

# Weekend Reading for Financial Planners (Jan 21-22)

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## **Executive Summary**

*Enjoy the current installment of “weekend reading for financial planners” – this week’s edition kicks off with a flurry of news about the DoL fiduciary rule, including a letter from Senator Elizabeth Warren asking major financial institutions that have already been working to comply with the rule if they’re now willing to support it (since they’re already almost done implementing the necessary compliance processes), a major report from the Consumer Federation of American finding that 25 of the leading financial services firms are holding out to consumers that they provide advice as an “essential service” even as they contend to regulators and the courts that they are merely in the business of selling products, and a review of the latest set of fiduciary rule FAQs released by the Department of Labor (which cleared a major concern about using fee-offset revenue-sharing arrangements in 401(k) plans).*

*From there, we have a few more articles delving deeper into the fiduciary rule as its applicability date looms, including: an analysis by Ron Rhoades of why ultimately most Financial Institutions will probably eschew the BICE rules and just become level fee fiduciaries using fee-based advisory accounts instead; criticism that the DoL still hasn’t sufficiently defined its “due diligence” expectations of how advisors should analyze the investments they’re recommending; and a look from Cliff Asness of AQR at some of the potential “unintended consequences” of the DoL fiduciary rule (such as whether, in the long run, consumers will end up trusting financial advisors too much, let their guard down, and ultimately allow even more harm to be caused down the road).*

*There are also a couple of practice management articles this week, from a review of the record-breaking pace of mergers and acquisitions amongst RIAs last year (though the total number of deals is still miniscule relative to the total number of advisory firms), to a look at how 1/3rd of the major RIAs last year actually saw a decrease in AUM as retirement withdrawals and even client deaths of their baby-boomer-centric clientele are beginning to take a toll, and a discussion of the blocking point amongst advisory firm owners that will cause most of them to fail to achieve their own long-term vision for their business.*

*We wrap up with three interesting articles: the first is a discussion of whether investment managers, from mutual funds to even RIAs, should consider adopting “fulcrum fees” in lieu of the traditional AUM fee, as a way to better align the interests of the manager and the client; the second is a look at the research on why ethical people end up making unethical choices, and the recognition that it’s creating a toxic employee culture that is the most common driver of employees making “bad” decisions; and the last is an interesting discussion from Bob Veres that even as advisors who work at broker-dealers complain that the media is maligning them as salesperson (when they’re really trying to give advice and act in their clients’ best interests), it’s actually the broker-dealer companies themselves, and their lobbying organizations, who are stating to the regulators and the courts that their “advisors” are really just mere salespeople and not advisors (and thus contend they shouldn’t be held to a fiduciary duty)... which means if you’re at a broker-dealer and want to be recognized as an advisor, you’ll have to start by convincing your own company to truly recognize you as such!*

*Enjoy the “light” reading!*

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Weekend reading for January 21st/22nd:

**Political Twist: Elizabeth Warren Asks Banks to Help Defend Fiduciary Rule (Yuka Hayashi, Wall Street Journal)** – As an anticipated fight over the DoL fiduciary rule gears up with President Trump taking office, this week [Democratic Senator Elizabeth Warren sent a letter](#) to 33 major financial institutions, praising them for their efforts in preparing to comply with the rule, and asking them whether at this point they would (still) support delaying the rule and/or if they would roll back their already-announced plans if the rule is pushed back. Notably, up to this point, many major financial institutions have opposed the rule, either directly or through their lobbying trade groups like SIFMA and FSI. However, given the depth of rollout at this point, [the question arises as to whether firms are still as negative about the rule](#) – given that by now they may have already implemented most of what they need to comply anyway. In fact, firms that have been the fastest to implement systems that comply with the fiduciary rule now actually have a competitive advantage to see the rule go through, as it leaves them better positioned than their competitors, which may be exactly the kind of support that Senator Warren is seeking. Of course, it's highly likely that at least some firms will continue to oppose the rule anyway, but if there are at least a set of early adopters prepared to comply with the rule that see a competitive advantage for it to stick around – such as Merrill Lynch with its new fiduciary commitment, or Commonwealth Financial, or even [Vanguard with its Personal Advisor Services solution](#) or [Schwab's Intelligent Advisory platform](#) – then a mere split, and the lack of “unanimous” support to strike it down, may ensure that the DoL fiduciary rule sticks around until its final April applicability date.

**Consumer Group Contends Brokerages Misrepresent Their Sales Focus (Liz Skinner, Investment News)** – As the next stage of the DoL fiduciary battle gears up, this week [the Consumer Federation of America released a new 16-page report](#), detailing how 25 major financial services institutions are claiming to regulators and the courts that they are merely engaging in the sale of financial services products (and thus shouldn't be held to a fiduciary standard), even as their consumer-facing marketing conveys that advice is an “essential service” being offered. The study notes that [financial services firm professionals commonly use titles like “Financial Advisor”, “Financial Consultant”, or “Retirement Consultant”](#), which is directly at odds with the fact that [broker-dealers only avoid fiduciary duty under the Investment Advisers Act of 1940 by maintaining that their financial advice is “solely incidental”](#) to their sale of brokerage products. In other words, financial services firms are claiming to the public that they're advisors, but claiming to regulators and courts that they're not in the business of giving advice, an impossibly contradictory position. Notably, the Financial Services Institute maintains that this is still a tenable position, given that in today's environment, a large number of financial advisors are dual-registered as *both* a registered representative of a broker-dealer *and* as an investment adviser representative of an RIA; nonetheless, it still raises the question of whether/why brokerage firms continue to fight the fiduciary rule, if they're going to claim that their advisors are primarily dual-registered fiduciaries (at least for their RIA business) already.

**Second Round Of DOL Fiduciary Rule FAQs Clears Confusion On Common Compensation Practice For 401(k) Advisers (Greg Iacurci, Investment News)** – Last Friday, the Department of Labor published [a new set of responses to Frequently Asked Questions \(FAQs\)](#) regarding the conflict of interest sections of the pending fiduciary rule. In its Q&A, the DoL resolved a major question looming regarding 401(k) plans in particular – whether an advisor charging clients a level asset-based fee for 401(k) advice could still use revenue-sharing payments (e.g., 12b-1 fees) to offset part or all of that level fee without running afoul of the conflict of interest rules. The technique is actually already a common practice in 401(k) plans, since the DoL previously affirmed it in [Advisory Opinion 97-15A](#), but attorneys have questioned whether the prior DoL opinion would still hold under the new rule. Fortunately for current providers, Q&A-7 of the new FAQ confirms that “nothing in the rule Rule or the Exemption alters the analysis of Advisory Opinion 97-15A”, which not only means the practice is permissible, but that since the fee-offset approach is still permitted to avoid a prohibited transaction, the 401(k) advisor wouldn't even need to rely on the Best Interests Contract Exemption to use it. On the other hand, for firms that charge level fees but don't perfectly fit the scenario under Advisory Opinion 97-15A, it remains unclear whether a fee-offset approach would still be permitted under the Level Fee Fiduciary “BICE Lite” exemption.

**B.I.C.E.: Financial Advisors Beware (Ron Rhoades, Advisor Perspectives)** – Under the DoL fiduciary rule, Financial Institutions that want to offer financial advice and be compensated by commissions (so-called “conflict compensation”) must comply with the “Best Interests Contract Exemption” (or BICE) rules. For many firms, their focus in complying with BICE has been on meeting new disclosure requirements regarding compensation, but Rhoades notes that it’s not enough to simply disclose conflicted compensation and proceed with business as usual, as [under BICE and its Impartial Conduct Standards, recommendations must still be given to clients “without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.”](#) This is an important distinction, as it means firms can’t simply rely on disclosure and then proceed to use products that provide them better revenue-sharing agreements or generate higher profits, particularly where there’s a precisely equivalent lower-cost alternative. Notably, this doesn’t necessarily require firms to eschew actively managed funds for index funds, but it does mean that if there’s an institutional share class and a higher-cost retail or revenue-sharing version of the share class, the advisor is expected to use the lower-cost version. Which means there will be especially high scrutiny on any types of third-party payments that do occur, and that ultimately Financial Institutions may just decide that it’s easiest to avoid the extra scrutiny altogether (not to mention the reputational risk of running afoul of the rule), and just solely utilize fee-based advisory accounts that can follow the much-easier (and less conflicted) level fee fiduciary exemption instead. In fact, even as many Financial Institutions step up to comply with BICE, Rhoades suggests that ultimately BICE (and the full BICE disclosures) will simply become an indicator for “conflicted advisor”, such that the media may soon steer consumers away from BICE advisors and towards level fee fiduciary advisors anyway.

**The Labor Department Still Has To Define The Hardest Part Of The New Fiduciary Rule (David Trainer & Sam McBride, Marketwatch)** – One of the fundamental requirements of the DoL fiduciary rule, in order to meet the Impartial Conduct Standards of the Best Interest Contract Exemption, is that a fiduciary must act with the “care, skill, prudence, and diligence” of a professional, including doing due diligence on potential investments. However, Trainer and McBride note that the DoL has done little to actually clarify its expectations for what constitutes the necessary level of due diligence, especially in the context of financial advisors who don’t necessarily have time to conduct comprehensive due diligence with objective supporting research on every possible investment. And notably, the history of fiduciary law makes it clear that just trying to manage risk through diversification is not sufficient to meet the diligence standard; in other words, it’s not enough to go light on due diligence, and hope that the client is diversified enough to mitigate the damage if an investment goes awry. Of course, it is feasible to “outsource” due diligence to third parties who do it, but in a world of financial media with a low signal/noise ratio, and a lot of highly-conflicted “sell-side” research, there aren’t necessarily very many sources of third-party objective due diligence. Which raises the question of whether/what kind of scrutiny the DoL will put on an advisor’s due diligence process, whether firms need to enhance their centralized due diligence departments to support their advisors, or whether more third-party due diligence and investment research services will soon crop up, specifically to help advisors address the issue (and help share in the liability risk).

**Caveat Investor? The Fiduciary Rule And Unintended Consequences (Cliff Asness, AQR)** – While he acknowledges that higher standards for financial advisors are a good thing, Asness notes that even if the rule on the whole is a net positive, there are likely to be a number of unintended consequences of the DoL fiduciary rule. Of course, Asness notes that it’s not realistically feasible to create laws that say people “must” be good (as you can’t legislate human behavior)... thus why the DoL fiduciary rule instead relies on provisions like [the availability of class action lawsuits after the fact](#) as a potential deterrent to bad behavior. However, that still raises the question of what constitutes “good” or “bad” behavior in the first place, especially since you don’t always know upfront what will turn out well (or not) after the fact. For instance, while a high volume of account churning is clearly bad, as is putting an old widow’s nest egg into a single tech stock – but what about situations where a higher cost investment really might have been better (for other features that a pure index fund can’t provide)? And what’s the risk that there will be even more scrutiny on after-the-fact bad investment performance (that couldn’t have been anticipated in advance, despite appropriate due diligence), or bad performance of just one investment without considering its context in the overall portfolio? Similarly, is there a risk that the “do what other professionals do” standard of judging professional

prudence will stifle innovation in financial services, as advisors will suddenly take a greater-than-ever risk of acting substantially different than the herd (as it's long been observed in the investing world that "it is better to lose conventionally" than by being unique). And ultimately, there's a risk that if investors accept that "all" advisors really are fiduciaries, they may actually let their guard down – which ironically *increases* the pressure to aggressively enforce the fiduciary rule from regulators, since consumers might no longer do their part. On the other hand, it's important to note that versions of a fiduciary rule have been around for a long time, and most of the concerns that Asness raises have already been effectively navigated in other parts of the investment world for decades; nonetheless, it's important to recognize that there are legitimate concerns in understanding how the fiduciary rule will be applied to a wide swath of advisors whose behavior has never been judged in this manner before.

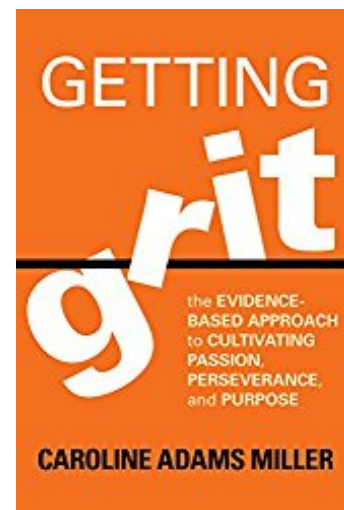
**RIAs Merging At A Record Clip, More Breakaways Become RIAs (Jeff Benjamin, Investment News)** – The merger and acquisition activity amongst the RIA community continues to accelerate, with 2016 showing a total of 138 transactions (up 10% over 2015 and nearly triple the volume of transactions in 2009). The rise in volume of deals appears to be driven by a number of forces simultaneously, including the aging adviser community, a desire to find economies of scale in greater size, and growing competitive pressures. In addition, the number of breakaway broker teams forming RIAs also hit a new high in 2016, up to more than double the volume from 2013. Other notable trends in advisor M&A included: the total AUM volume of deals hit a new record high (with a total of \$144B of acquisitions); the most common acquirer of RIAs are other RIAs followed by strategic acquirers, while the number of bank acquirers has crashed from its levels a decade ago; and the average size of an acquired firm is almost triple the average from just 5 years ago, while 2016 was the third time in 5 years that the average deal size was over \$1B of AUM. On the other hand, it's notable that relative to a total of 300,000 financial advisors and approximately 30,000 RIAs, a total volume of 138 transactions is still miniscule, and [questions remain as to what happened to the "age wave" of sales and the advisory firm "succession crisis" that was expected to hit by now as baby boomers retire](#). Though it remains unclear whether the number of transactions is simply underreported because more and more are happening as [private internal succession plans](#) instead.

**RIA Leaders 2017: Is This Decumulation? (Ann Marsh, Financial Planning)** – According to the latest "RIA Leaders" ranking from Financial Planning magazine, a whopping 1/3rd of the nation's largest RIAs *lost* assets under management in 2016, despite the overall ongoing growth of the RIA channel. The primary problem appears to be not the ability of RIAs to attract new clients (at least in the aggregate), but instead that the baby-boomer-centric demographic of RIA clientele is beginning to take its toll, from clients with ongoing retirement withdrawals, to clients who simply pass away and transfer or dissipate their wealth to heirs. As a result, Oxford Financial in Indiana saw its AUM fall from \$13.8B to \$13.6B, Savant Capital fell from \$4.4B to \$4.2B, and Evanson Asset Management was down from \$3.5B to \$3.4B. Notably, the sheer magnitude of outflows from withdrawals is still modest – in fact, Pershing notes that last year, the average advisory firm still had net positive flows from existing clients (i.e., more clients adding dollars to accounts than withdrew them), but the average growth rate on assets was 5%/year from 2011 to 2015 and just 2.8% last year. In addition, there's some evidence that [competitive headwinds are also taking a toll on RIAs](#), with 2016 also revealed as the worst year in a long time for organic growth rates of advisory firms. All of which suggests that even as the RIA community in the aggregate continues to grow, there will be more pressure than ever on advisory firms to systematize their marketing to grow in the coming years, in order to overcome a competitive landscape, an ongoing rise in client decumulation, and the attrition of clients who pass away.



## Why Most Advisors Won't Realize Their Business Vision And What To Do About It (Julie Littlechild, Absolute Engagement)

– In a recent survey, Littlechild found that nearly 2/3rds of all financial advisors state that they're not on track to achieve their business vision. In some cases, it's because what started out as a focused business has drifted off course over time; more often, though, the problem is simply that what's important to us changes over time, and suddenly what started out as a clear business vision no longer feels fulfilling anymore. Either way, though, it means that getting back on track will require making a change, and recognizing that change can be hard. Littlechild suggests that the first step is simply to give yourself permission to think differently – in other words, to take a step back, recognize that you may not be happy with the current trajectory of the business, and that *it's OK to start thinking of taking the business in a different direction*; otherwise, you risk getting stuck in a rut of what you've settled for, making only incremental changes that don't really realign the business to what engages you personally. In other scenarios, the key is recognizing that engaging in the change *will* take some hard work, and that you may need to build up your “grit” to power through for a period of time; fortunately, it appears that [grit can be learned](#) (or at least, your “grittiness” can be improved), but it may require changing who you spend time with (as gritty people tend to hang out with other gritty people, which helps them inspire each other and hold each other accountable), making a concerted effort to be more optimistic, and integrating things like meditation and exercise (which take time but actually help to give us focus). Other tips to breaking through include: embracing a “growth mindset”, where you recognize that change may not be instantaneous, but can be nurtured and achieved over time (though only if you *believe* that you have the potential to achieve that personal growth); and “clearing the decks” by making a deliberate mental effort to stop allowing yourself excuses. In other words, the key to change is almost all mental.



## A Fee Structure for Fund Managers Who Put Their Money Where Their Mouth Is (Jason Zweig, Wall Street Journal)

– As dirt-cheap index mutual funds and ETFs continue to proliferate, you'd think that traditional actively managed funds would be slashing their fees to compete; yet, in the past year, the average expense ratio of U.S. stock funds barely moved, inching down from 0.786% to 0.774% (and much of that decline still wasn't because funds cut fees, but was simply due to the fact that larger funds tend to be cheaper and grew faster, dragging down the average). Zweig suggests that one alternative would be to not just reduce the typical AUM fee charged by investment managers, but to change the entire *structure* of how fees are calculated instead, moving to a [“fulcrum fee” approach](#). The idea of a fulcrum fee is that the investment manager takes little or no compensation unless a particular performance target is reached – the fulcrum – and the manager then enjoys a larger upside compensation for exceeding the target (but only for exceeding it). One example from years ago was Warren Buffett, who in the 1960s had a fee structure where he charged 0% until returns exceeded 6%, and then took 25% of any gains above that threshold (and if he came up short one year, he wouldn't charge fees the next year until he made up the difference). This differs from the traditional hedge fund “2-plus-20” structure, which does have a form of fulcrum (participating in 20% of the upside above a target [of 0%]), but also charges a substantial AUM fee as well. Zweig suggests that a more pure fulcrum approach might be better, as it more fully aligns the incentive of the investment manager and the consumer. On the other hand, fulcrum fees actually *were* more common in the past, and their usage has actually declined, perhaps *because* it's riskier for the investment managers (who found that AUM fees

were more stable and that consumers were willing to pay them). Nonetheless, as active managers continue to struggle, arguably a fulcrum fee approach can at least be a way to make it clear [the investment manager will not just be a closet indexer](#) (which may be profitable under an AUM model, but would likely be doomed to failure under a fulcrum fee approach with a sufficiently high target).

**Why Ethical People Make Unethical Choices (Ron Carucci, Harvard Business Review)** – Most major companies today have ethics and compliance policies that all employees must sign, where they attest that they will conduct their business affairs in accordance with the highest ethical standards. Yet such pledges fail to prevent ethical breakdowns like Enron, or more recently Wells Fargo’s retail banking division. Which raises the question, why is it that corporate ethical failures seem to be so commonplace, even as there’s a rising attention towards making commitments to higher ethical standards (which is not unique to financial advisors and the looming DoL fiduciary rule)? Carucci suggests that the fundamental problem is that creating an ethical pledge doesn’t help when organizations still create environments in which people feel forced to make potentially unethical choices they never would have considered. For instance, some companies breed a culture where employees don’t feel that it is safe to speak up when there’s actually a problem. If employees feel like their feedback will be futile or retaliated against, they won’t help to prevent unethical behavior of peers before it compounds out of control. In other cases, the problem is excessive pressure to reach unrealistic performance targets, for which making “compromised” choices may feel like the only way out; in essence, while goals can help people to focus, unrealistic goals cause people to tunnel vision and focus in unhealthy ways and pursue potentially unethical tactics. Other “environment” challenges in a business that can trigger unethical behavior include: conflicting goals, such as those that pit internal departments against each other, and can cause resentment and backlash; failing to set a positive example (as a lot of ethical behavior really is determined by employee follow-on to action and behaviors at the top); and not talking about ethical behavior (as it turns out that it really *is* possible to teach people to better weigh principles against their choices, and that making ethics more top-of-mind really does lead to more ethical behavior).

**Where SIFMA And I Are In Total Agreement (Bob Veres, Inside Information)** – For those who work at broker-dealers, the past few years have been frustrating, as their entire business model is under assault from the media as the DoL fiduciary rule looms, even as most brokers already try to do the best thing for their clients, simply because it’s the right thing to do. Why all the negativity in calling brokers “salespeople”, if so many now have CFP certification, are trying to focus on providing advice (and not just selling products) to their clients, and already aim to do the best thing for those they serve? Yet Veres points out that it’s the lobbying firms of the broker-dealer community, such as SIFMA, that have been objecting to the DoL fiduciary rule by claiming it shouldn’t cover “activities that have never been understood to entail fiduciary duties, such as recommending the purchase of an investment product” and that a fiduciary duty “only applies where a heightened relationship of trust and confidence exists.” In other words, *even SIFMA is claiming that brokers at broker-dealers are merely engaged in the sale of products, and not the delivery of trusted advice*. Notably, this distinction between advice and sales isn’t new; in fact, [the entire foundation of Investment Advisers Act of 1940 recognizes that only those in the business of advice must register as advisors, and not those for whom advice is “solely incidental” to the sale of brokerage products](#). Nonetheless, the key point here is that if you’re a registered representative at a broker-dealer, the legal reality is that you *are* a salesperson for the company, and that’s exactly what the broker-dealers are stating to the courts and regulators. So if you’re a broker who wants to be recognized as an actual financial advisor and not characterized as a salesperson, start by taking the issue directly to your own broker-dealer, and tell them to stop lobbying that you shouldn’t be a fiduciary because you’re just a salesperson! Or alternatively, switch channels and become an independent RIA, where you really are legally an advisor and not a salesperson.

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I hope you enjoyed the reading! Please leave a comment below to share your thoughts, or make a suggestion of any articles you think I should highlight in a future column!

In the meantime, if you’re interested in more news and information regarding advisor technology, I’d highly recommend checking out [Bill Winterberg’s “FPPad” blog](#) on technology for advisors as well.

