Conflict Question Stalks ‘Proprietary’ Products

Many of the major brokerages have moved away from heavily selling their own mutual funds to clients. But the offering of “proprietary” products and attendant conflicts of interest are a perennial issue in the financial-services industry.

Consider two examples from the burgeoning world of automated...
“robo” advice services: Charles Schwab Corp. uses its own exchange-traded funds and Charles Schwab Bank deposit accounts among the holdings in its Schwab Intelligent Portfolios, with more than $4 billion invested. Vanguard Group generally recommends only its own funds to clients of its Vanguard Personal Advisor Services, overseeing $26 billion.

Many of the big traditional brokerages “have de-emphasized proprietary products and put them alongside other products” on the shelves, said Alois Pirker, a research director at Aite Group LLC. “But if you look at Schwab and others who offer portfolios with their own ETFs, you wonder if the trend has somewhat come full circle.”

Schwab and Vanguard both say that the low costs of their funds make them an excellent choice for investors, and their disclosure documents note they earn fees on their own products.

Separately, J.P. Morgan Chase & Co. has agreed to pay more than $200 million to resolve allegations by the Securities and Exchange Commission and other regulators that it didn’t make proper disclosures when touting its own investment products to clients over those offered by its competitors, The Wall Street Journal has reported. The settlement has been delayed as the SEC has pushed for additional consequences for the company, people familiar with the matter told the Journal.

A J.P. Morgan spokeswoman declined to comment for this article.

Regulators have been focused on conflicts of interest involving proprietary products for more than a decade. That is partly why major brokerages have widely adopted so-called open architecture, in which third-party products are offered alongside their own with no financial incentives for advisers to push the internal fare. But investors should still be cognizant of potential conflicts of interest regarding in-house investments or, say, when a brokerage recommends a loan product from a corporate affiliate.

When investors are offered a proprietary product, they shouldn’t be afraid to ask how much the broker or firm is going to earn on it, said Joseph Peiffer, a New Orleans lawyer and president of the Public
Investors Arbitration Bar Association. “A broker that won’t answer that question or is offended by that question is a red flag,” he said. Clients should also ask to see similar products from third-party firms, several industry and securities experts said.

Over the past several years, firms have been introducing automated investment-advice services that use computer models to create and manage portfolios of inexpensive funds. At some providers, including Schwab and Vanguard, investors can get help from human advisers as well. By using its own funds in its program, a firm may boost its fee income and assets under management.

Schwab’s Intelligent Portfolios include 54 ETFs from 11 fund providers, including 14 Schwab funds. Clients don’t pay a separate fee for the advice, but are charged on the underlying investments, including the proprietary funds. ETFs are chosen based on attributes including risk level and how closely they track their underlying indexes and then sorted by cost, a Schwab spokesman said. “For the asset classes in which a Schwab ETF has the lowest expense ratio, that is the fund we use, and that’s the benefit of including them,” he said.

Because paying lower interest rates on the Schwab bank deposits would mean greater income for the company, the bank rates are set by reference to an index, according to an Intelligent Portfolios disclosure document that lists potential conflicts and steps to mitigate them.

Clients of Vanguard’s advice service hold Vanguard’s so-called Admiral shares, the least expensive Vanguard fund shares available to individual investors, according to a spokeswoman. On the Vanguard Total Stock Market Index Fund, for example, expenses are just 0.05% of assets.

The brochure for Vanguard’s advice service says the recommendations will “normally be limited” to Vanguard funds. While that will generate fees for Vanguard, “any competing interests that could arise” are mitigated by the fact that Vanguard is owned by the funds and provides its services at cost, the document says.

In past years, firms including Merrill Lynch and Citigroup Inc. sold their in-house fund arms. UBS Group AG and Morgan Stanley continue to have their own mutual funds. Both companies say they no longer offer financial incentives to advisers to sell those products and the proprietary funds represent a very small percentage of clients’ mutual-fund assets: 5% at Morgan Stanley and less than 1% at UBS’s U.S. wealth-management arm.

Edward Jones has gone in the opposite direction, launching proprietary funds for the first time. But the eight Bridge Builder funds, with recent assets of about $20 billion combined, aren’t sold
directly to Edward Jones clients. Instead, the firm says the funds help it build portfolios for clients who pay a fee to the firm to manage their money.

The Edward Jones unit that serves as the portfolio manager of the funds parcels out the funds’ dollars among selected outside managers. This design gives the firm better control and allows it to offer better pricing in some instances, says Ryan Robson, a director at Edward Jones’s advisory platform.

The brokerage isn’t currently collecting any fees for its role in the funds, “hopefully eliminating the conflict of interest for brokers and the firm,” Mr. Robson says.

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Corrections & Amplifications

Charles Schwab’s Schwab Intelligent Portfolios include 54 exchange-traded funds from 11 fund providers, including 14 Schwab funds. An earlier version of this article incorrectly said there were 15 Schwab funds used in the advisory service.