ADVISORS GUIDE TO BEST INTEREST COMPLIANCE

April 7, 2016

On April 5, 2016 the Department of Labor released changes to proposed regulations that are scheduled to take effect starting April 10, 2017 and in full effect by January 1, 2018. These changes have been incorporated into this updated paper and the changes to the earlier version (as of February 4, 2016) are listed in the Appendix A.

Preamble

Forthcoming Federal regulations require financial advisors to IRAs (including rollovers) and ERISA plans to enter into a binding contract to act in the client's best interest or be subject to litigation and/or regulatory action by the IRS and/or Department of Labor. Note that discretionary accounts and where advisor compensation is limited to fees are specifically excluded from these regulations.

Regulations exclude existing accounts until new assets are added, at which point regulations take effect.

Acting in the best interest of the client is a simple enough concept to understand if we assume that all clients are alike and have the same interests. Unfortunately, this is not the case and every client has his/her own interests, needs, preferences and priorities in their investments.

Finding and interpreting these interests, needs, preferences and priorities are the foundation of a compliant best interest arrangement.

The open question is to what lengths should an advisor go to determine the client's best interest? One could take the simplistic approach of establishing a few investment categories and asking the client to pick one. Familiar categories might be Growth, Income, Capital Preservation, etc. Such shortcuts are of little use in explaining later why clients lost money since most clients will ask their advisor which to choose! An equally easy but just as ineffective method is to ask the client to pick from categories such as Conservative, Moderate or Aggressive.

Regulations actually require much more. Regulations require at a minimum…

> *"…advice that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and needs of the [client]".*

It is therefore necessary to discover a great deal about the client and his/her circumstances before making any investment recommendation. Bests interests will be different for each unique set of circumstances so one client may require more than one account to accommodate each set of circumstances.

Furthermore, to avoid the dire consequences of litigation and regulatory actions, the advisor must also be able to prove that actions were in fact in the client's best interest and that certain other requirements have been met. In summary, the advisor must:

- **Discover the best interests** of each client account and monitor to detect changes.
- **Interpret discoveries** to define investment requirements for the account.
- Make statement of recommendations to meet those requirements.

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- **Comply with Impartial Conduct Standards** which also requires limiting compensation to a reasonable level for the services provided and making no misleading statements.
- Transition to Impartial Conduct Standard may take years to complete.

While the best interest regulations apply only to IRAs and ERISA plans, the standards and practices to comply with them may be adopted for all client accounts. **By adopting the best interest practices for all accounts, the advisor can present a uniform high standard to the client instead of treating IRAs in one way and regular accounts at a lower standard.**

Discover the Best Interests

Discovery requires a conversation with each client to uncover his/her interests, needs, preferences and priorities. For most clients, this conversation must be in plain simple language and consist only of questions the client can answer.

The following are a list of topics can be used with or without this automation. Clients are invited to discuss those items for which they have answers or opinions. Reasonable assumptions are made in cases where clients don't provide answers.

This list represents a very high standard of care for which higher compensation should be expected. Advisors can omit certain items or add others to create a standard of care that is customized for that advisor. The standard of care will determine the share class or fee level that is appropriate.

The set of discoveries representing a high standard of care for each account are:

- Purpose of account (Each account has one purpose so multiple accounts may be needed)
  How the funds in the account will eventually be used, when and how much will be needed and the form of use (periodic or lump sum).
- Past investment behavior
  Clients past experience with market volatility and actions taken at the time of the volatility.
- Sources of funds
  Amount of funds currently available, how they are invested/held and client's ability to accumulate additional funds.
- Comfort in taking risks with these funds
  Where funds are currently invested/held is a starting point but conversation can also include willingness to put funds for this account at risk to pursue higher returns and amounts that should not be put at risk at all.
- Expectations
  Most clients have some idea of the investment return that they expect and this expectation establishes a mental boundary for satisfaction. Expectations may also include potential losses and volatility.
- Preferences, restrictions and exclusions
  Although infrequent, certain clients will have a pre-disposition to an investment, style, class, etc. This could be a desire to own or a desire to avoid.
- Fees and expenses

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Most clients recognize investment fees and expenses as compensation for services. The recognition of the value derived from paying these costs varies greatly from one client to the next so it is important to discover the client's attitude towards fees and expenses.

- Service and convenience

  The need for access to service as well as the method and quality of service is also very different from one client to the next. Clients who are put off by automated lines and technology need to use investments where a live human is readily available for service issues.

The results of this conversation are then interpreted into investment requirements. This process enables the advisor to make prudent recommendations which can later be proven.

Interpret Discoveries

The discoveries made about a client account are then interpreted into a set of investment requirements that are explained to clients. This interpretation is analogous to a medical diagnosis in which all the known facts are considered to reach prudent recommendations.

As with discoveries, the advisor can select how many and which investment requirements to consider. By removing requirements the advisor lowers his/her standard of care and conversely enhances the standard of care by taking additional considerations into account.

The following investment requirements are derived from the discoveries presented earlier:

- Threshold cash balance

  The total amount of cash that must exist or be accumulated. Investments are limited to funds in excess of the cash threshold. The threshold serves two essential purposes. First it avoids the waste of time and effort of creating investment strategies until there are sufficient funds to make such efforts worthwhile. Small accounts can therefore be handled profitably. The second purpose is to create a limit to potential losses, particularly during market stresses.

- Investable assets

  Amount available for investing after allocating the threshold cash. This includes accessibility of assets after consideration of withdrawal penalties, taxes and restrictions.

- Return goals

  The average net return required to reach the stated investment goal after considering the threshold cash, investable assets and any accumulation or use of funds.

- Volatility limitations

  Limits are set for historical volatility based on the client's propensity to react and level of concern about potential loss.

- Loss protection

  This requirement is satisfied by investments offering guarantees or active loss prevention strategies.

- Income required

  Specifies the level of income that is expected from the account. Income may be indexed to inflation, wages or other factor.

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- Time horizon
  The time horizon is the point when the financial goal is expected to be achieved.
- Restrictions and limitations
  These include guidance that is explicit or can be inferred from the client.
- Fee & expense quartile
  The expense quartile requirement is derived from the value that clients place on investment strategies, services and conveniences that are only available from more costly investments. The advisor's own compensation is factored into this requirement.
- Service alignment
  The service alignment refers to the service of the investment provider. The alignment is based on the breath of services provided, the quality and available methods of delivery.

Statement of Recommendations

The recommendations presented to the client represents the advisor's prudent choice based on the interpretation of the discovery and the choices available to the advisor.

The advisor is expected to use existing analysis tools and practices to select recommendations that meet the investment requirements.

The presentation of a statement of recommendations must include an explanation of the "menu" of products from which the recommendations were selected. The advisor must warrant that the "menu" does not limit his/her ability to comply with the Impartial Conduct Standard requirement.

The Statement of Recommendations also require:

- The specific investment recommendations being made
- Principal reason for each recommendation selected
- Comparison to current holdings
- Fact sheets
- Other required documentation

Comply with Impartial Conduct Standard

Throughout the discovery, interpretation and the statement of recommendations, the advisor is required to adhere to an Impartial Conduct Standard. In summary, this standard consists of four requirements:

- A written statement or contract between parties that may be client, responsible fiduciary, advisor or advisor's firm (depending on the situation) that complies with the requirements of the regulation, including acting in a fiduciary capacity.
- Act in the client's best interest with care, skill, prudence, and diligence under the prevailing circumstances.
- Receive no compensation that exceeds the services the advisor provides to the client.
- Make no misleading statements.

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Transitioning to Impartial Conduct Standard

While the regulations take full effect on January 1, 2018, the existing accounts need not be brought into compliance until assets are added.

What Is Needed Now?

Advisors will be expected to have the following in place when regulations take effect and will be applicable to all new accounts:

- Thorough knowledge and understanding of the new Best Interest Contract Exemption ("BICE") requirements and opportunities

  Understanding the full scope of the regulation and the way it will affect advisors is the very first step in successfully complying with the new requirements. There are a number of decisions that advisors can make to reduce the burden, increase marketability and reduce risks under BICE.

  DALBAR provides an online self-study course that provides the background necessary to profitably implement BICE. See http://training.DALBAR.com/.
- A contract template that complies with BICE and advisor's business

  Leading industry attorneys are in the process of developing BICE contract templates that will be available when BICE becomes effective. The advisor must select which template best suits the business model that he/she decides to use under BICE.
- The process of making recommendations based on discovering the client's best interest

  This process is the subject of this paper. The process may be undertaken manually for advisors with a limited number of clients but a large client base with require an automated system such as the DALBAR *Discover* system.
- Changes to any existing practices that do not comply with BICE

  After completing the self-study course at http://training.DALBAR.com/, the advisor will be able to identify and change the non-compliant practices that are in current use. The alternative is to engage an expert to conduct a review and make the required changes.
- Revisions to marketing materials, Websites and other forms of communication

  As is the case with existing practices the advisor can undergo the training and make required changes or engage an expert.
- Disclosures required by BICE

  Disclosures such as indirect compensation and potential conflicts of interest must be identified and an appropriate disclosure prepared.
- Notice to the Department of Labor of the intention to use BICE

  This required notice is given after all requirements are in place.

Additional material regarding best interest regulations and self-study programs are available at http://training.dalbar.com/.

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APPENDIX A
CHANGES TO EARLIER VERSION

Regulations apply only when new assets are added.

ADDED

Regulations exclude existing accounts until new assets are added, at which point regulations take effect.

REMOVED

The first stage of the transition is to ensure that any *new* business meets the new requirements, while the conversion of existing clients is taking place. It is critical to initially establish that the advisor has all the necessary tools and procedures in place to comply and is operating under current law for current events.

The second stage is the plan to raise existing clients to the new standard in an orderly way. Information that is already known about existing clients can save enormous amounts of time and make the task less burdensome. Upgrading clients to the new standard can also be integrated with regular periodic reviews to further reduce the administrative burden.

Cost Reduction and Recovery

The preparation for the new regulations, the conversion of existing clients to the BICE requirements and the ongoing expense of BICE compliance will materially increase the cost of doing business. Advisors need to take two actions to preserve profitability and grow business:

- Reduce Costs

  Time management becomes a more important consideration in the light of all BICE compliance requires. The knee jerk reaction to jettison small, unprofitable accounts may be unwise because of the lost relationships and ill will created. A more prudent approach is to spend only the time that compensation from these accounts can justify. This requires a flexible process of time management to replace the practice of delivering the same time and attention to all clients.

  Time management can also be enhanced by using the phone in combination with electronic communication

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instead of an in-person visit.

A second method of reducing costs is through the efficiency of an automated system. With the automated system, the advisor is guided through a process of discovery while simultaneously documenting the findings. Findings are stored and used for interpretation and archived with no further effort by the advisor.

A third method of cost reduction is to use discretionary accounts for small investors. Since the new regulations do not apply to discretionary accounts, the costs of servicing the small accounts can be dramatically reduced if the advisor is authorized to make investment decisions for the client.

- Recover Costs

  No clients are pleased to hear that costs are increasing. It is inevitable that there will be objections to charging an additional fee, even if it is the result of regulatory mandates. The public has absorbed cost increases due to government regulations in many industries, ranging from airlines, food, health care and others.

  If presented effectively, clients will also absorb the cost of government regulation in the financial advice business. Effectiveness is achieved by labeling the additional cost as a regulatory one and charging a reasonable fee. If for example an advisor estimates that these new regulations will require two hours per client, an appropriate regulatory fee can be based on the cost for two hours of the advisor's time.

Conversion Strategy

Conversion of existing clients to the best interest contract requires a compelling message, gathering known details about the client, scheduling and coordination and the ultimate interview and process. Transition methods are included in the DALBAR online self-study course at http://training.DALBAR.com/.

- Compelling Message

  On one hand, the client must be convinced that converting to BICE is in their best interest while on the other avoiding criticism of past practices. The messaging must also convey the fact that the government imposed requirements has made a surcharge necessary.

- Gathering Client Data

  Existing information about clients can shorten the discovery process. The available information should be retrieved and used as a precursor to interviewing the client.

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- Scheduling

  Scheduling client interviews will depend on the number of clients, their locations, ease of access, method of interview and urgency. The urgency is influenced by client's awareness and interest in the subject, clients who are likely to react negatively to the changes and importance of the client to the advisor.

- Interview and Process

  The interview and follow-up process will reflect the particular advisor's business.

Additional Note

DALBAR will be conducting beta tests on the automated *Discover* system in 2016. Advisors interested in participating in the beta test may contact DALBAR to enroll.

For information regarding DALBAR's automated *Discover* tool please contact Discover@DALBAR.com or call 617-723-6400

Nature of contract varies

MODIFIED

A written statement or contract between parties that may be client, responsible fiduciary, advisor or advisor's firm (depending on the situation) that complies with the requirements of the regulation, including acting in a fiduciary capacity.

Change in expected applicability date

MODIFIED

While the regulations take full effect on January 1, 2018, the existing accounts need not be brought into compliance until assets are added.

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