BROKER VS. INVESTMENT ADVISOR: WHAT ARE THE DIFFERENCES? WHY IS IT IMPORTANT TO YOU?

By: Fran Hayes, CFP®

BACKGROUND: **Broker and Advisor**

Both brokers and investment advisors are licensed professionals who assist investors with their financial goals and objectives. Brokers are regulated by the Financial Industry Regulatory Authority (FINRA) while investment advisors are regulated by either the Securities and Exchange Commission (SEC) or their home state regulatory body, depending on the advisor's level of assets under management. Although their roles might seem similar to an outsider, investment advisors and brokers perform very different roles and provide very different types of services in the delivery of financial services to investors.

A BROKER is defined as any person engaged in the business of effecting transactions (buying and selling securities) for the account of others.[1] Despite having many different titles (ie. *wealth manager, wealth advisor, investment consultant, financial advisor, financial consultant, and registered representative*), brokers are generally not considered to have a fiduciary duty to their clients.[2] Instead of being required to put their client's best interests ahead of their own, brokers are expected to deal *fairly* with their clients and adhere to a lower standard of legal care known as the *suitability standard*.[3] This standard requires a broker to know his/her customer's financial situation well enough to recommend investments that are considered *'suitable'* for that particular client.[4] In addition, brokers are not required to provide upfront disclosures like the ones required for investment advisors.

AN INVESTMENT ADVISOR operates quite differently from a broker and adheres to a stricter set of rules. An investment advisor is required to act in the best interest of his/her clients, putting the client's interests ahead of his/her own at all times.[5] This operating philosophy and legal requirement is called the *fiduciary standard*.[6] Under the *fiduciary standard*, an investment advisor must provide advice and investment recommendations that he/she views as being the best for the client. *Fiduciaries* must also adhere to the duties of *loyalty* and *care*.[7] Further, an investment advisor subject to the *fiduciary standard* is required to disclose all potential conflicts of interest to the client before entering into a contract for advisory services with that client.[8] As such, an investment advisor is legally prohibited from giving investment advice that may conflict with their client's needs.

As outlined above, there are significant differences with regard to industry rules, regulations and legal requirements in the way in which a broker delivers financial services to clients via the *'suitability standard'* and the way in which an investment advisor delivers financial services to clients via the *'fiduciary standard'*.

DUAL REGISTRATION & HYBRID MODEL: **Additional Investor Confusion**

The previous section reviews the major differences between the investment advisory (fiduciary) model and the brokerage (suitability) model. Further increasing the confusion for investors are the structures of 'dual registration' and the 'hybrid model'. Today, a large number of financial professionals serve as both investment advisors and brokers. As an example, an investor might open several accounts with a broker employed by one of the major brokerage firms (e.g., Merrill Lynch, Morgan Stanley, Wells Fargo, et al) or someone licensed with an independent broker/dealer (e.g., LPL Financial, Ameriprise, Cetera Advisors, et al). This broker (who usually has a different title that the firm allows him/her to use with the public) may sell the investor a fee-based/advisory account where the broker acts in the role of an investment advisor representative of the firm's advisory arm. The broker may also sell the investor other investment products where he/she earns a commission by acting in the role of a registered representative licensed with the firm's broker/dealer arm. In this scenario where the broker acts in the role of both investment advisor representative and registered representative, he/she is considered to be 'dually registered'. The 'hybrid model' is quite similar. In the 'hybrid model' the broker/advisor most often owns his/her independent registered investment advisory firm as opposed to being an employee of a brokerage firm.

One of the biggest potential issues for investors who are utilizing either a 'dually registered' or 'hybrid' model is that most often the lower legal standard of 'suitability', not the higher standard of 'fiduciary duty', applies to the relationship. This potential issue exists because the brokers at the major brokerage firms and/or at the independent broker/dealer firms can function as both an investment advisor and a broker in either the 'dually registered' or 'hybrid' models. As a result, determining if the financial professional is wearing the 'advisor hat' or the 'broker hat' is oftentimes very confusing for the investor.

COMPENSATION: **A Critical Component and Difference**

Investment advisors that operate on a *fee-only* basis (not 'fee-based') are compensated either by a fixed fee for their time or a percentage of the assets under management.

Brokers are compensated through commissions for the trades they place on behalf of their clients and/or the products they sell to their clients.

As described above, brokers who operate under a *fee-based* compensation arrangement within a 'dual-registration' or 'hybrid' structure can potentially earn compensation from fees paid directly by clients (similar to fee-only advisors) plus fees which they receive in the form of commissions from products they are licensed to sell.

Unlike investment advisors operating under a fiduciary standard, brokers are not required to inform their clients in detail how their compensation is earned. As such, the *fee-based* model may create significant potential conflicts of interest because the advisor's income is directly affected by the financial products he/she sells to the client.

THE 'FIDUCIARY RULE' DEBATE: A Typical Political Saga

In September of 2010 (under the Obama administration) the Department of Labor (DOL) proposed a rule to provide retirement investors with important new protections requiring that financial advisors act in their best interest. While many investors think that their financial advisor already is required to act in their best interest – like their accountant, attorney or doctor – the law hasn't always required it. Oftentimes, financial firms pay their advisors more to promote certain products rather than recommend what is best for their customer.

The objective of the DOL proposal was to close loopholes in existing rules that allowed financial advisors to avoid being considered 'fiduciaries'. The DOL estimated that these loopholes cost investors who are saving for retirement billions of dollars each year in conflicted investment advice. Many investors we speak with are both amazed and appalled that the current laws and regulations do not require a financial advisor to put the client's interests ahead of their own at all times.

One year after the DOL proposed this 'Conflict of Interest Rule' (more widely known as 'The Fiduciary Rule'), it was withdrawn amid a flood of criticism from the financial services industry. We find it to be no surprise that some of the more powerful lobbying firms representing the largest financial services firms (banks, brokerage firms, insurance companies) in the world were actively lobbying in Washington to stop the DOL's effort to institute this new investor protection rule.

The following points review the timeline of the DOL's 'Fiduciary Rule':

- In April 2015, the DOL re-introduced the proposal with significant modifications. Over the next 12 months, there was considerable industry debate about the structure and applicability of the rule. On April 6, 2016, the regulators made the rule final and announced an implementation date of April 10, 2017.
- On June 1, 2016, eight industry and trade groups filed the first lawsuit against the DOL in the northern district of Texas, claiming that the DOL didn't have the authority to enact the new rules. On June 8, 2016, President Barack Obama vetoed a congressional attempt to block the rule, and Senator Paul Ryan's push to override the veto failed along party lines by a 230 – 180 vote.
- On February 3, 2017, President Donald Trump ordered the DOL to review the fiduciary rule by issuing an official memo. Trump directed the DOL to prepare an updated economic and legal analysis of the rule, considering whether it has harmed or is likely to harm investors due to a reduction in savings offerings, whether it has resulted in disruptions within the retirement services industry that may adversely affect investors or retirees, and whether it is likely to cause an increase in litigation and prices for retirement services. If the answer is yes to any of these points, or if the DOL finds the rule is inconsistent with President Trump's stated priority "to empower Americans to make their own financial decisions" then he directs the DOL to publish a proposed rule rescinding or revising the fiduciary rule.
- On February 9, 2017, a Texas Judge threw out the case against the fiduciary rule, in an 81-page opinion, shooting down each of the major arguments against the proposed rule by the plaintiffs.
- On March 3, 2017, the DOL issued a proposed rule, calling for a 60-day delay to the fiduciary rule's April 10 applicability date – to June 9, 2017. In addition, the DOL opened a comment period – due April 17th – on the issues raised in President Trump's memo.
- On March 10, 2017, the DOL issued a field advisory bulletin indicating that it will not enforce the rule in the near term. It determined that relief is appropriate to protect against potential investor confusion and related marketplace disruptions that could be attributable to uncertainty regarding the delay decision.
- On March 16, 2017, the U.S. Chamber of Commerce filed a request to the Texas Court for an injunction blocking implementation of the rule pending the appeal of its case to the 5th Circuit. On March 20th, the Court denied the motion, leaving the timetable to be determined by the DOL.
- On April 5, 2017, the DOL officially delayed the April 10th implementation date until June 9, 2017.
- On May 23, 2017, DOL Secretary Alexander Acosta announced that the initial implementation date of the rule will not be delayed beyond June 9, 2017. However, industry experts believe it is likely that there could be wholesale changes to the rule in the near future.

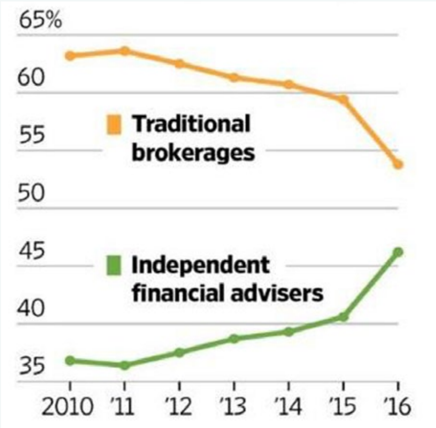
INDUSTRY MOMENTUM: **Investors are Beginning to Understand**

Over the last 10 plus years the investing public has become much more aware of the distinct differences between the broker/sales model and the advisor/fiduciary model. The investing public has been 'voting with their wallets' as they continue to choose the investment advisor model over the broker model. As a result, the U.S.'s largest brokerage firms have been steadily losing market share to independent investment advisors. The chart below from the research firm Cerulli Associates shows that traditional brokerage firms' market share of client assets has shrunk from 63% of assets in 2010 to 59% of assets in 2015, while independent advisors' share has grown from 37% to nearly 41% of assets. We believe this trend will continue.

The world of investment advice can be fraught with conflicts of interest, opaque disclosure and an overall lack of transparency. Seeking out an investment advisor who will act as your fiduciary can help to potentially eliminate many of the problems associated with the commission-driven, product-focused broker model. Because a fiduciary is required, by law, to give full and complete disclosure of how they are compensated as well as any potential conflicts of interest that may exist before doing business with any prospective client, the investing public is in a better position to make a more informed decision.

SHIFTING LANDSCAPE

Investors have been moving more of their assets to independent advisers from traditional Wall Street brokerages in recent years.



Source: Cerulli Associates
THE WALL STREET JOURNAL.

THE FIDUCIARY RULE: **One Big Open Issue Remains**

As previously indicated, the DOL made a final decision to begin implementation of the fiduciary rule starting June 9, 2017. Different aspects of the rule will be phased-in between June 9, 2017 and January 1, 2018. The **'big open issue'** for investors is that the rule only covers retirement accounts. Most investors have both retirement accounts as well as non-retirement accounts, commonly known as taxable accounts. As a result, investors who are receiving advice from a broker regarding their taxable accounts will not have their interests put ahead of the broker's interests and/or the brokerage firm's interests. In addition, there will not be a requirement to disclose to the investor all potential conflicts of interest.

Implementing the fiduciary rule for retirement investors is an excellent first step. However, we believe that it is extremely important to have the same rules apply to investors with taxable accounts. Until this gap is closed, the investing public will be at a disadvantage. We certainly hope and expect to see our lawmakers eliminate this 'one big open issue' and take the next step in providing a level playing field for investors. We encourage you to write to your congress and senate representatives about this issue.

SUMMARY: **Where Does Round Table Stand?**

Since the founding of Round Table Wealth Management in 1999, the firm has always operated in a fiduciary capacity. Our client-centric approach to helping families and individuals achieve their financial goals and dreams has always put the client's interests ahead of our own. We strongly believe that, as a Registered Investment Advisor, it is not only the required way of serving clients from a legal perspective, it is the right thing to do. We also believe that by acting as a fiduciary we are in a better position to more effectively meet our client's needs.

At Round Table, we will continue to be champions for the best interests of our clients and will always be staunch advocates for the fiduciary model. We believe that an advisor who is held to a fiduciary standard occupies a position of special trust and confidence when working with clients because he/she is required to act with undivided loyalty to the client. Further, we believe strongly that it has clearly been proven and validated in the marketplace to be the better model for the investor because of the dramatic reduction in conflicts of interest (which generally result in higher fees), greater choice of investment options and no sales of proprietary investment products to clients.

Lastly, we expect the industry and political debate regarding the fiduciary rule to be very fluid. We will continue to keep you informed of key developments regarding this important issue. Please let us know if we can help answer any questions you may have.

ABOUT THE AUTHOR:

Fran Hayes
CFP®

Fran Hayes, CFP® serves as Senior Director of Strategic Relationships at Round Table Wealth Management. He is a 33-year veteran of the financial services industry and is responsible for Round Table Wealth Management's strategic relationships. His primary responsibilities include supporting the firm's business development initiatives with institutional partners and the introduction of high-net-worth clients to Round Table. His industry knowledge, management experience with growth-focused businesses and his relationships within the RIA community will help support the growth of the firm and its brand.

Round Table Wealth Management is a leading, independent, fee-only SEC Registered Investment Advisor (or "RIA") with offices in New York and New Jersey. RTWM operates as a multi-family office with approximately $1 billion in assets under management as of December 31, 2016, and serves a diverse client base throughout the U.S. as well as internationally. Founded in 1999 to provide objective investment advice, RTWM offers a wide range of advisory services and investment solutions that are tailored to the specific needs and requests of each client. Learn more at **www.roundtablewealth.com**.

Footnotes

1. Securities Exchange Act of 1934, Sec. 3 (a) (4) (A)
2. SEC Study on Investment Advisers & Broker-Dealers, January 2011, page iv
3. SEC Study on Investment Advisers & Broker-Dealers, January 2011, page iv
4. FINRA Rule 2111, Suitability (a)
5. Investment Advisors Act of 1940, Sec. 211 (g) (1)
6. SEC Study on Investment Advisers & Broker-Dealers, January 2011, page iii
7. Investment Advisors Act of 1940 as referenced by Investopedia Website (www.investopedia.com)
8. SEC Study on Investment Advisers & Broker-Dealers, January 2011, page iii