A. DUTIES OWED TO CLIENTS, 5. DISCLOSE AND MANAGE CONFLICTS OF INTEREST:

4: THE DUTY TO DISCLOSE AND MANAGE MATERIAL CONFLICTS OF INTEREST INVOLVING PROPRIETARY PRODUCTS

Frank, a CFP® professional, has a Client, Margaret, a single parent of two young children who is in her early 30s and works full time. Margaret became Frank's Client after they met while serving together on the Board of Trustees at the school their children attend. Margaret tells Frank that she needs life insurance to protect her children and that she wants advice on how to save for retirement and her children's college education. Frank agrees to provide Financial Advice on these issues.

Frank is an insurance agent for Old Jersey Life who only is licensed to sell life insurance and fixed annuity products. Under his agent agreement with Old Jersey, Frank is required only to offer Old Jersey products. Old Jersey offers a variety of life insurance products, including term and permanent life insurance. Permanent life insurance accumulates cash value over time that the policy owner may use to fund a lifetime death benefit or for other purposes, such as supplemental retirement income. Term insurance provides a death benefit only for a defined period. Premiums usually are higher for permanent life insurance than for term insurance.

Frank receives commissions and certain employment benefits from Old Jersey. Frank earns commissions from selling insurance products that are based on a percentage of the premium that the Client pays. Frank receives a commission that is a higher percentage of the premium that the Client pays for some Old Jersey products than other Old Jersey products. Frank conducts a careful analysis of the Client's needs and the available Old Jersey products and recommends a product that is in Margaret's best interests. Assume that Frank fulfilled his Duty of Care and Duty of Loyalty in making his recommendation.

QUESTION 1:

Which of the following are not Material *Conflicts of Interest* under the *Code and Standards*?

RESPONSE OPTIONS:

A. **Frank's contract with Old Jersey requires Frank exclusively to offer Old Jersey products to his Clients.**

B. **Frank and Margaret met while serving on the Board of Trustees of their children's school.**

C. **Frank receives compensation only for providing Financial Advice on the sale of insurance products.**

D. **The premiums of permanent life insurance are higher than the premiums for term insurance, which means that Frank receives more compensation when he sells a Client permanent life insurance than when he sells a Client term life insurance.**

Best Response: Response B. This question involves the Duty to Disclose and Manage Conflicts of Interest (Standard A.5.), and the definitions of Conflict of Interest and Material (Glossary).

When providing Financial Advice, a CFP® professional must make full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship. A Conflict of Interest occurs when a CFP® professional's interests (including the interests of the CFP® Professional's Firm) are adverse to the CFP® professional's duties to a Client. A Conflict of Interest is Material when a reasonable Client or prospective Client would consider the information important in making a decision.

As described in the fact pattern, Response B is not a Conflict of Interest. The fact that Frank met Margaret while serving on the Board of Trustees at the school does not make Frank's interests adverse to his duties to Margaret.

Response A is a Material Conflict of Interest. Frank has a financial incentive to sell Old Jersey products to Margaret. The Old Jersey products may be more expensive than other products available in the marketplace. Frank's interests are adverse to Margaret's interest in obtaining objective Financial Advice and paying less for the products that she purchases. The Conflict of Interest is Material because a reasonable Client would consider important in deciding whether to accept Frank's recommendation the fact that Frank may offer only Old Jersey products.

Response C is a Material Conflict of Interest. Frank has an interest in selling insurance products to Margaret, as opposed to other types of investment products, because he receives compensation only for selling insurance. This creates a Conflict of Interest because Frank's interest in receiving compensation is adverse to his duty to provide Margaret with objective Financial Advice about whether she needs insurance, and if so, how much. The Conflict of Interest is Material because a reasonable Client or prospective Client would consider it important to know, in deciding whether to accept Frank's recommendation about which products to purchase, how and when Frank is compensated when he provides Financial Advice regarding the products that Margaret should purchase. Margaret is particularly likely to consider the information

Material because the Financial Advice concerns her retirement and her children's college education, and thus may affect her personal and financial circumstances for a long time.

Responses D and E are Material Conflicts of Interest. Frank's interest in receiving greater compensation (for selling permanent life insurance and for selling certain types of policies) is adverse to his duty to provide Margaret with objective Financial Advice. These Conflicts of Interest are Material because a reasonable Client or prospective Client would find the information important in making a decision about whether to accept Frank's recommendations.

QUESTION 2:

What must Frank do to address these Material Conflicts of Interest?

RESPONSE OPTIONS:

A. Frank must disclose his Material Conflicts of Interest to Margaret, obtain her informed consent, and manage the conflicts in Margaret's best interests.

B. Frank must obtain Margaret's informed consent to any Material Conflicts of Interest in writing.

Best Response: Response A. This question involves the Duty to Disclose and Manage Conflicts of Interest (Standard A.5.).

When providing Financial Advice to a Client, a CFP® professional must make full disclosure of all Material Conflicts of Interest with the Client that could affect the professional relationship, obtain the Client's informed consent, and manage the conflict in the Client's best interests.

In making the disclosure, the CFP® professional must provide the Client with sufficiently specific facts so that a reasonable Client would be able to understand the Material Conflicts of Interest and the business practices that give rise to the conflicts, and give informed consent to such Conflicts of Interest or reject them. Ambiguity in the disclosure provided to the Client will be interpreted in favor of the Client. The Duty to Disclose and Manage Conflicts of Interest does not require a CFP® professional to disclose Conflicts of Interest in writing, but CFP Board recommends written disclosure as a best practice. Evidence of oral disclosure of a conflict will be given such weight as CFP Board in its judgment deems appropriate.

A CFP® professional also must obtain the Client's informed consent. Written consent to a conflict is not required. In determining whether the disclosure about a Material Conflict of Interest provided to the Client was sufficient to infer that a Client has consented to a Material Conflict of Interest, a CFP® professional should consider whether a reasonable Client receiving the disclosure would have understood the Conflict of Interest and how it could affect the advice the Client will receive from the CFP® professional.

A CFP® professional also must manage Material Conflicts of Interest by adopting and following business practices reasonably designed to prevent Material Conflicts of Interest from compromising the CFP® professional's ability to act in the Client's best interests.

In this case, one way that Frank may make full disclosure of all Material Conflicts of Interest that could affect the professional relationship would be by providing Margaret with the following information:

- That his agent agreement with Old Jersey requires him exclusively to offer Old Jersey products, even if other products available in the marketplace might have a lower cost or have features that would make them a better fit for Margaret's circumstances.
- That he only is authorized to sell insurance products and that he receives compensation only on the sale of insurance products, and that this provides him with a financial incentive to recommend insurance products even if other types of products that he is not permitted to sell might be a better fit for Margaret's circumstances.
- That there is a difference between permanent and term life insurance, and explain that difference.
- That Margaret will pay higher premiums for permanent life insurance and that Frank will receive more compensation for the sale of permanent life insurance, and that this provides Frank with an incentive to sell permanent life insurance.
- That Frank expects to earn more compensation over the term of certain insurance products than others, and the types of products that will pay him more compensation.
- That this provides him with a financial incentive to recommend those insurance products over others where he will earn a lower aggregate amount of compensation.

For Frank to sell Margaret the policy, Margaret also must provide her informed consent to the Material Conflicts of Interest. Margaret's informed consent may be inferred if Frank's disclosures are sufficiently specific.

Frank also must manage the Material Conflicts of Interest by adopting and following business practices that are reasonably designed to prevent the Material Conflicts of Interest from compromising his ability to act in Margaret's best interest.

B is not the best response because a CFP® professional is not required to obtain the Client's informed consent in writing. Obtaining the Client's informed consent in writing is a best practice, but informed consent may be inferred if the disclosures are sufficiently specific.

QUESTION 3:

Which of the following is the best statement with respect to Frank's management of the Material Conflicts of Interest?

RESPONSE OPTIONS:

A. **Frank is required to eliminate Material Conflicts of Interest from his planning process.**

B. **Frank satisfies his duty when he discloses his Material Conflicts of Interest to Clients and they provide their informed consent.**

C. **In addition to disclosing Material Conflicts of Interest and obtaining the Client's informed consent, Frank must adopt and follow business practices reasonably designed to prevent Material Conflicts of Interest from compromising his ability to act in the Client's best interests.**

Best Response: Response C is the best response. This question involves the Duty to Disclose and Manage Conflicts of Interest (Standard A.5.).

A CFP® professional has a duty to adopt and follow business practices reasonably designed to prevent Material Conflicts of Interest from compromising the CFP® professional's ability to act in the Client's best interests.

Here Frank has Material Conflicts of Interest because he may sell only proprietary products, he receives compensation only for the sale of certain products, and he receives more compensation for selling some products than others. Frank must take steps to ensure that his recommendation is based on the Client's goals, risk tolerance, objectives, and financial and personal circumstances, and not his potential compensation. As a best practice, Frank should consider documenting the basis for making the recommendation.

Response A is not the best response because the *Code and Standards* does not require a CFP® professional to eliminate all Material Conflicts of Interest.

Response B is not the best response because disclosing Material Conflicts of Interest and obtaining the Client's informed consent is not all that the *Code and Standards* requires when a CFP® professional is providing Financial Advice and has a Material Conflict of Interest. A CFP® professional also must properly manage the conflict.

Relevant Standards and Definitions: Duty to Disclose and Manage Conflicts of Interest (Standard A.5.); Definitions of Conflict of Interest and Material (Glossary).