6. MANAGING CONFLICTS OF INTEREST ARISING FROM DIFFERENT PRODUCT RECOMMENDATIONS

Gabriella is a CFP® professional who is a registered representative with a broker-dealer. She provides comprehensive financial planning to her Clients Santiago and Renata, a couple in their mid-40s who recently received a $50,000 inheritance. Santiago and Renata have no immediate need for the money, and asked Gabriella to invest the funds for them as supplemental retirement income.

Gabriella is considering recommending that Santiago and Renata add to their existing modest portfolio by investing the $50,000 in a mutual fund portfolio. Gabriella has identified two possible mutual fund portfolios that would meet the couple's needs. Specifically, Gabriella determined that the benefits of both portfolios are the same and will meet Santiago and Renata's goals, risk tolerance, objectives, and financial and personal circumstances. Further, with respect to both portfolios, Gabriella's firm would earn a 5.5% initial commission (or load) on the sale of the mutual funds, with a 25-basis point trailing 12b-1 fee. However, the expense ratio of one mutual fund portfolio is a little lower than the other. Furthermore, Gabriella's firm will receive revenue sharing payments from the mutual fund company that has the lower expense ratio. Gabriella's firm does not allow its individual representatives to receive additional direct or indirect compensation or benefits resulting from revenue sharing payments paid to the firm.

Gabriella recommends that Santiago and Renata purchase the mutual fund portfolio that would result in revenue sharing payments paid to Gabriella's firm (and has the lower expense ratio).

QUESTION:

Which of the following is the best statement(s) with respect to Gabriella's obligation to manage conflicts of interest?

RESPONSE OPTIONS:

A. **Gabriella may make the recommendation of the lower cost mutual fund portfolio without any disclosure or other management steps because the payment of revenue sharing payments to Gabriella's Firm is not a Material Conflict of Interest.**

B. **Gabriella can recommend the mutual fund portfolio that would pay revenue sharing so long as she discloses the firm's conflict of interest and receives the Clients' informed consent because the expense ratio of that mutual fund portfolio is lower than the other and the recommendation is less expensive for Santiago and Renata.**

C. **Gabriella must recommend the mutual fund portfolio that does not pay Gabriella's firm revenue sharing because the payment of revenue sharing is a Material Conflict of Interest that cannot be adequately disclosed or otherwise managed.**

Best Response: Response B is the best response. This case study involves the Duty to Disclose and Manage Conflicts of Interest (Standard A.5.) and the definitions of Conflict of Interest and Material (Glossary).

A Conflict of Interest exists 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. When providing Financial Advice to a Client, a CFP® professional must avoid conflicts or 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.

To manage conflicts, CFP® professionals must 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. As described in CFP Board's Guide to Managing Material Conflicts of Interest, in developing business practices for conflicts management for identified conflicts, a CFP® professional should review and evaluate the CFP® Professional's Firm's conflict management or mitigation practices and any additional conflict management practices that the CFP® professional follows. The CFP® professional then should consider and implement any additional steps the CFP® professional needs to take to properly manage conflicts in accordance with the CFP® professional's Duty of Care, in a manner that is reasonably designed to result in Financial Advice that is in the Client's best interests despite the conflict of interest. The CFP® professional's process must reflect the practices of a prudent CFP® professional and must be proportional to the size of the conflict. The greater the conflict of interest, the more carefully CFP Board will scrutinize the conflict management process. A CFP® professional also should consider documenting the basis for the recommendations, including the conflict management process that the CFP® professional followed. A CFP® professional should keep in mind that a Material Conflict of Interest may be so great that it cannot be reasonably managed and therefore must be avoided.

In this scenario, Gabriella's firm will earn more compensation if she recommends that Santiago and Renata purchase shares of the mutual fund company that pays revenue sharing. This is a Material Conflict of Interest under CFP Board's *Code of Ethics and Standard of Conduct (Code and Standards)* because Gabriella is incented to recommend the mutual fund portfolio that will generate revenue sharing payments to her firm. Therefore, Response A is not the best response. Gabriella must ensure the conflict is adequately disclosed to Santiago and Renata and obtain their informed consent to the conflict prior to providing Financial Advice to the couple.

A CFP® professional might be able to manage a Material Conflict of Interest such as this one through a process, consistent with the CFP® professional's Duty of Care, that is reasonably designed to result in Financial Advice that is in the Clients' best interests despite the conflicts of interest. Here, Gabriella can manage the Material Conflict of Interest created by the payment of revenue sharing payments to her firm by relying on the type of prudent process described above to determine which alternative is in the best interests of Renata and Santiago based on their goals, risk tolerance, objectives, and financial and personal circumstances. As noted above, Gabriella has already determined that the benefits of investing in the two mutual fund portfolios are the same and the cost to Renata and Santiago is less if they invest in the mutual fund portfolio that pays revenue sharing. Therefore, under these circumstances, the payment of revenue sharing to the firm is not compromising Gabriella's ability to act in Santiago and Renata's best interests if she recommends the mutual fund portfolio that has the lower expense ratio. Response B is the best response.

Response C is not the best response because, in addition to relying on her firm's disclosures, she can manage the conflict of interest resulting from the recommendation of the fund that pays revenue sharing through a process, consistent with the CFP® professional's Duty of Care, that is reasonably designed to result in Financial Advice that is in the Clients' best interests despite the conflicts of interest. If she could not act in the Client's best interests, then she may need to limit the Scope of Engagement or decline to provide the Financial Advice.

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