Regulation Best Interest Recommendation Selection Process

Account Type Recommendation Selection:

Regulation Best Interest expands the requirements of a financial professional (FP) to use diligence and care when making recommendations related to the type of account a retail customer should establish. The care obligation of regulation Best Interest requires a process be followed to help determine the account type that is in the client's best interest.

Private Client Services provides multiple account options on the brokerage platform as well as advisory platform. In addition, many of our financial professionals also offer outside advisory account options that need to be taken into consideration when making an account type recommendation.

Listed below are a series of questions or considerations that should be considered when evaluating the type of account that would be in a retail customer's best interest.

Considerations for recommending a broker/dealer account type:

- Does the customer prefer to make the investment decisions and want a representative to execute the orders?
- Does the customer want occasional advice or recommendations on investments?
- Does the customer prefer to approve all trade activity in the account?
- Does the customer plan to buy only a few securities and follow a buy-and-hold strategy?
- Does the customer prefer to pay commission for each transaction?
- Does the customer have limited available assets, below account minimums on an advisory account option?

Considerations for a directly held account vs. a brokerage account:

- Does the customer plan to develop a portfolio of investment holdings utilizing multiple product providers, investment vehicles, and holding periods?
- Does the customer want to purchase individual stocks, bonds, or ETF investments?
- Does the customer want to trade options, utilize margin, or have check writing availabilities?
- Does the customer plan to follow a buy and hold strategy with limited (or a single) product provider?
- Does the customer plan to purchase an annuity product?

Considerations for recommending an advisory account type:

- Does the customer want a financial advisor to manage the investment portfolio?
- Does the customer want a fiduciary relationship with a financial advisor?
- Does the customer prefer to pay a fee based on assets under management?
- Does the customer want the financial advisor to make investment decisions on their behalf(discretionary relationship)?
- Does the customer want ongoing account monitoring?
- Does the customer want professional money management access?
- Does the customer want to utilize an investment policy statement?

Based on the answers to these questions, you as the financial professional should be able to ascertain the best account type to recommend to your customer, either a brokerage account, directly held account, or an advisory relationship account.

Registration Type Recommendation Selection

Once the account type recommendation has been selected, the next determination relates to the best registration type to be recommended to the customer. The registration types available include individual, joint, IRA, 529, etc. and may be available for broker dealer business, advisory business or both.

In most cases, the registration type will be determined by the overall purpose or goal of the account, and the customer will generally decide if the account should be individual or joint. Joint account options (WROS, TIC, etc.) are presented as options rather than recommendations.

Advisory account options will depend on the availability of services and registration types offered by the RIA. Non-PCS advisory firms should have their own processes for registration type selection and dually registered reps should consult with their advisory procedures for additional guidance.

PCS Advisors account options should be reviewed with the customer based on the customer's preferred services and money management method. Once discussed, the advisor should determine which registration type best fits the customer and make the recommendation(s). The PCS Advisory Account Selection Disclosure is used to identify the recommended account options presented to the client, and which option is selected by the customer. (https://pcsbd.net/wp-content/uploads/2019/04/PCS-Advisory-Account-Selection-Disclosure-Fillable-03312019.pdf)

Investment Recommendation Selection:

Regulation Best Interest expands the requirements of a financial professional to use diligence and care when making investment recommendations to a retail customer. The care obligation of regulation Best Interest requires a process be followed to help determine when a recommendation is in the client's best interest.

Private Client Services provides access to a large range of products including mutual funds, annuities as well as individual stocks, bonds, and other products available for recommendation to customers. The fundamental objective when determining what product type and specific product to recommend to a customer is to determine which product is best suited to meet the goals and objectives of the client, while taking into account the client's risk profile. In addition Regulation Best Interest requires that an financial professional also utilize their skill to evaluate the product prior to the recommendation to determine other factors such as product performance during differing market conditions, overall cost to the client, liquidity factors (if an identified consideration for the specific customer), overall strength and stability of the product provider, and product features and benefits of the product.

Many of these considerations will be completed the same way for many products such as individual stock or bond recommendations but will have added considerations for other products. Below are guidelines that have been developed to assist financial professionals as they evaluate potential product recommendations for retail customers.

Mutual Funds

Since mutual funds provide a wide range of investment objectives and carry varying levels of risk it is important to review the fund prospectus to identify if the fund meets the objectives and risk levels that are acceptable to the client. Once this has been determined the financial professional should consider the following reviews to determine if the fund is in the best interest of the client using the care obligation requirements:

- The strength of the product manufacturer. There are thousands of mutual funds distributed by hundreds of manufacturers. The review must consider the stability of the product provider as well as the history of the fund itself. Newer funds have less track record and therefore greater uncertainty and risk.
- The share class being purchased must be reviewed to determine if the expenses associated with the class are in the best interest of the client. Long-term investments placed into C-share funds may result in higher overall costs to the client as compared to other share classes available in the same fund. Likewise, short term investments placed into A-share funds may result in higher costs as compared to C-share funds.

Share class selection may have multiple justifications and situations that need to be considered. There is no set rule that is used in determining share class appropriateness, but a review of the overall costs to the client over the anticipated holding period should be reviewed so each available share class may be evaluated and used to determine the best option.

- The fund internal expenses should be reviewed as compared to other similar funds offered by other product providers as part of the evaluation process. Internal expenses vary by product provider and should be considered when evaluating overall fund performance as well as management style of the fund manager(s).
- Source of funds identifies where the money is coming from to fund the investment and identify if the purchase is part of a switch. A switch occurs when a sale of one fund is used to purchase a new position where a new commission is generated. PCS defines a switch when the two transactions occur within a 45-day timeframe. If a switch is identified the additional costs associated with the switch must be included in the recommendation decision. The review must include a determination if a comparable fund is available within the same fund family, if the comparable fund performance is acceptable, and if the additional cost to the client may be avoided. Regulation best Interest does not require that every recommendation be made utilizing the lowest cost option for the customer but does require the cost to be a contributing factor in the recommendation selection process.
- Regulation Best Interest's care obligation charges the financial professional with the obligation to utilize their professional knowledge to evaluate product recommendations considering how the product performs in different market conditions. When evaluating a mutual fund the FP should review the past performance of the fund as compared to other funds in the same sector to evaluate the performance during both up markets as well as down markets to determine how the fund performs against its peers, as well as evaluate if the fund demonstrates a greater downside negative performance, indicating greater downside risk to the customer in a negative market condition. This review may include review of performance charts as well as comparing fund beta to other similar funds.

Variable and Equity Index Products

Variable annuities are complex products with multiple sub-accounts and varying product features and enhancements. VA recommendations must be determined on a case by case basis since each customer's needs are unique and each VA contract has varying features and benefits. VA's, like mutual funds have different share classes and expense structures that must be considered when determining a recommendation. Annuities are long-term investments which must be suitable for the client. Private Client Services discourages switching from one product to another without very sound reasons. Annuities are designed to provide tax deferred buildup of assets and may be purchased to provide a death benefit and/or income payment for the owner's lifetime.

- Liquidity: VA contracts have varied withdrawal options and are purchased as long term investments, usually for retirement purposes as a supplement to other retirement accounts. The liquidity needs of the customer must be considered when recommending a VA product. Newer product releases may have a liquidity rider that provides for charge free withdrawals; however, these riders include an additional cost to the customer. These additional costs must be considered with the liquidity needs of the customer.
- Surrender Charges: VA contracts generally have surrender penalties if the funds are withdrawn prior to the end of the surrender period. Surrender periods vary by product and by share class. Depending on the liquidity needs of the customer the surrender schedule and related surrender charges must be considered as part of the recommendation decision. Most contracts will have a 10% annual surrender free withdrawal feature that should also be considered for customer liquidity needs. PCS has determined that annuities with surrender schedules greater than 10 years or surrender charges higher than 10% are never in the best interest of the customer and will not be approved.
- Concentration: When reviewing an annuity product, the FP should review the current holdings of the customer to determine if there are other annuity contracts currently owned by the customer. Due to factors such as liquidity

and cost annuity contracts that make up greater than 50% of a customer's investments should be reviewed carefully prior to recommending additional annuity holdings. Special attention should be placed on the review of liquidity needs as well as diversification of sub-accounts.

- Death Benefit: VA contracts provide for death benefit payouts which avoid probate and flow directly to the beneficiaries. VA contracts calculate death benefits and accumulated death benefit guarantees differently by contract type. If the VA is being purchased for the death benefit, the review should consider the different death benefit options and which option best benefits the customer.
- Internal expenses: The internal expenses of a VA are charged directly to the policy owner and can have a large effect on the performance of the contract. A review of the internal expenses, M&E, rider, admin fees and sub-account costs must be completed to determine the appropriateness of the recommendation.
- Bonus Features: Some VA contracts will allow for a "bonus" where the value of the annuity is increased at the time of sale. Bonus features are never free to the policy owner and the costs associated with the bonus must be disclosed to the client prior to the sale. These costs will also affect the performance of the policy. Many bonus features are utilized to offset surrender penalties when replacing one contract with a new annuity contract. Special attention must be given to these situations to determine if the customer will be placed in a better position if utilizing a bonus feature and if the cost is justified.
- Riders: VA's may have enhanced features called riders. Riders may be added to a policy to allow for guaranteed withdrawals, income, accumulation, or death benefit. Riders are sometimes key determining factors to recommend an annuity product to meet a specific customer need. Every rider has a cost to the policy owner and must be disclosed prior to the sale. These costs must also be factored into the recommendation determination.
- Replacements/1035 exchanges: A replacement/1035 exchange is when one insurance policy or annuity is sold and replaced with a new policy. Replacement/1035 exchange applications require additional disclosure to the client as well as enhanced review. A replacement/1035 should always benefit the client or place the client in a better position than the replaced policy. Every replacement/1035 recommendation must include a side by side comparison of death benefit, expenses, and riders to determine if the replacement is in the customer's best interest.
- Share Class: Annuity contracts may be issued with varying share classes, each with different cost structures and features/benefits. Some share classes are designed for shorter holding periods, liquidity needs, or only offer limited features. The share class determination of a recommendation must coincide with the best needs of the customer.
- Tax Considerations: VA policies provide tax deferral benefits to withdrawals as a reason for purchasing a contract. When a VA is purchased in a qualified account the tax benefit does not apply since the funds are already in a tax deferred status. The purchase must provide additional benefits to the client to justify the purchase. Careful consideration must be taken when reviewing retirement plan rollovers into VA contracts to ensure that a different product is not in the best interest of the client. Additionally, all 401K rollovers must include a customer signed rollover disclosure form. (New for Regulation Best Interest)
- Senior Clients: Best interest standards must be considered when making recommendations to older investors. Considerations when dealing with senior investors include:
    - Current and prospects for employment
    - Primary expenses including whether the customer still has a mortgage
    - Sources of income and whether it is fixed or will be in the future
    - Income needed to meet fixed or anticipated expenses
    - Savings for retirement and how they are invested
    - Liquidity needs
    - Financial and investment goals (income needs, preservation of capital, accumulation of assets for heirs)
    - Health care insurance and future needs to fund health costs

These additional considerations are crucial to the recommendation decision and should be well documented for any recommendation. Senior customers represent a higher level of risk and additional care must be taken to ensure the recommendation represents the best interest for not only the customer, but also consider any beneficiaries named on the contract.

Variable Universal Life products: As with any insurance policy, a VUL contract is written with specific purpose. These contracts may be used in multiple advanced planning strategies and the recommendation for a policy purchase must be reviewed with sufficient detail to allow the FP to understand and justify the recommendation. All policy features, benefits and costs must be included in the recommendation due diligence to ensure the policy recommendation is in the customer's best interest.

Equity Indexed Annuities are a hybrid of a fixed and variable annuity but have very different features and benefits and perform very differently. An EIA is an annuity product that is tied to the performance of a market index such as the S&P 500, or another index. The annuity performance will depend not only on the performance of the applicable index, but also based on the parameters set up when purchasing the annuity.

Many considerations used during the review of VA contracts are the same for EIA contracts, but there are some additional considerations.

- Earnings cap/limit: Most EIA contracts will have a listed earnings cap or limit. This identified the maximum growth limit for the contract, no matter how well the underlying index does. This limit must be used in the recommendation decision and be acceptable to the customer.
- Participation Rate: This identifies the level of participation in the growth of the index the contract will credit to the owner. An index may perform higher than the cap rate, but if the participation rate is only 50% then the contract may not achieve the cap rate. The participation rate must be used in the recommendation decision and be acceptable to the customer.
- Indexing Method: There are multiple indexing methods that are available with indexed products, depending on the contract purchased. The indexing method determines how the performance is credited to the contract, for example the method may be an annual reset, biennial, high water mark, point to point, or other methods as defined within the contract. The indexing method must be used in the recommendation decision and be acceptable to the customer.

Recent product developments in the annuity product space have resulted in hybrid products that also may include downside performance protection limits, index sub-account options, and fee-based compensation models. These products are very complex and may include upside performance limitations or participation rates, extended indexing methods, of additional fees and expenses. Additional care must be taken when evaluating these products to ensure all product features and benefits as well as cost structures are included in the best interest recommendation determination prior to presenting to the customer.

Brokerage Products

Brokerage accounts allow customers to purchase various investments within a single account. The securities included in this section include: Equities(Stock), Fixed Income (Bonds), Options, Exchange Traded Funds (ETF), Mutual Funds, Unit Investment Trusts (UIT), and Exchange Traded Real Estate Investment Trusts (REIT).

Recommendations for brokerage products include the following considerations:

- Each equity and/or fixed income issue must be evaluated to determine the risk associated with the holding. Risk levels vary widely depending on the underlying strength of the issuing company and historical performance of the price and dividend if applicable. The client's risk tolerance must be compared to the risk of the purchase as a factor of the recommendation.
- Fixed Income products range in risk depending on the issuer and are assigned a rating. The rating must be considered to determine the perceived risk by the rating agency and is directly related to the risk tolerance of the

customer. Additional consideration needs to be taken regarding the rate of return, any premium in the price of the bond, payment history of dividends and timing of dividends.

- How a new purchase fits into a portfolio of equities is also a factor that must be considered when making a recommendation. A specific transaction may be outside the client's risk tolerance, but when reviewed with a portfolio may be supplemented with other holdings that offset the risk and contributes to a best interest determination.
- ETF's are portfolios of equities that trade on an exchange with price variations like an individual equity position. ETF's generally will invest in specific market sectors or with very specific portfolio objectives. ETF's price will vary throughout the trading day and are liquid just like an equity investment.
  ETF's also have varying risk levels which must be evaluated and compared to the client's risk tolerance as part of the review. The ETF investment objective must be compared to the objective of the customer to ensure the recommendation is in the customer's best interest. ETF's may be recommended as part of a portfolio to provide additional diversification over individual equity positions.
- Mutual fund recommendations made within a brokerage account should include all of the review considerations outlined in the Mutual Funds section above.
- A UIT is a specific portfolio designed to meet a designated objective and risk level. The portfolio will generally be limited in holdings and have significantly less holdings than a mutual fund or ETF. A UIT also has a set maturity date and may have liquidity limitations. UIT's must be reviewed not only for risk tolerance and investment objective, but also for liquidity need versus the client's goals and needs. At maturity, a UIT owner has the ability in most cases to roll the portfolio into the next issue class, extending the maturity timeline. If the transaction being recommended is a rollover, the cost or load must be reviewed to ensure the client is receiving all breakpoints, or reduced sales charges available. UIT recommendations must consider all product features, costs, and limitations to ensure the best interest of the customer is being met prior to recommending a UIT.
- A REIT is a portfolio of real estate holdings designed to both appreciate and provide income based on interest paid by the underlying holdings. Exchange Traded REITs provide liquidity to the investor and are priced based on the market in which they trade. A REIT is considered an alternative investment since it invests in real estate. Exchange traded REITs are considered significantly less speculative than non-traded REITs but still must be evaluated for risk and objective versus the client's suitability information. REITs have additional risk due to the underlying portfolio being subject to interest rate risk, especially in an increasing interest rate environment. Recommendations of REITs should consider all holdings for the customer to ensure the risk level of the portfolio does not exceed the client stated risk tolerance.
- Options: Recommendation considerations for options contracts vary based on the type of option transaction, strategy, risk tolerance, maximum gain, and maximum potential loss on the contract. Options may be used as hedge strategies or in a more aggressive strategy. Recommendations for options investing requires additional knowledge and separate approvals by the firm and require review of the underlying security or index prior to determining best interest for the customer.

Brokerage Account Strategy Selection:

Regulation Best Interest does NOT require every recommendation made within a brokerage account to be documented if the firm and Registered Representative can describe the overall purpose, goal or strategy used to base the recommendations. For example, a retail customer brokerage account may be made up of a combination of stocks, preferred stock, individual bonds, ETF holdings, and money market assets. Depending on the percentage of these holdings the overall strategy may be growth, income, or a combination. As Registered Representatives it is your responsibility to know your customer, understand their suitability information, and make recommendations designed to assist in achieving the account goals.

To identify the strategy for a brokerage account (and avoid documenting each individual recommendation) you need to discuss the investment goals, timeframe, risk exposure, tax situation, and other factors with the client. Working with the client, an investment strategy should be developed which aligns with the client profile, particularly account investment objective and risk tolerance, including a breakdown of asset categories you will use to create and maintain the strategy within the account.

Following are the PCS recommendations for portfolio construction by investment objective and risk tolerance (as defined in the Customer Account Form):

Investment Objective(IO)	Risk Tolerance(RT)	Equity	Fixed Income	International	Cash & CE
Preservation of Capital	Low/Conservative	0-10%	70-90%	0-5%	0-20%
Moderate Income	Moderately Conservative	10-25%	50-75%	0-10%	0-15%
Balanced Growth	Moderately Conservative or Moderate	30-50%	30-50%	0-15%	0-10%
Growth of Capital	Moderate or Moderately Aggressive	50-75%	10-25%	0-25%	0-5%
Aggressive Growth	Moderate Aggressive or High Risk	50-90%	0-15%	0-30%	0-5%

The account strategy is developed on an account by account basis in alignment with the client profile and is created by identifying the combination of Investment Objective(IO) and Risk Tolerance(RT) that best fits with the client needs and goals for the account. Each strategy has built in flexibility that allows the Registered Representative to make recommendations based on current market conditions and allows the portfolio to vary depending on the type of investment identified as being in the client's best interest. Recommendations should be made in the investment categories according to the strategy guidelines listed above, based on the IO and RT selected for the account.

Regulation Best Interest requires brokerage accounts to have an identified strategy if recommendations are going to be made for the account without the requirement to document each individual recommendation.

PCS will utilize the above referenced strategies when reviewing account activity to confirm best interest recommendations and compliance with Regulation Best Interest. Registered Representatives may be contacted to provide additional information and justification when account holdings are determined to be outside of the portfolio construction recommended by the IO and RT selection.