Custodians ponder charging RIAs asset-based fees

A new pricing model has RIAs and custodians in reevaluation mode

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By **Jeff Benjamin**

The fee arrangement developed over the past 20 years between registered investment advisers and custodians might be about to change dramatically.

As custodians reevaluate the value of their services to RIAs, and RIAs reassess their fiduciary duty to clients, there are growing discussions about

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The proposal, **detailed earlier this year in a blog post** by Pinnacle Advisory Group director of wealth management Michael Kitces, would upend the current practice of custodians earning revenues from RIAs' clients and letting RIA firms ride for free.

Even in the earliest stages of the discussion, with no custodian having yet come forward with an official plan to change its pricing model, lines are being drawn and heels dug in.

Pressure from the likes of Mr. Kitces, who comes to the argument from a strong fiduciary position, is forcing custodians to take a closer look at the numbers.

"If you think about how custodians are paid, we have the same challenge advisers do; their assets-under-management fee is tied to the value of the portfolio and we know they do a whole bunch of work beyond just investments," said David Canter, head of the RIA segment at Fidelity Clearing & Custody Solutions.

With that in mind, Mr. Canter said Fidelity is doing a lot of research around the **"custody value stack."**

Citing such chores as shareholder servicing, tech support and marketing support, Mr. Canter said, "We do a whole bunch of things beyond pure custody."

send out confirmations, and look out for dividend payments," he added. "We're at the discovery stage with this."

But a lot of RIAs prefer the status quo.

"Advisers are so used to getting custody for free that I've already heard a lot of resistance that they don't want to pay for it," Mr. Kitces said. "Of course, the reality is they already pay for it, just indirectly through all the ways that custodians skim dollars on the back end."

Most custodians would likely take issue with the reference to "skimming dollars" off clients, but there is no denying that clients represent the primary revenue stream for a custodian.

There are basically three ways a custodian makes money: on asset balances, interest spreads and trading. The first two involve leveraging investor **cash and cash-equivalent balances** for significant revenues.

Last year, for example, **Charles Schwab Corp.** generated over half the company's revenue from interest spreads in client accounts, according to Mr. Kitces.

The third revenue stream for custodians is shrinking fast as trading becomes a discounted commodity.

"What's clear is that there needs to be a reevaluation of the price-value-cost dynamic," said Gabriel Garcia, head

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"For custodians, the cost of doing business is increasing, and productivity gains alone are not sufficient to offset costs," he said. "RIAs, on the other hand, are experiencing pricing stability and growing profitability. There's a need to reconcile this dichotomy, as it is hard to imagine why custodians would continue to provide technology, invest in compliance and regulatory requirements, and provide safety and security of assets in a cyber world without a reasonable return on investment."

Rush Benton, senior director of strategic wealth at Captrust, said falling trading costs are part of the reason that changing the fee model is a "bad idea."

"It doesn't move the needle for clients or firms," he said. "Trading fees are going to zero anyhow, and custodians are making their money on deposits, margin balances and activity fees."

Kashif Ahmed, president of American Private Wealth, said asking RIAs to pay a custodian fee based on assets is "most certainly a bold idea," but "the time for this change might not have arrived yet."

"If the end client is not complaining about this arrangement now, then why change anything?" he said. "Perhaps if the RIA is picking up the cost, they may gravitate to a cheaper custodian, but that custodian may not be better overall for the RIA's business, and/or the end client."

But Steve Lockshin, principal at AdvicePeriod, said custodians charging fees at the RIA level can't happen soon enough.

custodians would offer tiered pricing based on size and not try to make any additional profits from a negotiated spread on margin and money markets, but instead charge their cost plus a reasonable margin for profit, then the simple business-to-business arrangement would take hold between the consumer and adviser, and adviser to custodian."

From Mr. Kitces' perspective, and maybe in an ideal world, nobody's fees or revenues would change much if custodians stopped charging clients fees and started charging advisers a few basis points pegged to client assets on the platform.

He proposed the idea of 5 basis points, but admits the asset-based fee would have to be set to make financial sense for all parties, whether higher or lower.

"I find it supremely ironic that RIAs push clients to pay fees and not hidden back-end commissions on products, and then resist the suggestion that we should pay fees and not back-end commissions on custody," Mr. Kitces said.

The second argument against an asset-based custodian fee is more nuanced, he explained.

"Some RIAs are much better at playing the game of minimizing the custodian's profits than others, because they manage trades efficiently with rebalancing software, minimize cash balances, etc.," Mr. Kitces said. "For those RIAs to pay a custody fee, they may actually end up paying more than they do today because they're really good at minimizing the custodian's profits."

On that point, Mr. Kitces said, "custodians have really painted themselves into a corner, because their best and these hidden costs, would get a fee decrease when the custody fee equalizes the costs. Basically, the compensation system from RIAs to custodians is so broken that the worst and least client-centric advisers are subsidizing the best ones."

For the pricing model to work to the satisfaction of fiduciary purists, custodians will also have to rethink their use of no-transaction-fee platforms and the use of funds charging 12b-1 fees that generate various forms of soft dollars.

"There are too many games being played with hidden profit centers, soft dollars, and unnecessary negotiations for what is otherwise a commodity service," Mr. Lockshin said. "This is all likely to change significantly in the coming decade with the advent of blockchain and the simplification of data flow. As I often say, as soon as moving your brokerage account is as easy as moving your phone number to a new carrier has become, we can expect to see a very different landscape for the financial service industry."