5%

[1] Source for advisory fees: Contract for services. (Known)
[2] Source for product costs: based on Morningstar report (Known).
[3] Source for sales charges: Transaction costs based on (average transaction cost X number of transactions in the period) (Good-faith estimate)
[4] There were no advisory fees (Known)
[5] Source for product costs: based on Morningstar report (known) and prospectus (known) .
[6] Source for sales charges: Internal firm report (known)

Assist the client in obtaining the underlying investment expenses: The advisor may fulfill the requirements of this practice by instructing the client in how to obtain the underlying investment expenses. Such assistance would involve directing client to a third-party vendor such as ________, or Morningstar, or _________, and helping the client calculate the investment expenses. The advisor's duty is to take reasonable care to assist the client in attaining the necessary information for the annual report.