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Advisor Corner: Understanding the Differences between RIAs and Brokers, Suitability and Fiduciary

There are a lot of regulatory uncertainties hanging over the investment industry in the wake of the Dodd Frank Wall Street Reform and Consumer Protection Act, which President Obama signed into law in July. In this issue, we focus on the main differences between brokers and registered investment advisors (RIAs), what these differences might mean for investors, and how the legislation could affect brokers and RIAs. To provide insight, we spoke with Skip Schweiss, President, TD Ameritrade Trust Company and Managing Director of Advisor Advocacy for TD Ameritrade Institutional.

Q: What are the key differences between RIAs and brokers?

Schweiss: There are four main areas of difference. First, RIAs are registered with and regulated by either the Securities and Exchange Commission (SEC) or their appropriate state securities regulator(s), depending on the amount of assets they manage. Brokers, on the other hand, are overseen by the SEC and are usually a member of the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization (SRO) for broker/dealers doing business in the United States.

Second, Brokers and RIAs operate under two distinct statutes. Most brokerage activity is regulated under the Securities Exchange Act of 1934, while most advisory activity is regulated under the Investment Advisers Act of 1940.

Getting to the practical side of things, brokers typically are compensated by charging a commission on the sale of an investment product. In contrast, RIAs more typically charge fees for advice. Finally, brokers are held to “fair dealing” standards of commerce and are subject to a “suitability” standard of care with their clients, meaning that their investment recommendations must be “suitable” for the needs of the client.

RIAs, however, are subject to a “fiduciary” standard of care with their clients. That means that their investment recommendations must be in

the best interest of the customer and the customer’s interests must come first.

Think of it this way. If you walk into a Ford dealership, the Ford salesman is going to do everything he can to sell you a Ford. And a Ford vehicle will likely ‘suit’ your needs. But you could also choose to hire someone to help you determine exactly which vehicle would really be best for you, among the many brands and models out there. Although this person would receive a fee for services rendered, he or she would be indifferent as to what car you buy because that form of payment has taken the conflict out of the relationship.

Another metaphor can be found in the medical profession. Today we pay our doctor to evaluate our condition and to prescribe any necessary treatments. What if there were another model where we didn’t have to pay the doctor for that evaluation, but instead the doctor was paid by the pharmaceutical company for prescribing medications, or the surgeon for prescribing surgery? I might be glad that I no longer have to pay the doctor, but unsure about how the potential conflicts might impact my overall health care.

I don’t mean to say that either model is better than the other. Each one has its place in helping investors reach their investment goals.

Q: What do these differences mean for end-investors?

Schweiss: Investors should consider which model better fits their needs. For example, I may have an IRA rollover from a prior employer and I just want to get some advice on which investments I might consider, without any ongoing relationship with a broker or advisor. I’m willing to pay for that advice in the form of one-time commissions charged on the sale of those investment products.

Or I may want ongoing advice and be willing to pay an ongoing fee for that type of service. In that circumstance, I may be willing to hire an RIA to

offer continuous advice and oversight of my portfolio. One thing to note is that most RIAs have account minimums that may start at \$100,000 or more. For people who don't have that level of assets, the commission model may be a better fit.

As over the years brokers got more and more involved in the provision of ongoing advice, there's been some blurring of the lines and that's why the regulatory push.

Q: What, if any, does the current legislation mean for me as an RIA?

Schweiss: Under the Dodd-Frank Act, the SEC was asked to take six months to study the different regulatory schemes and oversight mechanisms and decide what might be done differently, if anything. The report is due in January, and changes, if any, wouldn't happen until after that time.

While the outcomes of the study are uncertain, there's reason to believe brokers and advisors may become subject to the same standards of care with respect to providing investment advice about securities to retail customers.

So if you're an RIA, it's possible that your brokerage competitors may come under a fiduciary standard of care as RIAs have been since 1940. If the SEC adopts such an approach following its six-month study, it will level the playing field in terms of the standard of care for "personalized investment advice about securities to retail customers."

It's also possible that an industry SRO may have common oversight of RIAs and brokers, which is not the case now. In addition, if an RIA manages client assets in the aggregate between \$25 million and \$100 million, its regulator will likely shift from the SEC to the state(s) in which it is registered.

Q: What does the legislation mean for me as a broker?

Schweiss: If the SEC adopts a uniform, fiduciary standard of care for a broker's client relationships, the broker will still be able to charge

commissions for its services. In fact, the bill says that just because you charge commissions doesn't mean you are violating a fiduciary standard, nor does the fact that you sell proprietary products. You likely will, however, be held to a higher standard of care in those client relationships when providing personalized investment advice about securities.

With the fiduciary standard, it's all about the process you follow for arriving at your recommendations. A lot of fiduciaries form an investment policy statement that outlines how they are going to make investments for you and monitor them on an ongoing basis. It gives a framework for how the relationship will be conducted going forward.

It's also possible that RIAs may come under common SRO oversight with brokers. Currently FINRA oversees only brokers.

Keep in mind that nothing is set in stone at this point. The financial overhaul bill didn't so much lay out explicit changes as it did ask government bodies to do a study and make rules based on the outcome of the study. Though there is a leaning toward the fiduciary standard, there's no way to tell if that's where the SEC will come out.

Skip Schweiss is President of TD AMERITRADE Trust Company and Managing Director of Advisor Advocacy for TD AMERITRADE Institutional.

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