DALBAR'S
BEST INTEREST INVESTMENT RECOMMENDATIONS

Advisor Role under Best Interest Regulations

In the era when the contractual obligation is to act in the client's best interest, investment decisions can no longer be based on the judgement of the individual advisor or a policy of the advisor's firm. In the case of the advisor's judgement, an enormous business risk is introduced if two clients with similar circumstances receive contradictory recommendations from advisors of the same firm. However, the use of a firm-wide policy for recommendations would be a violation of the best interest contract that requires consideration of each client's needs, circumstances and situation.

The consequences of failing to comply with the best interest contract are severe but can be avoided by adopting practices that are prudent, loyal, and untainted by conflicts of interest, based on the client's best interest. These practices, however, must be uniform and consistently used in order to offer any protection.

Prudence requires that the advisor and financial institution making the recommendation act with 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, without regard to the financial or other interests of the advisor or financial institution.

Almost as important as complying with the best interest contract is the need to prove that compliance. The diagnosis that leads to each recommendation is a permanent record of what facts were known at the time of the recommendation and prevents claims of misconduct when future losses occur.

A further requirement of a best interest contract is that recommendations cannot be subject to conflicts of interest. Complying with the no conflict requirement requires that the advisor and financial institution is able to show that recommendations were not influenced by payments or other compensation derived from the recommended investment.

It is therefore necessary to define how best interest is determined and then later proven. Practices to comply with best

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interest contract requirements can then be put in place.

Discarded Considerations:

Several factors that may have influenced investment recommendations in the past must be abandoned because they fail to meet best interest standards. A new set of decision-making standards must replace these existing practices.

Before discussing standards that will meet the new requirements it is necessary to identify practices that can no longer be considered in presenting a recommendation to a client. These practices fall into two categories:

Expert Only Practices are those that rely on expertise but do not involve the client's specific situation, needs or desires. BICE recommendations require taking prudent steps in an attempt to determine what the client's best interests are. These are unlike existing practices with the requirements of knowing the client and not making unsuitable recommendations.

Incentive Driven Practices are those that are based on paying some form of compensation to the advisor or financial institution. These prohibited practices are likely to be identified in policies or in patterns of recommendations.

❑ Expert Only Practices

While an advisor's and a firm's expertise is an expected component in making investment recommendations, the requirement to act in the client's best interest means that the expertise cannot be the only basis.

Reliance on training, licenses, certifications or experience are insufficient to meet BICE requirements. The recommendation must include considerations about the client. Without the client element, the recommendation cannot be in that client's best interest.

Other Expert Only Practices include financial institution's own policies, sales agreements, research opinions and focus products.

Investment recommendations made without prudently considering the client's needs are a violation of a best interest contract.

❑ Incentive Driven Practices

While BICE permits various forms of incentive compensation to advisors and financial institutions, it is required that such compensation does not influence which investments are recommended.

Examples of prohibitions are making recommendation based on the expectation of **Commissions**

- ✓ 12-1 fees
- ✓ Finders fees
- ✓ Revenue sharing arrangements
- ✓ Bonuses or other payment
- ✓ Non-cash incentives

Changes for Rollovers:

Rollovers are potentially the largest growth areas and are subject to the most rigorous changes.

The new regulations treat recommendations to roll assets out of an ERISA plan to be a fiduciary act, requiring the investor protection of a best interest contract. There is, however, an educational exclusion provided that:

Information and materials do not include recommendations with respect to specific investment products or specific plan or IRA alternatives, or recommendations on investment, management, or value of a particular security or securities, or other property.

- No reference is made to the appropriateness of any individual investment alternative or any individual benefit distribution option for the plan or IRA, or a particular participant or beneficiary or IRA owner.

If adopted, these provisions prevent the advisor from adding value for the client in today's largest potential market. Success in the rollover market will almost certainly require BICE.

Required Considerations:

BICE requires either that the following be taken into account in making investment recommendations or that a statement be presented to the client to consider them. The way in which these items are weighed and interpreted is left to the judgment and expertise of the advisor. The advisor must be prepared to demonstrate that the interpretation of these items is reasonable:

- Other assets
- Income and investments such as:
  - Equity in a home
  - Social security benefits
  - Individual retirement account/annuity investments
  - Savings accounts
  - Interests in other qualified and non-qualified plans

Additional Client Considerations:

Advisors need to find ways to add value to their clients so as to avoid excessive compensation violations. The best way to avoid excessive compensation violations is to broadly consider what is in the client's best interest. For example, if an advisor establishes that the client's best interest is to have lifetime income and recommends an annuity, there is very little value added and compensation should be very low. If best interest considerations for the same client includes the items on the list below and others, the value and allowable compensation is greatly increased.

Best practices suggest that investment recommendations also include the following considerations for and about the client:

PURPOSE AND FINANCIAL GOALS FOR THE FUNDS INVOLVED

Define each major purpose of funds and a minimum and optimum financial goal (dollars needed to accomplish that purpose) for each. The purposes can be generic (make a lot of money) or specific such as a purchase, income or commitment. Arrange purposes in order of importance, taking each minimum and maximum separately… so minimum retirement income may be more important than minimum education but optimum retirement may not be.

THE CLIENT'S TOLERANCE FOR RISK IN PURSUING EACH PURPOSE OR GOAL

Clients are willing to take greater risks in pursuing one purpose over another. Each goal is examined to assess the current tolerance for risk. It should also be noted that the tolerance for risk changes when circumstances or market conditions change and as the time for achieving the goal

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approaches.

Time horizon for achieving the goal

The timeframe for when the funds will be used for each specific purpose is established. The time horizon can be a single event such as a purchase or continuous income.

Likely behavior during times of market stress

History has shown that clients fail to achieve potential returns from their investments primarily due to their own behavior. This leakage of returns can be abated by investment recommendations that set reasonable expectations and revisiting recommendations in times of market and other stresses. The behaviors causing the greatest leakage are loss aversion during high volatility, delaying investments due to hesitation and attempts at market timing.

Expected outcomes

Expectations that clients have for investment returns, volatility and potential losses are determined and addressed before making recommendations. Expectations should be aligned with the investments the client holds. Misalignments are a frequent cause of client dissatisfaction and loss of business.

Investment preferences, restrictions or exclusions desired by the client

Clients often have pre-dispositions about which investments are desirable and which are not. Understanding these individual preferences is essential to acting in the client's best interest.

Fees and expenses

While no client desires to pay high fees, clients recognize different values and are willing to pay extra for those values. The most frequent example is paying for active management. Clients who understand that circumstances arise where a prescribed passive investment may not be the best alternative are willing to pay higher fees for active management.

Service and convenience

Individual client's service requirements also vary greatly,

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from continuous monitoring of investments to those who prefer a hands off approach. The investment recommendation should reflect the preference for service. Clients who expect continuous monitoring are best served by investments that provide extensive high quality support.

Investment Menus and Proprietary Funds

Best interest contracts do permit the use of pre-selected menus and proprietary funds as investment choices but there are conditions that must be met.

Conditions would apply to firms that limit the products that their advisers can recommend based on the receipt of third party payments or the proprietary nature of the products (i.e., products offered or managed by the firm or its affiliates) or for other reasons. The conditions require that such firms provide:

- Notice of the limitations to plans, participants and beneficiaries and IRA owners. It is insufficient for the notice merely to state that the financial institution “may” limit investment recommendations, without specifically disclosing the extent to which the financial institution in fact does so.
- A written finding that the limitations do not prevent advisers from providing advice in those investors' best interest or from otherwise adhering to Impartial Conduct Standards.
- Ensure that any additional compensation received in connection with the advice is for specific services.

Record Keeping Requirements

There are six critical activities that must be recorded to satisfy the BICE requirements and to protect the advisor and financial institution from excessive risk and liability: Discover: Client’s best interests, updated periodically as circumstances change.

Contract: Executed by client and meeting regulatory requirements and specifying the services that the advisor provides.

Interpret: Explanation of the factors used and how those factors led to investment requirements that are used to develop recommendations. (This is the function of today’s investment policy statement.)

Recommend: Investments recommended and the rationale for

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how they meet the investment requirements.

Implement: Client approval and execution of required transactions.

Monitor: Results of monitoring client's performance in relation to goals and any necessary changes.

Computer Models:

Current practice of manual oversight is not feasible under a best interest arrangement. The basic reason for this is that:

- ✓ Current practice of oversight occurs after the client agrees to execute a transaction.
- ✓ Best interest requires oversight of the recommendations to the client, which occur before client agrees to execute the transaction.

This basic difference in addition to the complexities and time consuming nature of the best interest oversight make reliance on manual procedures unfeasible.

The practical alternative is the use of one or more computer models to capture and interpret the best interest information in a way that can be shown to be prudent. Computer models must:

- Provide a consistent basis for making recommendations.
- Eliminate risk of human error.
- Interact with separately controlled investment models for recommendations to meet investment requirements.
- Handle changes to decision rules and record them when they occur.
- Permanently record facts as they were known at the time of every recommendation. Includes historical data, current information and projections.
- Entirely eliminate any responsibility for events that occur after recommendations are made.
- Facilitate follow-up to identify changes.

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