Registered Investment Advisors

How They Compare to Broker-Dealers

by Julian W. Wells, Joshua S. Bratspies and Jordan D. Weinreich

Registered investment advisors (RIAs) are a growing sector of the wealth management industry. Over 2,000 new RIA firms were created last year alone.[1] There are now more than 30,000 RIAs in the United States, and over 3,000 of them have in excess of $1 billion in assets under management.[2] This tremendous growth reflects the fact that an increasing number of investors are choosing RIA firms instead of traditional broker-dealers for their investment and wealth management needs.

While RIAs and broker-dealers often provide many similar investment services, it is important to know that they differ in a number of significant ways, including the following: 1) they operate within different business platforms and have different access to resources; 2) they are compensated differently; 3) they are held to different legal standards of care; 4) they are subject to different oversight; and 5) they have different procedures to resolve disputes with investors. Each of these major differences is discussed in more detail below.

Business Platforms

RIAs and broker-dealers operate within different business platforms and have different access to resources. Broker-dealers may clear their own trades, maintain custody of their clients' assets and offer proprietary investment products and investment research, which they own or control. Broker-dealers typically offer their clients a broad array of financial products and services, including, among other things, credit cards, mortgages and securities-backed loans.

RIAs, on the other hand, are usually not associated with any broker-dealers. They clear investment transactions and custody client assets through third-party financial institutions, typically brokerage firms and/or banks.[3] RIAs seek investment products and investment research from third parties and their access to such resources may be limited. Moreover, RIAs generally do not offer the full array of financial products and services that are available at traditional brokerage firms.

As such, the scope of an investor's needs may impact whether the investor is better suited to invest with an RIA or a broker-dealer.

Compensation

RIAs typically charge an annual fee equal to a percentage of assets under management. The percentage generally starts at around one to 1.5 percent and declines as the size of the client's portfolio increases.[4] In contrast, broker-dealers may charge a fixed fee, a per-trade fee on the purchase or sale of an investment product, or a fee based on the percentage of assets under management. The commission rate may vary depending upon the type of investment product and the size of the investment. Alternatively, a flat fee per share (typically $0.05 to $0.15 per share) with a cap may be charged. In recent years, however, more and more broker-dealers have been moving to

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a fee-based approach.[5]

Each compensation model has its advantages and disadvantages. An investor who has a relatively small amount of assets to invest, but wants to actively trade equities, may be better served by a fee-based compensation arrangement. On the other hand, an investor who has significant assets to invest, but intends to engage in relatively few trades, may be better served by a commission-based compensation structure. Accordingly, before opening an account with an RIA or broker-dealer, investors should consider which compensation arrangement best suits their individual investment needs.

Standard of Care

RIAs and broker-dealers operate under two distinct statutes. RIA activity is regulated under the Investment Advisors Act of 1940,[6] while broker-dealer activity is regulated under the Securities Exchange Act of 1934.[7] As a result, RIAs and broker-dealers are held to different legal standards of care with regard to their investor clients. Investment recommendations made by broker-dealers must be 'suitable' for the needs of their clients.[8] RIAs, however, are subject to a higher 'fiduciary' standard of care.[9]

As a fiduciary, RIAs owe their clients an affirmative duty of utmost good faith.[10] The Securities and Exchange Commission (SEC) has stated that an RIA's fiduciary obligations to a client include, among other things: 1) making a full disclosure of material facts, including conflicts of interest; 2) having a reasonable, independent basis for investment recommendations; and 3) executing securities transactions for the client in such a manner that the client's total costs or proceeds in each transaction are the most favorable under the circumstances.[11]

Although brokers are generally not considered fiduciaries, they nonetheless "must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [broker] to ascertain the customer's investment profile."[12] The factors to be considered by a broker include, among other things, the client's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs and risk tolerance.[13]

The gap between the duties owed by brokers and RIAs to their respective clients may soon be narrowing. Section 913 of the Dodd-Frank Act directs the SEC to study the need for establishing a new, uniform, federal fiduciary standard of care for brokers and RIAs who provide personalized investment advice to retail clients.[14] The Dodd-Frank Act further authorizes the SEC to establish such a standard if it sees fit.[15] This process is still ongoing and, to date, no rule changes in this regard have been implemented.

Regulatory Oversight

RIAs are regulated by the SEC and/or state regulators pursuant to the Investment Advisors Act and similar state blue sky laws.[16] Broker-dealers, however, are expressly excluded from the act.[17] Instead, broker-dealers are subject to a comprehensive regulatory regime imposed upon them by self-regulatory organizations (SROs) (*e.g.*, Financial Industry Regulatory Authority (FINRA), Chicago Board of Options Exchange (CBOE), Dept. Market Regulation, NYSE Regulation, Inc.) as well as oversight by the SEC and state regulators. The purpose of regulatory oversight is, among other things, to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.[18]

Historically, the SEC has been able to conduct on-site examinations of about eight percent of SEC-registered RIA firms per year, with over 40 percent of these firms having never been examined.[19] This is in contrast to the approximately 55 percent of brokerage firms that are examined annually by FINRA and/or the SEC.[20] Several efforts have been made to close this oversight gap. For example, the Investment Adviser Oversight Act of 2012, ultimately a failed bill, sought to shift oversight of RIAs from the SEC to an SRO.[21] More recently, in 2014, the SEC launched its "Never-Before Examined Initiative," pursuant to which the SEC seeks to use a targeted, risk-based strategy to examine certain RIAs that have been registered for more than three years but have not yet been examined.[22]

New Jersey's securities regulator, the Bureau of Securities, has its own approach to targeting firms for examination. The bureau requires all state-registered investment adviser firms to complete an annual, online, written examination. The examination seeks information regarding firm organization, business model and investment concentration, as well as information regarding the representatives associated with the firm. Examination responses are used to determine whether a more in-depth examination is necessary, to analyze areas of concern or priority for the bureau, as well as to monitor the latest trends in the investment advisory field.[23]

In addition to compliance examinations, both the SEC and state regulators have the authority to pursue civil or administrative actions against RIAs and their representatives premised on securities fraud.[24]

Dispute Resolution

With rare exception, an aggrieved investor's only course of action against a broker-dealer is to pursue a claim in FINRA dispute resolution's arbitral forum. Most, if not all, FINRA member firms include a pre-dispute arbitration clause in the client account agreements.[25] Even in the absence of a pre-dispute arbitration clause, FINRA members and associated persons must arbitrate if the client so demands.[26] RIAs, on the other hand, are not regulated by FINRA and are not subject to mandatory arbitration under the FINRA code or otherwise. Nonetheless, many RIAs include binding arbitration clauses in their account agreements. Often, these arbitration clauses require arbitration with the American Arbitration Association (AAA) or JAMS (formerly Judicial Arbitration and Mediation Services).

FINRA arbitration offers an enforcement mechanism not found in court or in other arbitral forums. If a brokerage client is awarded damages against the firm or one of its registered persons, the award must be satisfied within 30 days of receipt of the award, unless the member firm or associated person files a motion in court to vacate the award.[27] If the member or associated person fails to pay the award within 30 days (and has not sought *vacatur*), FINRA may provide notice to that party that failure to comply with the award within 21 days will result in a suspension or cancellation of membership or a suspension from associating with any member.[28] This would prohibit the firm or individual broker from conducting business in the United States. Because FINRA has no regulatory jurisdiction over RIAs, it could not impose these conditions upon an RIA or its investment advisers.

The future of mandatory arbitration in both the broker-dealer and RIA contexts remains uncertain. Section 921(a) of the Dodd-Frank Act authorizes the SEC to prohibit or restrict mandatory pre-dispute arbitration clauses in brokerage and RIA customer agreements.[29] To date, the SEC has taken no action in this regard, but at least one SEC commissioner has expressed concern with pre-dispute mandatory arbitration clauses, believing that "investors should not have their option of choosing between arbitration and the traditional judicial process taken away from them at the very beginning of their relationship with their brokers and advisers."[30]

Final Thoughts

Despite offering similar services and financial products, RIAs and traditional broker-dealers differ in a number of important ways that may be considered advantages or disadvantages, depending upon the needs and investment profile of a particular investor. While recently enacted and proposed legislation suggests a growing trend toward more uniformity, it remains to be seen how much reform will ultimately take place in this area. In the meantime, investors would be wise to familiarize themselves with the differences between RIAs and traditional brokers before making their

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investment and wealth management decisions. ⚖

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ENDNOTES

1. *See* meridian-iq.com.
2. *See id.*
3. *See* Investment Advisers Act Rule 206(4)-2. 17 CFR 275.206(4)-2.
4. *See Investment News,* 2013 Financial Performance Study of Advisory Firms.
5. The Rise of the Registered Investment Adviser, *Bloomberg Businessweek*, March 3, 2011, available at bloomberg.com/bw/magazine/content/11_11/b4219041484091.htm.
6. *See* 15 U.S.C. §80b-1, *et seq.*
7. *See* 15 U.S.C. §78c.
8. *See* FINRA Rule 2111.
9. *See* Investment Adviser Oversight Act of 2012, H.R. 4624, 112th Cong. (2012).
10. *See SEC v. Capital Gains Research Bureau, Inc., et al.,* 375 U.S. 180, 194 (1963).
11. *See* Advisers Act § 206(3); *In the Matter of Kidder Peabody & Co., Inc.,* Investment Advisers Act Release No. 232, 43 S.E.C. 911 (Oct. 16, 1968) ("Full disclosure of such potential conflict must be made to apprise the client of relevant facts so that the client is able to give his informed consent to transactions executed for the client, or to reject such transactions if he so desires.").
12. *See* FINRA Rule 2111.
13. *See id.*
14. *See* The Dodd-Frank Wall Street Reform and Consumer Protection Act at §903.
15. *See id.*
16. *See* 15 U.S.C. §80b-1, *et seq.*
17. *See* 15 U.S.C. §80b-2(a)(11)(C).
18. *See* sec.gov/about/whatwedo.shtml; finra.org/industry/oversight.
19. *See* sec.gov/spotlight/investor-advisory-committee-2012/investment-adviser-examinations-recommendation-2013.pdf.
20. *See* finra.org/newsroom/speeches/060612-testimony-committee-financial-services.
21. *See* Investment Adviser Oversight Act of 2012, H.R. 4624, 112th Cong. (2012).
22. *See* sec.gov/News/PressRelease/Detail/PressRelease/1370540814042.
23. *See* nj.gov/oag/newsreleases15/pr20150427a.html.
24. *Regulation of Investment Advisers*, Staff of the Investment Adviser Regulation Office, March 2013, available at sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.
25. FINRA Rule 2268.
26. FINRA Rule 12200.
27. FINRA Rule 12904(j).
28. FINRA Rule 9554.
29. *See* 15 U.S.C. 78o; 15 U.S.C. 80b-5.
30. *Outmanned and Outgunned: Fighting on Behalf of Investors Despite Efforts to Weaken Investor Protections,* Speech of Comm'r Luis A. Aguilar, April 16, 2013, available at sec.gov/News/Speech/Detail/Speech/1365171515400.

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