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Whose Fiduciary Standard Are You Using?

The Securities and Exchange Commission's Regulation Best Interest is not only confusing to clients, it's confusing to financial advisors as well. One advisor told me that he now adheres to a fiduciary standard because of this regulation.

My response: "Well, not really!"

While the regulation requires advisors to put clients' interests ahead of their own at the time of a securities transaction, a true fiduciary standard asks you to put clients ahead *at all times*. It's not limited to the time and date of a particular trade.

Take a group whose view on the matter is likely more orthodox: CFP mark holders. Those holding the designation have three core duties:

1. *The duty of care*. They must act with the care, skill, prudence and diligence that a prudent professional would exercise in light of a client's goals, risk tolerance, objectives and personal circumstances.
2. *The duty of loyalty*. They place the interests of their clients above the interests of themselves and their firms, avoiding conflicts of interest, disclosing to the client any material conflicts that do emerge, obtaining the clients' informed consent and properly managing conflicts.
3. *The duty to follow client instructions*. CFP mark holders are required to comply with the objectives, policy restrictions and other terms of engagement for dealing with clients and all the reasonable and lawful directions of the client.

These obligations don't stop and end with a securities transaction. They stand at all times—unlike Reg BI, which only applies at the time a recommendation is made to a client. The CFP code of standards goes beyond, covering all financial assets—as well as to other aspects of a client's financial world, like tax strategies and insurance recommendations in which the Reg BI has no interest.

But whether the advisors are following a CFP standard or a Reg BI standard, there are conflicts that often fall through the cracks—things the advisors often miss. Here we're going to examine four conflicts that are often overlooked: proprietary advisory platforms, forgivable transition notes, advisory administration fees and markups on third-party money managers' management fees.

Proprietary Advisory Platforms

We see both broker-dealer RIAs and large producer groups (super OSJs) offering their own proprietary managed advisory programs. These are their primary profit centers. Yet if you give an advisor a 100% payout for a product that comes from your firm's proprietary platform—while paying less for something from another advisory platform—that's a conflict of interest. Broker-dealer RIAs do this. So do some independent RIAs.

Michael Kitces, the creator of the Nerd's Eye View blog, says, "To the extent that the RIA platform is giving different payouts to advisors for different investment solutions, that definitely raises conflict of interest concerns, as it's literally a financial inducement to guide clients towards one solution over another.

"That doesn't automatically make it wrong (not all conflicts of interest result in outright harm), but it's certainly concerning, to say the least. Notably, the SEC's fiduciary framework does generally allow such conflicts with some disclosures, although the Department of Labor's original fiduciary rule back in 2016 would have outright banned such practices (as a 'more stringent' version of fiduciary where such conflict can't be mitigated and disclosed, but would have had to be eliminated altogether)."

For fiduciary standard purists, anything with the word "proprietary" in front of it ought to invite skepticism.

More specifically, conflicted platforms do the following things:

- They offer payout advantage for proprietary advisory platforms over non-proprietary platforms (say, a 100% payout for something from the firm's platform over 90% for a product from an outside platform).
- They limit the selection of competing advisory platforms.
- They promote proprietary platforms on their company website and at conferences while limiting the exposure from competing platforms.
- They put pressure on advisors to move client assets to proprietary platforms.
- They penalize advisors and clients for holding advisory assets away at turnkey asset managers or outside custodians like Schwab or Fidelity IWS. One way they do this is by imposing platform fees, usually paid by the advisor, costing 5 to 10 basis points on assets. They do this because they otherwise miss out on embedded profit they receive when those assets are in a brokerage account. The platform fee helps them make up the profit difference. Remember, a substantial percentage of broker-dealer RIAs won't allow advisors to custody advisory assets outside of their clearing firms. For a fiduciary, the client advantages to using Fidelity IWS or Schwab for advisory assets are numerous, but the most obvious one is that the clients don't pay ticket charges on stocks and ETFs. (Most B-D RIAs require clients to pay ticket charges, but not all.)

Transition Forgivable Notes

Last year, our recruiting firm was approached by a broker-dealer owned by an insurance company. The B-D boasted about its generous transition packages to advisors who joined, and said it paid more forgivable note money than most competitors. But there is no free lunch. We did some digging and found the firm charged an advisory administration fee that tiered around 18 to 28 basis points, a very high cost for clients to incur when much better values were available.

We did a formalized cost analysis comparing a fiduciary-focused option (in other words, one with a low administrative fee) to options that paid substantial up-front note money—along with a high administrative fee.

In most cases, it was the clients who paid for the advisors' up-front note money, more than three times over during a seven-year note period.

For our analysis, we took a real-world advisor with $90 million in assets: $40 million of that was in stocks and ETFs; $30 million was held with a third-party manager; $20 million was in mutual funds and variable annuities. The advisor had $900,000 in gross dealer concessions and 250 brokerage accounts. To transition to his new firm, the advisor was given a $315,000 forgivable note payable over seven years. This firm charged 30 basis points in administrative all-inclusive wrap fees (the assets were managed at Pershing). There was also a 15 basis point markup on third-party money manager fees.

The advisor's clients ended up paying $1.155 million in advisory administrative fees over seven years to service that $315,000 note.

We compared what would have happened to him in a hypothetical situation at a fiduciary-focused broker-dealer RIA. This time, there was no forgivable note. There was a flat $50 annual service charge per client account. He got 2% to 5% in trailing GDC. The advisor's transition expenses were covered, and there was another $30,000 paid in incidentals.

Those clients would have paid only $87,500 in admin fees over the same seven years.

This particular analysis compared two different broker-dealer RIAs, but an independent RIA can offer even greater cost savings to clients. Forgivable note money makes it clear whether a CFP is putting his clients' interests above his own—or if he's taking a large amount of note money at his clients' expense.

Advisory Administration Fees

Broker-dealers warn advisors about future fee compression, yet no one seems to be discussing the elephant in the room, which is broker-dealer RIA expense compression. Many broker-dealer RIAs charge 10 to 15 basis points in administration fees on advisor-directed advisory assets for billing and performance reporting. But a growing number of fiduciary focused broker-dealer RIAs and producer groups are charging flat fees of $50 to $75 per account annually, which substantially cuts the clients' expenses.

Independent turnkey RIAs are going one step further, as they bundle everything (the 100% payout, compliance, operations, the technology stack, E&O insurance, advisory billing and performance reporting) into a single cost as low as 10 basis points on client assets. If there is one thing that gives broker-dealer RIAs an arrhythmia, this is it.

Markups On Third-Party Money Manager Management Fees

Broker-dealers use markups on third-party manager fees to help themselves pay for their large forgivable transition notes. But this costs clients dearly. The markup (which the firm may refer to as a "marketing reallowance") can overrun the original manager's charge by as much as 10 to 50 basis points. Advisory departments may claim the charge is for ongoing due diligence on the money manager, but the reality is that it's all profit. The markup, after all, is not charged on the firms' proprietary asset management platforms—only on non-proprietary ones. That's a conflict of interest. Not all broker-dealer RIAs do it, but an increasing number have added the fees, which are more pronounced at larger broker-dealer RIAs.

Advisors are often unaware of these extra fees—sometimes they find out about it through happenstance. One advisor told us he was exploring Fidelity IWS as a custodian. He asked Fidelity out of curiosity if it contracted with a particular money manager and what the management fee was. He discovered he was paying 20 basis points more for the money manager's management fee than what Fidelity IWS was quoting.

It's hard to adhere to a fiduciary standard when dealing with such opaque costs. You don't know what the large checks being waved in your face represent—since how they are being paid for is muddled at best. You don't know what your alternative options are in the marketplace. But it's imperative to know what the conflicts are if you want to adhere to the standard, especially if you are a CFP with a legal obligation. That standard has been required by the CFP Board for client investments since June 2020, and those who run afoul of it risk disciplinary action by the board. In the future, you must be hypervigilant about these conflicts and the better options available to you and your clients.

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