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Policy Insight

Broker-Dealers and Investment Advisers in the U.S.

Business Practices and Investor Understanding

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Individuals are being asked to bear more responsibility for their future financial security. To make appropriate decisions, many turn to professionals for assistance. However, the U.S. financial services industry has become increasingly complex in recent decades, as firms have launched products and services that have blurred the traditional distinctions between broker-dealers and investment advisers. Despite the U.S. Securities and Exchange Commission's (SEC's) efforts to clarify and explain these distinctions, consumers still struggle to distinguish broker-dealers from investment advisers and to evaluate the quality of the advice they are being given.

On paper, the roles and responsibilities of these financial professionals are relatively distinct: a *broker* trades securities on behalf of clients; a *dealer* conducts transactions in securities for his or her own accounts; and an *investment adviser* provides recommendations to others about securities. From a public policy standpoint, the dividing line between broker-dealers and investment advisers has always been a crucial one, since it ensures that the industry is relatively transparent, easy to navigate, and properly regulated. The blurring of this line hinders the ability of regulators to design and implement appropriate policies.

The complexity and lack of adequate transparency in the industry were spotlighted in the wake of the $50 billion alleged fraud by Bernard Madoff, manager of Bernard L. Madoff Investment Securities LLC, which was dually registered with the SEC as both a broker-dealer and an investment adviser. The case highlights the need for the SEC to improve enforcement of oversight and to overhaul its regulatory framework. As the SEC and other federal agencies implement changes, it is essential to have a clearer understanding of the industry's complexities and evolving business practices. In this *Policy Insight*, we draw on the findings of a recent RAND study on broker-dealers and investment advisers to address two important questions: (1) What are the current business practices of broker-dealers and investment advisers? and (2) Do investors understand the differences between broker-dealers and investment advisers?

Current Business Practices

From 2001 through 2006, the number of investment advisers in the Investment Adviser Registration Depository (IARD) database grew significantly, from 7,614 to 10,484. Over the same period, as shown in Figure 1, the number of broker-dealers in the Financial and Operational Combined Uniform Single (FOCUS) Report database declined from 5,526 to 5,068.

Some firms were registered in both the IARD database as investment advisers and the FOCUS database as broker-dealers. The number of such dually registered firms stayed relatively stable from 2001 to 2006, at between 500 and 550 firms.

Characteristics of Broker-Dealer and Investment Adviser Firms. An analysis of firms in the IARD database in 2006 indicates that investment advisers vary greatly in size, assets under management, financial services, and business affiliations. More than half of the firms with individual clients employed no more than 10 individuals, but 69 large advisory firms with individual clients had more than 1,000 employees. Dually registered firms tended to be larger than the rest of the investment advisory firms. Data on assets under management also indicated the heterogeneity of advisory firms. In the fourth quarter of 2006, 5 percent of investment advisory firms managed 83.8 percent of total assets under management in the industry.

Nearly all investment advisers used fees based on the percentage of assets under management as the primary form of compensation. For all types of investment advisers, financial planning and portfolio management for individuals and small businesses topped the list of the reported advisory activities. Some of the advisory firms also provide

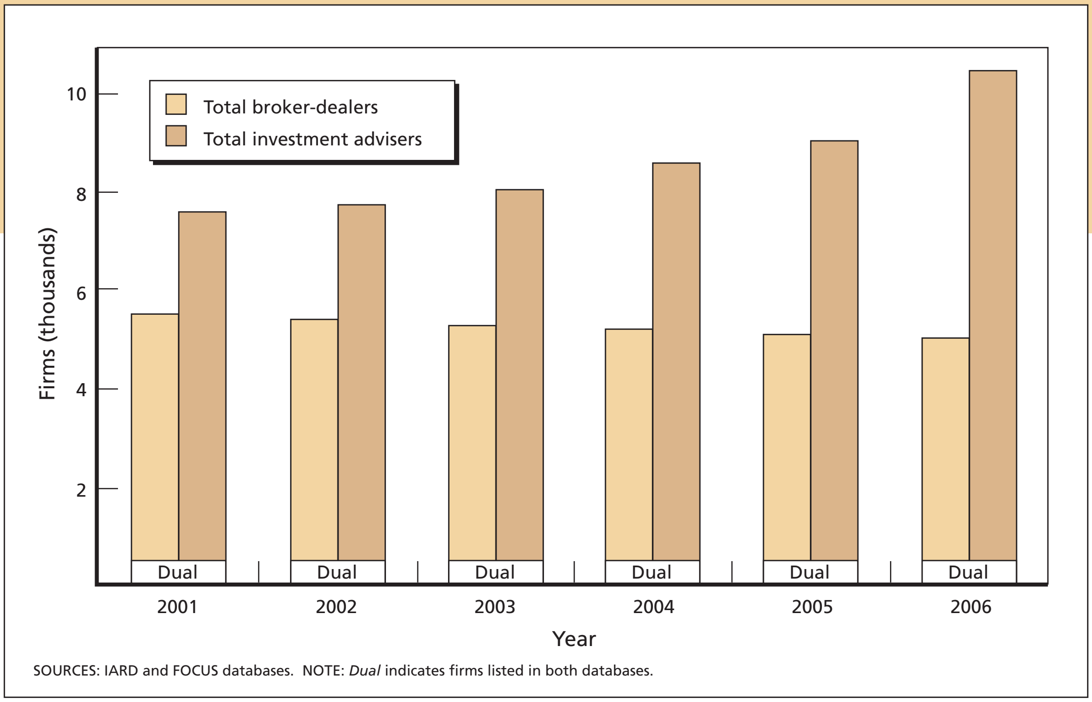

Figure 1. Broker-Dealers, Investment Advisers, and Dually Registered Firms (2001–2006)

pension-consulting services, sponsor wrap-fee programs,[1] and manage portfolios for investment companies and wrap-fee programs.

The database on broker-dealers contained extensive information on their financial standing. Distributions of assets and ownership equity were significantly tilted. The mean of total assets reported in 2006 was more than $1 billion, whereas the median was less than $500,000. The brokerage firms that cleared or carried customer accounts were much larger than the rest of the firms: Means of reported assets and ownership equity among the former were $10 billion and $250 million, whereas for the latter these figures were about $25 million and $7 million. Like investment advisers, dually registered brokerage firms were vastly larger than the rest of the broker-dealers. In addition to such conventional brokerage activities as selling corporate equity and debt securities, some of the broker-dealers conducted floor trades, underwrote securities, and sold life insurance and annuities.

Some corporations appeared to have multiple subsidiaries or business units, each registered separately as an investment adviser or broker-dealer, although the data did not identify these relationships.

From 2001 to 2006, dually registered firms reported significant increases in revenues, expenses, and net incomes. Larger firms tended to affiliate with other firms and offer a fuller range of services. For example, more than one out of every five investment advisers had a related broker-dealer, municipal-securities dealer, or government-securities broker-dealer. Similarly, about 40 percent of broker-dealers directly or indirectly controlled,[2] were controlled by, or were under common control with a firm engaged in advisory activities. In many cases, it was hard to separate the services and business relationships of firms that were dually registered or affiliated with other firms. Some corporations appeared to have multiple subsidiaries or business units, each registered separately as an investment adviser or broker-dealer, although the data did not identify these relationships.

Services Provided. To gain better insight on how firms interacted with clients, provided services, and disclosed relevant information, we collected business and legal documents from 29 sampled firms. To supplement the documentary evidence, we conducted thorough reviews of the publicly available Web sites of these 29 responding firms as well as of another 34 randomly selected firms.[3] In Table 1, we report the types and number of advisory services offered both by investment advisers and broker-dealers.

Not surprisingly, we found that large broker-dealers provided most of the advisory services. All these brokerage firms are dually registered. In contrast, smaller broker-dealers were less likely to be engaged in advisory services. With regard to a presentation of the fees and commissions, we found that, compared with large advisory firms, large broker-dealer firms more frequently included fee tables and an explanation of commissions in the documents or on the Web site. However, smaller brokerage firms perform poorly in this regard. Our findings also indicate that brokerage firms were equally likely to use (1) percentage of assets under

1 In a wrap-fee program, a client is provided with advisory services, asset allocation, portfolio management, and other related services for a single fee based on the size of the account.

2 The SEC defines "control directly or indirectly" as "to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise."

3 Our study used stratified sampling procedure. Firms were stratified by type (broker-dealers and investment advisers) and size.

Service	Broker-Dealers			Investment Advisers		
	All	Large[a]	Other	All	Large[a]	Other
Cash-flow planning, budgeting, budget-management planning	10	8	2	17	6	11
Investment, portfolio, and asset management and monitoring	18	11	7	35	10	25
Investment, portfolio, and asset evaluation, review, and planning	14	10	4	25	9	16
Tax-planning strategies	8	7	1	17	6	11
Education and college planning	12	8	4	15	5	9
Retirement planning	12	8	4	24	8	16
Estate planning	13	9	4	16	3	13
Insurance and risk evaluation, planning, and analysis	7	5	2	16	4	12
Total firms	**25**	**13**	**12**	**38**	**10**	**28**

Table 1. Advisory Services Provided by Investment Advisers and Broker-Dealers

[a]In terms of number of accounts and size of account holdings in 2001–2006.

Table 2. Disclosures Found Across All Sources of Information

Type of Disclosure	Broker-Dealers			Investment Advisers		
	All	Large[a]	Other	All	Large[a]	Other
Differences between investment advisers and broker-dealers	31(8)	31(8)	0(0)	13(7)	10(4)	3(3)
Conflicts of interest	32(12)	31(11)	1(1)	19(10)	10(4)	9(6)
Compensation structure	37(13)	32(10)	5(3)	18(12)	7(4)	11(9)
Code of ethics or fiduciary oath	30(9)	30(9)	0(0)	29(9)	15(5)	14(9)
Client duties and responsibilities	29(12)	25(9)	4(3)	27(19)	14(7)	13(12)
Client rights	25(11)	23(9)	2(2)	21(10)	16(7)	5(3)
Future performance	32(12)	26(9)	6(3)	17(11)	8(7)	8(4)
Total firms	**25**	**13**	**12**	**38**	**10**	**28**

[a]In terms of number of accounts and size of account holdings in 2001–2006.

management, (2) transaction-based fees, and (3) flat fee as the method of compensation for their services, whereas investment advisers relied heavily on (1) and (3). In general, we observed that the industry is very heterogeneous and complex, with thousands of firms offering very diverse products and services.

Information Provided to Customers. We also assessed the availability and timing of disclosures provided by firms to clients in the marketing brochure, product brochure, print advertisement, account agreement, pricing schedule, separate disclosure document, or Web site. In Table 2, we report the aggregate numbers of identified disclosures and the number of firms for which the specific disclosure was found in at least one of the sources of information (in parentheses).

We found that larger firms more frequently provide disclosure statements to their clients and are more likely to present each disclosure in at least one of the information sources. Explanation of the compensation structure was the most frequently identified type of disclosure for the broker-dealers. For the large broker-dealers, we were also able to identify significant numbers of disclosures related to differences between investment advisers and broker-dealers, conflict of interest, code of ethics, or fiduciary oath.

A statement on a code of ethics or a fiduciary oath was the most frequently identified disclosure across all sources of information for investment advisers. As in the case of broker-dealers, smaller advisory firms were less likely to present disclosures.

Overall, we observed that firms provide a very uneven amount of information to prospective clients. Larger firms tended to provide a more complete set of information, although in some cases the volume of information seemed overwhelming for inexperienced clients. In contrast, for many small firms, we were not able to identify disclosures related to differences between investment advisers and broker-dealers and to conflict of interest and client rights.

Investor Understanding

To examine investor understanding of the distinctions between broker-dealers and investment advisers, we conducted a household survey and a series of intensive focus groups consisting of experienced and inexperienced investors. The survey was completed by 654 U.S. households.

Respondents were presented with a series of specific services and obligations (provide advice about securities, execute stock or mutual fund transactions, recommend specific investments, etc.) and were asked to indicate which items applied to a particular type of financial service professional. In general, the roles and obligations of broker-dealers and investment advisers were confusing to most of the survey respondents. Widespread use of other professional titles, such as *financial adviser*, *financial consultant*, and *financial planner*, also blurred the distinction between broker-dealers and investment advisers. Six focus groups, consisting of 10 to 12 participants representing both experienced and inexperienced investors, confirmed these survey findings.

Despite the confusion with the terminology and increasing complexity of the industry, most of the survey respondents and focus group participants had long-term relationships with their broker-dealers and investment advisers and expressed satisfaction with the services provided. Professional attentiveness, accessibility, and the expertise of the industry professionals appealed to most of the survey respondents. Focus group participants emphasized trust as a key feature of the relationship with their broker-dealers and investment advisers. Unfortunately, as evidenced in the Madoff case, consumers are not always able to correctly gauge who is trustworthy.

Policy Implications

The industry is heterogeneous and complex, with thousands of firms taking many different forms and offering many sets of services and products. As a result, investors are frequently unable to distinguish between broker-dealers and investment advisers along the lines defined by federal regulations.

The need for improved financial literacy among consumers as they take more personal responsibility for their financial decisions is clear. Education programs will help consumers to become more knowledgeable about financial terms, definitions, roles of the industry professionals, and other aspects of the industry. The financial services industry needs to step up its efforts in this regard. But better educated consumers are only half of the equation.

The other half of the equation is to improve transparency and accountability. Future policy initiatives and SEC regulatory propositions must be based on clearer distinctions about the activities, disclosures, and legal duties of broker-dealers and investment advisers. This would benefit investors and financial professionals as well as industry regulators.

Further Reading

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