Fiduciary Reference

Analysis of Investment Fiduciary Issues

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Why Avoiding Conflicts of Interest Matters

Advisor DNA found in the Advisers Act of 1940 and championed for generations is *objective advice. It's knowing that conflicts can be toxic. Yet, in some quarters today industry and regulatory views reject this bedrock principle. Instead, they view conflicts as inevitable and "acceptable." This is a sharp departure from precedent that many RIAs fervently reject. Here, eight advisors explain "why"*

Knut A. Rostad *

Introduction and Summary

In September 2016 the Institute released a paper that surveyed the ADVs of 135 RIAs and nine large financial services firms. 1. Form ADV Part I and Part II offers investors a wealth of data about the scope and nature of an RIA's business. The Institute sought to describe key RIA attributes regarding business lines, employees' registrations, revenues and compensation and conflicts.

The 135 RIA firms aggregated assets are $465 billion. 18% of the 135 firms post AUMs of $3 billion or more; 82% from $250 mm up to $3 billion. 99% of the firms receive compensation as a % of AUM; 61% by hourly fees.100% perform portfolio management services; 94% financial planning services.

This paper follows our September 2016 paper by highlighting 25 of the 135 RIAs that further minimize their conflicts by refraining from certain practices. The 25 firms are identified and eight firm principals provide comments (noted below) on 'Why avoiding conflicts of interest matter.' Their remarks are illuminating, addressing topics from the "philosophical" to the "practical." In summary, their views may be distilled to 'Avoiding conflicts is essential to providing true advice.'

- These firm principals believe their mandate is to avoid conflicts; it is not to disclose conflicts. Why? Disclosing conflicts can limit or taint the client relationship, add burdens to the firm and confuse staff.

- More broadly, avoiding conflicts reinforces objective advice. Clients sense the difference, that objective advice is not conflicted advice and a product recommendation. They sense the difference between a client advocate and a product advocate. With a client advocate, clients tend to be more trusting and respectful and have deeper advisor relationships. They show greater confidence in the advice rendered and, critically, in their own financial situation. This is powerful.

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Background

Investment Advisers Act of 1940. The foundation of federal securities laws for investment advice and the importance of fiduciary duty derives from the Investment Advisers Act of 1940. "Fundamental to the (Investment Advisers) Act is the notion that an adviser is a fiduciary," notes Robert E. Plaze. Former Deputy Director of the Division of Investment Management of the SEC.[2]

An SEC report that became a basis for the Advisers Act was highlighted by the Supreme Court in 1963 in the landmark case, SEC v Capital Gains Research Bureau.[3] As the Court notes about the report:

"The report reflects the attitude – shared by investment advisers and the Commission – that investment advisers could not 'completely perform their basic function – furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments – unless all conflicts of interest between the investment counsel were removed."

Key Conflicts of Interest. Broker dealers are structured to distribute products while investment advisers are structured to render advice. As a result, brokers key conflicts of interest revolve around how the broker and the BD are compensated. Understandably, successful brokers tend to be the best sales persons. The upfront commissions to brokers are often transparent; yet, the total compensation to the firm and the broker paid by the manufacturers is often not as transparent.

In contrast, investment advisers' compensation paid by clients' fees are typically transparent and the core underlying investment expenses are usually either as transparent or easy to attain and figure. Some RIAs have also urged their investment adviser representatives to register as brokers or insurance agents, to become a "fee and commission" firm. Further, many RIAs have firm wide relations with other firms that present conflicts of interest. These registrations and firm relations also create conflicts, which are noted below.

Key Survey Findings

Characteristics of the 135 RIA firms regarding employees' registrations. lines of business, proprietary and principal trades; advisor compensation not paid by clients; material conflicts of interest

- 35% of the RIAs report employees registered representatives of a broker-dealer. (Part 1 A. 5 B 2) 39% of the RIAs are licensed agents of an insurance company or agency. (Part 1 A 5.B 5)

  2% of the RIA report the entity or a related person buy or sell securities from advisory clients or to advisory clients. (Part 1 A 8.A 1) 17% of RIAs recommend securities to advisory clients in which the advisor or related person has some proprietary interests. (Part 1 A 8 A. 3)

- 34% of RIAs exclusively receive fees from clients. (Part 2 5 C, E) Of the 66% of the RIAs that receive other forms of compensation, 52% receive brokerage compensation and 34% receive insurance compensation. 76% of RIAs have "a relationship material to their business that creates a material conflict of interest with your clients."

How many of the 135 firms decline engaging in all five practices which present conflicts? Firms that decline registering advisers as insurance agents (1) or registered representatives (2). Decline selling proprietary products. (3) Decline receiving compensation other than fees paid by clients. (4) Also, do not disclose a relationship "material" to their business that creates a "material conflict of interest with your clients." (5) Combined, only 25 firms, 18% of the 135 firms, disclose they have chosen to not engage in any of these practices.

Twenty-five RIA firms that Choose to Avoid Practices or Firm Relationships that Create Conflicts

Advisory Firm	Location	AUM (billions $)
Oxford Financial Group, LTD	Carmel, IN	$13.6
The Colony Group, LLC	Boston, MA	$4.9
WE Family Offices, LLC	Miami, FL	$4.2
Sontag Advisory, LLC	New York, NY	$4.1
Welch & Forbes LLC	Boston, MA	$3.9
Symmetry Partners	Glastonbury, CT	$3.7
Balasa Dinverno Foltz, LLC	Itasca, IL	$3.1
Orgel Wealth Management, LLC	Altoona, WI	$3.0
Joel Isaacson & Co., LLC	New York, NY	$2.9
South Texas Money Management	San Antonio, TX	$2.8
MRA Associates	Phoenix, AZ	$2.4
EP Wealth Advisors, Inc.	Torrance, CA	$2.2
Matter Family Office	Clayton, MI	$2.2
Greenspring Wealth Management, Inc.	Towson, MD	$2.1
Andersen Tax LLC	Mclean, VA	$1.9
Modera Wealth Management, LLC	Westwood, NJ	$1.6
Sand Hill Global Advisors, LLC	Palo Alto, CA	$1.6
Water Oak Advisors, LLC	Winter Park, FL	$1.4
Accredited Investors, Inc.	Edina, MN	$1.4
GM Advisory Group	Melville, N.Y.	$.59
Traphagen Financial Group	Oradell, N.J.	$.42
Mois and Fitzgerald Tamayo	Orlando, Fla.	$.39
Starfire Investment Advisers	Southfield, Mich.	$.35
Ritter Daniher Financial Advisory	Cincinnati, Ohio	$.33
Net Worth Advisory Group	Sandy, Utah	$.26

Advisors' Speak Out on Conflicts

The 25 firms were invited to comment on avoiding conflicts of interest. Eight firm principals did so:

Michael Delgass, JD, Sontag Advisory
Derek Holman, CFP, EP Wealth Advisors
Joel Isaacson, Joel Isaacson & Company
Josh Itzoe, CFP, Greenspring Wealth Management
Ross Levin, CFP, Accredited Investors
Dan Moisand, CFP, Moisand Fitzgerald Tamayo
Tom Orecchio, CFA, Modera Wealth Management
Patrick Sweeny, Symmetry

Their comments, reproduced in full below (on pages 5 to 9), are important. They are important because they express concerns derived from practical experiences serving clients. Concerns that get to the nature of conflicts' harms. These are harms to investors, the advisor – client relationship and the advisory industry. These comments also reflect age-old principles from jurists and advisory leaders.

Early career experiences in brokerage firms marked some of these advisors. **Patrick Sweeny** remarks, "I was taken aback by how much pressure there was (at a brokerage) to sell proprietary products... I'm a big critic of the broker-dealer model… and a fan of many individual brokers." **Derek Holman** adds about his experience at a BD, that one manager told him, "Success in the industry depends on selling and not on advising." **Tom Orecchio** recalls he started in a firm with commissions and an annual sales contest where prizes and trips were awarded. "I was never comfortable. These incentives changed behavior and I did not like what I witnessed."

Fees, planning versus asset growth. **Joel Isaacson**, "There is a tension between planning and asset management growth. Planning is as close to pure advice as we can get, where we can provide the greatest value." **Sweeny** adds, "We are passionate about thoughtful and in-depth financial planning, (which he predicts, will increasingly) differentiate great advisors."

Clients: conflicts undermine the value of your advice. **Ross Levin** says his clients know, "They receives our advice for only one reason … we believe it our best advice." **Dan Moisand** says it this way, "Clients take advice more to heart when they know it's true advice." **Holman**, who dropped insurance licenses three years ago, candidly explains, "There was always confusion when we would switch and disclose our sales biases. This was not the way we wanted to provide advice…. Straight fee only provides clarity and simplicity."

Transparency. **Sweeny** stresses, "We take a lot of time to make sure investors understand what they are paying. Total cost transparency is so important." **Holman** adds, "Most investors we meet pay more in fees but don't see it. With us, they generally pay less, but see it. When investors don't see the fees they tend to think the services are free." **Josh Itzoe**, "Full fee transparency … (creates) a depth of trust you can't get otherwise. At the wire houses we felt conflicts and the lack of fee transparency created more of an adversarial relationship."

Conflicts, professionalism and trust. **Itzoe**, "There is no doubt in my mind that conflicts around compensation prevents the advisory industry from being recognized as a true profession." **Moisand** says conflicts must be avoided because managing conflicts doesn't cut it for clients or the firm. "Managing conflicts requires the firm follow additional procedures… I don't worry about conflicts I avoid." **Levin** concludes, "Nothing is completely without conflict, but reducing conflicts as much as possible increases the likelihood of receiving objective, client-centered advice.

Michael N. Delgass, J.D.
Sontag Advisory

"Howard Sontag founded the firm in 1995 with a legal background in taxation and benefits. I joined Sontag Advisory in 2005, also with a legal background in estate planning and taxes. This legal background informs the firm's approach to wealth management and what acting In a fiduciary capacity means. There are "bright lines" – such as no proprietary products – which clients easily see. These Bright lines are sometimes subjects of media headlines of company wrongdoing and clients understand they should not be crossed. There are also many less-bright lines – "dull Lines" – that we also believe should not be crossed.

Dull lines are less apparent to most clients but still important to client-centered advice. Maintaining a uniform fee schedule across asset classes is a good example of this.

In some cases, the dispersion of client accounts can create potential conflicts when some are billed and others (perhaps held away) are not, and there a fixed dollar fee may be a way of ensuring objectivity. We try very hard to avoid situations that create conflicts, and create billing arrangements to minimize them where necessary.

Firm culture matters. We aim to "walk this walk", in part, by embedding issues of fiduciary due care and loyalty into our annual employee and executive reviews. This is hard to measure and quantify, but we ask that supervisors evaluate their reports in part on how well they adhere to our core values, and how well they maintain focus on the client's best interests.

We seek to identify specific employee choices and actions that demonstrate, in our view, an understanding of and fidelity to a high fiduciary standard. We highlight these examples and sometimes publicly commend the individual to reinforce our fiduciary culture."

Derek Holman, CFP
EP Wealth Advisors

When I was in college, I loved learning about how businesses worked, and the capital markets since they are an accumulation of all those businesses. I like the big picture. And so after I graduated I wanted to go work for a Wall Street firm, as any kid with my interests would want to, and I wanted to give people valuable investment advice.

But the two Wall Street firms I worked for were far different than I expected. I remember one manager telling me, quite directly, that success in the industry depended on selling well—not on advising well.

This bothered me, but I didn't know that there was another way. I shared my experience with my longtime and trusted friend Brian Parker, who also was in financial services. He had similar experiences, and we both quickly realized this was not the advice we'd give our families and decided to start an independent firm where we could provide objective financial advice.

For a number of years we were fee based and continued to offer insurance to our clients, but there was always confusion from our clients when we would switch to disclose our sales biases. This was not the way we wanted to provide advice and, so, overtime we sold less and less insurance, becoming "culturally fee-only."

Three years ago, we dropped our insurance licenses, which wasn't a major event for our clients. Though there is a price to pay for being transparent. Not just the revenue from commissions but the time to explain the different options with clients. Most investors we meet pay more in fees, but don't always see it, and with us, they generally pay less but see the fee. When investors don't see the fees they tend to think the services are free. It is certainly easier to work in that environment, but it erodes trust with the client over the long term and that didn't sit well with us.

Straight "fee only" provides the clarity and simplicity to operate our business because new and veteran employees understand that our model really puts the client first, and they want to give family-worthy advice too.

Joel Isaacson
Joel Isaacson & Company

After graduating with an MBA in financial planning from Golden Gate University, I started an RIA within an accounting firm in my first job. There-after, twenty-three years ago, I started my own firm.

We always focused on tax and financial planning and we charged retainers. We felt this compensation arrangement presented the fewest possible conflicts with clients. Asset management services followed. At the start (this was before Schwab) we would mail checks to Vanguard.

I have always felt there is a tension between emphasizing "planning" on the one hand and "asset management growth" on the other. "Planning" is as close to pure advice as we can get and is where we can provide the greatest client value. Planning should be an advisor's priority. Too often it seems there is a great focus in the industry on asset management services – which inherently has many more conflicts than does planning.

Further, with the commoditization of investing and spread of digital platforms today, this tension is clearer than ever. Quality planning is increasingly more important.

We don't promote our firm; we rely on referrals. Most potential new clients we see come from banks or wire houses. So they come into our office knowing our firm is fee-only and stresses planning and advice and is not about investment products and commissions.

Josh Itzoe, CFP
Greenspring Wealth Management

My partner and I came from stints at Morgan Stanley and at Merrill Lynch and came up with idea for Greenspring in 2002 and then the firm was founded in 2004.

There was a push in the early 2000s in the wirehouses to do more fee-based business and our training programs were structured this way. We had about 95 to 98% of our business on the fee-based side when we left. Our transition to a fee-only RIA was much easier because we weren't really leaving any revenue behind that would have been critical to launching. So, we didn't see the purpose in having a BD relationship and felt like a fee-only RIA aligned with our vision and being a fiduciary would help us differentiate (this was before most people had much of a concept of what it meant to be a fiduciary).

At Morgan and Merrill we were not good at sales; we wanted to be good at advice. We attended NAPFA study groups before leaving the BDs and were regarded with some skepticism. From the start we believed being fee-only was very important. We also believed in full fee transparency because we felt like it created a depth of client trust you just can't get otherwise. At the wirehouses we felt conflicts and the lack of fee transparency created more of an adversarial relationship that put us in a difficult position and clients at a disadvantage. There's a powerful connection formed with clients when they know you are advocating for them alone and making sure the marketplace treats them fairly.

A little later in 2006, we saw an opportunity to get into the 401(k) business and promote fiduciary principles and practices. As we got deeper into it, I realized how confusing and opaque is the world of fees. It bothered me so I wrote a book called *Fixing the 401(k)* and dedicated a whole chapter to deciphering 401(k) fees and expenses.

There's no doubt in my mind that it is conflicts of interest around compensation that prevents the advisory industry from being recognized as a true profession – and not just one big sales organization. I think that's a big reason why CPAs and attorneys are often viewed as "trusted" advisors much more so than financial advisors.

Over the years (especially early on), some people encouraged us to sell insurance or other products. The rationale was we left a lot of money on the table. We disagreed. We have always believed that over the long-term it's our true independence and objectivity that sets us apart and receiving indirect compensation waters down that message and changes the way you advise clients. Personally, I would rather make less money but be able to sit in front of a client who has confidence that any recommendation I make to them is based on merit alone.

Today there is much talk around asking an advisor if he or she is a fiduciary. I think this is the wrong question. Being a fiduciary is simply "table stakes". The better question is: 'what's your expertise, experience, qualifications, processes and ideas that qualifies you to be a fiduciary.' I've often said that the word "fiduciary" is not simply a noun (who you are). Instead (and more importantly), being a fiduciary is a verb - it's what you DO that actually matters. Rather than simply asking prospective advisors if they are willing to accept fiduciary responsibility for their advice, prospective clients (both individuals and plan sponsors) would be well-served to ask questions to determine what qualifies the potential advisor to be the most capable fiduciary for their needs.

Ross Levin, CFP
Accredited Investors

Clients understand what we do and why we do it. A client knows he receives our advice for only one reason – It's because we believe it is our best advice. When our motivations are aligned with our clients', our advice is more apt to be taken and less apt to be ignored. We believe that this leads to better outcomes for the client. This is not only in the clients' best interest, it is in our firm's best interest.

The industry is famous for complex products and unfathomable prose that may confuse not only clients, but people placing the products. Legendary investor, Warren Buffet, has written about annual reports he cannot understand and how he tends to avoid investing in those businesses.

When you get through the complexities and dense writing, you may more clearly see the conflicts of interest. These conflicts are incentives which may impair objectivity and potentially influence an advisor. And research tells us that even the very best intentioned advisors can fall prey to these conflicts. Nothing is completely without conflict, but reducing conflicts as much as possible increases the likelihood of receiving objective, client-centered advice.

Experience teaches that conflicts are often synonymous with complexity. The wisdom of Occams' Razor - the simple solution is often the better solution – may seem less impressive, but is generally far more effective.

Dan Moisand, CFP
Moisand Fitzgerald

Some advisors seem to figure that managing conflicts is just as good as avoiding conflicts. I disagree. Avoiding conflicts always beats managing conflicts, for a number of reasons.

After over twenty years advising investors, there is no doubt clients take advice more to heart when they believe it's true advice, unimpaired by products or business interests. Their confidence in the advice and their own financial situation grows. The advisor / client relationship can become more meaningful, the opportunity for the advisor to provide greater value can increase.

From a business perspective, managing conflicts requires the firm must follow additional procedures. Conflicts that are avoided require no such procedures to manage. In this sense more conflicts means more regulation. Finally, from a personal perspective its really simple. I don't worry about conflicts I avoid.

Tom Orecchio, CFA
Modera Wealth Management

I have been fee-only for so long it's just what we do. I started in a firm that was fee and commissions and was there for four years until 1994. I did well and believe my clients were well served. But I was never entirely comfortable. As in when, once a year, the firm would have a contest and brokers and advisers could win prizes or trips. These incentives changed behavior and I did not like what I witnessed.

We have a conflict in our AUM fee model which we disclose on our ADV and verbally. Such as when a client asks whether she should pay off her mortgage. I believe our firm culture is highly sensitive to conflicts. It's deeply engrained. It's simple. For example, we don't do gifts or entertainment. Period. We politely decline such offers and may ask they be donated to charity, instead. It's so much simpler to avoid than it is to manage conflicts.

It appears the industry is coming in this direction on the brokerage front. There is a greater awareness of the importance of conflicts. However, in insurance, there has not been much change from how it was twenty years ago.

Patrick Sweeny
Symmetry

"My partner, David Connelly, and I came out of several years on Wall Street in institutional trading And sales and then at Dean Witter Reynolds serving high-net-worth individuals. We formed Symmetry in 1994 and our experience at Witter was particularly important. I was taken aback by how much pressure there was there to sell proprietary products to individual clients. This was my first experience with conflicts of interest. I am a big critic of the broker-dealer model, but am also a big fan of many individual brokers who, none-the-less, serve their clients despite the BD system.

At Symmetry we went fee-only and used Dimensional Fund Advisors and Vanguard. Today we advise clients directly and sub advise to advisors nationwide. We are missionaries about investor education and especially about investing costs. We take a lot of time to make sure investors understand what they are paying. Total cost transparency is so important. We are also passionate about what we believe will differentiate great advisors from also-rans in the future. This is financial planning that is thoughtful, in-depth and well-researched and delivered with outstanding service.

We have been fiduciaries since 1994 and are committed to helping brokers come to the RIA side and become the true professionals' investors sorely need. Minimizing conflicts of interest is key to becoming a profession."

Notes

1. RIA Survey Methodology

The RIAs were derived from Financial Advisor Magazine's July 2016 RIA Survey & Ranking list. The list includes the top 610 RIAs categorized and sorted by total assets under management, and is available at the following link: http://www.fa-mag.com/userfiles/2016_FA_Issues/July_2016/RIA_Files/jul_fa_RIA2016_Ranking_3.pdf.

Only RIAs with $250 million assets under management were considered, and every 3rd RIA beginning with the first on the list (CAPTRUST) was selected for Form ADV evaluation.

2. Robert E. PLaze, "Regulation of Investment Advisers by the U. S. Securities and Exchange Commission", http://www.stroock.com/siteFiles/PAFile120.pdf

As Plaze writes on page 31 and 32:

"Fundamental to the Act is the notion that an adviser is a fiduciary. As a fiduciary, an adviser must avoid conflicts of interest with clients and is prohibited from overreaching or taking unfair advantage of a client's trust. A fiduciary owes its clients more than mere honesty and good faith alone. A fiduciary must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice, and it may be faulted even when it does not intend to injure a client and even if the client does not suffer a monetary loss. 175 The landmark court decision defining the duties of a fiduciary is Justice Cardozo's opinion in *Meinhard v. Salmon,* in which he explains that:

Many forms of conduct permissible in the workaday world for those acting at arm's length are forbidden by those bound by fiduciary ties. A fiduciary is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.176

These concepts are embodied in the anti-fraud provisions of the Advisers Act. As the Supreme Court stated in *SEC v. Capital Gains Research Bureau, Inc.*, its seminal decision on the fiduciary duties of an adviser under the Act, "[t]he Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."177

3. https://www.sec.gov/divisions/investment/capitalgains1963.pdf