CYA: Compliant Yearly Audit Trails / Fiduciary Standards & Best Practices What to do When You are Responsible for Someone Else's Money

Investing Today (After June 30th, 2020) While Complying with DOL Reg BI, SEC Fiduciary and Other Applicable and Pending Standards

OVERVIEW

Service

1. Investment
    a. Broker
    b. RIA
2. Insurance
3. Advice/Planning

Investment Accounts

1. Qualified (Retirement)
2. Non-Qualified

Retirement Accounts

1. ERISA
2. Non-ERISA

Clients

1. Individuals
2. Entities
3. Special Situations
    a. Trusts
    b. Minor
    c. Elderly
    d. Special Needs
    e. Spendthrift

BACKGROUND

Several different laws and regulations that can but all have same duties and care

1. **UPI - Uniform Prudent Investor Act**
   Individual Trustee – usually not a professional but has responsibility thrust upon them

2. **ERISA - Employee Retirement Income Security Act**
   HR Director & CFOs – responsible for oversight of plan participants
   Professional Plan Fiduciaries

3. **UPIFA - Uniform Prudent Management Of Institutional Funds Act**
   Board members who serve on Non-Profits

CURRENT LEGAL & REGULATORY ENVIRONMENT

TRUSTEE/FIDUCIARY DUTIES

Duty	UPIA	ERISA	UPMIFA
Prudently Administer	§16047(a)	§1104(a)(1)(B)	§ 64.2-1101(B)
Return Objectives	§16047(b)	§1104(a)(1)(B)	§ 64.2-1101(E)(1)(e)
Risk Expectations	§16047(b)	§1104(a)(1)(B)	§ 64.2-1101(E)(2)
Diversify	§16048	§1104(a)(1)(C)	§ 64.2-1101(E)(4)
Fair Fees	§16050	§1104(a)(1)(A)(ii)	§ 64.2-1101(C)(1)
Prudently Delegate	§16052(a)(ii)	§1104(a)(1)(B)	§ 64.2-1103(A)(2)
Monitor Delegates	§16052(a)(ii)	§1104(a)(1)(B)	§ 64.2-1103(A)(3)

INVESTMENT PROFESSIONAL DUTIES

Suitability	Reg BI	Fiduciary
FINRA Rule 2111	17 CFR 240.15l-1	Not Adopted
Regulatory Notices 12-55, 12-25 and 11-25	Securities Exchange Act of 1934	Investment Advisers Act of 1940 Sections 206(2), 206(4) and 207
	Investment Advisers Act of 1940	Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933
	Dodd-Frank Act Section 913	
Know Your Customer FINRA Rule 2090	FORM CRS	FORM ADV

Uniform Prudent Investor Act

(UPIA)

Code of Virginia
Title 64.2. Wills, Trusts, and Fiduciaries
Chapter 7. Uniform Trust Code
Article 9. Uniform Prudent Investor Act

Uniform Prudent Investor Act (UPIA) is a standard that sets out guidelines for trustees to follow when investing trust assets on behalf of a trustor. It also applies to financial professionals who make recommendations or place trades on behalf of clients. It is an update to the former "Prudent Man" standard intended to reflect the changes that have occurred in investment practice since the late 1960s. Specifically, the Uniform Prudent Investor Act adopts a modern portfolio theory (MPT) and total return approach to the exercise of fiduciary investment and discretion.

KEY TAKEAWAYS

- The Uniform Prudent Investor Act (UPIA) is a statute that sets out guidelines for trustees to follow when making investments on behalf of others, an update to the Prudent Man Rule.[1]
- The Prudent Man Rule stated that a trust fiduciary was required to invest trust assets as a “prudent man” would invest his own assets.
- The UPIA requires trustees to take into account a diversified portfolio approach that follows modern portfolio theory and a total return approach.

Understanding Uniform Prudent Investor Act
Adopted in 1992 by the American Law Institute's Third Restatement of the Law of Trusts. Updates Prudent Man Rule.
Total portfolio approach and eliminating category restrictions on different types of investments, creates greater degree of diversification in investment portfolios. Can include alternative investments such as derivatives, commodities, and futures. While these investments individually have a relatively higher degree of risk, they could theoretically reduce overall portfolio risk and boost returns when considered in a total portfolio context.

The Prudent Man Rule
The Prudent Man Rule was based on Massachusetts common law written in 1830 and revised in 1959. It stated that a trust fiduciary was required to invest trust assets as a "prudent man" would invest his own assets, with the following in mind:

- The needs of beneficiaries
- The need to preserve the estate
- The need for income

A prudent investment will not always turn out to be a highly profitable investment; in addition, no one can predict with certainty what will happen with any investment decision.

More recently, the prudent man rule has been renamed the prudent person rule. This set of guidelines can also be applied outside of trustee domains, where it is referred to as the prudent investor rule.

The Uniform Prudent Investor Act's Updates to the Rule

The Uniform Prudent Investor Act made four main changes to the previous Prudent Man Rule standard:

- A trust account's entire investment portfolio is considered when determining the prudence of an individual investment. Under the Uniform Prudent Investor Act standard, a fiduciary would not be held liable for individual investment losses so long as the investment was consistent with the overall portfolio or investment objectives.
- Diversification is explicitly required as a duty for prudent fiduciary investing.
- No category or type of investment is deemed inherently imprudent. Instead, suitability to the portfolio's needs is considered. As a result, investment junior lien loans, investments in limited partnerships, derivatives, futures, and similar investment vehicles are now possible. However, speculation and outright risk-taking is not sanctioned by the rule and remain subject to possible liability.
- A fiduciary is permitted to delegate investment management and other functions to qualified third parties.

The Uniform Prudent Investor Act's most important change was that the standard of prudence would henceforth be applied to any investment in the context of the total portfolio, rather than to individual investments.

Modern Portfolio Theory (MPT)

Developed by economist Harry Markowitz in the 1950s.

It's possible to design an ideal portfolio that will provide the investor maximum returns by taking on the optimal amount of risk.

Diversification of securities and asset classes or the benefits of not putting all your eggs in one basket.

Stocks face both systematic risk—market risks such as interest rates and recessions—as well as unsystematic risk—issues that are specific to each stock, such as management changes or poor sales.

Proper diversification of a portfolio can't prevent systematic risk, but it can reduce unsystematic risk.

Pros

- No timing the market: Most investors want to maximize their returns for minimal risk but don't have the time, knowledge, or emotional distance to be successful at market timing.
- Suitable for average investor: An average investor can benefit from applying MPT or incorporating its key ideas to achieve a balanced portfolio that is set up for long-term growth.
- Decreases risk in investing: Spreading your investments across assets that aren't positively correlated protects you from changes in the market.

Cons

- Not based on modern data: The concepts of risk, reward, and correlation that underlie MPT are derived from historical data. This data may not be applicable to new circumstances in the market.
- Standardized assumptions: MPT functions bases on a standardized set of assumptions about market behavior. These assumptions may not bear out in a constantly changing financial climate.

Prudent Investor Rule

The Heart of the Prudent Investor Rule is –

1. Align market risk with beneficiary risk tolerance and
2. Manage risk on an ongoing basis.

Planning for your financial future is a taking a shot at a moving target.

Examples

Plan to work until age 70, but lose your job at 66?

Cut back to part-time to care for a Parent/Spouse/Child?

Spouse dies earlier than expected, and, you receive only one Social Security retirement benefit check instead of two?

Inflation turns out to be higher than anyone expected?

Future uncertainty factors are what make long-term planning such a challenge.

No way to know for certain what will happen – Plan for what could happen & Develop multiple “what if” scenarios. Create a plan that — despite all the unknowable variables — can offer a reasonable likelihood of ensuring financial stability in your later years.

EMPLOYEE RETIREMENT INCOME SECURITY ACT

(ERISA)

DOL's April 10, 2017 final regulation redefined the term Fiduciary for the Employee Retirement Income Security Act of 1974, (ERISA) and the Internal Revenue Code of 1986 (the Code), but was postponed until .

Best Interest - advice that is provided with – the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances and needs of the retirement investor, without regard to the financial or other interests of the advisor, financial institution, or any affiliate, related party, or other party.

* DOL officials have repeatedly identified as their chief rulemaking objective that plans, participants and IRA clients who transact on the basis of fiduciary recommendations, be assured of their ability to enforce the best interest standard of conduct against advisors and firms. The emphasis is on creating an enforceable standard because Code § 4975 contains no private right of action.

ERISA Named Fiduciaries

ERISA defines a fiduciary to be any person who exercises any discretionary authority or control over the management of the plan, or renders investment advice for a fee or other compensation, or exercises any authority or control over the management or disposition of plan assets.

<u>PLAN SPONSOR “CEO”</u>

- Almost always a fiduciary
- Oversees all the other fiduciaries
- Duty to monitor the other fiduciaries and replace them if they are failing to do their responsibilities under ERISA

<u>PLAN TRUSTEE “CFO”</u>

- Responsible for prudently selecting and monitoring plan investments
- Ensures that expenses paid by the trust are reasonable
- Has fiduciary duties and fiduciary liability and is overseen by the Plan Sponsor

<u>PLAN ADMINISTRATOR “COO”</u>

- Responsible for overseeing plan operations
- Can be a single person or consist of a retirement plan committee
- Has fiduciary duties and fiduciary liability and is overseen by the Plan Sponsor

Fiduciary Service Providers & Sample Fiduciary Duties

3(16) PLAN ADMINISTRATOR

- Named fiduciary with specific administrative duties
- Can sign 5500
- Typically signs distribution, loan and hardship forms
- Assures plan remains in compliance with plan document, required testing and participation notices
- No investment responsibilities

3(21) INVESTMENT ADVISOR

- Advises on Investment Policy Statement (IPS)
- Advises on fund menus and helps with monitoring fund menu
- Recommends changes in accordance with IPS
- No administrative responsibilities

3(38) INVESTMENT MANAGER

- Named fiduciary (typically as “investment manager”)
- Draft IPS
- Responsibility for determining and monitoring fund menu in accordance with IPS
- Has authority to make investment changes

ERISA Fiduciary Rules

ERISA regulates the retirement plan industry, so it's important that you and the plan sponsor be familiar with its rules.

There are three primary sets of rules that serve as the foundation of fiduciary responsibility common to all ERISA fiduciaries: the exclusive purpose rule, the fiduciary standard of care, and the prohibited transaction rules.

Exclusive Purpose

One of the most important ERISA fiduciary rules is the exclusive purpose rule: "A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries."

Fiduciary Standard of Care

In order to fulfill the exclusive purpose rule, ERISA established the fiduciary standard of care under Section 404.

The Four Basic Fiduciary Standards are:

1. Loyalty -Fiduciary duty is for the exclusive purpose of:
    i. Providing benefits to participants and their beneficiaries; and
    ii. Defraying reasonable expenses of administering the plan.
2. Prudence - Fiduciaries must act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. The prudence standard under ERISA is not referring to a "lay person" but rather a prudent fiduciary. Therefore, this standard obligates a fiduciary who lacks experience or expertise in such matters to seek the assistance of an expert in order to fulfill his or her fiduciary responsibility. The fiduciary

must have a process for selecting such an expert that considers the expert's qualifications and merits. The fiduciary also has a duty to monitor the expert if the expert's task is ongoing.

3. Diversification - Fiduciaries must diversify the investments of the plan to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so. Factors that may be considered for prudent diversification may include:
   iii. Purpose of the plan
   iv. Amount of assets
   v. Investment acumen of the participants
   vi. Participant demographics
4. Following the plan's governing documents - Fiduciaries must operate the plan in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with ERISA provisions.

Prohibited Transaction Rules

To enforce the exclusive purpose and prudency rules, ERISA established the concept of "prohibited transactions" exercised by parties in interest to the plan.

Takeaway

All retirement plans have one or more fiduciaries who are responsible for the plan. Under ERISA, plan fiduciaries have a legal obligation to operate the plan on behalf of plan participants and their beneficiaries, and not on behalf of owners, the employer, or key employees. They must also take special care with the plan's investments, avoid conflicts of interest, and always follow the plan documents (as long as such documents are consistent with ERISA provisions). Fiduciaries should always act in the best interest of participants and beneficiaries of the plan to help fulfill their duty under ERISA.

ERISA Fiduciary Rules in Practice

The ERISA requirement of prudence applies to every fiduciary decision, not just investments, and encompasses all aspects of managing the plan. Some of these decisions include the selection of investments, the selection of service providers, and the decision to continue to offer specific investments or to use specific service providers (a process known as "monitoring").

ERISA's prudence standards focus on the procedures a fiduciary should use when determining a proper course of action and maintaining documentation to support these determinations. The following test of procedural due diligence evaluates the process a fiduciary should use to reach a certain decision or make a particular choice (but does not evaluate merely the result of that decision or choice).

Fiduciaries must:

- Investigate and evaluate decisions;
- Maintain records; and
- Obtain expert assistance where necessary.

Fiduciaries must periodically monitor and evaluate their decisions to ensure they remain in the best interest of the plan participants. Fiduciary duties relate to the actions a fiduciary should take and not what results he or she should achieve. Therefore, prudent behavior is critical. Additionally, fiduciaries must obtain expert assistance when they do not have the knowledge, experience, or access to data needed to fulfill the duty to investigate.

In summary, the ERISA fiduciary exclusive purpose rule and prudency standard are clearly defined, but both rules ultimately require fiduciaries to take many steps to protect participants and beneficiaries. The risks of not following the fiduciary standard of care rule include harming participants and beneficiaries of a plan and not meeting the retirement plan goals and objectives. For example, not depositing employee deferrals timely to the plan is not only a fiduciary violation, but also jeopardizes participants' retirement outcomes.

Takeaway

Fiduciaries must carry out their fiduciary responsibilities solely in the interest of the participants and beneficiaries with the goal of providing benefits to them:

- Defray reasonable expenses of administering the plan;
- Act with prudence by investigating before making any plan decisions, documenting the decision-making process, hiring experts when they don't possess the knowledge or skills to make a decision, and monitoring if their decisions are still ideal based on the exclusive purpose rule and taking action if not;
- Diversify investments in a prudent manner in order to minimize risk; and
- Follow the plan documents to the extent that they are not contrary to ERISA rules.

ERISA is complicated, but fortunately, the rules recognize this and actually require plan fiduciaries to seek expert help from a plan advisor such as you. Fiduciaries are required to document how they make decisions, including how they hire and oversee experts. Advisors can act as the "plan quarterback" to assist fiduciaries in working with service providers and keeping up with requirements and best practices. However, advisors should be aware of their fiduciary status under the DOL fiduciary regulations and be able to explain to the plan's named fiduciaries their fiduciary role in making investment recommendations.

ERISA Fiduciary Liability

If fiduciaries do not follow the ERISA fiduciary rules, they are potentially personally liable. There is no "corporate veil" protection for fiduciaries. As a result, ERISA is a "personal liability" law.

If the DOL determines that plan, processes were not prudently followed and those actions harmed participants or beneficiaries, the fiduciaries could be personally liable.

Functional fiduciaries bear the same responsibilities and personal liability as named fiduciaries.

The extent to which a fiduciary is personally liable will vary according to multiple factors. There are ways to reduce fiduciary liability, as we'll visit later in the course.

Fiduciary liability is not limited to the extent of a person's actions. ERISA §405 makes a fiduciary liable for another fiduciary's breach, under certain circumstances. Through this co-fiduciary liability, a co-fiduciary who is not the fiduciary directly responsible for a breach may ultimately be liable for restoring a loss to the plan (or participants/beneficiaries). A "co-fiduciary" is nothing more than a fellow fiduciary; there is no distinct co-fiduciary status that is somehow different from that of a "true fiduciary."

UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

(UPMIFA)

Code of Virginia
Title 64.2. Wills, Trusts, and Fiduciaries
Subtitle III. Trusts
Chapter 11. Uniform Prudent Management of Institutional Funds Act

The Uniform Prudent Management of Institutional Funds Act ("UPMIFA") was adopted by the National Conference of Commissioners on Uniform State Laws in 2006 to succeed and replace the Uniform Management of Institutional Funds Act

UPMIFA sets forth rules regarding the management and investment of institutional funds, as well as the delegation of the investment and management of institutional funds, the expenditure of endowment funds, and the release of restrictions on restricted assets.

Board Members and Their Fiduciary Responsibilities

Directors of a nonprofit organization have fiduciary duties and thus have the responsibility to protect and preserve the organization's resources for the public benefit or charitable purposes for which the organization was established. This means that the directors accept the role of stewardship of the nonprofit's assets to confirm that resources are utilized in a reasonable and appropriate way. As persons of trust, board members have the authority and obligation to act prudently, honestly and in good faith on behalf of their nonprofit.

In general, the exercise of fiduciary responsibilities involves fulfilling the duties of care, loyalty and obedience:

- Duty of Care: Exercise prudent judgment in decision-making and provide oversight for all activities that advance the nonprofit's effectiveness and sustainability.
- Duty of Loyalty: Act solely in the best interests of the nonprofit rather than pursuing courses of action that further a board member's self-interest.
- Duty of Obedience: Confirm that the nonprofit obeys its stated mission and purpose and that it acts in accordance with applicable laws and ethical practices.

An extension of the duty of obedience is the duty of transparency, which is the obligation of the board to make certain that the nonprofit is open in its operations. This duty of transparency includes confirming that all tax filings have been made and are available to the public.

Critical Board Fiduciary Functions

Board members are expected to be active participants in meetings, do their homework and be knowledgeable about the work of the nonprofit. In satisfying its fiduciary obligations, the board must establish and maintain a policy and administrative framework within which the nonprofit operates, which generally includes:

- Establishing a budget – typically on an annual basis – that dedicates resources to the programs and initiatives created to help the organization accomplish its mission and goals.
- Designing and implementing a system to regularly monitor, evaluate and report on the nonprofit's financial condition and performance.
- Installing a performance tracking system and holding the organization's chief executive and staff accountable for results and adherence to policies.
- Adopting policies to govern major transactions, including the acquisition of assets.
- Creating a compliance system to confirm that all IRS tax filings and reporting are satisfactorily completed on a timely basis and that regulatory and disclosure requirements are met.

- Implementing an independent external audit on a regular basis – usually on an annual basis – to assess the organization's financial condition and viability, including the effectiveness of risk management and control systems.
- Developing a written conflicts of interest policy to confirm that board members are familiar with the types of activities or transactions that may impact their ability to serve as a board member or participate in certain decisions.
- Creating and implementing policies and guidelines for investments and spending, and providing oversight on how investments are managed and what is spent.

Fiduciary Investment and Spending Responsibilities of Boards

As mentioned, the board takes on the role of stewardship of the nonprofit's assets to confirm that these resources are utilized in a reasonable and appropriate way. Since its adoption in 1972 by the National Conference of Commissioners on Uniform State Laws (NCCUSL), the Uniform Management of Institutional Funds Act (UMIFA) has provided guidance to organizations on the management, investment and spending of funds held by nonprofits. In 2006, the Uniform Prudent Management of Institutional Funds Act (UPMIFA) was adopted by NCCUSL to address shortcomings in UMIFA and is designed to:

- Update the prudent investment standard for nonprofit funds.
- Provide clearer rules and guidance on spending from institutional funds and enable nonprofits to more easily deal with market fluctuations in the value of funds.
- Simplify rules on the release and modification of restrictions on charitable funds to permit more efficient management.

In one form or another, UPMIFA guidelines have been implemented in all states except Pennsylvania, which will be addressed in a following section.

UPMIFA Accumulation and Spending

The most significant change in UPMIFA from earlier guidelines is the elimination of the historic dollar value (HDV) limitation on spending from institutional funds. Under UMIFA, net appreciation of an endowment fund could be spent although the HDV had to be preserved. For example, assume that a nonprofit received an original endowment of $1 million, which represents the HDV of the donation. If the market subsequently declines and the fair market value of the fund fell to $980,000, the nonprofit would not have been permitted to touch the money for expenditures under the old rules. Subject to the donor's intent, UPMIFA now permits an institution to accumulate or spend as much of an endowment fund as the nonprofit deems prudent for the uses, benefits, purposes and duration for which the endowment fund is established.

There are exceptions to the more expansive rule under UPMIFA. When a donor expresses intent clearly in a written gift instrument, UPMIFA requires that the charity follow the donor's instructions. In addition, UPMIFA does not apply to private foundations held by individual trustees or commercial trustees, such as banks or trust companies, even if the sole beneficiary is a charity. Such trusts are instead governed by the instruments establishing them and applicable state trust law.

The UPMIFA prudence guideline is consistent with standards already applied throughout business, legal and investment communities: A board member must act in good faith and with the care an ordinarily prudent person in a like position would exercise in similar circumstances. In making a determination to accumulate or spend endowment fund assets, a nonprofit's board is to apply the prudent person standard and consider, if relevant:

- The duration and preservation of the endowment fund.
- The purposes of the institution and the endowment fund.
- General economic conditions.
- The possible effect of inflation or deflation.

- The expected total return from income and the appreciation of investments.
- Other resources of the institution.
- The investment policy of the institution.

UPMIFA Investing Standards

UPMIFA allows board members the freedom to implement an investment policy that meets the intent of the endowment fund and to use their business judgment in managing fund assets. In making decisions on managing and investing an institutional fund, subject to the intent of a donor, the board must consider:

- The charitable purposes of the institution and the purposes of the institutional fund.
- General economic conditions.
- The possible effect of inflation or deflation.
- The expected tax consequences, if any, of investment decisions or strategies.
- The role that each investment plays within the overall investment portfolio of the fund.
- The expected total return from income and the appreciation of investments.
- Other resources of the institution.
- The needs of the institution and the fund to make distributions and to preserve capital.
- An asset's special relation or special value to the charitable purposes of the institution.

UPMIFA prudent investing standards require a board to fulfill its duty of care and to manage costs. Investment decisions must be considered as part of the overall investment strategy and within the context of the institutional fund's investment portfolio. UPMIFA requires diversification of assets, absent special circumstances, and the strategy must be based on risk-return objectives that are suitable for the nonprofit and the fund. The board may delegate management and investment of the fund to external agents as long as it acts prudently and in good faith in selecting the agent and establishing the scope and terms of the delegation. The board must also periodically review the agent and its performance.

Overview

<u>TRUSTEES</u>

UPIA – individual who becomes responsible. Not a professional. Not trained

ERISA – HR Directors & CFOs of retirement plans. Not a professional. Some training

UPMIFA – on board of nonprofits and charities.

Doesn’t matter which type you are, you have the same basic guiding principles and owe the same duties of care.

IS THERE A RIGHT ANSWER OR A WRONG ANSWER?

No. There are a spectrum of prudent answers. There are no right or wrong bright-line answers. Two different individuals addressing identical scenarios can arrive at different answers and both be right. Given the same facts and circumstances trustees can come to differing conclusions and there are a continuum of more prudent and less prudent answers.

How do you show good governance? Need to be thoughtful and deliberate in addressing your duties. How do you show you were thoughtful and deliberate? You create a record to document the process you used to arrive at your decisions.

The process is the important part, not the answer. It’s all about the process and you show it by documenting it.

PROVING PRUDENCE & GOOD FAITH

Good Governance Process

Due Diligence standard required may change, but the process will always be the same

Create a Memo to demonstrate 4 elements.

- Duty – Recognize your obligations
- Policy - Method to Fulfill your Duties
- Procedure – Actions to implement Policy to fulfill your Duties
- Record – Document your Actions to implement Policy to fulfill your Duties

REPEAT at least ANNUALLY

PROVING PRUDENCE & GOOD FAITH

Duty of Care -

Investment Policy Statement

Usually, a form document generated by investment provider. This does not delegate all responsibilities/liabilities by delegating authority to an investment provider

1. Duty - Acknowledge your Duties - IPS recognize responsibilities and
2. Policy - Adopt policies to address your Duties
3. Procedure – Implement Policies to address your Duties
4. Record – Document your Acknowledge of your Duties, the Adoption of policies to address Duties and the Implementation of those Policies to address your Duties

Establish a Procedure & Review *at least* Annually. Why review at lease annually – creates feedback loop where you Create a Record that you followed the Procedure.

Investment Policy Statement Summary

- Response to instructions you give investment professional when delegating your Duties
- They develop the document with the guidance you provided as to what you want - Expectations
- This is how we will address your instructions in implementing your overall investment plan and address each instruction
- How do you divide it into sectors?

Rate of Return

- Was this duty performed reasonably in establishing a ROR with these circumstances?
- *No Right or Wrong*
- Another person could disagree with or come up with a different answer and both be right.
- How do you show reasonableness? Thoughtful, documented actions
- What is the administrative plan?
    - Look to Plan Document/Investment Policy Statement/Trust for Purpose
    - Present Value
    - Payment to meet Purpose
    - Future Value – duty to future beneficiaries (No duty if contingent/conditional – if anything left, then pay to)

- Time value of money – Present value Future Value Payments Time Horizon = Rate of Return
- Inflation adjusted? Maybe

- As soon as you get result it is wrong. Real world will be different, but it best we can do to address duty.

- *Do this every year*

Risk – Set risk expectation

Liquid (Investment manager) – easy to calculate – Risk characteristic analysis

Trustee/Fiduciary need risk in addition to standard performance reports (Monthly, Quarterly, Annual)

Illiquid –Art, Baseball Cards, Ranch, Farm, Part Owner Gas Station

How do you measure? *Perform Annually*

1. Over-concentration/Excessive leverage – *acknowledge and address*
2. Overvalued – all assumptions (Distributions, Rate of Return) are based on erroneous value since initial valuation is wrong. Hard to be prudent when your valuation is wrong.
3. Limited liquidity – may take long time to sell - limits distributions

Don't want to acknowledge Over-concentration/Excessive leverage – better to address it first and state that you are aware and recognize the risk, you have a duty to administer in spite of the known risk, this is how you measure the risk, and this is process how you balance the objectives and assets provided.

"I'm aware and am doing the best you can under the circumstances presented to you."

Bear Market

Poor asset performance is inevitable over time and will jeopardize fulfilling objectives.

Best Practice - Address it from beginning and practice what you will do – Over an extended period of time will have poor performance so have procedure to follow when it does

1. **How bad can it get?**

   I have already established purpose and process of pro forma withdrawal rate

   In down market still get some growth, even if small

2. **What happens is shortfall?**

   Define it and address procedure

   Procedure - How much safe investments in portfolio? Short duration, investment grade, good credit quality – divide shortfall into safe investments = how long can survive shortfalls

Why do you do this? It's like doing a fire drill

Measure performance – prudence requires track actual performance against stated objectives as laid out in administrative plan

- Expected total return from income and appreciation of capital
  - How do you measure?
- Multiple performance calculations available
- Liquid – Investment manager can perform
  - Is performance report consistent with best practices? Since inception – since you started how have you done?
  - More data is better so longer the record the
  - Does it show fees? What is the real performance net of fees?

- Illiquid -

Benchmarking

Determine your benchmarks for loss and return. Based on these benchmarks, develop a portfolio that targets the intersection of your loss tolerance and required rate of return.

Prudent in testing of performance evaluation of fulfilling delegation – acting consistently with guidance

Need comprehensive and thoughtful approach to measuring performance outcomes

No perfect benchmark – are you in the range

- Target ROR
- Actual ROR net of Fees
- Return outcome
- Target Risk outcome

- Vs 100% Bond Portfolio
- Vs 100% Stock/Equity Portfolio
- Vs Strategic Benchmarks – US Stock, Non-US Stock & Bonds (Same Risk & Return) Was division selected appropriate?
- Vs Risk Benchmark – Morningstar allocations
- Vs Peer Group Benchmark – What did other advisors with similar mandate with similar time frame do? (Not have to beat, but within a reasonable range)

Benchmarks will win – not real. Not have fees, cash to make distribution, perpetual rebalanced (impractical due to taxes & costs).

Benchmarking

Can defend your actions/decisions if get sued – you can disagree with decisions, standard is not that you made the best decision, but that you acted prudently, in good faith and in the best interest of the client, you thoughtfully and deliberately developed a process, followed it, monitored delegation and reviewed it annually– standard is “Prudent”

Duty to Diversify – a trustee must "diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."

- No bright line –
- Process – Avoid lack of diversification
- Delegated to Investment manager
    - Security level of diversification – too much concentration in single holding -not enough eggs in basket
        - Diversify firm specific risk?
    - Sector level diversification – same type of holdings
        - Well diversified securities, but all concentrated within same area – Look through holdings
        - Second Trustee – loans money in second or third position on real estate and the market drops. Not
    - Asset Class – Large Cap, Mid Cap, etc.

*Practice Tip – Get a letter from investment management professional that in their professional opinion it has adequate security, sector and/or asset class diversification

Alternative Assets

Pitch - If have this asset class then will have small percentage (10%) in portfolio then higher rates of return and lower levels of risk

- Not a common definition of Alts – what does Alts mean in this circumstance?
- Lock up periods – entry or exit dates? Can I get in and out 2 to 3 settlement?
- Fees – consistent with existing holdings fee schedule? Different fee structure for Alt?
- Conflict of Interest – Did your parent company or a division of it create this Alt?
- Expected rate of return – what is the expectation?
- Benchmarking – what do you compare it to?

Fees

May only incur costs that are appropriate and reasonable based on the actual holdings, the overall investment strategy and purposes and objectives to be obtained, and the skills required to perform these

Who got paid what and by whom, and was it fair?

- Largest distribution – Beneficiary
- 2nd – Investment Manager
- 3rd – Fiduciary

Two different approaches for compensating Investment Manager

Commission vs. Fee Based

Which is best? Depends

What do you do?

Know who is getting paid what by whom?

Perform a Fee/Cost Study – what is the normal industry standard for the investments that you actually have? Fee base & Transaction

Know what the fee is – written down

What was actual fee

Annually Review – what did we actually pay

Conclusion : You want to be in average – Not the highest or the lowest, but somewhere in between

Selection of Investment Professional

Why did you select this particular investment manager?

1. Duty to prudently select advisor
2. Duty to prudently delegate – establish target rate of return, distribution rate, expected risk,
3. Duty to monitor activity

What do I need to know about this advisor in order to select them?

Legitimate reasons – Subjective analysis of this person

- Proper Licensure & Certifications
- Understands trustee duties and obligations and accepts deligation
- Agrees to additional reporting requirements
- Perform thorough background investigations – FINRA & SEC

Document process in memo and *repeat it every year*

TYPES OF REPRESENTATION

CHOOSING AN INVESTMENT PROFESSIONAL

A qualified investment professional can help you make sound investment decisions. Investment professionals include registered financial professionals, also known as registered representatives or stockbrokers, investment advisers and financial planners. The person or team of professionals you work with will depend on the type of financial help you seek.

THE SELECTION OF AN AGENT

Bad Reasons

- Friends with manager
- Good returns
- Explains things well

Good Reasons

- Investment process
- Good standing / credentialing
- Will accept delegation document

VETTING AGENT DUE DILLIGENCE

- www.FINRA.org/brokercheck
- Copy of firm's ADV filing
- Is the manager/firm in good standing?
- Are there complaints or settlements?
- Any felonies reported?
- Employment history?

SERVICE

Buy and Sell securities and other investment products

Provide advice about securities tailored to the needs of their clients and

Buy and Sell securities and other investment products

Provide an array of financial services that vary from provider to provider

    Planning, Buy and Sell & Provide Advice

Sell life, health and property insurance policies, and other insurance products, including annuities.

ROLE

Agent – legally obligated to act on behalf of the company; contractually, must provide that company's products before others. There is no obligation for transparency or disclosure yet monetary incentives often exist to recommend a particular product type or design.

Broker – Acts on behalf of client in obtaining most competitive product. In reality, many who hold themselves out as brokers are actually simply agents for multiple carriers. This is especially true in life insurance. Varying commission structures may create incentive to recommend certain carriers or to structure products in a specific manner. As with the agent, no transparency or disclosure is required.

Registered Representative – because variable life is considered both insurance and a security, they require a higher level of disclosure, whether sold through an agent or broker. Product details are outlined in a prospectus as required by the Securities and Exchange Commission (SEC).

Fiduciary – is legally obligated to represent the client and act in their best interest. As such, a fiduciary must provide full transparency and disclosure regarding advantages, disadvantages and risks of products, structure, cost minimization alternatives, conflicts of interest and compensation. Thus, the fiduciary, in essence, becomes the client's professional buyer and advocate.

REGISTERED FINANCIAL PROFESSIONALS

Buy and sell securities for their customers, including individual investors. They are regulated by FINRA and the SEC.

There are various types of investment professionals. And the products and services each type can—or cannot—provide will depend on the license(s) and training the person or firm has.

What they are: A broker-dealer firm is in the business of buying and selling securities—stocks, bonds, mutual funds, and certain other investment products—on behalf of its customers (as broker), for its own account (as dealer), or both. The registered financial professionals who work for broker-dealers—the sales personnel whom some people refer to as stockbrokers—are technically known as registered representatives.

Who regulates them: With few exceptions, broker-dealer firms must register with the Securities and Exchange Commission (SEC) and be members of FINRA. Individual registered representatives, or registered financial professionals, must register with FINRA, pass a qualifying examination, and be licensed by your state securities regulator before they can do business with you. You can obtain background information on broker-dealer firms and their registered financial professionals—including registration, licensing, and disciplinary history—by using FINRA BrokerCheck or calling us toll-free (800) 289-9999. You can also contact your state securities regulator. To find your regulator, check the government listing of your phone book or contact the North American Securities Administrators Association at www.nasaa.org or (202) 737-0900.

What they offer: Broker-dealer firms vary widely in the types of services they offer, falling generally into two categories—full-service and discount firms. Full-service firms typically charge more for each transaction, but they tend to have large research operations that their registered financial professionals can tap into when making recommendations, can handle nearly any kind of financial transaction you want to make, and may offer investment planning or other services. Discount broker-dealer firms are

usually cheaper, but you may have to research potential investments on your own—though the firm websites may have a lot of information you can use. The products registered financial professionals can sell you depend on the licenses they hold. For example, a registered financial professional who has passed the Series 6 exam can sell only mutual funds, variable annuities, and similar products, while the holder of a Series 7 license can sell a broader array of securities. When a registered financial professional suggests that you buy or sell a particular security, he or she must have reason to believe that the recommendation is in your best interest based on a host of factors, including your income, portfolio, and overall financial situation, your tolerance for risk, and your stated investment objectives.

INVESTMENT ADVISERS

Provide advice about securities tailored to the needs of their clients. They are regulated by the SEC or state securities regulators.

Although most people would use an "o," we purposely spell adviser with an "e" when we talk about investment advisers. That's because the laws that govern this type of investment professional spell the title this way.

What they are: An investment adviser is an individual or company who is paid for providing advice about securities to their clients. Although the terms sound similar, investment advisers are not the same as financial advisors and should not be confused. The term financial advisor is a generic term that usually refers to a broker (or, to use the technical term, a registered representative). By contrast, the term investment adviser is a legal term that refers to an individual or company that is registered as such with either the Securities and Exchange Commission or a state securities regulator. Common names for investment advisers include asset managers, investment counselors, investment managers, portfolio managers, and wealth managers. Investment adviser representatives are individuals who work for and give advice on behalf of registered investment advisers.

Who regulates them: The SEC regulates investment advisers who manage $110 million or more in client assets, while state securities regulators have jurisdiction over advisers who manage up to $100 million. Advisers with less than $100 million in assets under management (AUM) must register with the state regulator for the state where the adviser has its principal place of business. When a state-registered adviser's AUM reach the $100 million threshold, the adviser may elect to register with the SEC—but when the adviser's AUM exceeds $110 million, it generally must register with the SEC. It is important to find out exactly which services a professional who wears multiple hats will provide for you and what they will charge for their services. You can get background information on both SEC- and state-registered investment advisers by using FINRA BrokerCheck or calling us toll-free (800) 289-9999.

You can also get background information by visiting the SEC's Investment Adviser Public Disclosure database.

What they offer: In addition to providing individually tailored investment advice, some investment advisers manage investment portfolios. Others may offer financial planning services or, if they are properly licensed, brokerage services (such as buying or selling stock or bonds)—or some combination of all these services.

FINANCIAL PLANNERS

Provide an array of financial services that vary from provider to provider. Regulation and licensing depends on the services offered.

What they are: Financial planners can come from a variety of backgrounds and offer a variety of services. They could be brokers or investment advisers, insurance agents or practicing accountants—or they have no financial credentials at all. Some will examine your entire financial picture and help you develop a detailed plan for achieving your financial goals. Others, however, will recommend only the products they sell, which may give you a limited range of choices.

Who regulates them: Unlike other professions discussed in this chapter, the financial planning profession does not have its own regulator. Instead, individuals who call themselves financial planners may be regulated in relation to other services they provide. For example, an accountant who prepares financial plans would be regulated by the state Board of Accountancy, and a financial planner who is also an investment adviser would be regulated by the Securities and Exchange Commission or by the state where the advisor does business. If a planner you're considering uses a particular professional credential, be sure to check out that credential using our Professional Designations lookup tool. Some financial planners might use designations that require little experience, study or continuing education—or which lack processes for verifying the person actually holds the credential or for filing complaints. Other planners might hold a credential that is far more difficult to get and to keep, such as the Certified Financial Planner® designation, or CFP®, issued by the Certified Financial Planner Board of Standards. This designation requires at least three years of experience, imposes fairly rigorous standards to earn and maintain, allows investors to verify the status of anyone claiming to be a CFP and has a disciplinary process. But be aware that a designation alone is not the only criteria by which to base your financial planner selection.

What they offer: The breadth and depth of services a financial planner offers will vary from provider to provider. Some create comprehensive plans that delve into every aspect of your financial life, including

savings, investments, insurance, college savings, retirement, taxes and estate planning. Others have a more limited focus, such as insurance or securities. Some only prepare plans, while others also sell investments, insurance, or other products. If they sell products, their recommendations typically will correspond with the products or services they sell. For example, an insurance agent will tell you about insurance products (such as life insurance and annuities) but likely won't discuss other investment choices (such as stocks, bonds or mutual funds). You'll want to make certain you fully understand which areas of your financial life a particular planner can—and cannot—help with before you hire that person.

INSURANCE AGENTS

Sell life, health and property insurance policies, and other insurance products, including annuities. They are regulated by state insurance commissions. Some insurance products, like variable annuities, are securities under federal law. Others, like fixed- or fixed-indexed annuities, are not.

What they are: An insurance agent is a salesperson who can help individuals and companies obtain life, health or property insurance policies and other insurance products including different types of annuities.

Who regulates them: Every state, along with the District of Columbia and U.S. territories, has an insurance commission that licenses the insurance agents and insurance companies who do business in that jurisdiction. State insurance commissions also impose sales and marketing rules and require companies to file financial reports to assess their ability to honor claims. You can contact your state insurance commissioner by visiting the website of the National Association of Insurance Commissioners (NAIC) at www.naic.org. NAIC also offers a database of financial and disciplinary information for insurance companies nationwide. If an insurance agent offers products that are considered securities—such as variable annuity contracts or variable life insurance policies—the agent must also be licensed as a registered representative and comply with FINRA rules.

What they offer: Insurance agents described as "captive" work exclusively for one insurance company and can sell only the policies and products that company offers. Independent insurance agents can represent multiple companies and typically try to find insurance policies that offer the best coverage for your circumstances.

FEE APPROACHES

How Are Fiduciary Financial Advisors Paid?

Financial advisors may be paid on commission, with fees or through a combination of the two. When you hire a new financial advisor, it's important to ask if they are a fiduciary and how they make their money. This helps you gauge for yourself any potential conflicts of interest. Advisors are commonly paid in the following ways:

Commission-Only Financial Advisors

Commission-only advisors only make money when they sell investments or a particular financial product. Often, commission-only financial advisors are employed by broker-dealers and are only held to a suitability standard. Make sure a commission-only financial advisor is a fiduciary or that you fully understand the products and fees being sold to you before doing business with them.

Fee-Only Financial Advisors

Fee-only advisors only make money from client fees. These might come as flat or hourly fees or as a percentage of all of the assets they manage for you. They do not earn commissions on investments, nor do they get a fee when you buy or trade securities. Because of this, fee-only financial advisors generally have fewer conflicts of interest than other advisors, and they still must disclose any conflicts they do have. Fee-only financial advisors are almost always fiduciaries.

Fee-Based Financial Advisors

Fee-based advisors may have fees like fee-only financial advisors, but they also may earn money from commissions or referral fees, like commission-only advisors. If you choose a fee-based advisor, you want to make sure they are always acting as a fiduciary. Some fee-based advisors may not act as a fiduciary when they perform certain tasks. It's important to note that just because an advisor receives a

commission for a product, that doesn’t necessarily mean it’s not in your best interest. Certain products, like life insurance, may only be sold with a commission-based model, says Karen Van Voorhis, a certified financial planner and Director of Financial Planning at Daniel J. Galli & Associates in Norwell, Mass.

Many financial advising professionals advocate for people to use fee-based and fee-only advisors. That’s because someone who you are paying a fee to, instead of someone being paid a commission by a company, may prioritize your financial wellness more than someone who will make money regardless of if you return to them in the future.

Managed (AUM-based)
- RIA
- SMA
- Negotiable
- Fee easy to track
- Fiduciary Standard

Brokered
- 12(b)(1)
- Good for buy and hold
- “Bond bunker”
- Low basis stocks
- Suitability Standard

Standards

Suitability

Suitability obligations are critical to ensuring investor protection and promoting fair dealings with customers and ethical sales practices. FINRA Rule 2111 governs general suitability obligations, while certain securities are covered under other rules that may contain additional requirements.

FINRA Rule 2111 requires that a firm or associated person have a *reasonable basis* to believe *a recommended* transaction or investment strategy involving a security or securities *is suitable* for the customer. This is based on the information obtained through reasonable diligence of the firm or associated person to ascertain the customer's investment profile.

The rule states that the customer's investment profile "includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs [and] risk tolerance," among other information. A broker's "recommendation," which is based on the facts and circumstances of a particular case, is the triggering event for application of the rule.

Brokers must have a firm understanding of both the product and the customer, according to Rule 2111. The lack of such an understanding itself violates the suitability rule.

Suitability Obligations

Rule 2111 lists the three main suitability obligations for firms and associated persons**.**

Reasonable-basis suitability requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. Reasonable diligence must provide the firm or associated person with an understanding of the potential risks and rewards of the recommended security or strategy.

Customer-specific suitability requires that a broker, based on a particular customer's investment profile, has a reasonable basis to believe that the recommendation is suitable for that customer. The broker must attempt to obtain and analyze a broad array of customer-specific factors to support this determination.

Quantitative suitability requires a broker with actual or de facto control over a customer's account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, is not excessive and unsuitable for the customer when taken together in light of the customer's investment profile.

FINRA RULES 2000. DUTIES AND CONFLICTS 2090. Know Your Customer

Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.

.01 Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.

REG BI

On June 5, 2019, the Securities and Exchange Commission (“SEC”) adopted Regulation Best Interest, which establishes a new standard of conduct under the Securities Exchange Act of 1934 (“Exchange Act”) for broker-dealers and natural persons who are associated persons of a broker-dealer (“associated persons”) (unless otherwise indicated, together referred to as “broker-dealer” or “you”) when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer.

“When making such a recommendation to a retail customer, you must act in the best interest of the retail customer at the time the recommendation is made, without placing your financial or other interest ahead of the retail customer’s interests.”

This ***general obligation*** is satisfied only if you comply with four specified ***component obligations*****:**

Reg BI Broker Requirements*

- Disclosure Obligation: Provide certain prescribed disclosure before or at the time of the recommendation, about the recommendation and the relationship between the retail customer and the broker-dealer.

- Care Obligation: Exercise reasonable diligence, care, and skill in making the recommendation.

- Conflict of Interest Obligation: Establish, maintain, and enforce policies and procedures reasonably designed to address conflicts of interest.

- Compliance Obligation: Establish, maintain and enforce policies and procedures reasonably designed to achieve compliance with Reg BI.

Ensuring Client Cooperation

To fulfill your **Duty Of Care** obligation under Reg BI, you need *comprehensive information* about your retail clients' entire investment profiles, including the types of accounts they own. If a client withholds relevant information about accounts and investments held away, it may be nearly impossible for you to make thoughtful "best interest" investment and account type recommendations.

Under Reg BI, you are required to assess the client's

- investment risk tolerance,
- objectives,
- time horizon,
- longevity,
- investment experience, and
- history as an investor.

Record complete, accurate data as evidence that you have considered all key factors, to put the client's best interests first. This is required by investment firms and FINRA

* Use FINRA Reg BI & Form CRS Firm Checklists.

Reg BI vs IA Fiduciary Duty Standard

The SEC's Regulation Best Interest (Reg BI) standard of conduct **enhances the existing suitability standard** for broker-dealers, when making investment recommendations. Whether a retail investor chooses a broker, an investment advisor (IA), or a hybrid broker/IA*, the client is entitled to a recommendation that is given in his/her best interest, and does not place the firm's or financial professional's interests ahead of the investor*.

A key difference between Reg BI and the IA Fiduciary Standard is that the IA's responsibilities include providing ***ongoing*** advice and portfolio monitoring over the course of the relationship. In the Advisers Act, this is referred to as a "**duty of care and a duty of loyalty**" in the context of broad investment portfolio management. Brokers do not have a duty of loyalty; instead, they must act in the retail client's best interest at the time a transaction-specific recommendation is made.

Reg BI also prohibits brokers who do not also carry a FINRA Series 65 or 66 from referring to themselves as "financial advisers"; instead they are "financial professionals." IAs may refer to themselves as "financial advisers."

Fiduciary Duty

A Registered Investment Adviser’s (RIA) and its Investment Adviser Representatives’ (IARs) obligations as fiduciaries are quite extensive. Even seasoned Investment Advisers may not fully understand their fiduciary obligations.

Fiduciary duty encompasses 7more than just the duty to be honest and avoid negligence. Advisers also owe an affirmative duty of loyalty, which means RIAs and IARs must always put their clients’ interests ahead of their own.

The fiduciary duty owed by RIAs and IARs includes all of the following obligations:

- Duty to give advice that is completely disinterested;
- Duty to provide thorough written disclosures of potential or actual conflicts of interest in the RIA’s Form ADV Part 2 Brochure and Form CRS (if SEC Registered), along with the IAR’s Form ADV Part 2B Supplement and the firm’s advisory agreement;
- Duty to maintain strict confidentiality; and
- Duty to refrain from engaging in fraud and other misconduct.

The obligation to recommend suitable investments is just one element of an adviser’s fiduciary duty.

Investment advisers owe their clients a fiduciary duty to act with loyalty, fairness, and good faith.

RIAs and IARs owe a duty to obtain best execution of clients’ securities transactions, provided they recommend the broker-dealer to be used. Advisers must disclose any outside business activities that might create a conflict of interest. If an RIA agrees to vote proxies for clients, it must always act in their best interest when making those voting decisions.

As the threat from cyber-attacks increases, RIAs owe a fiduciary duty to implement a cybersecurity plan to guard against those risks. Advisers must also implement comprehensive business continuity plans to protect clients from harm if an event occurs that will disrupt the RIA’s services, either temporarily or

permanently. Succession planning is one strategy to keep the firm operational if a key member of the RIA dies or becomes incapacitated.

An adviser's duty of loyalty requires an RIA to eliminate, if possible, or make full and fair disclosure of all conflicts of interest that might cause the IAR to offer advice that is not disinterested. If an adviser does not make full disclosure, the client is not capable of giving informed consent to the conflicts of interest.

Disclosures must be sufficiently specific, so clients are able to understand the material conflict of interest. Disclosing that an adviser "may" have a specific conflict of interest, which already exists, is not sufficient. Using the word "may" could be appropriate to disclose a potential conflict that does not currently exist, but that might reasonably be expected to arise at some point.

The Interpretation makes it clear that an adviser's duty of care includes the:

- Duty to provide advice that is in the client's best interest;
- Duty to seek best execution; and the
- Duty to monitor the account throughout the relationship.

The duty of care also applies to an RIA's engagement of a sub-adviser. Additionally, an adviser's fiduciary duty may extend to recommendations it makes regarding insurance products. IARs may not take off their fiduciary hat when they recommend insurance products.

The duty of care requires advisers to provide advice and monitoring in a manner that is consistent with the agreed upon advisory relationship. Advisers can in a written agreement limit the duration of the investment advisory services provided or state how frequently the account will be monitored. Although the federal fiduciary duty cannot be waived entirely, RIAs and clients can alter the adviser-client relationship, as long as there is full and fair disclosure and informed consent.

Components of the Federal Fiduciary Duty under the Advisers Act

The Advisers Act establishes a federal fiduciary duty for investment advisers, made enforceable by the Act's antifraud provisions. That duty does not explicitly appear in the language of the statute and has never been defined by rule. It exists only in a series of court and SEC cases and statements.

Duty of Care

The duty of care includes:

(i) the duty to provide advice that is in the best interest of the client,
(ii) the duty to seek best execution of a client's transactions where the adviser is responsible for selecting broker-dealers to execute client trades, and
(iii) the duty to provide advice and monitoring throughout the relationship.

The duty of care requires an adviser to make a reasonable inquiry into its clients' objectives and to have a reasonable belief that the advice it provides is in the best interest of the client based on those objectives.

Duty of Loyalty

The duty of loyalty requires that an adviser not subordinate its clients' interests to its own. To fulfill its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship, including the capacity in which the firm is acting with respect to the advice provided. Additionally, an adviser must eliminate or expose through disclosure all conflicts of interest that might incline the adviser to render advice that is not disinterested.

Disclosures must be considered in light of all the facts

Whether disclosure is full and fair depends on, among other things, the nature of the client, the scope of the services, and the client's ability to understand any material fact or conflict. Full and fair disclosure for

an institutional client can differ significantly from full and fair disclosure for a retail client because the former generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications. Nevertheless, disclosures must be clear and detailed enough for every client, regardless of its nature, to make an informed decision to consent to the conflict or reject it. For retail clients in particular, the Release acknowledges that it may be difficult to provide disclosure regarding complex or extensive conflicts that is both sufficiently specific and understandable. In these cases where an investment adviser cannot fully and fairly disclose a conflict to a client such that the client can provide informed consent, advisers are instructed to eliminate the conflict or adequately mitigate the conflict such that full and fair disclosure and informed consent are possible.

"**Putting the client first" versus "not subordinating the client interest"**

The SEC's initial draft interpretation, which proposed to interpret that the law "requires an investment adviser to put its client's interests first." The Final Interpretation states: an investment adviser must "not subordinate its clients' interest to its own."

Fiduciary duty varies depending on the client

What constitutes a reasonable understanding of a client's investment profile varies depending on the client

The duty of care includes not only a duty to provide investment advice that is in the best interest of the client, but also a duty to provide investment advice that is suitable for the client. To provide such advice, an adviser must have a reasonable understanding of the client's investment objectives and the Release acknowledges that how an adviser develops such a reasonable understanding differs between retail investors and institutional investors. The basis for such a reasonable understanding generally would include, for retail clients, an understanding of the investment profile, or for institutional clients, an understanding of the investment mandate. For retail clients, the Release suggests an adviser should, at a minimum, make a reasonable inquiry into the client's financial situation, level of financial

sophistication, investment experience and financial goals – what is commonly called, in sum, the client's investment profile. Additionally, it generally will be necessary for an adviser to a retail client to update the client's investment profile in order to maintain a reasonable understanding of the client's investment objectives and adjust the advice to any changed circumstances.

By contrast, the nature and extent of the reasonable inquiry into an institutional client's objectives generally is shaped by the specific investment mandates from those clients. The Release provides that an adviser engaged to advise on a particular portfolio of an institutional client would need to gain a reasonable understanding of the client's objective within that portfolio, but not the client's objectives within its entire investment portfolio.

There's no waiving away the Fiduciary Duty

An adviser's fiduciary duty is principles-based, applies to the entire relationship between the adviser and its client, and follows the contours of the relationship—so that the adviser and its client may shape the relationship by agreement, provided there is full and fair disclosure and informed consent. The Release opines that this principles-based fiduciary duty has provided sufficient flexibility to serve as an effective standard of conduct for advisers, regardless of the clients they serve. Although the scope of the fiduciary duty will vary with the scope of the relationship, it may not be waived. Rather, it will apply in a manner that reflects the agreed-upon scope of the relationship. An agreement to waive an adviser's federal fiduciary duty generally, such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts, or (iii) a waiver of any specific obligation under the Advisers Act, would be inconsistent with the Advisers Act, regardless of the sophistication of the client. This is perhaps uncontroversial; but one can imagine many specific types of waivers that will be accepted as appropriate between clients and their adviser, and this language presents at least the possibility of second-guessing.

COMPLIANCE LIBRARY DOCUMENTATION
Show that Trustee/Fiduciary fulfills duties (Job Description).

Job description comes from statute. This reduces risk for Trustee Fiduciary.

INVESTMENT GOVERNANCE IN PRACTICE

- Return Objectives – Financial Plan/Investment Policy Statement/
- Risk Expectations – Risk analysis
- Diversification - Analysis
- Fees – Advisory/Brokerage
- Monitoring / Benchmarking – WBI CY

COMPLIANCE LIBRARY

- Return Objective: Targeted Rate of Return - Duty to establish return expectations
- Distribution: Targeted Distribution Rate – to manage consistence with trust purpose
- Risk (SD): Risk expectancy - to manage risk expectations to be reasonable with return objectives
- Bear Market Plan: Things go badly - What are you going to do when bad performance
- Safe Holding Ratio: If bad performance - how long can you continue performing purpose under bad circumstances
- Performance: Reporting requirements - How will it be reported to compare past performance to current performance
- Diversification: May delegate to a professional but must still supervise and monitor adherence –
    - Security, Sector, Asset Class
- Alts: (Clearly define what types & % and expected performance and how measure)
- Fee: Want to be average
- Selection of Investment Professional: Qualifications and Background
- Benchmarks: Risk vs Return and acceptable range

RETURN OBJECTIVE
(Goals – Financial Plan/Investment Policy Statement/Trust or Plan Document)

(Financial Planning Software)

Solve for the return that is needed to accomplish the financial objectives (create the portfolio “pro forma”):

- PV – Corpus
- N – Time Horizon
- PMT - Contribution / Distribution Rate
- FV – Terminal Value

SOLVE FOR RETURN

RISK EXPECTATIONS

(Risk Analysis)

RISK ASSESSMENTS - How much risk do you want?
Eliminate the stereotypes that have made risk tolerance useless. Use leading scientific theory to objectively pinpoint an investor's Risk Number. Simple or detailed. Across the room or across the world.

PORTFOLIO ANALYSIS - How much risk do you have in your portfolio?
Does your risk tolerance correlate with your investments? A portfolio-wide Risk Number and 95% Probability Range enable you to make investment decisions and demonstrate alignment.

PROBABILITY MAPS - How much risk do you need to reach your goals?

Measurement of Risk Via Price Fluctuation

- Standard deviation
- Risk adjusted return (Sharpe Ratio)
- Value at Risk (prospective estimate)
- Max Drawdown (retrospective)

Sources of risk that cause price fluctuation

- Leverage
- Difficult Valuation
- Concentration (Lack of Diversification)
- Limited Liquidity

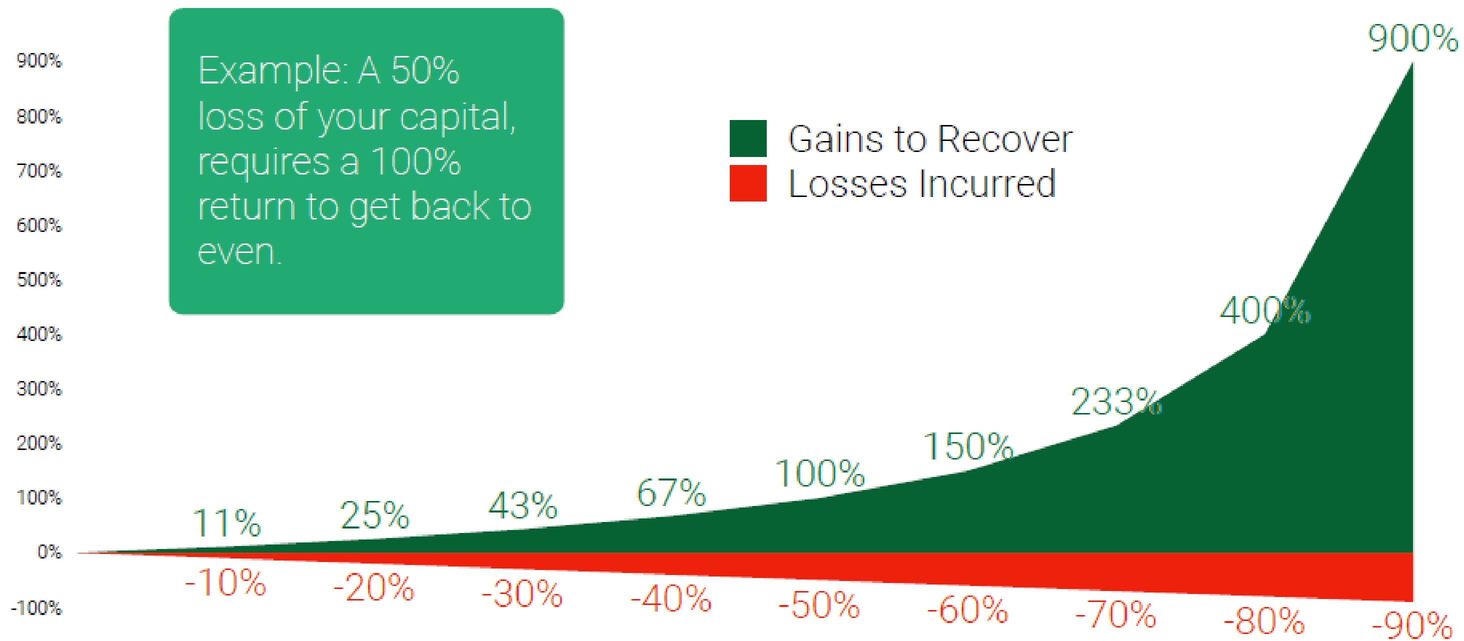
Risk Capacity - The alignment of Risk Tolerance and Portfolio Risk only goes so far. You have to build portfolio capable of achieving goals.

Buy & Hold - Does it Work?
During a Bull Market investing looks easy. What happens when it is not a Bull Market?
Buy & Hold investors bail & fail.
The average investor

- Fails to capture the market's return through traditional approaches and
- Large losses drive them out of markets.

Is there a better way?

BEAR MARKET CONTINGENCY



DOT-COM CRASH
9/2/2000 - 10/9/2002

-47.41%	768
Max Drawdown	# of Days Peak to Trough
10/23/2006	1,475
Recovery Date	# of Days to Recover

FINANCIAL CRISIS
10/10/2007 - 3/9/2009

-55.25%	517
Max Drawdown	# of Days Peak to Trough
4/2/2012	1,120
Recovery Date	# of Days to Recover

Source: Morningstar, 2020. Total Return, Daily.
Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly.

Annual returns can trick investors into thinking that published returns are consistently achieved, when they are not. Focus on the sequence of returns - gains AND losses.

Manager A- 33% Average Return

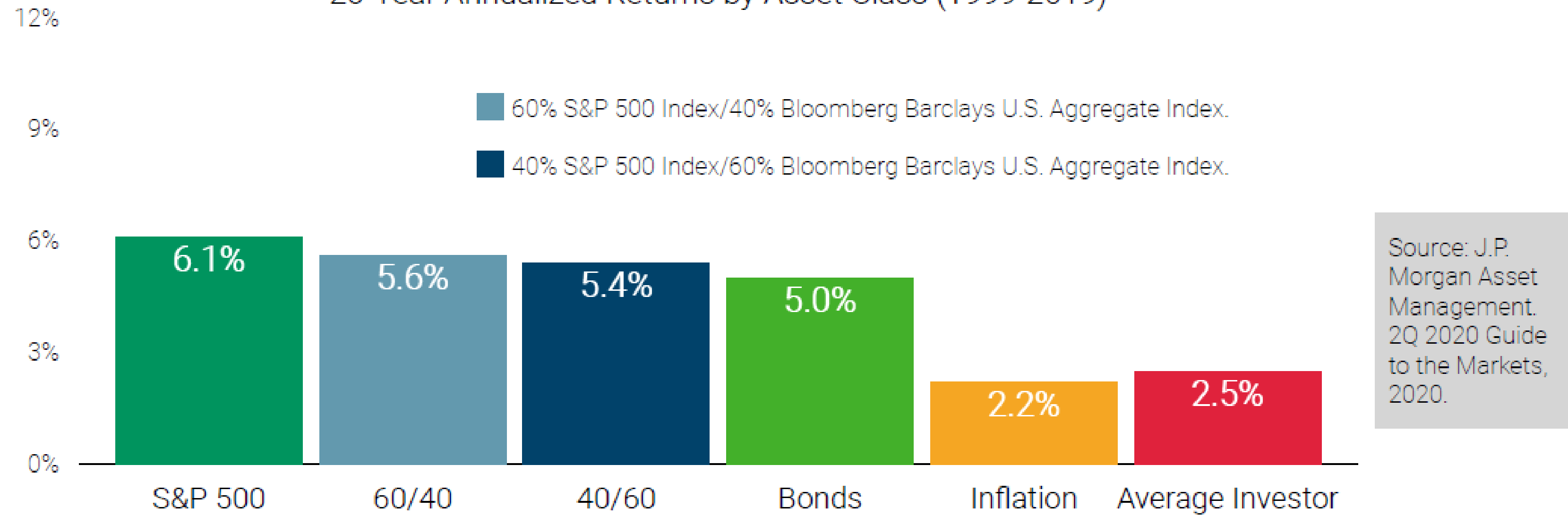
	Starting Value	Rate of Return	Ending Value
Year 1	$1,000,000	**99%**	$1,990,000
Year 2	$1,990,000	**-99%**	$19,900
Year 3	$19,900	**99%**	**$36,600**

Manager B- 5% Average Return

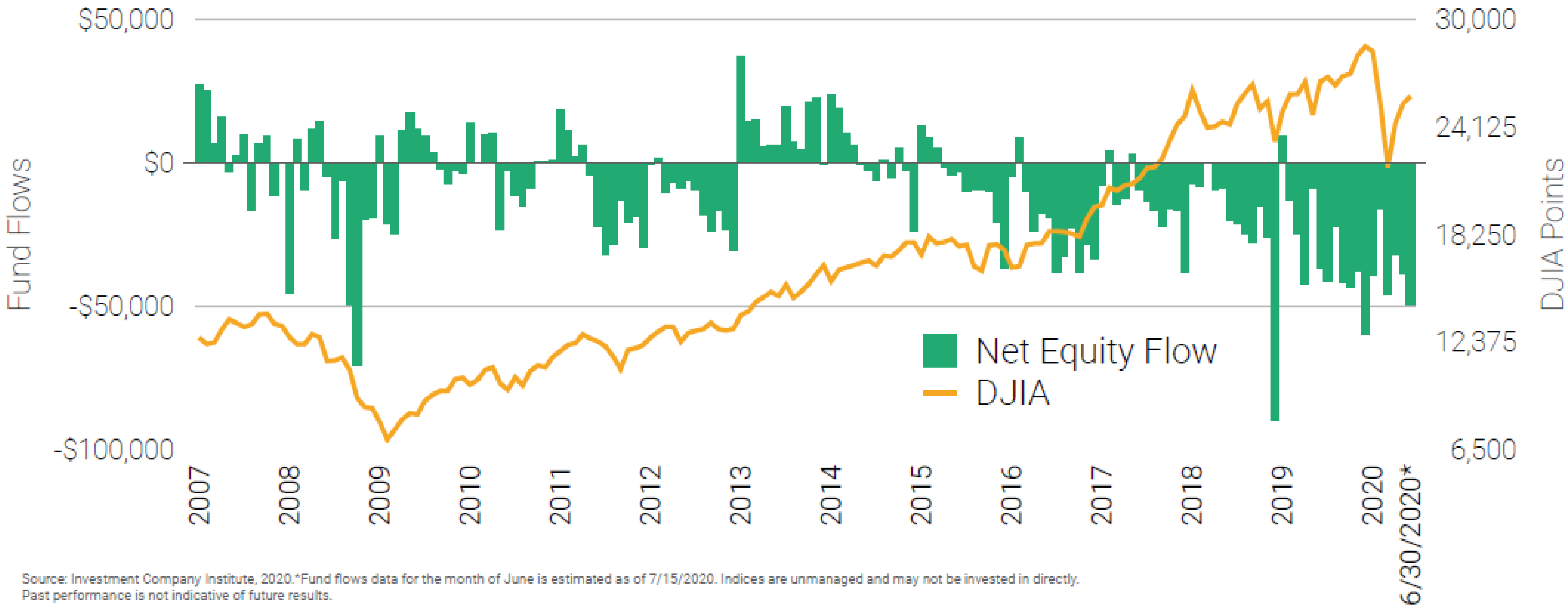
	Starting Value	Rate of Return	Ending Valu
Year 1	$1,000,000	**15%**	$1,150,000
Year 2	$1,150,000	**-15%**	$977,500
Year 3	$977,500	**15%**	**$1,124,125**

Source: WBI. Indices are unmanaged and may not be invested in directly. For illustrative purposes only.
Past performance is not indicative of future results.

20-Year Annualized Returns by Asset Class (1999-2019)



Indices are unmanaged and may not be invested in directly. Past performance is not indicative of future results.
Average investor return provided by J.P. Morgan based on analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior.



Source: Investment Company Institute, 2020.*Fund flows data for the month of June is estimated as of 7/15/2020. Indices are unmanaged and may not be invested in directly.
Past performance is not indicative of future results.

PERFORMANCE CALCULATION

Common Problems:

- No performance data is available
- No “Since Inception” Data
- Non-Standard Time Periods (Feb 2017 - Feb 2018)
- No Risk Data
- IRR, not Time-Weighted Return
- Return Before Fee

Establish the dollar loss you are willing to take in pursuit of your goals and establish your required rate of return based on investable assets, income, qualified plans, and government benefits, as well as retirement income need. Inflation assumptions are integrated to help ensure investors do not outlive their income streams. Then sift through thousands of managers and strategies to construct a portfolio that seeks to achieve the highest risk-adjusted return possible at the level of loss the client is willing to tolerate with the goal to increase investment success by reducing risk to capital and growing capital balances to fund your lifestyle in retirement.

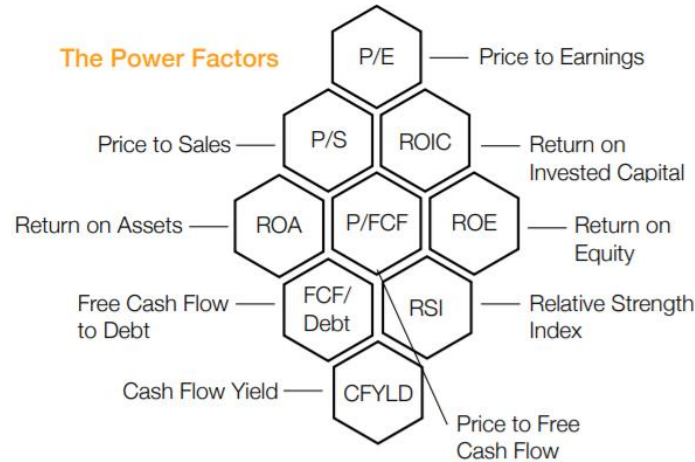
BUY DISCIPLINE

POWER FACTOR SECURITY SELECTION

Screening Criteria

- Quality fundamentals and high dividend yields, or "power factors"
- Reasonable value
- Positive revenue and earnings trends
- Positive price momentum

The Power Factors

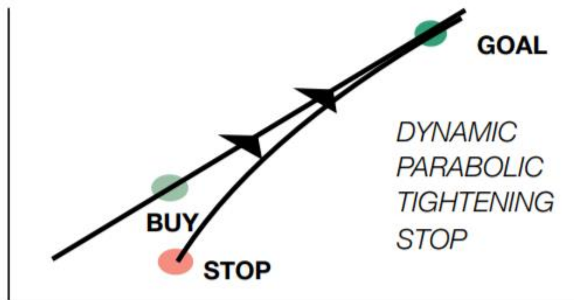


BOND MODEL

- Produces weekly signals targeting the best credit opportunities and the most effective duration for fixed income holdings
- Models evaluate U.S. High Yield Bonds, U.S. Investment Grade Corporate Bonds, and U.S. Treasuries
- Macroeconomic factors evaluated include:
  - interest rates
  - credit spreads
  - valuation
  - momentum
  - technical market indicators in fixed income, equity and commodity markets

SELL DISCIPLINE

DYNAMIC TRAILING STOP



- Our risk management system applies a goal and a proprietary dynamic trailing stop to each invested position
- As a security appreciates towards the goal, the stop tightens in an effort to reduce risk and systematically harvest gains
- The stop process is internally managed, it is not a conventional market or limit order stop placed with a brokerage firm

DIVERSIFICATION

- Security level diversification
- Too few securities (firm-specific risk)
- “Grandpa’s bank stock”
- Sector level diversification
- Lots of securities all in… [tech], [2nd TD]...
- The unfortunate case of Herbert Brede
- Asset class diversification
- Holding assets that have low correlation

DIVERSIFICATION & "ALTs"

What is an "Alt?"

- Hedge Fund
- Private Equity Fund
- MLP
- Structured Note
- Buffered Beta
- Commodity SMA
- Liquid Alt
- REIT

Questions to Ask

- Lock Up?
- Fee?
- Conflicts of Int?
- Expected Return
- Expected Risk
- Corr. to S&P
- Benchmark

Financial Professionals Operating from MA or Financial Professionals Servicing Clients/Prospects in MA

Recommendations in a Best Interest World – Massachusetts

NEW REQUIREMENTS EFFECTIVE 9/1/2020

Overview

The Massachusetts Securities Division ("MSD") is the first state regulator to adopt a rule to hold broker-dealers and their representatives to a fiduciary standard when making recommendations to their customers (the "MA Rule"). To meet this fiduciary duty, broker-dealers and their agents must adhere to duties of utmost care and loyalty to the customer. These new standards do not apply to investment advisory business in Massachusetts. The MA Rule becomes effective on September 1, 2020.

Comparison of Reg BI and MA Fiduciary Rule

Reg BI provides that a broker-dealer and financial professional "...act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interest of the retail customer." Reg BI also requires that the broker-dealer identify and at a minimum disclose or eliminate, all conflicts of interest associated with such recommendations.

The MA Rule provides that a broker-dealer make recommendations and provide investment advice "without regard to" the financial or any other interest of any party other than the customer or client. The MA Rule also requires the broker-dealer "Make all reasonably practicable efforts to avoid conflicts of interest, eliminate conflicts that cannot be avoided, and mitigate conflicts that cannot be avoided or eliminated."

The Fiduciary Rule applies to all Broker-Dealers (BD) and Financial Professionals (FP) conducting securities business into and/or from Massachusetts. This means that any BD or FP with an office in Massachusetts or any BD or FP who does business with a client located in Massachusetts will be subject to the MA Rule.

Updates to Firm Policy

Effective September 1, 2020 the firm will require the same duty of loyalty and care requirements as those under Reg BI for commission accounts for ALL customers where either of the following conditions exist:

- The customer is a resident of or is domiciled in the state of Massachusetts
- The financial professional is conducting business in the state of Massachusetts with a customer outside of the state

"ALL customers" includes the following Prospect and Client Types: Persons, Estate, Trust, Entity and Corporate Retirement Plan (CRP).

Duty of Loyalty

The duty of loyalty requirement must be satisfied by providing the BD Form CRS and BD Firm Brochure

Duty of Care

The duty of care requirement must be documented using one or more of the following methods:

- Duty of Care New Account Addendum for all new accounts
- Product Suitability Packet for Variable Annuities and Alternative Investments
- Duty of Care Worksheet for certain transactions and services in existing accounts
- Rollover Transfer Disclosure Form; and if applicable pre-approval of the rollover – only applies to a natural person
- Contemporaneous documentation for recommendations not subject to above

For specific guidance on the application of the above requirements, please refer to the Duty of Care Requirements Grid for MA Fiduciary Rule.

N.Y. Supreme Court Overturns Sales Regulations on Annuities and Insurance

APRIL 29, 2021 • TRACEY LONGO

Insurance agents and advisors in the state of New York won a monumental lawsuit today to overturn the state's best interest sales standard governing the sales of annuities and life insurance on the grounds that the standard was unconstitutional.

The New York Supreme Court Appellate Division reversed a 2019 ruling affirming that the New York State Department of Financial Services was within its authority when it issued Regulation 187, which permits agents or brokers to make a recommendation only if they believe the sale is in the consumer's best interest.

Agents and advisors have experienced unreasonable difficulty attempting to comply with regulation requirements that are often "subjective," the court ruled, echoing the arguments of the lead plaintiffs in the case, the Independent Insurance Agents and Brokers of New York and the National Association of Insurance and Financial Advisors—New York, which sued to overturn the regulation.

"Once a recommendation is deemed to have been made, the guidelines with respect to the suitability information that producers must obtain from the consumer and the suitability considerations that must necessarily be disclosed are inadequate to the extent that they rely upon subjective terms that lack long-recognized and accepted meanings and provide insufficient guidance with respect to how producers must conduct themselves in order to comply with the amendment," the ruling said.

Since early in the 20th Century, New York has traditionally imposed some of the nation's most stringest regulations on insurance sales. Many life insurers have created separate policies with more explicit consumer disclosures to do business in the state.

"Our members have tried mightily to comply with the regulation, but, as the court found, it has been extremely difficult to meet the vague and subjective standards of the rule," said Marc Cadin, the CEO of

Finseca, an advocacy group for securities professionals, in a statement. “We look forward to continuing to serve the insurance-buying public with the best service to meet their financial needs, and we will continue to work with the Department of Financial Services to ensure we are best protecting New York consumers.”

Regulation 187, which is similar to the U.S. Department of Labor’s fiduciary standard, took effect in 2019, when state regulators sidestepped the National Association of Insurance Commissioners' efforts to create a model standard for annuity and life insurance sales.

The insurance agent trade groups argued that the rule is “unreasonable, arbitrary and capricious and lacks a rational basis” and it is unconstitutionally vague.

According to the court decision: "While the consumer protection goals underlying promulgation of the amendment are laudable, as written, the amendment fails to provide sufficient concrete, practical guidance for producers to know whether their conduct, on a day-to-day basis, comports with the amendment's corresponding requirements for making recommendations and compiling and evaluating the relevant suitability information of the consumer.”

According to Jason Berkowitz, chief legal and regulatory affairs officer of the Insured Retirement Institute: “Today’s New York appellate court decision is important, but it may not be the final step in the legal process, as the decision may be appealed to the New York Court of Appeals. [The Insured Retirement Institute] continues to advocate for uniform adoption of the National Association of Insurance Commissioners’ best interest model regulation by all states to avoid a patchwork of conflicting standard-of-conduct regulations for annuity sales.”

The state’s Department of Financial Services said it is currently reviewing the decision. The department “continues to believe in the consumer protective notion that insurance agents and brokers must not put their own profits above the needs of the consumers who turn to them for advice,” said a spokeswoman

for the department in a statement. “This is the heart of the regulation. We are reviewing the decision and will consider our appellate rights.”

The New York rule imposed a number of requirements on agents and insurance and annuity companies:

- It required a recommendation to be in the best interest of a consumer by furthering the consumer’s needs and objectives and that it be made “without regard to the financial or other interests of the producer, insurer or any other party.”
- It required the disclosure of all suitability considerations and product information that formed the basis of any recommendation.
- It permitted agents or advisors to make a recommendation only if they had a "reasonable basis to believe that the consumer can meet the financial obligations under the policy."
- It prohibited an agent or broker from telling a consumer that a recommendation was part of their financial planning, investment advice or related services (unless the agent or broker was a certified professional in that area).
- It required insurers to "establish and maintain procedures to prevent financial exploitation and abuse."

The proposal did not apply to sales of mutual funds or other securities, unless these were related to annuity or life insurance products. Life insurance policies and contracts used to fund qualified retirement plans, ERISA plans and employer-sponsored IRAs were also exempted from the rule by New York.

CASE STUDIES

SUMMARY

There are many different laws and regulations relating to investment service providers. They vary depending on the type of services provided and the manner in which those services are provided. Regardless of the specific statute or regulation imposing the duty there is one underlying concept that runs throughout them all – Put the Client's best interest first when making decisions. In order to prove that you are complying with this golden rule you must document each step and keep it current. You can delegate some tasks, but the duty to monitor and ultimately both the responsibility and liability remain. An Investment Policy Statement is only the first step. Acknowledge risks and address them. There are no right or wrong answers. The best you can hope to do is minimize the potential for bad outcomes by limiting losses when possible. Create a compliance library, update it at least annually and hope you never need it. Do the right thing and document what you do.