Financial planner and investment advisor compensation paid by third parties

Category : Payment of Investment Advisors, Financial Planners, and Investment Counselors

Published by The Skilled Investor on Aug/1/2005

Financial Planner and Investment Advisor Compensation Paid by Third PartiesThere are three primary types of third party or commission-based compensation: commission-only, fee-based commission, and fee-offset commission. How an advisor is compensated can be a very important issue. With commission-only advisors, there is no direct cost to the client for planning and advice. The advice appears to be free, but it is not. Most clients find that 'planning' conversations focus quickly on the purchase of products through a commissioned advisor.   When choosing an advisor, individuals should first decide the type of advisor compensation that makes them most comfortable. How an advisor is compensated can be a very important issue. When you hire a financial planner or investment advisor, 1) you pay directly for his services, 2) a third party pays your adviser for you, or 3) these compensation methods are combined.   This article focuses on third party paid compensation, which is by far the most prevalent method of adviser compensation. For information on client paid advisor compensation, see: Financial planner and investment advisor compensation paid by clients For *The Skilled Investor’s* judgment on preferred advisor compensation arrangements for individual investors, see, Does it matter how financial planners and investment advisors are paid? and Fee-only compensation aligns the interests of clients and their financial advisors.   There are three primary types of third party or commission-based compensation: ->Commission-only: A third party pays commission fees, referral fees, or other fees to your advisor, and you pay nothing directly.   ->Fee-based commission: Your advisor accepts commissions and fees from third parties in addition to fees he charges against your assets.   ->Fee-offset commission: Your advisor accepts commissions and fees from third parties in addition to fees he charges against your assets. Your advisor rebates to you some or all of the fees he receives. With commission-only advisors, there is no direct cost to the client for planning and advice. This makes third party compensation appealing to many people – it appears to be free. Many individuals do not want to pay for directly for advice. By avoiding direct payments to an advisor, they hope that they will get a better deal. In addition, commission-only advisors argue that individuals only pay, when clients choose to follow the advisor’s recommendations.   Since commission-only advisors are not paid unless they sell products, most clients find that ‘planning’ conversations focus quickly on the purchase of specific investment and financial products through the advisor. When the client buys a product, such as an investment security or an insurance contract, fees will either be deducted from the client’s investment funds or will be rebated to the advisor by the financial industry firm that sold the product. The specifics about advisor commission payments may or may not be disclosed.   With the purchase of an insurance product, a commissioned advisor collects a fee, which could range upward to the amount of the first year’s premium. He may also collect a smaller trailing fee each year, as long as the policy remains in effect.   For securities investments, some specific third party compensation may be disclosed. For example, when one purchases mutual funds through a commissioned advisor, you will pay some combination of a) a front-end load or sales charge, b) a contingent deferred sales charge, and c) annual/periodic 12b-1 marketing fees, which are added to annual management fees. (See: Avoid mutual funds with sales commissions and 12b-1 fees, How much do hidden mutual fund trading expenses cost you?, and Beware of large and hidden mutual fund costs.)   Mutual fund investors, who purchase shares

through a commissioned sales advisor, are asked to make choices between Class A, Class B, and Class C mutual fund shares. As clients decide which of these share classes to purchase, the exercise appears to be about how to minimize investment costs. In reality, the client is deciding how their advisor and his firm will be compensated by the mutual fund for selling commissioned mutual fund shares to the client.   These Class A, Class B, and Class C mutual fund shares create an illusion of choice, yet more cost-effective alternatives will probably go unstated. Were the investor to purchase shares directly from the same mutual fund or chose an equivalent no-load fund, they would purchase a different class and pay none of these fees. [For more background on these mutual fund share classes, see these
Financial Industry Regulatory Authority (FINRA) Investor Alerts: "Understanding Mutual Fund Classes"
http://www.finra.org/InvestorInformation/InvestorAlerts/MutualFunds/UnderstandingMutualFundClasses/index.htmand "Class B Mutual Fund Shares: Do They Make the Grade?"
http://www.finra.org/InvestorInformation/InvestorAlerts/MutualFunds/ClassBMutualFundSharesDoTheyMaketheGrade/index.htm   Regarding the other two third party compensation methods, fee-based commissions and fee-offset commissions, these involve indirect compensation from the client to the advisor. The client does not pay a check directly, but fees will be charged against his assets and transferred to the advisor.   Regarding fee-based commission compensation, it is reasonably clear why this method is appealing to advisors. They receive payments from multiple sources, including you. However, you pay an annual percentage fee drawn against assets, and because of commissions, you still could receive biased advice that favors the financial interests of the advisor. Regarding fee-offset commission compensation, this arrangement is a bit of an oddity. You will pay for the advisor’s services through asset management fees. In addition, your advisor will accept third party commission payments, but will rebate some or all of these third party payments to you. On the surface, this seems appealing, and the advisor may argue that this compensation approach is the best of both worlds. Seemingly, you pay for unbiased advice and, if there is a third party commission, some or all of these commissions may go toward reducing your asset fee payments.   What could be better? Well, there are some inherent difficulties with this approach. To ensure that the advisor remains completely unbiased from a financial conflict-of-interest standpoint, he should rebate 100% of commissions to you. However, advisors can have significant costs in maintaining commissioned sales relationships with financial services companies. These costs include demands to meet sales quotas plus order processing and other administrative costs.   If an advisor does not keep some of these commissions to cover his costs, then he will incur extra overhead without compensation. To cover these costs, the advisor would need to increase the fees that he charges against the client’s assets. This negates the supposed advantages of fee-offset compensation. On the other hand, if he keeps some of the commissions, then how does the client know that the original advice was completely unbiased? (Note also, that an advisor might be legally barred from rebating fees -- see NASD Rule 2420.)

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