A. DUTIES OWED TO CLIENTS, 3. DUTY OF COMPETENCE:

1: APPLYING THE DUTY OF COMPETENCE TO FINANCIAL ADVICE, INCLUDING WITH RESPECT TO A CLIENT'S EXISTING ANNUITY

SCENARIO:

Kaitlin, a 55-year-old single woman with no children, visited Dee, a CFP® professional, to engage Dee for Financial Planning. Kaitlin reports the following:

- Her current annual salary is $120,000.
- She enjoys working and intends to continue working until at least age 70.
- She has an emergency fund of approximately 6 months of monthly fixed expenses.
- Her work provides adequate short-term and long-term disability insurance and health insurance.
- She has approximately $900,000 in her retirement accounts (both 401(k) plan accounts and IRAs). Between her own contributions and her company's match, Kaitlin contributes approximately $15,000 per year to her 401(k) plan account. Her assets are in a target-date mutual fund aligned with a retirement at age 70.

In addition to her retirement account statements, Kaitlin provides her latest account statement from a fixed indexed annuity tracking a broad equity market index. She explains she purchased the policy seven years ago using the proceeds from an inheritance. The performance of the fixed indexed annuity motivated Kaitlin to seek Financial Planning.

- Based on the account statement, the annuity has an account value of approximately $100,000 and a cost basis of $80,000. Because the seven-year surrender charge period recently expired, the policy's account value and surrender value are the same.
- Kaitlin explains that she bought the annuity because the idea of guaranteed lifetime income appealed to her, but she did not pay much attention to how the annuity works. A neighbor who was an insurance agent recommended the product.
- She is confused because the annuity's growth was much lower than her investments in the stock market, even though the annuity supposedly tracks a market index.
- While Dee has a basic understanding of annuities, she is not insurance-licensed.

When Dee asks Kaitlin about her financial priorities and risk tolerance, Kaitlin says her biggest worry is outliving her savings, given that she does not have a family that could help support her. This is why she purchased the annuity. She says she understands the need to take risks in the market, but she is risk averse. Kaitlin does not know whether to keep the annuity or do something different.

QUESTION:

Which response concerning the fixed indexed annuity is the most appropriate?

RESPONSE OPTIONS:

A. **Dee recommends that Kaitlin cash out the annuity and move the funds to an account that Dee will manage in a portfolio with a mix of equities and bonds. Dee assumes that the fixed indexed annuity underperformed the equity market in recent years because of product fees, but she does not review the policy contract or conduct other research to understand the annuity's performance. Dee tells Kaitlin that since the surrender period is over, she will not have to pay a fee to liquidate the fixed indexed annuity and invest in the equity and bond markets. Dee tells Kaitlin that Dee's management of the assets in the equity and bond markets will achieve a return that will provide Kaitlin with higher income in retirement than the annuity would provide.**

B. **Dee discloses to Kaitlin that she is not insurance-licensed and cannot provide Financial Advice concerning the annuity itself or include the annuity's cash value when calculating her AUM fee. Dee tells Kaitlin she will make a note in her firm's client relationship software database that Kaitlin has the annuity. Kaitlin did not amend the Scope of Engagement or consider the assets in the fixed indexed annuity when developing the financial planning recommendations.**

C. **Dee asks Kaitlin for the contact information of the person who originally recommended the annuity, but Kaitlin does not have that information. Therefore, Dee, after seeking permission from Kaitlin and coordinating with her firm, discusses the annuity with Fatima, a competent insurance-licensed resource, to learn more about the fixed indexed annuity. Fatima has helped the firm provide Financial Advice to other Clients who had fixed indexed annuities In each circumstance, the firm determined that Fatima provided services in those clients' best interests, and the firm knows, from periodically reviewing online regulatory databases that disclose professional misconduct, that Fatima has no record of misconduct. Dee provides Fatima with an overview of Kaitlin's financial and personal circumstances, including that not outliving her savings is important to Kaitlin.**

Best Response: Response C is the best response. This case involves the Duty of Competence (Standard A.3.), the Fiduciary Duty (Standard A.1.), including the Duty of Care (Standard A.1.b.), The Duty to Provide Information to a Client When Providing Financial Planning (Standard A.10.b), and Duties When Recommending, Engaging and Working With Additional Persons (Standard A.13.). This case study does not address how the Duty of Loyalty or the Financial Planning Practice Standards apply to the scenario.

Under the Duty of Competence, a CFP® professional must provide Professional Services with competence, which means with relevant knowledge and skill to apply that knowledge. When the CFP® professional is not sufficiently competent in a particular area to provide the Professional Services required under the Engagement, the CFP® professional must gain competence, obtain the assistance of a competent professional, limit or terminate the Engagement, and/or refer the Client to a competent professional. The CFP® professional shall describe to the Client any requested Professional Services that the CFP® professional will not be providing.

At all times, when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary and, therefore, act in the best interests of the Client. The Fiduciary Duty includes a Duty of Loyalty, a Duty of Care and a Duty to Follow Client Instructions. The Duty of Care requires a CFP® professional to act with the care, skill, prudence and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives and financial and personal circumstances.

In this case, Dee is providing Financial Planning. Therefore, Dee is providing Professional Services and must satisfy the Duty of Competence. Additionally, Dee is providing Financial Advice to a Client and must satisfy the Fiduciary Duty, including the Duty of Care. Because Dee is providing Financial Planning, Dee must provide the information to Kaitlin required under Standard A.10.b. Among other things, Dee must provide Kaitlin with written terms of the Engagement, including the Scope of Engagement and any limitations.

Response A is not the best response. Dee provided Financial Advice about the fixed indexed annuity without the necessary competence and did not gain competence, obtain the assistance of a competent professional, limit or terminate the Engagement, or refer Kaitlin to a competent professional as the Duty of Competence requires. Dee also failed to act with the care, skill, prudence and diligence that a prudent professional would exercise in providing this Financial Advice, and thus violated the Duty of Care.

Specifically, Dee made assumptions about the product's costs and features and acted on those assumptions without verification. Had Dee gained competence about the fixed indexed annuity, obtained the assistance of a competent professional, or otherwise acted with the care, skill, prudence and diligence that a prudent professional would exercise, she would have learned that her assumptions were inaccurate. Specifically, Dee's explanation to Kaitlin that the annuity "underperformed" compared to the broader equity market was inaccurate because the equity market is not the correct benchmark for assessing a fixed indexed annuity's performance. Had Dee gained competence, she would have understood that Kaitlin's fixed indexed annuity generally performed as it was designed to perform.

Dee also would have learned that even though the statement Dee reviewed showed that the fixed indexed annuity was out of the surrender period, withdrawals taken before age 59 ½ are typically subject to a 10% early withdrawal penalty tax, and thus Kaitlin would incur additional tax costs when cashing out the annuity.

Additionally, Dee did not compare the costs, risks and benefits of the current course of action (keeping the annuity) versus her proposed course of action (cashing out the annuity and investing the assets), nor did she assess Kaitlin's expressed priority to not outlive her savings. She did not consider the difference between the risk-reward profiles of the two different asset classes or explore how much income the annuity might produce.

Finally, Dee did not act prudently by claiming that her management of the assets would result in more income in retirement than the fixed annuity; market investments involve risks (including risks of losing the investment) and Dee cannot be certain of the market's future performance

Response B is not the best response. Under the Duty of Competence, a CFP® professional may limit the Engagement to the services they are competent to provide. Dee, however, did not effectively limit the scope of the Financial Planning

Engagement. The Duty to Provide Information to a Client When Providing Financial Planning (Standard A.10.b) required Dee to provide in writing any limitations to the Scope of Engagement. Accordingly, Dee needed to state explicitly in the Scope of Engagement that she was not providing Financial Advice about the Fixed Indexed Annuity. Additionally, even if the Scope of Engagement is limited to exclude Financial Advice about certain Financial Assets, a CFP® professional should consider those "held-away" assets in the analysis, as those Financial Assets may affect the Financial Planning recommendations. Even though Dee implied she would take the annuity into account when developing her recommendations by stating she would make a "note" of the annuity, Dee did not consider how assets held in the fixed indexed annuity would affect her Financial Planning recommendations. Finally, Dee properly did not consider the assets in the annuity when calculating her fee.

Response C is the best response. Even though Dee herself lacked competence about the fixed indexed annuity, Dee fulfilled her Duty of Competence by obtaining the assistance of a competent professional, Fatima. As required by the Duties When Recommending, Engaging and Working With Additional Persons, Dee had a reasonable basis for recommending Fatima given her reputation, experience and qualifications. Dee had personal experience working with Fatima, other Clients previously received services from her that were in their best interests, and the firm knows, from periodically reviewing online regulatory databases that disclose professional misconduct, that Fatima has no record of misconduct.. Additionally, consistent with the Duty of Care, Dee provided Fatima with relevant information concerning Kaitlin's financial and personal circumstances so that Fatima could consider this information.

By asking Fatima for assistance, Dee learned:

- The product performed as it should have. The annuity was not designed to track the broader equity market but instead was designed to give bond-like returns when the market was up and provide principal protection when the market was down.
- Keeping Kaitlin in a fixed indexed annuity as part of her financial plan can help meet Kaitlin's objectives, and, in particular, could address her concern about outliving her savings.
- Even though the surrender period ended, Kaitlin would face tax consequences if she cashed out the annuity before age 59 ½. Accordingly, Dee would need to consider these costs when evaluating whether to recommend that Kaitlin cash out the annuity.
- Kaitlin may exchange her annuity for a product that is a better fit through a 1035 exchange without incurring a penalty tax.

Fatima offers to review Kaitlin's profile more closely and recommend an annuity that will best fit Kaitlin's personal and financial circumstances and to meet with both Dee and Kaitlin to discuss that recommendation, as well as the alternative of keeping the existing annuity or cashing out the annuity.

Relevant Standards and Definitions: Duty of Competence (Standard A.3.); Fiduciary Duty (Standard A.1.); Duty of Care (Standard A.1.b.); Duty to Provide Information to a Client When Providing Financial Planning (Standard A.10.b) Duties When Recommending, Engaging and Working With Additional Persons (Standard A.13.).