



## Is my Financial Advisor a Fiduciary or a Stockbroker?

### What is the fiduciary duty and why is that important?

The *fiduciary duty* requires an investment adviser, by law, to act in the best interest of her clients, putting her clients' interests ahead of her own at all times.<sup>i</sup> Under the *fiduciary duty*, an investment adviser must provide advice and investment recommendations that she views as being the best for the client. In addition to being obligated to put clients' interests ahead of their own, fiduciaries must also adhere to the duties of *loyalty* and *care*.<sup>ii</sup> An investment adviser, subject to the *fiduciary duty*, is required to provide up-front disclosures to the client, *before* any contracts are signed to provide investment advice. These disclosures cover important topics such as the investment adviser's qualifications, services provided, compensation, range of fees, methods of analysis, record of any disciplinary actions and possible conflicts of interest, if any.<sup>iii</sup> An investment adviser that has a material conflict of interest must either eliminate that conflict or fully disclose to its clients all material facts relating to that conflict.<sup>iv</sup>

The world of investment advice is plagued with conflicts of interest, obscure disclosure and an overall lack of transparency. Seeking out an investment adviser who will act as your fiduciary can help to eliminate many of the problems associated with commission-oriented, product focused salespeople. Because a fiduciary is required, by law, to give full disclosure of how they are paid as well as any conflicts of interest they may have, *before* you do business with them, you as the consumer are in a better position to make an informed decision.

### How is a stockbroker different from a fiduciary and why should I be concerned?

A stockbroker is defined as any person engaged in the business of effecting transactions (buying and selling securities - trading) for the account of others.<sup>v</sup> Brokers have many different titles these days with some of the more common being: *wealth manager, wealth advisor, investment consultant, financial advisor, financial consultant and registered representative*.

Regardless of their title, stockbrokers are generally not considered to have a fiduciary duty to the client.<sup>vi</sup> Stockbrokers are able to avoid the higher legal standard of the fiduciary duty due to an exemption they receive from the definition of Investment Adviser (fiduciary). This exemption, which can be found under section 202 (a) (11) (C) of the Investment Advisers Act of 1940 reads: *any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor*. In other words, in the eyes of the Investment Advisers Act of 1940, brokers are generally not considered to be fiduciaries because their advice is merely incidental to the sale of their products. Instead of being obligated to put their customers' interests ahead of their own, brokers are instead expected to deal *fairly* with their customers and adhere to the *lower standard of legal care, known as the suitability doctrine*<sup>vii</sup>. The suitability doctrine requires a broker to know her customer's financial situation well enough to recommend

investments that are considered *suitable* for that particular client.<sup>viii</sup> Brokers are not required to provide up-front disclosures like the ones required for investment advisers.<sup>ix</sup>

As a consumer, caution should be exercised when dealing with a broker. Because a broker is only required to establish suitability, she is *not legally obligated* to put your interests ahead of hers. She may in fact sell you the investment that pays her the most commission, so long as the investment is deemed suitable. She is also able to sell you proprietary products if her firm offers them. Finally, she may be subject to conflicts of interest that could influence her investment recommendations while at the same time not being required to disclose those conflicts of interest to her client.

### **Who is a fiduciary and who is a stockbroker?**

**Investment Adviser** (see Investment Advisers Act of 1940) means any person who, for compensation, engages in the business of advising others, either directly or indirectly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities. Investment advisers are subject to the higher legal standard of care known as the *fiduciary duty*. Investment advisers also use a number of titles in addition to investment adviser, such as: *investment manager, portfolio manager, wealth manager, and asset manager*. Investment advisers provide ongoing advice and investment management based upon the client's objectives. Typically the investment adviser is given discretionary authority over the client's investments. Discretionary authority allows the investment adviser to make investment decisions in the portfolio without having to get prior approval from the client. Investment advisers carry a license called the "series 65 or series 66." Investment advisers are monitored by either the U.S. Securities and Exchange Commission (SEC) or state regulators.

**Stockbrokers** (also called Financial Advisors, Wealth Managers, etc.) are subject to the lower legal standard, known as the suitability doctrine (stockbroker). Most of the financial advisors working at the largest Wall Street Brokerage firms (wirehouses) fall into this category. Brokers carry a license called the "series 7." Brokers are monitored by the SEC, state regulators and industry self-regulatory organizations.

**Dual Registration** can make the legal situation very confusing. Today, a large number of financial advisors serve as *both* investment advisers and brokers. According to a FINRA study, 88% of investment adviser representatives are also registered as brokers.<sup>x</sup> For example, you open several accounts with a financial advisor employed by one of the major brokerage firms. The advisor may sell you a "fee-based" account where she acts an investment adviser and concurrently sell you bonds or limited partnerships in another account where she gets a commission (which you may not even see) and functions as a broker. Which hat does she want to wear today and how much does she want to get paid? The *biggest issue for clients* of dual registrants is that ultimately the lower legal standard typically applies to the dual registrant wirehouse broker who can function as both an investment adviser and stockbroker.

**Insurance Licensing** is also common for many brokers and investment advisers. Insurance products can have massive embedded commissions and present significant conflicts of interest for financial advisors. These conflicts of interest are generally not disclosed and the fiduciary duty is not followed.

## How can I tell if my adviser is a fiduciary or a stockbroker?

- Look at the disclosures on the advisor's website, marketing materials and business cards. Brokers who sell products & dual registrants will have disclosures that look something like this:

Company XYZ makes available products and services offered by XYZ, a registered broker-dealer and Member Securities Investor Protection Corporation (SIPC). Insurance and annuity products are offered by DDT, a licensed insurance agency and wholly owned subsidiary of XYZ.

Banking products are provided by XXY, Members FDIC and wholly owned subsidiaries of XYZ

- Ask, "Are you legally obligated to put my best interests ahead of yours?" "Will you be serving as my fiduciary?"
- Ask, "Will my account be an advisory account or a brokerage account?" An answer of brokerage account will be your clue that you have found a stockbroker or dual registrant.
- Ask to see the advisor's form ADV. The form ADV will describe, among other things, fees & compensation, types of clients, disciplinary information, conflicts of interest, and education. If the advisor cannot provide you with an ADV, then the advisor is most likely a broker. Bear in mind that just because you get an ADV however, doesn't mean that the advisor doesn't also put on the broker hat from time to time if she is dual registrant.
- Ask if the advisor is *fee-only* or "*fee-based*". Fee-only advisers will be fiduciaries. Fee-only advisors cannot legally accept commissions and their only source of revenue is the fee they charge for advice and investment management. Since brokers are commission oriented, they cannot legally hold themselves out as fee-only. "*Fee-based*" however is a very different story. A "*fee-based*" advisor offers advisory accounts as well as brokerage accounts and is a dual registrant. So while she may put on the advisory hat one day, the next day she might put on the brokerage or insurance agent hat to sell some limited partnerships or annuities.
- Ask what licenses the advisor has. A "series 7 license" means the advisor is registered as a stockbroker (the series 7 is the broker examination). The series 65 or 66 means she is registered as an investment advisor. Having both the series 7 and 65/66 equates to dual registration, which brings about the problems we covered previously in this article. Having an insurance license means she can sell you life insurance and annuities and accept commissions.

## Why do Conflicts of Interest Matter?

According to Merriam Webster, a conflict of interest is defined as: *a conflict between the private interests and the official responsibilities of a person in a position of trust.*

If you are a client at a Wall Street Bank/Brokerage firm, you will likely be exposed to significant conflicts of interest. You are a client because you are looking for advice. However, what you receive may be something very different. These firms are in the business of selling products and producing a profit for shareholders. As brokers, exempt from the definition of investment adviser, advice from their salespeople is typically considered *incidental to the sale of products they are promoting* or helping you

buy. In other words, broker dealer firms are there to facilitate a transaction on behalf of the customer, with the focus on the transaction and not the advice. Also, as we learned earlier, many advisors at these firms are able to switch hats on a whim playing broker one minute and advisor the next. The broker's ability to offer both advisory and brokerage accounts creates serious conflicts of interest. These conflicts are often centered on how the broker gets paid.

**To demonstrate just how deep the conflict can be**, let's consider an example. Suppose that a woman named Sue recently sold her company and has decided to retire. Her husband, Bob, a recently retired executive, has a pension that provides for most of the couple's living expenses and they have no debt.

#### Hypothetical Clients Sue & Bob

Age:	65 years old
Children:	3
Grandchildren:	4
Total Investable Assets:	\$5.0 million dollars
Net worth:	\$6.50 million dollars
Pension & Soc Security:	\$100k annually
Goal:	\$150k annually in portfolio income

To keep this example simple let's just *focus on what can happen* when Sue and Bob walk into the office of a dual registrant, insurance licensed salesperson at traditional Wall Street Brokerage firm.

Example options A & B (in terms of payment to the stockbroker):

- A. The stockbroker shows the clients a \$1m variable annuity with a 7% commission and a \$4m investment in bonds, limited partnerships & structured notes at an average of 3% commission.

Result is an **immediate non-transparent commission of \$190,000 to the stockbroker.**

- B. The stockbroker shows the clients a \$5m balanced wrap mutual fund advisory account at a 1% annual fee (paid at .25% quarterly)

Result is an **immediate fee of \$12,500 to the stockbroker.**

You don't have to be very good at math to see that **by changing the product mix, the stockbroker can dial up or dial down how much he or she gets paid.** Does the stockbroker want to get paid \$190,000 or \$12,500 this month? What a dilemma! To add insult to injury, in many cases, especially with annuities and investment bank products, the commissions are not transparent and difficult to gauge.

This payment scheme should certainly cause you to think twice about where you get financial advice. Caution should be exercised with dual registrants, especially those who are also insurance licensed. Do your homework. Ask lots of questions. Be critical of anything with a huge prospectus – these investments generally enrich the stockbroker completely at your expense.

**There is a better way to receive investment advice** – work with a *fee-only* advisor who is subject to the Investment Advisers Act of 1940 and *operates as a fiduciary for clients*. There is a great comfort that comes in knowing your advisor is putting your interests ahead of her interests and not merely selling you products for commission.

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#### **About the author of this article.**

Ethan S. Braid, CFA is the founder of HighPass Asset Management – an independent, fee-only, registered investment advisory firm with a fiduciary duty to the clients it serves. Mr. Braid has been passionate about managing client investment portfolios and providing customized financial planning advice since he started working in the investment industry 20 years ago. Mr. Braid earned a BS in finance from Robert Morris University, an MBA from Cleveland State University and he is also a CFA charterholder. The CFA program is a graduate level, globally recognized, multi-year program with a focus on investment knowledge. Candidates for the program commit an average of 900+ hours of cumulative study time to complete all three levels.

Mr. Braid is devoted to being an expert in the field of wealth management for high net worth individuals and families and for many years, has read one book per month on subject areas such as: estate planning, retirement planning, investment analysis, mergers & acquisitions and behavioural finance. Mr. Braid also has a passion for business history with a focus on the late 19<sup>th</sup> & early 20<sup>th</sup> centuries. To date, Mr. Braid has read 100+ books on the subject areas above.

When Mr. Braid is not helping clients, he enjoys: reading, cooking, his yellow Labrador retriever, fly fishing, hiking, travel, playing guitar, and riding his horses.

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<sup>i</sup> Investment Advisers Act of 1940, Sec. 211 (g) (1)

<sup>ii</sup> SEC Study on Investment Advisers and Broker-Dealers, January 2011, page iii

<sup>iii</sup> SEC Study on Investment Advisers and Broker-Dealers, January 2011, page 19

<sup>iv</sup> Investment Advisers Act of 1940, Sec 211. (g) (1)

<sup>v</sup> Securities Exchange Act of 1934, Sec 3. (a) (4) (A)

<sup>vi</sup> SEC Study on Investment Advisers and Broker-Dealers, January 2011, page iv

<sup>vii</sup> SEC Study on Investment Advisers and Broker-Dealers, January 2011, page iv

<sup>viii</sup> FINRA RULES, 2111. Suitability (a)

<sup>ix</sup> See FINRA RULES, 2260. Disclosures & SEC Study on Investment Advisers and Broker-Dealers, January 2011, page 19

<sup>x</sup> FINRA November 2<sup>nd</sup>, 2010 letter to the SEC Secretary, Elizabeth Murphy