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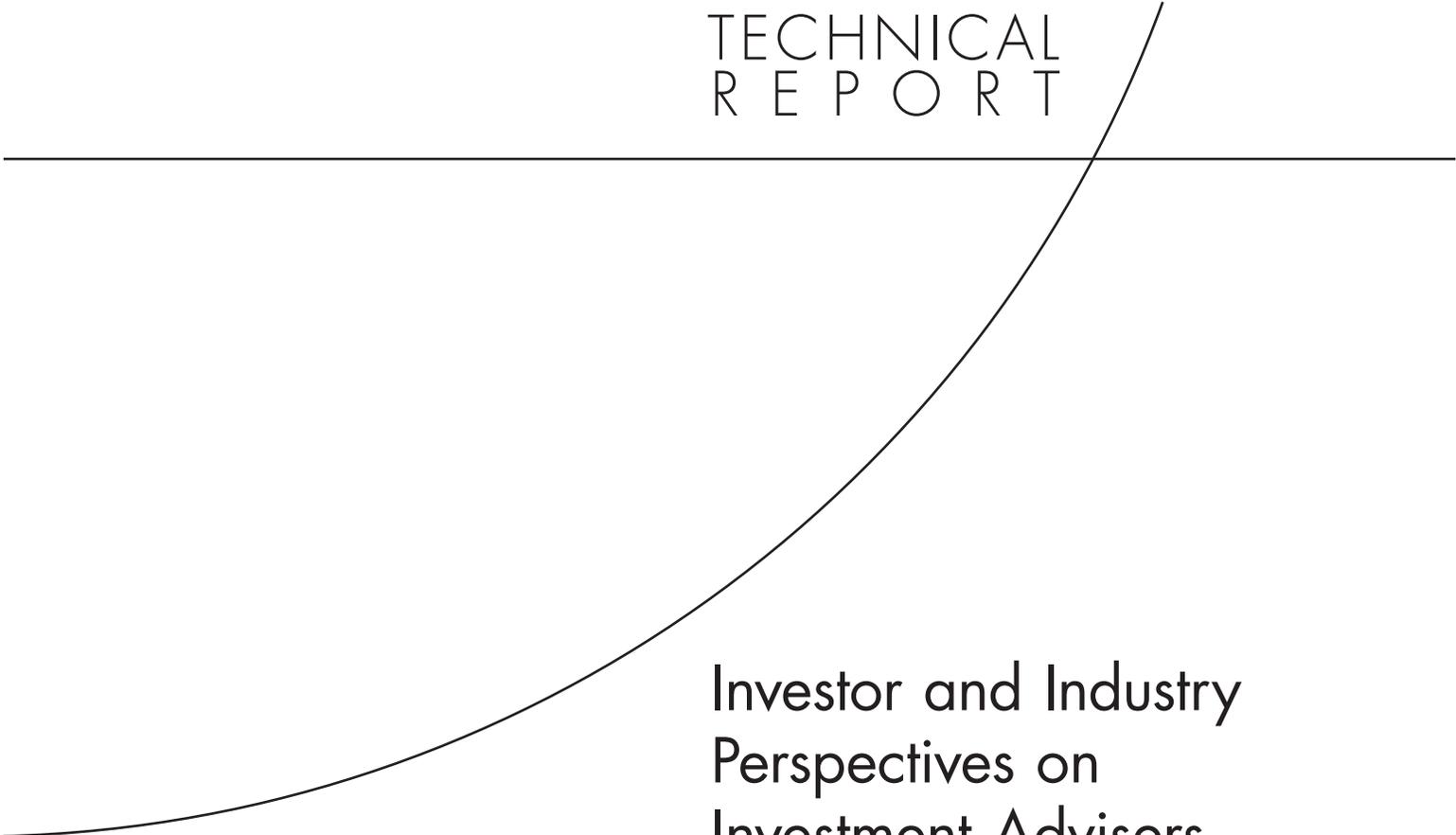
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# Investor and Industry Perspectives on Investment Advisers and Broker-Dealers

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Sponsored by the United States Securities and Exchange Commission



INSTITUTE FOR CIVIL JUSTICE

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The research described in this report was conducted by the LRN-RAND Center for Corporate Ethics, Law, and Governance within the RAND Institute for Civil Justice and commissioned by the U.S. Securities and Exchange Commission (SEC).

**Library of Congress Cataloging-in-Publication Data**

Investor and industry perspectives on investment advisers and broker-dealers / Angela K. Hung ... [et al.].

p. cm.

Includes bibliographical references.

ISBN 978-0-8330-4403-7 (pbk. : alk. paper)

1. Securities—United States. 2. Securities industry—Law and legislation—United States. 3. Investment advisers—Legal status, laws, etc.—United States. 4. Stockbrokers—Legal status, laws, etc.—United States.

I. Hung, Angela K.

KF1070.I58 2008

346.73'0922—dc22

2008002124

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Published 2008 by the RAND Corporation  
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## Executive Summary

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The financial service industry is at a crossroads regarding its regulatory and legal status. As the industry has become more complex, it has become increasingly difficult for regulators to design regulations that govern the different financial services available in this market. In theory, financial professionals are relatively distinct: A *broker* is defined as someone who conducts transactions in securities on behalf of others; a *dealer* is defined as someone who buys and sells securities for his or her own accounts; and an *investment adviser* is defined as someone who provides advice to others regarding securities. Broker-dealers and investment advisers are subject to different federal regulations: The Securities Exchange Act of 1934 (48 Stat. 881) regulates brokers and dealers, and the Investment Advisers Act of 1940 (54 Stat. 847) regulates investment advisers.

In light of these differences in definitions and regulations, the dividing line between broker-dealers and investment advisers has always been an important one. However, trends in the financial service market since the early 1990s have blurred the boundaries between them. Firms are constantly evolving and bundling diverse products and services in response to market demands and the regulatory environment. Although the SEC has attempted to clarify the boundaries between broker-dealers and investment advisers—first in a 1999 proposed rule that was then modified and became the 2005 rule, “Certain Broker-Dealers Deemed Not to Be Investment Advisers” (SEC, 2005)—the regulation was challenged and eventually overturned.

During the rule-making process, the SEC received more than 1,700 letters from financial professionals, investors, and consumer groups expressing concerns about what investors understand about the differences between brokerage and advisory accounts, the legal obligations of each type of account, and the effect of titles and marketing on investor expectations. As a result, the SEC recognized that any future regulatory reform would have to be based on a clearer understanding of the industry’s complexities, including the changing business practices of broker-dealers and investment advisers and how investors perceive these practices. In response, the SEC commissioned RAND to conduct this study.

### Study Purpose and Approach

The main purpose of this study was to provide the SEC with a factual description of the current state of the investment advisory and brokerage industries for its evaluation of the legal and regulatory environment concerning investment professionals. This study did not evaluate the

legal or regulatory environment itself; nor does this resulting report make policy recommendations. Specifically, the study addressed two primary questions:

- What are the current business practices of broker-dealers and investment advisers?
- Do investors understand the differences between and relationships among broker-dealers and investment advisers?

To describe industry practices, we collected and analyzed information from a number of sources: previous studies of the subject, primarily in economics and business publications and in popular sources, such as trade journals and financial media; data derived from regulatory filings submitted by investment advisers and broker-dealers from 2001 to 2006; business documents used by a sample of firms; and two sets of personal interviews: one set with 26 interested parties with different perspectives on the industry and one set with financial service firms.

To assess investor understanding, we collected and analyzed data from an extensive household survey and from focus groups consisting of experienced and inexperienced investors. The survey, which was completed by 654 U.S. households, asked about perceptions of the differences between investment advisers and broker-dealers, experience with financial service providers, and the level of satisfaction with the services received. Six focus groups with 10 to 12 participants each allowed for interactive discussion of the same topics and offered the opportunity to probe for the assumptions and reasoning that lay behind certain responses.

Overall, we found that the industry is very heterogeneous, with firms taking many different forms and offering a multitude of services and products. Partly because of this diversity of business models and services, investors typically fail to distinguish broker-dealers and investment advisers along the lines that federal regulations define. Despite their confusion about titles and duties, investors express high levels of satisfaction with the services they receive from their own financial service providers.

## **Current Business Practices of Investment Advisers and Broker-Dealers**

We provide a descriptive analysis of the business practices of thousands of investment advisers and broker-dealers based on data they report in regulatory filings. We focus attention on firms that report that they offer both brokerage and advisory services or are affiliated with firms that offer the complementary service. We attempt to clarify the differences between such firms and those that specialize solely in brokerage or advisory services. Our analysis confirms what many stakeholders expressed in their interviews: The industry is composed of heterogeneous firms that provide a range of services and are engaged in a variety of relationships with one another, and, therefore, it is not surprising that investors fail to distinguish financial service providers along the regulatory lines.

### **Number of Firms and Firm Size**

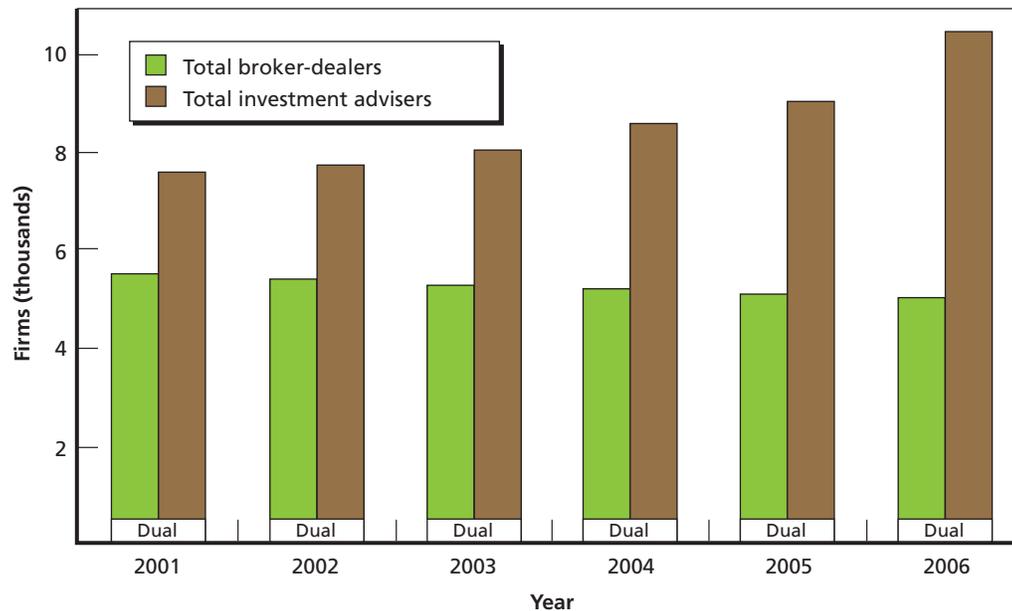
A relatively small number of large firms provide a full range of services, are often affiliated with other financial service providers, and conduct an overwhelming proportion of the investment advisory and brokerage businesses. On the other end of the spectrum are a great number of relatively small firms that provide a limited range of either investment advisory or brokerage services, but they frequently report affiliations with firms providing complementary services.

Figure S.1 displays year-end industry snapshots of the number of brokerage and investment advisory firms from 2001 through 2006, as described in data we obtained from the SEC Division of Investment Management and from the Financial Industry Regulatory Authority (FINRA). During this time period, the following changes took place:

- The number of investment advisers in the Investment Adviser Registration Depository (IARD) database grew substantially, from 7,614 in 2001 to 10,484 in 2006, whereas the number of broker-dealers declined from 5,526 to 5,068.
- The number of broker-dealers in the Financial and Operational Combined Uniform Single (FOCUS) Report database declined from 5,526 to 5,068.
- The number of dual registrants (firms in both databases) in these data remained relatively constant (between 500 and 550 each year).
- The share of broker-dealers that were dually registered increased slightly, from 9.5 percent to 10.6 percent, while the share of investment advisers that were dually registered fell from 6.9 percent to 5.1 percent.

Although some investment advisory firms are very large, most are rather small. Among investment advisory firms with individuals as clients at the end of 2006, more than half reported having no more than ten employees. Only about one-fourth of these firms reported having more than 50 employees, and less than 8 percent reported having more than 100 employees. However, 69 investment advisory firms with individual clients reported that they

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



SOURCES: Broker-dealer data are from FOCUS reports. Investment adviser data are from IARD .  
NOTE: *Dual* indicates firms listed in both databases.

RAND TR556-S.1

employed more than 1,000 individuals each. Almost 40 percent of investment advisory firms reported that some of their employees were registered representatives of a brokerage firm.

We also analyzed data on more than 5,000 broker-dealers registered at the end of 2006, but these data do not contain reports on employment and clientele. Much more information is available on firm finances. A defining attribute of a broker-dealer is whether it clears or carries customer accounts. Those firms that do must file a FOCUS report, Part II, while the others need file only the abbreviated Part IIA report. The Part II filers constitute only about 10 percent of registered broker-dealers but tend to be much larger than Part IIA filers.

Among broker-dealers, distributions of assets and ownership equity are heavily skewed, with one group of firms being vastly larger than the rest. The mean of total assets reported in the fourth quarter of 2006 is more than \$1 billion, but the median is less than \$500,000. The difference between mean of ownership equity (\$32 million) and the median (\$340,000) is also quite striking. Much of this variation is associated with filing status. The means of reported assets and ownership equity among Part II filers are \$10 billion and \$250 million, respectively, whereas the corresponding means among Part IIA filers are about \$25 million and \$7 million.

### **Financial Services**

Most firms reported being engaged strictly as either an investment adviser or as a broker-dealer without any affiliations with those that provide the complementary service. Many others, however, were directly engaged in only one type of activity but were affiliated with a firm engaged in the other type. The remainder, a minority of firms, were directly engaged in both brokerage and advisory activities.

As the economic scope of a firm grows, it tends to engage in a much fuller range of services and consequently is affiliated with other financial service firms or conducts a significant amount of business in both the investment advisory and brokerage fields. Smaller firms, which are much more numerous, tend to provide a more limited and focused range of either investment advisory or brokerage services, although they frequently report some sort of affiliation with firms providing the complementary service.

Almost 95 percent of investment advisory firms with individual clients provide portfolio management for individuals or small businesses, with about 14 percent of those firms managing a wrap-fee program. Overall, about 6 percent of investment advisory firms with individual clients sponsor a wrap-fee program. After portfolio management, the most frequently provided advisory service is financial planning, reported by about half of the firms. Almost 20 percent engage in pension consulting. More than 25 percent of investment advisory firms with individual clients reported being engaged in business activities other than advisory services, including broker-dealer (7 percent), registered representative of a broker-dealer (12 percent), and insurance agent or broker (12 percent). Our assessment of these data, in combination with other evidence, indicates the presence of substantial reporting error in the regulatory filings.

Among broker-dealers in the Central Registration Depository (CRD) database at the end of 2006, the most frequently reported business activities were mutual fund retailer (52 percent), retailing of corporate-equity securities over the counter (50 percent), and private placement of securities (50 percent). Part II filers were more likely than Part IIA filers to report engagement in all but 7 of the 28 different business activities described in the data. More than 20 percent of the broker-dealers reported being engaged in the investment advisory service business. Overall, about 7 percent of total quarterly revenues of broker-dealers were reported

for a fee category that included *but was not limited to* investment advisory service fees. Even among firms that reported being engaged in investment advisory services, this share is just 8 percent. However, further inspection of the data indicates that investment advisory service fees may have accounted for a large share of revenues at smaller firms.

### Dual Activity and Affiliations

The number of firms dually registered in the FOCUS and IARD databases remained relatively constant at 500 to 550 from 2001 through 2006. However, the number of dually registered firms grew as a proportion of all broker-dealers, and these dually registered firms grew substantially in terms of mean reported revenues, expenses, and, generally, net incomes over the entire period. With respect to assets under management by these dually registered firms, the total amount in discretionary accounts increased slightly from 2001 to 2006, while the amount in nondiscretionary accounts increased by about 75 percent.

Firms that directly provide either investment advisory or brokerage activities but not both may be affiliated with firms that provide other financial services. Overall, almost one out of every four investment advisers with individual clients has a related person who is also an investment adviser, and this other adviser could, of course, engage in other business activities. Moreover, more than one out of every five advisers reported that a related person was a broker-dealer, municipal-securities dealer, or government-securities broker or dealer. About 17 percent reported that a related person was an insurance company or agency, and 11 percent reported that a related person was an investment company.<sup>1</sup>

Among broker-dealers, more than 20 percent of registered firms in the fourth period of 2006 reported current or expected engagement in investment advisory services. Only about half of these firms are included in the contemporaneous IARD database. Many, but certainly not all, of the other half were confirmed to be state-registered investment advisers. We also obtained data on broker-dealers' affiliations, but these data are much less detailed than the data on investment advisers. About 40 percent of broker-dealers either directly or indirectly control, are controlled by, or are under common control with a firm engaged in the securities or investment advisory business. About 8 percent of broker-dealers are directly or indirectly controlled by a bank holding company or other banking institution.

Firms reporting such affiliations play a disproportionately large role in the market. For example, investment advisory firms that report no direct engagement in brokerage activities but that a related person is a broker-dealer constitute less than 15 percent of all reporting firms but managed more than one-fourth of all accounts and almost two-thirds of all assets reported at the end of 2006. Among broker-dealers, 69 percent of Part II filers reported affiliations with securities or investment advisory businesses, as opposed to 38 percent of Part IIA firms, which tend to be much smaller.

These affiliations further blur the boundaries among types of financial services. In many cases, we found it difficult to disentangle the services and business relationships of firms that were dually registered or affiliated with other firms. Some corporations may have multiple subsidiaries or business units, each registered separately as an investment adviser or broker-dealer, but these data do not identify these relationships. By comparing details across databases, we noted many inconsistencies and inaccuracies in the information reported. For example, many invest-

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<sup>1</sup> In regulatory filings, *person* can indicate a person or other legal entity, such as an affiliate business.

ment advisory firms that were not sole proprietorships reported being engaged as registered representatives of broker-dealers. Other investment advisers reported being engaged as broker-dealers, but we could find no evidence that they were dually registered. In most of these cases, the firms appear to be affiliated in some way with a broker-dealer with a distinct CRD number, including one investment advisory firm that reported having more than 1,000 employees who were registered representatives of a broker-dealers.

In a few case studies, we attempted to classify firms based on reported activities and affiliations and found that we had to piece together the evidence based on multiple sources of information, such as regulatory filings, business documents, Web sites, and firm interviews. What became clear was that the registered firms may be involved in multifaceted relationships spanning a variety of business activities. Given such complexity, it is not surprising that the typical retail investor finds it difficult to understand the nature of the business from which he or she receives investment advisory or brokerage services.

### **Disclosures**

Both investment advisers and broker-dealers are required to provide certain disclosures to clients and potential clients. In interviews with interested parties, many claimed that the disclosures themselves are problematic. First, they are not written in a way that is easily understandable to the average investor, and the information they provide is inadequate. Second, the financial service provider does not do enough to help investors understand disclosures—that is, they present the required disclosures without taking time to explain them. Third, many said that investors do not take the necessary time and effort to fully read and understand disclosures.

Participants in firm interviews described the lengths to which these firms go to make full disclosure, including efforts to produce booklets written in plain English rather than legal language. Several of these participants acknowledge that, regardless of how carefully they craft documentation, investors rarely read these disclosures.

We examined many types of disclosures: descriptions of the differences between investment advisers and broker-dealers, conflicts of interest, compensation structure, code of ethics and fiduciary oath, future performance, and so forth. We referred to multiple sources—published studies, business documents and Web sites, and interviews with both financial service professionals and investors.

In the business documents submitted by investment advisers, the most frequently identified disclosures concerned the code of ethics and fiduciary oath. In the documents submitted by broker-dealers, the most frequently identified disclosures concerned issues of compensation—e.g., how clients compensate the firm, how other firms compensate the firm, and how employees are compensated. In contrast, the most frequently found disclosure on the Web sites of both investment advisers and broker-dealers was related to future performance.

### **Investor Understanding**

To assess the level of investor understanding about a range of issues, we administered a large-scale, national household survey and conducted six intensive focus-group discussions with both experienced and inexperienced investors. Both methods were designed to identify investor understanding of the distinctions between investment advisers and broker-dealers and the relationships among them. Our analysis confirmed findings from previous studies and from

our interviews with stakeholders: Investors had difficulty distinguishing among industry professionals and perceiving the web of relationships among service providers.

About two-thirds of all survey respondents were classified as “experienced” investors (that is, they held investments outside of retirement accounts, had formal training in finance or investing, or held investments only with retirement accounts but answered positively to questions gauging their financial understanding). Of the 349 respondents who reported using a financial service provider, 73 percent seek professional assistance for advising, management, or planning, and 75 percent seek professional assistance for conducting stock-market or mutual fund transactions.

We presented respondents with a list of services and obligations and asked them to indicate which items applied to investment advisers, brokers, financial advisors or consultants, or financial planners. Their responses indicate that they view financial advisors and financial consultants as being more similar to investment advisers than to brokers in terms of services and duties. However, regardless of the type of service (advisory or brokerage) received from the individual professional, the most commonly cited titles are generic titles, such as *advisor*, *financial advisor*, or *financial consultant*. Focus-group participants shed further light on this confusion when they commented that the interchangeable titles and “we do it all” advertisements made it difficult to discern broker-dealers from investment advisers.

Comments from focus-group participants expand on the survey responses. Like survey respondents, focus-group participants indicated that they would be willing to seek services from an investment adviser or a broker, but for different reasons. The compensation structures, disclosure requirements, and legal duties make investment advisers appealing. However, account minimums, industry certification, and costs make brokers appealing. Even though we made attempts to explain fiduciary duty and suitability in plain language, focus-group participants struggled to understand the differences in standards of care. Furthermore, focus-group participants expressed doubt that the standards differ in practice.

However, despite their confusion about titles and duties even among experienced investors, most survey respondents and focus-group participants are happy with their own financial service provider. It is clear from their responses that that personal service given by the financial service provider is a very important dimension of the business relationship. For survey respondents, the most common types of positive comments attributed to financial service providers are personal, service-related attributes, such as attentiveness and accessibility. These attributes were mentioned more than dimensions such as expertise or performance. For focus-group respondents, attentiveness and accessibility were also mentioned as important dimensions, but the most commonly mentioned attribute they sought was trustworthiness. We do not have evidence on how levels of satisfaction vary with the actual financial returns arising from this relationship. In fact, focus-group participants with investments acknowledged uncertainty about the fees they pay for their investments, and survey responses also indicate confusion about the fees.