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

7. THE DUTY TO MANAGE MATERIAL CONFLICTS OF INTEREST WHEN MAKING AN ACCOUNT TYPE RECOMMENDATION

Ann, a CFP® professional, works for a large dually registered broker-dealer/investment adviser firm. Ann has a new client, Sam, who is in his late-20s and never has invested in the market. Sam has $100,000 in a savings account, and he has asked Ann to help him invest the assets in mutual funds. Sam hopes to use the investment to pay for a vacation home but does not plan to use the funds for at least 10 years. Sam has a moderate risk tolerance. Sam believes he will have approximately $10,000 in additional funds to invest each year, probably all at once because of anticipated annual bonus payments. Since Sam is new to investing, he wants Ann to provide ongoing assistance with his investments; however, he does not want to give Ann discretion in his account.

As a representative of a dually registered firm, Ann could recommend that Sam open either a non-discretionary advisory account or a brokerage account. If Sam opens a brokerage account, he will pay a commission (or transaction-based fee) to Ann (and her firm) every time he buys or sells an investment. If he opens an advisory account, he will pay Ann (and her firm) an annual fee of 1.25% of the assets in the account. Over time, Ann and her firm likely would receive more compensation through the advisory account than the brokerage account. However, advisory accounts provide clients with additional services, including ongoing advisory services, as compared to brokerage accounts.

Ann identifies the Material Conflict of Interest that arises from her account type recommendation and the compensation she may receive. She sufficiently discloses the conflict to Sam and obtains his informed consent to the conflict prior to providing Financial Advice.

QUESTION:

Which of the following is the best statement(s) with respect to Ann's management of her Material Conflict of Interest?

RESPONSE OPTIONS:

A. **Ann could manage the conflict by recommending that Sam open a brokerage account and purchase front-end load mutual funds with the initial $100,000 investment, but then transfer the existing mutual funds and make new purchases in an advisory account the following years.**

B. **Ann could recommend either account type so long as her fees are competitive with other firms.**

C. **Ann should make her recommendation of account type using a process reasonably designed to result in a determination of which account is in Sam's best interest.**

D. **Ann must recommend the brokerage account to Sam because it likely will result in him paying less over time.**

Best Response: Response C is the best response. This case study involves the Fiduciary Duty (Standard A.1.), 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 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 this case, the likelihood that Ann will receive greater compensation over time if Sam opens an advisory account than a brokerage account is a Material Conflict of Interest. As noted, Ann adequately disclosed the Material Conflict of Interest and obtained Sam's informed consent to the conflict.

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 individually uses. The CFP® professional should then 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. CFP® professionals 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 case study, Ann likely will receive more compensation over time if Sam invests through a fee-based (advisory) account as compared to a commission-based (brokerage) account. As a result, Ann has a greater incentive to recommend a fee-based advisory account than the commission-based brokerage account. However, fee-based accounts provide clients with additional services, including ongoing advisory services, as compared to commission-based accounts. Sam has indicated that, although he may only invest funds once per year, he intends to continue making investments and, because he is a novice investor, he needs ongoing assistance with his investments.

To manage this conflict, Ann should look first to her firm's conflicts management or mitigation policies and procedures to ensure that the recommended account type is and remains appropriate, including with respect to the account type selection process and any required periodic review of accounts. If these firm policies and procedures do not adequately address the management of Ann's conflict of interest, then she also can manage the Material Conflict of Interest by relying on her own process for determining which alternative is in the best interest of her Client based on the Client's goals, risk tolerance, objectives, and financial and personal circumstances, in a manner that reflects the practices of a prudent CFP® professional. Therefore, Response C is the best response.

Response A is not the best response because any recommendation that Sam purchase a mutual fund that is subject to a front-end sales load and, shortly thereafter, move those mutual fund shares into an investment advisory account that is subject to an asset-based advisory fee would result in Sam effectively paying twice for the same recommendation. Under the facts as described, this is a conflict that cannot be managed under the *Code and Standards*.

Response B is not the best response because the obligation of the CFP® professional is to make a recommendation in the best interest of the Client. The fact that Ann's fees are in line with another financial professional's does not satisfy Ann's Duty of Care. As described above, Ann must use a process to determine which alternative is in her Client's best interest based on the Client's goals, risk tolerance, objectives, and financial and personal circumstances. For example, the facts stated above indicate that Ann may determine that the advisory account and the associated ongoing monitoring that the advisory account will provide are in Sam's best interest even though it will likely provide more compensation to her over time. For that reason, Response D also is not the best response.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.), Disclose and Manage Conflicts of Interest (Standard A.5); definitions of Conflict of Interest and Material (Glossary).