Episode 94: Understanding an Advisor's ADV Part 2 brochure to evaluate how an advisor may work with you - Part3.

00:00
Bob French
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00:50
Alex Murguia
All right, so item eleven, code of Ethics. What does that mean? I don't know. If people are aware of every advisory firm needs a Code of ethics and that's actually reviewed by the SEC, et cetera. Another thing that I don't know if people are aware of is anyone that is sort of a relatively senior level person within a firm or is involved in a client relationship in which investments are involved, they actually have to report on a monthly basis their holdings. Not only that within the house or quarterly basis, even within the house as well. Like my wife would have to do that as well. Item eleven has all of that stuff baked in. Ryan, take it away.

01:38
Ryan Walter
Yeah. All investment advisors are required to have a Code of Ethics that governs the conduct of their staff who are in a position to take advantage of their knowledge of what's going on in client accounts for their own benefit to the detriment of those clients. So those Code of Ethics are going to look at a number of things. Like Alex said, they're going to look at your if I'm an Advisor representative, they're going to look at my personal brokerage accounts, all the securities transactions that I've engaged in where there's a possibility of manipulative or fraudulent conduct on my part. They're also going to look at the people in my family who live in my household. They would look at my wife's brokerage statements to make sure that I'm not telling her what to do in her account to disadvantage McLean clients. And that's all to basically look for a few things.

02:36
Ryan Walter
Am I trading ahead of clients or front running clients? Am I using my knowledge of what's going to take place in client accounts so I could trade my own account first or insider trading as well? If you are a client and you're an insider, you're an executive of a publicly traded company. I may not be able to trade in your company's stock except during specific periods of time under my firm's code of ethics. Because of the possibility that you, as an insider to that company, could pass inside information to me and I could trade on the basis of that information. So the Code of Ethics is really going to be designed to account for those potential risks. Required me to make certain reports about my securities trading to my employer so that they can supervise and account for those risks and make sure that clients really aren't being taken advantage of by me, based on my sensitive position, sensitive information that I have access.

03:38
Alex Murguia
And this is something that at least McLean takes very seriously. I mean the code of ethics and this is where we know more than one occasion these sort of yearly reviews, making sure we're up to date with all the compliance laws, where we bring everyone together and just go over this over and there's attestations around this. So this part isn't just lift service. I mean this is where you're reviewing a firm. This is where you get a sense of the culture as well. I think it's very important.

04:11
Ryan Walter
Yeah. They also talk about less material things like can we get or give gifts to clients? Where are the boundaries there? If you've ever had an advisor that said, no, I can't travel with you for this golfer tree because my compliance officer says it's against our code of ethics. That's why. Because they shouldn't be taking gifts from clients or policy against it, something like that.

04:37
Alex Murguia
And not that there's anything wrong with a genuine sort of wanting to give a gift. It's just, again, like a Chinese wall, if you will. Brokerage practices, item eleven. That's a whole page. What's that about?

04:54
Ryan Walter
Yeah, this is talking about the firm that's actually going to hold your assets. Okay. And so in McLean's case, that's going to be TD or Schwab in a couple of weeks. Schwab itself or fidelity.

05:09

Alex Murguia
Yeah. So this is the custodian effectively, right?

05:12
Ryan Walter
Exactly. And the custodian more often than not is going to be a broker dealer. That's why it's the brokerage practice. So who do we as an investment advisor recommend serve as the custodian for your assets? And also because the custodian is going to hold your assets more often than not, they're also going to be the firm that transacts for your assets. They're going to be the ones who are placing the trades that are going to the market looking for the best price in your equities or fixed income trades or ETFs, and executing those trades at the best available price depending on where their liquidity sources are. But this is going to generally talk through, these are the custodians we recommend. This is kind of what we use to evaluate the services that they provide. And again, here are some conflicts that we have because maybe we receive certain things from these custodians in exchange for recommending them.

06:18
Ryan Walter
Maybe we get access to trading software, maybe we get access to institutional share classes of vehicles which might be cheaper for our clients than the retail share classes. A bunch of research, trade support, help desk support, could be a ton of different things that advisors receive from their recommended custodians. And that's why I said earlier that almost all advisors are going to have some degree of conflict because once you're accepted as an advisor that's allowed to access Schwab or allowed to access Fidelity, you're going to get those things automatically, right? And so almost every advisor at least has a conflict at that level. We recommend a custodian, and they give us trading support. They give us trading software, something. But this section is talking about those things. Who do we recommend and what do we get in exchange? How do we assess the value of the services they're providing, and what are the conflicts associated with our recommendation?

07:26
Alex Murguia
Yeah. No. I think so. A comment I'll make here a couple of them, and that's where okay, these are independent registered investment advisors, like a McLean. Right? There's an advantage of being able to engage in three institutional custodial relationships schwab, Fidelity, TD, Pershing could be another one, et cetera. There's these custodians. Goldman Sachs is not doing custody right relative to an advisor with one, like a big box advisor. And I know I'm kind of picking on them a little bit because why not, right? The reality is they're just predicated on just using the services within that one institution where we have everything available as you can make the case that more is available within an independent advisory firm, even though it may look like, oh, these are small time guys. No, that's not the case at all. That's the first point. The second point here is that McLean, as were growing, we actually had one custodial relationship, TD Ameritrade.

08:31

Alex Murguia
Why? Because from a business standpoint, again, it goes back to you don't want to be somebody's biggest client. You don't want to be somebody's first client. You don't want to be somebody's smallest client. That kind of argument. Right. And as you're starting out, it's actually quite difficult for an advisor to really engage with these institutions because they don't want to engage an advisor that just has $10 million or something like that. The economics don't work out for them. And so we bundled our assets all in TD because we knew them really well. We knew that if we made a we're at 200 million AUM, and we knew that if we made a call, we're a big client for them, whereas if we broke it down into $75 million increments, they're not taking our call as fast to solve client problems exception handling and things like that.

09:15
Alex Murguia
So what you may see in the trajectory of a firm is as they're building up, they probably focus one custodian, and then as they get larger and larger, they splinter it out simply because there's more available to them and they're big enough within each custodian that their calls will be answered to solve your problems. I think that's the case, yeah. Do they always offer you stuff.

09:38
Ryan Walter
To.

09:39
Alex Murguia
Kind of service you? Yeah, they do. I mean, you get sort of software. They provide certain softwares and things like that to better your business that they've created themselves, that you use them, and then they could technically be charging you for that, but they don't. And so that's disclosed here, but I don't know if that would be disclosed here. It's not soft dollars. It's just like marketing or something help or something like that.

10:00
Ryan Walter
Yeah, it's a non soft dollar economic benefit, I think.

10:04
Alex Murguia
There you go. There are benefits like that. And why would you not engage in somebody if there aren't any underlying benefits that help you service your clients?

10:13

Ryan Walter
Right. No, I think that stands to reason myself.

10:17
Alex Murguia
Okay, you see that? That's in the next page. Page twelve non soft dollar research benefits. Anything there other than yeah. McLean uses with TD, they have a software for rebalancing portfolios. We use that. There's a ticket charge for that they cover, and that's about it on that one. Sometimes, based on the assets that you have with them, there's transaction fees that they waive, things along those lines. And that's stated there. I'm kind of just quickly skimming through here. Ours. Anything here that you see within ours that makes sense to bring up?

10:56
Ryan Walter
Is there like a marketing reimbursement?

11:02
Alex Murguia
Let me say it another way. What would you see in somebody's benefits that would make you think, what's this about?

11:09
Ryan Walter
This doesn't look right. It's tough because everything might have a legitimate justification behind it, but what would some kind of rational question.

11:23
Alex Murguia
It not necessarily saying it's bad or good, but what would be like, I want to find out more about this.

11:29
Ryan Walter
What I would want to find out more about would be something that incentivizes my advisor to turn over my account frequently and incur a lot of trading.

11:40
Alex Murguia
Costs.

11:42
Ryan Walter
When it may be in their benefit, but not my benefit. So that would be like a soft dollar arrangement where every time they place a trade, $10 comes out of my account to pay for that trading cost. And one dollars of that goes into the advisor's soft dollar account so that they can use that credit basically to buy research from whatever the broker.

12:06
Alex Murguia
And that's a game. Buying research is what the hell does that even mean, right?

12:12
Ryan Walter
So that would be something that I would be on the lookout for. That's a very clear incentive for the advisor to put my interest aside to cost me money so that they could get something in exchange.

12:25
Alex Murguia
Okay. The next one is brokerage for client referrals. We were part of that. And what that is? Schwab TD Fidelity. A lot of advisory firms cut their teeth by just focusing 100% of their business on getting referrals from the branch offices and converting them into clients. Because at a higher asset level, the branch offices can't really service those. Oh, well, they can, but they can't provide the full level of service that advisors@high.net worth can. And so they all engaged in referral programs in which a lot of advisors were part of. We were part of it as well. And it's disclosed here, although I think that's ending soon, Ryan, especially with the merger coming through. But it's still active. So we have it for 2023. Directed brokerage. What does that mean for our listening audience?

13:19
Ryan Walter
Yeah, directed brokerage is typically where the client says, I don't care who you recommend, my assets are at Interactive Brokers, let's say, and I'm going to keep them there, and that's where they need to stay. I'm not going to go to Fidelity.

13:35
Alex Murguia
Or It, and that's fine. And the reality is this goes back to discretionary and non discretionary. We wouldn't even deal with that at McLean. It's just not worth the want. And keep this in mind if you're a consumer. I'm not saying requesting this is off, but you don't want to be an exception to the workflow of the firm. You're going to because that's where mistakes happen when you need a special workflow just to deal with your

issues. That's how mistakes happen. I can't stress that enough. So if Ryan were to come and say, no, but I need my assets know independent broker dealer, because whatever I know my cousin's the CEO. I would say, get your cousin to give you the name of an advisor that uses them because we wouldn't be a good client for you. No, it's just the reality invariably things go wrong like that, and so you kind of want to avoid that.

14:26

Alex Murguia

There's a piece here on trade corrections that's an interesting concept that I'm not so sure the consumers know about. How does that work? Let's say your client, I make a mistake on your trade, as opposed to doing ten shares, I did 100 shares, that kind of thing. Fat finger error. What happens?

14:45

Ryan Walter

Yeah, the advisor is a fiduciary to the client. And from the SEC's perspective, if the advisor is responsible for a trade error, then the advisor shouldn't be retaining any of the gain, and if there's a loss, should be making the client whole for that loss. So if it was a $10 trade or if there was a $10 limit on an order, and instead you put in $100 limit, and the client incurred whatever amount of harm as a result of that error, then the advisor. If it was the advisor's fault that the error occurred, the advisor is the one who's going to have to make the client whole for.

15:29

Alex Murguia

Look, let's say we find this error a month later. It can still be fixed. Like the custodians have the ability to fix it. And yeah, if it happens to work in McLean's favor, it goes to charity. If Ryan is owed money, we make it right. Now, the question that I would be asking, if I'm a consumer and I don't think this gets enough play is errors and emission insurance, which I don't technically see it right here, and I don't know if it's somewhere in the adv, but there's some advisory firms that don't have Eno insurance, which I think is absolutely crazy. Yeah. They say, oh, no. Well, I don't know what the premiums are. It's 15,000 a year. And you know what? If I don't have an error of greater than X amount for ten years, I can self fund it. I think that's like people that don't get home insurance because whatever, and I know some major firms that don't have Eno insurance.

16:23

Alex Murguia

And I just think it's almost reckless on a couple of levels because if you're dealing with million dollar minimums, you could have a significant error. I'll leave it at that, which I just find just mind boggling.

16:36

Ryan Walter

Yeah, and there are some regulators that try and address mean you see it from service providers. Now also, like Schwab, for example, as a custodian will not work with an advisor. They have a certain level of errors and emissions coverage. And I think that's probably going to be something that you'll see kind of spread out throughout.

16:58
Alex Murguia
I've always wondered why that's not a requirement. Like full stop.

17:02
Ryan Walter
Right. Some states, if the advisor you're working with or considering is a state registered advisor, ask them what their net capital requirements are. Because some firms kind of try and place a net capital requirement on a firm to make sure that they have adequate funding, they can continue operations, number one. Number two, that if there is a claim against the firm, that there's at least something that they can claim against. But so ask them what their net capital requirements are and maybe see if you can get comfort from that number. If they have custody or if they have discretion, they're probably going to be subject to a much higher net capital requirement than not. But that's still not going to be good enough. That's not a total substitute for having Eno insurance because those net capital numbers are going to be relatively low. They're going to be in $25,000 range compared to a policy that's going to give you a million dollars of coverage.

18:01
Alex Murguia
And something, Ryan, we didn't say. I think you did at the very first episode. At this point, which is becoming another arc. If you're over $100 million, you're registered with the SEC. If you're under $100 million in assets, you're registered by the state, just FYI. And so that's what he was referring to. If you're registered with the state, that's what he means. There's that piece. Okay. And what I'm going to do, we're just going to go with this one, and I can just chop it up myself, but we can just go with it since we have a good rhythm right now. Item 13 review of accounts. What is that?

18:41
Ryan Walter
This is telling you, as the consumer, who is responsible for reviewing accounts, when and in response to what events are those reviews conducted? That's basically it. It's usually going to say we have an investment committee or we have management team. They review it on at least a quarterly basis, at least annual basis, whatever the case may be. They may also look at your account in response to extreme volatility or a material change to your personal circumstances.

19:16
Bob French

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19:38
Alex Murguia
Yeah. And so this is kind of a tell in terms of going back to my restaurant example. How often do they look at this stuff? What do they state in an exam, though? They will reconcile this to see if it's reality or you're just giving it lip service. So you want this to be very clear and consistent for you because then you know that okay, this firm is well run, if you will. Is that a fair statement on my part?

20:04
Ryan Walter
Yeah, I think so. And I think having somebody who's reviewing accounts, who is not the person who you meet with every time you want to talk about your accounts and who's actually giving the advice, somebody who's a little bit independent of the person who actually made your account look the way it does so you have a fresh set of eyes looking at it. It's not just the same person looking at it every time. That's valuable if it's feasible. Some firms are just one person that just doesn't exist.

20:34
Alex Murguia
Yeah, and look, I said this once a while back, and somebody wrote in and saying, that's not the case all the time. And my response was, yeah, you're right. But I think sometimes if you're looking to engage an advisory firm, you want to make sure that there's checks, that there's some institutional quality behind it, like point blank. If anything happens to Ryan, I know that I have two other people within his firm that I can speak to. Now, if you have an advisor that's a one person shop and it's a lifestyle practice, et cetera. Not saying that it's a bad thing, but there are certain things that you cannot derisk for your own situation, and that's that it's all contingent on that one person being able to do everything, and that can become problematic. I'm saying it with all due respect to the one person shops and things.

21:37
Ryan Walter
Like that, because those can work wonderfully, and there are a lot of really great and really accomplished and capable people who do that.

21:48
Alex Murguia
Just keep track of their client, then. Do they have 500 clients or do they have 40 clients?

21:55
Ryan Walter
That's a fair point. Yeah. And you, as the client, need to be comfortable knowing that it's a one person shop. And if you're comfortable with that, then that's awesome. That means you're a good fit for that.

22:06
Alex Murguia
And that's another question we didn't ask in the services. It's a fair game to ask them, how many relationships do you manage? Because there's only so many people an advisor can manage. And so I would definitely ask them that. And if they're managing in the hundreds and they're a one person shop, then they're kind of being chintzy about their business. I think that's a fair statement.

22:28
Ryan Walter
I would personally agree with that.

22:30
Alex Murguia
Yeah. Okay, so item 14, client referrals and other compensation. How important is this entry?

22:40
Ryan Walter
Yeah, it could be important for a conflict perspective. This is kind of talking about other areas where McLean, any other firm, fill in the blank firm might get compensated. So, for example, in this section, we reiterate some of the things we talked about in item twelve, the brokerage practices section, for the compensation or benefits rather that McLean gets from a firm like TD for recommending TD as a custodian. It's also going to talk about being in receipt of referral compensation. Potentially, if I refer a client to another investment advisor and I get 10% of the advisory fee in exchange for that referral, we might talk about that here. We might talk about our payment of referral fees here as well. We pay referral fees to other advisors in exchange for receiving client referrals.

23:37
Alex Murguia
Yeah, this happens less and less. We used to have referral agreements like, of a CPA sent to somebody and things like that, but I think we have legacy ones, but there's nothing new. It just becomes a hassle to keep track of, to be honest with you, and it's just not worth the aggravation of that. You don't want to get it wrong, that kind of thing. And here's where we have our I rebuild thing, the stuff that we get from TD Ameritrade. But I think you're going to see dribs and drabs of this from everyone to some extent.

24:13
Ryan Walter
You're going to see a lot of repeats between ten and 14 for a lot of phones, and between twelve and 14 reiterating a lot of the same. Okay, yeah.

24:27
Alex Murguia
And then 15 we have custody, and we gave custody its whole treatment in the first episode. We did. But what would you want to be looking for here?

24:36
Ryan Walter
This is where you can find out the exact type of custody that a firm might have. And so a firm that says, let's look at the very last sentence in this section. Accordingly, MAMC will follow the safeguard specified by the SEC rather than undergo annual audit. And so that's telling me as a client, okay, McLean doesn't have the type of custody to where the SEC would force them to undergo a surprise annual CPA examination. And so I could say from that the SEC doesn't think that this is a risky enough type of custody to subject the McLean to that requirement. And so I feel a bit better. Yes, McLean has custody in some capacity, but the SEC says it's not that bad. And so I'm kind of inclined to.

25:35
Alex Murguia
Again, yeah, there's workflow issues that sometimes you want know, have something that could be considered custody because it just makes it easier. But in terms of handling money, like managing there's, there should always be, in my view, a separation unless it's just a completely different business than what we're running.

25:55
Ryan Walter
But the SEC says you don't need a second set of eyes on as long as you tell us that you're doing this. We don't need somebody else overseeing your work. Which means they don't view it as.

26:07
Alex Murguia
Particularly so effectively you can say we don't have custody investment. Well, this is being recorded. Is that a correct statement on my part?

26:18

Ryan Walter
Well, we say custody on the part one, I believe, but it's not the type of custody that subjects you to the audit. So it's what I perceive to be like the reduced risk form of custody.

26:32
Alex Murguia
Yeah. And the ones that subject it to the audit. There could be many business reasons for it. But like I said, we said earlier, whenever you see things go sideways it's because of that largely. Okay. Investment discretion, we spoke about that and we see the finish line here in our thing. Investment discretion. I think we've spoken about it. But you may want to just reiterate real quick here, since we're on this item limited power of attorney, I think you're going to see that as par for the course.

27:04
Ryan Walter
And really, it's something that needs to be granted to the advisor so that the advisor has a legal basis for being authorized to engage in trading in your account. Because that know, regardless if McLean is the advisor to the account is still held in your name as the client. And so if I'mclean and I tell Schwab the broker, hey, place this trade in John Smith's account, schwab is going to say, not so fast, how are you authorized to trade in John Smith's account? It's not McLean's account. It's John Smith's account. And so we have to show Schwab the client has granted us a limited power of attorney to trade in that account before Schwab will open up the gates and allow us in to trade in that bought discretion means that you've given McLean the power to trade in the account without talking to you first.

28:00
Ryan Walter
Nondiscretion means that they run their trade recommendations by you and you have to contend.

28:06
Alex Murguia
Okay. Item 17 voting client securities. Again, we have discretion. Let's say we buy Apple. Apple has some sort of board meeting where they want to get rid of Tim Cook for something and we have to vote on it. Take it away, what happens here? Yeah.

28:26
Ryan Walter
So some firms will vote those proxies on your behalf. Some firms will hire a third party to evaluate and vote on those proxies. Some firms won't touch it with a ten foot pole for whatever reason. They just don't want to be in that business line. But this is going to tell you what your firms or the firm you're evaluating, what their practices are in this respect, whether they have any conflicts associated with proxies because maybe they have relationships with certain issuers or something like that. But this is going to tell you what they

are and if they do vote proxies, where you can get information on what their proxy voting history has been so you can evaluate how they voted proxies previously and make sure it's in alignment with how you would want those proxies to be voted because ultimately you own those securities. And so the client, or the advisor, rather, should either be voting it under a set program where they have a plan and it's fully disclosed and they follow that plan for how to vote proxies all the time or they should be taking your thoughts and opinions and objectives into account when they're voting proxies so that they can kind of express your view through their proxy votes.

29:51
Alex Murguia
The reality is if you're using an advisor, some weird circumstance, they're not going to ask you every time there's an issue. They're just not. You can't run a business if you get 500 things to vote on. So I'll leave it alone at that. And then the last one, which I think is an interesting one, just financial information, how do you even know if your advisor is solvent?

30:16
Ryan Walter
Right. And the answer is that it needs to be disclosed here if they're not solvent. So if they have a reasonable basis for believing they're going to be unable to meet their financial commitments to clients, then they would need to disclose that fact here. What does that mean? That means I don't know whether the lights are going to be on three to six months from now. I can't in good conscience say that they definitely will be. So I have to put that in writing in this section. There's other things that would need to be disclosed here if you were like maybe the subject of a bankruptcy proceeding. I think if you require prepayment of $1,200 or more in fees, six months or more in advance, then you'd be required to submit a balance sheet along with your adv so that people could see what your financial condition is.

31:13
Ryan Walter
Because you're giving them a lot of money a fairly long time in advance, and you want to be sure that they're going to be around to fulfill that commitment to you.

31:23
Alex Murguia
No, that's great. I think that's important and that's a fair question to ask. That's it. We did it, man. I think this will end up being the third one like The Lord of the Rings. Yeah, right. And we're all jumping on the bed up and down holding hands like Frodo and whatever. Gandalf or whatever. No, man, I think it was great. Look, we took our time with this simply because there's no way to give it the time. It's an important topic and it is what it is. I don't want to go blow through it. I think over the last three episodes, just listening to us go over the adv, this is how you. Become an informed consumer. And I get it. Oh, I don't have time to listen to it. But again, you spent 30 years building up your wealth. It behooves you to figure out if I am going to use a professional advisor.

32:17
Alex Murguia
This is how you know what you're getting into in a major way, other than just, oh, this is my buddy, he likes the color blue, I like the color know it's meant to do.

32:31
Ryan Walter
This is the stuff that the SEC people at the SEC got in a room and said, this is what we feel is the most important information for clients. That all clients should, you know, I think we should look at it. We as consumers should look at it in the same light. I don't agree with everything the SEC does, but I think there's value in this document. And I think that if they say that clients should know about this, then clients should at least take a second to think about this and look through the documents because there is a lot of important information.

33:06
Alex Murguia
And again, you feel free to download this. We'll have it in the show notes so you can see McLean, so you see what something looks like if you compare them to others. You can use that as a baseline based on this conversation. But other than that, Ryan, I've taken up a ton of your time. I really appreciate it. And I appreciate and actually congratulate the folks that have listened in because I think this is something that no, it's for their best interests. And so congratulations on showing the commitment relative to the responsibility that this entails. So I think it's fantastic. Thank you for listening, everyone. Ryan, any parting thoughts? How people can find out more about you if there's an advisor listening in? I like this guy.

33:44
Ryan Walter
Ryan RIA Lawyers is our website. We wanted the most kind of common sense, firm name and website you could think of. So visit us rialawyers.com or shoot me an email. Ryan@rialawyers.com and we'll jump on a call. We'll exchange emails, however you want to address things. But I'm around and I'm easy to reach if you need to get a hold of me.

34:09
Alex Murguia
All right, thank you, man. I really appreciate it. And say hi.

34:12
Ryan Walter
We'll do. Thank you again for the opportunity to be here.

34:15
Bob French
Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with a risk, including risk of loss. Past performance does not guarantee future results.