

## The Critical Difference Between a Stockbroker and Registered Investment Advisor

By W. Scott Simon

Copyright © 2005 by W. Scott Simon. All rights reserved.

Maybe you've heard the word "fiduciary" mentioned a lot in the media over the past few years. A "fiduciary" is someone that manages money for the benefit of another called a "beneficiary." A fiduciary is bound by law to place the interests of its beneficiary first - before the fiduciary's own interests.

You would think that anyone offering financial advice to their clients is a fiduciary. If you think that, you'd be wrong. Stockbrokers (also called "Registered Representatives," "Account Executives," "Financial Advisors" or "Wealth Managers") are not fiduciaries, even though they have engaged in high-visibility advertising to portray themselves as full-service investment advisors. (Ask your stockbroker/registered representative/account executive/financial advisor/wealth manager if he or she holds a series 7 securities license. If he or she does, then it's probable that they aren't a fiduciary.)

A "Registered Investment Advisor," subject to the Investment Advisers Act of 1940, is a fiduciary.

The legal investment advising standards that govern a non-fiduciary stockbroker and a fiduciary Registered Investment Advisor are very different.

A non-fiduciary stockbroker follows only the "suitability" standard, which doesn't require a stockbroker to place the interests of its clients ahead of its own. Under the non-fiduciary suitability standard, a stockbroker need provide only "suitable advice" to its clients - *even if the stockbroker knows that the advice is not the best advice.*

A Registered Investment Advisor must follow the "trust" standard - the highest known in law - which requires it to place the interests of its clients ahead of its own and fulfill critical fiduciary duties of trust and confidence. Under the fiduciary trust standard, a Registered Investment Advisor must provide its "best advice" to a client.

Even if a non-fiduciary stockbroker wanted to follow the trust standard of law and become a fiduciary to its clients, it cannot do so because of the contract it has with its broker-dealer. Such contracts require the stockbroker to place the interests of the broker-dealer before the interests of the stockbroker's clients.

A stockbroker, then, owes fiduciary duties only to its *broker-dealer* - not to its investment clients. A Registered Investment Advisor owes fiduciary duties only to its *investment clients* because it doesn't have a broker-dealer.

Stockbrokers, subject to the Securities Exchange Act of 1934, maintain that they are regulated heavily by the Securities and Exchange Commission ("SEC"), the National Association of Securities Dealers and/or the various agencies in the states in which they do business. None of this less strict

regulation concerning the “suitability” standard, though, registers stockbrokers with the SEC as investment advisors under the more strict regulation concerning the “fiduciary” standard of the Investment Advisers Act of 1940.

The critical difference between a stockbroker and a Registered Investment Advisor is that the Registered Investment Advisor is subject to the high fiduciary legal standard when providing investment advising services while the stockbroker is not. This difference could have a major impact on your investment portfolio and hence your retirement lifestyle.



- Home
- What we do for you
- Tools
- Presentations
- Order
- Renew
- Update
- Contact Us

Coming soon...

Search

for topics and articles in our Archives

- Practice Management
- Portfolio Management
- Early Warning
- Client Services
- Trendspotter
- The Profession
- The Insider
- Media Reviews
- Bob Veres E-Column
- Parting Thoughts
- Past Issues

**The New Last Word**

May 1, 2005

You probably know that sometime last Thursday, the SEC posted its most recent Release on the so-called Merrill Lynch Rule ("Broker-Dealers Deemed Not To Be Investment Advisers;" Release No. 34-51523; new rule 202(a)(11)-1 under the Investment Advisers Act of 1940. The Release (<http://www.sec.gov/rules/final.shtml>) runs a full 117 pages, and basically reaffirms that BDs are exempt even if they charge asset management or fixed fees for their advisory services. But then goes on to say that they are NOT exempt if they charge a separate fee for advisory services, or if they hold themselves out to the public as financial planners, or providers of financial planning services, or deliver a financial plan in the course of offering those advisory services.

Let's take a quick tour of what is said in this important document, hitting the highlights and quoting from the most important passages, in hopes that I can save you the chore of reading through the full text. I happen to think there's a lot of good in this Release, which preserves for the SEC what IT wants (to allow the brokerage industry to reprice its services away from commissions toward less conflict-ridden fees without having to take on fiduciary liability), and gives the planning profession most of what IT wants (to make it clear to the public when brokers are acting as brokers and making it hard for salespeople to pretend to be fiduciaries or financial planners).

The document starts out in an encouraging way, by acknowledging the points that were made by the FPA and the financial planning community generally when it says:

"we share the concern that there is confusion about the differences between broker-dealers and investment advisers, and although we believe that some of that confusion may be a result of broker dealer marketing (including the titles broker-dealers use)" but went on to suggest that the 1940 act may not be the right rule to be amending, that instead the complaint should come under the rules governing broker-dealers directly (the Securities Exchange Act of 1934):

"we believe that many of these concerns may more appropriately fall under broker-dealer regulation and, as stated below, the Chairman has directed our staff to determine and report to us within 90 days the options for most effectively responding to these issues and a recommended course of action."

On page 8, the SEC staff acknowledges that it is acting with an agenda: giving brokerage firms an incentive to switch from commissions to fee-based compensation structures:

"Fee-based brokerage programs responded to concerns we have long held about the incentives that commission-based compensation provides to churn accounts, recommend unsuitable securities, and engage in aggressive marketing of brokerage services. We were troubled that application of the Advisers Act to broker-dealers offering these new brokerage programs would discourage their development, which we viewed as potentially providing benefits to brokerage customers."

From here, the SEC staff outlines what it believes it has accomplished with the new rule:

"The rule is designed to avoid application of the Advisers Act to broker-dealers merely because the

re-price their full service brokerage or provide execution-only or similar discount brokerage services in addition to full-service brokerage. As discussed in more detail below, we believe the rule draws an appropriate line as to when a broker-dealer's advisory activities trigger application of the Advisers Act."

It goes on to say that merely charging a fee for services rendered does not mean that the brokerage firms are acting as advisors—which is apparently a point made by some of the more than 1,700 letters the SEC received when it put the rule out for comment. Then it offers a bit of history, which essentially says that broker-dealers used to be paid fixed commissions for their services, and to provide what used to be called "brokerage house advice:" research on potential investments. They had separate departments which offered asset management services similar to independent companies, and generally charged fees for those relationships. These separate departments, and the independent companies, were required to participate in a "mandatory census" (registration), and the brokerage house advice was deemed to be incidental to the brokerage activities that were already being regulated elsewhere. (At the time the Advisers Act was passed, the regulatory concern was so-called "tipsters" who were calling themselves investment advisors.)

At this point, the argument becomes tricky and perhaps self-serving. Originally, brokerage firms were compensated by a fixed commission method, while advisory divisions and independent RIAs charged fees. The SEC argues that simply because the original Act defined fees as RIA-related and commissions as brokerage-related doesn't mean that they were meant to be a distinguishing characteristic forever.

It takes exception with a particular group of letter-writers, who made what I think is a great point: that brokerage and execution services are becoming commodities (which was probably never envisioned by the Congress of 1940) and therefore the brokerage firms are quietly shifting their value-added over to the advice component of the relationship. The SEC doesn't see it that way, and seems to dance around the commoditization issue as it tries to break down those who make this migration argument:

"these commenters argue that broker-dealers providing ANY investment advice should be registered as investment advisers under the Advisers Act. They assert that today, brokerage is incidental to the advisory services provided by full-service broker-dealers, and point to brokerage advertising that emphasizes the quality of the advisory services provided by the brokerdealer as indicative of this change. These comments fail to give weight to Congress' decision to include the exception in the Advisers Act, and fail to recognize the historical role of advice in retail brokerage... Full-service broker-dealers have always sought to develop long-term relationships with their customers who often come to rely on them for expert investment advice. And full-service retail broker-dealers have always relied on ancillary services, such as advisory services, to promote and sell their brokerage services."

What is interesting here is that the SEC seems not to see the difference between research departments and "tipster" kind of advice to customers to induce them to make trades (what brokers have traditionally done), and the kind of advice that helps you design an overall portfolio for your childrens' education and a comfortable retirement (which would seem to be more related to what RIAs have traditionally provided). To the SEC, apparently, one kind of advice is the same as the other.

So what, exactly, is the SEC requiring now? It imposes two conditions on broker-dealers who don't want to register certain accounts as RIA relationships:

"The rule is available to any broker-dealer registered under the Exchange Act that satisfies two conditions: (i) any investment advice it provides to an account must be solely incidental to the brokerage services provided to the account (and thus must be provided on a non-discretionary basis); and (ii) advertisements for and contracts, agreements, applications and other forms governing its accounts must include a prominent statement that the account is a brokerage account and not an advisory account, and that the broker-dealer's interests may not always be the same as the customer's.

"Customers would be encouraged to ask questions about their rights and the broker-dealer's obligations to them, including the extent of the broker-dealer's obligations to disclose conflicts of interest and to act in their best interest. This would include information about sales incentives and how a broker-dealer is compensated. In addition, the broker-dealer must identify an appropriate

person at the firm with whom the customer can discuss the differences between brokerage and advisory accounts."

The accounts must also be nondiscretionary--a topic which is described at length later in the Release, where a few incidental exemptions are discussed.

Does the SEC mandate disclosure language? Indeed it does. For all accounts opened after July 22 2005, customers will see this language somewhere in every new account form:

"Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over time."

Finally, you have two additional lines in the sand which, I think, were unexpected and that advisors will find interesting and helpful. One is an interpretation that "the payment of a separate fee [for advisory services] is a bright line test to distinguish brokerage activities from advisory activities." I think that means that if a customer pays for a financial plan, and then opens an account with the broker, then the relationship is advisory and should be regulated under RIA provisions. So you won't see brokerage firms offering millions of perfunctory financial plans as a powerful sales tool, unless they decide to register.

The second line has to do with the term "financial planning," and would seem to be a juicy bone thrown to the FPA and the planning profession that managed to get 1,700 comment letters into the SEC's decision mill. The language of the Release seems to be pretty clear: if the brokerage firm or broker provides a financial plan, or financial planning services, or holds itself out as a financial planner, then RIA registration is required. Here's the exact language of the Release:

"Under rule 202(a)(11)-1(b)(2), a broker-dealer would not be providing advice solely incidental to brokerage if it provides advice as part of a financial plan or in connection with providing planning services and: (i) holds itself out generally to the public as a financial planner or as providing financial planning services; 148 or (ii) delivers to its customer a financial plan; or (iii) represents to the customer that the advice is provided as part of a financial plan or financial planning services. As a result, when the advice described above is provided, a broker-dealer that advertises (or otherwise generally lets it be known that it is available to provide) financial planning services must register under the Act (unless an exemption from registration is available). Further, a broker-dealer that provides such advice and delivers a financial plan to a customer or represents to a customer that it provides such advice as part of a financial plan or in connection with financial planning services must also register under the Act (unless another exemption from registration is available) and treat that customer as an advisory client."

A few pages later, the Release directly addresses the potential for weasel-wording around this issue when it says that brokerage firms "must treat as advisory clients all those customers to whom it delivers a financial plan, regardless of what it chooses to call the plan."

And: "The broker-dealer must also treat as advisory clients those customers to whom it represents that its advice is part of a financial plan even if it uses some other term to describe the plan. Whether a particular document is, under the rule, a financial plan will turn on whether the document or representation bears the characteristics of a financial plan. Whether a communication represents that the services provided are financial planning services will depend on how a reasonable investor would understand the services described in the communication."

I agree with you that those references to other unspecified potential exemptions is troubling, but assuming they are not significant, this means that if you want to distinguish between fiduciaries and non-fiduciaries, between RIAs and those who masquerade as RIAs, simply ask the broker if he/she provides financial planning services. This would appear to protect the enormous investment the profession has made in the term "financial planning." I think even the FPA will be surprised by this remarkable concession.

But the concession doesn't stop there. The Release also goes out of its way to note something that

the financial planning profession has often wished that the SEC would appreciate that financial planners are a different kind of professional altogether. Here's what the ruling has to say on the subject:

"Although most financial planners are registered under the Advisers Act or similar state statutes, financial planners today belong to a distinct profession, and financial planning is a separate discipline from, for example, portfolio management. This development has occurred only relatively recently, over approximately the last twenty five years – well after the enactment of the Investment Advisers Act in 1940."

It is surely good news that the SEC recognizes these obvious facts on the ground, even though it suggests that the securities industry's primary regulatory body will now have to figure out how to regulate this group that has grown up since the '40 Act. There follows a few pages of explanation, which basically tell us that the SEC didn't want to discourage brokerage firms from doing due diligence on their customers by prohibiting them from collecting financial planning information, and so adopted instead a "holding out" rule that prevents them from calling themselves financial planners without RIA registration. At the end, the commissioners turn a nice trick on the SIA, which argued that brokerage houses needed to know when they did or did not have to register, and therefore should be allowed to provide investment advisory services without any registration issues whatsoever:

"Our approach would provide broker-dealers the certainty they need to determine when their advisory activities will trigger obligations under the Advisers Act because they can control how they hold themselves out to the public and their customers."

What did the Release NOT do? It specifically and by name did not prohibit BD organizations from calling their brokers "financial advisors" or "financial consultants" or other terms which strongly suggest an RIA connection.

Effective dates? As mentioned before, the advertising and disclosure rules go into effect on July 22 which means that brokerage firms must stop advertising their financial planning activities on that date, and incorporate the new disclosure language into their documents BY that date. If they do not or if they decide to designate certain of their accounts as RIA accounts, they will have until October 24 to accomplish this. My guess is that there are hundreds, perhaps thousands of brokers who will petition their home offices for permission to become RIAs within the system and to open up financial planning investment advisory relationships with their clients between now and then. How those decisions come down will be one of the most interesting things to watch in the months ahead

At the end, the ruling effectively creates an obligation to study a variety of issues and meet again to see whether there's anything that was missed here. I might suggest that the difference between "tipster/research department" advice and "investment advisory" advice would be a good topic to talk about, but it is not currently on the list. The questions posed, however, seem to be good ones. (After each question, I've offered what I think most financial planners are hoping the conclusions will be.)

"Should the Commission seek legislation that would integrate the existing regulatory schemes applicable to broker-dealers and investment advisers that provide services to retail clients?" (Potentially risky to advisors who don't have a lot of clout in Congress.)

"Should sales practice standards and advertising rules applicable to advice provided by broker-dealers be enhanced?" (RULES are not the problem; we have plenty of those, and we still get a constant stream of scandals. Let's acknowledge that advice is the value-added these days, and that brokerage firms are selling advice rather than execution, and make them register.)

"Should broker-dealers who provide investment advice but who are excepted from the Investment Advisers Act nonetheless be subject to the fiduciary obligations imposed by that Act on investment advisers?" (It depends on what kind of advice they offer. If they're delivering tipster advice from the research department, then maybe not.)

"Should obligations under the Investment Advisers Act applicable to dually-registered broker-dealers be modified or streamlined in order to eliminate regulatory overlap and reduce regulatory burdens?" (Only to the extent that you're willing to reduce regulatory burdens on the professionals

who have NOT been involved in routine scandals.)

"Are there areas in which the Commission, alone or in concert with other agencies, can engage in investor education efforts to assist investors to better understand the duties and obligations of their financial service providers?" (You betcha. And we'd be happy to help with the actual wording.)

If you want to read the Release in its entirety, the link is provided at the top of this column. If nothing else, reading through the 284 footnotes will provide a history of the thinking behind many of the decisions that the SEC formulates. For now, I think the dawning efforts to use "fiduciary" as a bright line may have been premature, now that the term "financial planning" is available to us.

And I think that this ruling helps restore some balance in the marketplace. The most aggressive sales organizations had managed to obscure the difference between asset gatherers and financial planners. Now, if you're mostly gathering assets, you either have to give the public a clue to your real agenda or take the plunge and live under fiduciary regulation.

No, it's not perfect. But it's the best we've had in quite a while.

Have a great week.

Best,

Bob Veres

Copyright © 2005 Bob Veres. All rights reserved.

Design by 