

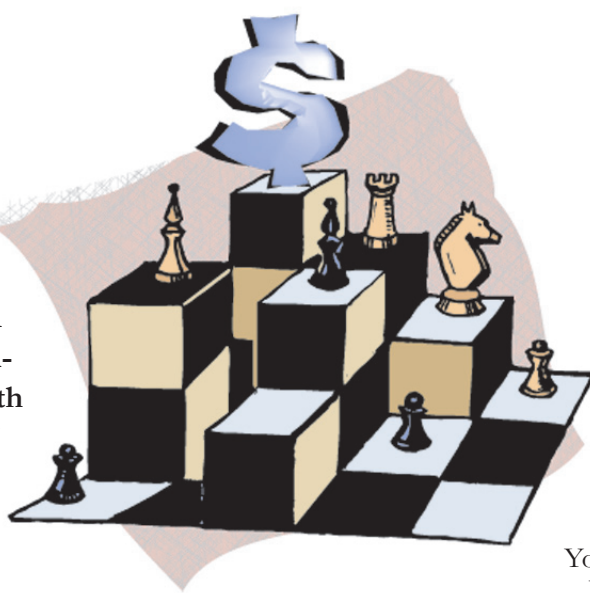
# Financial Professional Terms: What They Mean and Why You Should Care

By Harold Evensky and William Reichenstein

**B**roker, registered investment advisor, financial planner, insurance agent, investment advisor, and wealth managers: These are a few of the common terms used to describe various financial professionals.

Many individual investors are confused by these terms, and do not have a clear understanding of what distinguishes one professional from another.

This article will clarify these terms and discuss differences in the duties owed by financial professionals to their clients.



Brokers and broker-dealers—the firm the broker works for—are registered with and regulated by the Financial Industry Regulatory Authority (FINRA), which was formed in 2007 by a merger between the National Association of Securities Dealers (NASD) and the regulation arm of the New York Stock Exchange.

Brokers are paid by commission or a commission-related compensation scheme based on a customer's transactions. Any advice provided by a broker is “solely incidental to the brokerage services.”

“Investment advisor” is also a legal term. As the name suggests, these professionals are in the business of providing investment advice. They are often called registered investment advisors, or RIAs. Depending on the size of their business, they are registered with the Securities and Exchange Commission (if they have \$25 million or more in assets under management) or their state securities regulator (if they have less than \$25 million under management). These professionals are subject to the Investment Advisory Act of 1940, which means that they have a fiduciary duty to act in the best interest of their clients.

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## Brokers vs. Investment Advisors

In the world of financial advisors, there are two major regulatory environments; practitioners in these environments are brokers and investment advisors.

“Broker” is a legal term. Brokers are in the business of buying and selling securities at their clients' direction. Another name for a broker is registered representative (or, registered rep). These individuals may work for broker-dealers such as Merrill Lynch, A.G. Edwards, Edward Jones, and UBS, or they may be associated with small local practices such as “Johnny Jones Investments.” If you walk into a commercial bank lobby, the investment professional you meet will likely be a broker. In addition, insurance agents who also offer investments are almost always brokers.

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## Other Titles

Adding to the confusion is the fact that there are numerous terms for financial professionals that are not legal terms. These include financial planner, wealth manager, and financial advisor.

Although there is no legal restriction preventing someone from using these terms or some variation, from a regulatory perspective they must be acting as either a broker or investment advisor. It is important that you determine which of these two “hats” they are wearing as their obligations to you are dependent on their regulatory environment.

## Legal Obligations

In dealings with clients, brokers are legally subject to a “business standard,” while investment advisors are subject to a “fiduciary standard.”

### Business Standard

The business standard (from the NASD Code of Conduct Rule 2310) requires that brokers recommend only assets that are “suitable” for the investor, based on their financial situation, needs and other security holdings. It does not include the duty to act in the client’s best interests.

It should come as no surprise that the definition of “suitable” is subject to much interpretation. Consequently, investors who believe their broker acted inappropriately are frequently faced with having to resort to court or arbitration to determine whether investments sold or recommended by their brokers were “suitable.”

A business standard also does not mandate the disclosure of potential conflicts of interest. In fact, in order to eliminate confusion, in one ruling, the SEC proposed a disclosure requirement for brokers that read: “Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons’ compensation, may vary by product and over time.”

### Fiduciary Standard

The fiduciary standard is a sig-

nificantly more rigorous standard that includes the duty to act in the client’s best interest. It also includes duties related to transparency, full disclosure, minimization and disclosure of conflicts of interest, diligence, fairness, loyalty, reasonable compensation, and full disclosure of compensation. In addition, an investor should expect a fiduciary to provide up-front disclosure about their qualifications, what services they provide, how they are compensated, possible conflicts of interest, and whether they have any record of disciplinary actions against them.

## How Are They Paid?

If you receive financial advice from a professional, you will pay for it. Sometimes the costs are evident, while at other times they are hidden or, at a minimum, less evident.

Brokers are paid with commissions for completing your security transactions. Commissions vary with the nature of the investment product. The commissions may come in the form of front-end commissions, smaller annual trailing fees, or both.

For example, a broker who recommends the purchase of American Fund’s Growth Fund of America Class A shares will share with his or her broker-dealer the upfront commission of up to 5.75%. This commission, referred to as a “load,” is reduced for larger purchases. In addition, you will pay an annual trailing fee, called a 12b-1 fee, equal to 0.25% of the account’s value.

In contrast, investment advisors are paid through a fee-only structure. The fees are most often based on a percent of “assets under management,” referred to as AUM. This is the total amount of assets on which the advisor provides advice. For example, many financial planners charge an annual fee of 1% of assets under management for accounts of up to \$1 or \$2 million and generally something less for larger amounts.

Another form of fee-only compensation is to charge an hourly fee, or to charge an annual retainer fee for a bundle of services. In fee-only struc-

tures, investment advisors are charging for their advice; their compensation does not depend upon the investment security or product they recommend.

Some advisors act in both capacities. This is referred to as “fee based” instead of “fee only.” When providing advice for a fee (generally a charge for the initial planning), the advisor is acting as an RIA and often charges a flat fee. Implementation may then be based on recommendation of commissioned products. For this activity, the advisor is acting as a broker under FINRA.

## Conflicts of Interest

This section provides examples of some of the conflicts of interest facing investment professionals. But first, we need to explain differences in compensation structures.

### Load vs. No-Load Mutual Funds

Suppose you are seeking advice on the selection of a mutual fund. And suppose your current portfolio is such that a large-cap value fund would be a good recommendation. If you walk into a retail investment office, the broker may recommend the (hypothetical) ABC Value Fund. It has a one-time 5.75% front-end commission and charges a 1.25% annual expense ratio. The expense ratio is the total cost, in percent, that is deducted annually from the investor’s account. Most (1% of the 1.25%) goes to pay for the cost of managing the portfolio and other expenses, while 0.25% is a 12b-1 fee that is an annual trailing commission. The broker and his broker-dealer will share in the 5.75% commission and the 0.25% annual trailing fee.

If you seek the help of a fee-only investment advisor, she would more likely recommend the (hypothetical) XYZ Value Fund, a no-load large-cap value fund with a 1% annual expense ratio. The total costs of the average broker-sold fund are higher than those of the average no-load fund: Although both have to pay the 1% annual fee to the mutual fund managers, the broker-sold funds have the additional costs

that are paid to the broker and broker-dealer. As a fee-only advisor, she cannot accept commissions. However, she will independently charge a fee for her advice.

### Choice of Share Classes

A conflict of interest may affect the choice of mutual fund share class that a broker recommends.

For example, for mutual funds that have multiple share classes, the most common are A and B shares. Both shares represent ownership of the same underlying portfolio; the only difference between them is in their cost structures.

Typically, A shares might have a front-end load of up to 5.75%, and charge an annual expense ratio of 1.25%, which consists of 1% management fee and a 0.25% 12b-1 fee. In addition, the front-end commission is less on larger purchases. It might be 5% on purchases of at least \$25,000, 4.5% at \$50,000, 3% at \$100,000, and continue to fall until it is 0% on purchases of \$1 million or more. The transition values where commissions start to drop are called break points.

In contrast, B shares do not have a front-end commission, so the broker can legitimately claim that “all of the funds go to work for the investor.” However, B shares might have a 2% annual expense ratio, consisting of a 1% management fee and a 1% 12b-1 fee that is shared by the broker and broker-dealer. In addition, B shares have a contingent deferred sales charge (CDSC)—a commission on withdrawals that declines over time—a typical example being 5% on withdrawals in the first year, 4% in the second and third years, 3% in the fourth, 2% in the fifth, 1% in the sixth, and no CDSC for withdrawals in the seventh year or later.

The brokerage firm wants to ensure that it receives a full commission no matter which share class is bought. For purchases below \$25,000, their cost structures ensure this outcome.

For a one-year horizon, the A shares have a total cost of 7% (5.75% front-end load plus 1.25% expense ratio),

while the B shares have a total cost of 7% (2% expense ratio plus 5% CDSC). After two years the A shares have a total cost of 8.25% (5.75% plus two years at 1.25% each), while the B shares have a total cost of 8% (two years at 2% each plus 4% CDSC). After seven years, the A shares have a total cost of 14.5%, while the B shares have a total cost of 14%. Although these numbers ignore the time value of money, they illustrate that the total costs of both share classes are similar for purchases of less than \$25,000.

The issue of whether A shares or B shares are better from the investor’s standpoint depends on a number of factors, but the most significant is the amount of money invested.

For individuals investing amounts that do not exceed the first break point, there is usually not a significant difference in total costs. However, investors making larger purchases can take advantage of the break points. For these investors, the A shares usually have lower costs. For these larger purchases, the commissions are usually higher on the B shares.

This alternative commission structure poses a potential conflict of interest. Although the broker has a legal obligation to recommend the share class that is better for the client, it is a wise investor who verifies the recommendation.

### Mutual Funds vs. Annuities

Many commission structures for mutual funds involve break points, where commissions are reduced for higher initial purchase values.

Variable annuities do not offer the advantage of break points, and for that reason, brokers often receive higher commissions for selling variable annuities than mutual funds.

For example, let’s consider an individual who is considering investing \$10,000. An investment made in the A shares of the ABC Value Fund is likely to produce a commission and trailing 12b-1 fee to the broker and broker-dealer that is the same as the ABC Value Fund held in a variable annuity. So, there may not

be a conflict of interest for investors who make a small investment.

However, the conflict of interest can be extreme for large sales. Suppose Ellen retires and wants to roll \$500,000 from her 401(k) into a traditional IRA. Her broker could recommend that the rolled funds be: 1) invested directly in mutual funds; or 2) held in mutual funds within a variable annuity. If the rollover were invested directly in mutual funds, Ellen would more likely be subject to a 2% commission (or \$10,000), where the 2% reflects the benefit of the typical break point. If the funds are placed in a variable annuity and a mutual fund is purchased inside the annuity, then the effective commission to the firm would more likely be 5.75% of \$500,000, or \$28,750.

There are no break points for variable annuity investments. As a consequence, the broker has an incentive to recommend the annuity even though it may not be in the best interest of the investor.

### Immediate Annuities

Brokers are not the only professionals who face conflicts of interest. As the following example illustrates, fee-only investment advisors face a conflict of interest when it might be appropriate to recommend the purchase of an immediate annuity.

Mary is a fee-only investment advisor who charges 1% per year on assets under management. Her 75-year-old female client has a current investment portfolio of \$1,000,000. Mary’s analysis concludes that it’s in her client’s best interest to purchase a \$250,000 lifetime payout annuity with a 10-year certainty guarantee. If her client buys this payout annuity, she will have to liquidate \$250,000 of her managed investment account to pay the insurance firm for the purchase of her immediate annuity.

The fee-only advisor has a significant potential conflict of interest. If Mary makes the appropriate recommendation and her client in fact reduces her managed account from \$1,000,000 to \$750,000, Mary’s annual fee from her client drops from \$10,000 to \$7,500.

## Questions to Ask

This section provides a list of questions that you should ask yourself to determine what services you want the financial professional to provide. It also provides a list of questions to ask the financial professional.

### Questions to Ask Yourself

What services do you want your financial professional to perform?

- 1) Assistance in buying and selling securities?
- 2) Advice regarding the proper allocation of your investments as a function of your overall financial situation and your personal goals and risk tolerance?
- 3) Advice regarding the selection of specific investments and managers?
- 4) Investment management advice on an on-going status?
- 5) Financial planning, which extends beyond investment management and may also include some combination of tax planning, insurance planning (sometimes called risk management), and estate planning?

### Questions to Ask Financial Professionals

Here are some of the questions you may want to ask your financial professional.

- 1) Will you act in my best interest, and will you put that in writing?
- 2) Will you provide advice that is goal-oriented? (This requires that you and the adviser talk about why you are investing.)
- 3) Will you assist me in developing an investment policy statement that is appropriate for my unique circumstances?
- 4) Do you provide regular updates showing the returns on my portfolio?
- 5) How are you compensated?
- 6) Will you disclose all significant conflicts of interest?
- 7) Will you explain all costs of all investments you recommend?
- 8) What is your investment philosophy? For example, how do you ensure adequate diversification and that costs are controlled?

### Fees vs. Commissions

It's not only the retail investor who has to wade through the confusion of fees versus commissions. This issue has long been a contentious item for professionals and regulators. During the last few years, it has been a major focus for the SEC, the primary regulatory authority for the financial services industry. The debate centered on what has become known as the "Merrill Rule."

Historically, in accordance with the law, brokerage firms charged commissions for transactions and RIA's charged fees for advice. However, as business and technology evolved, brokerage firms developed investment offerings referred to as "separate accounts," or "wrap accounts," that provided investors with the ability to open an account

and have a professional manager select individual stocks and/or bonds for their accounts.

Recognizing the business opportunity offered by these managed accounts but wishing to avoid having to be held to the fiduciary standard associated with registration as an investment advisor, Merrill Lynch asked the SEC to allow the firm to charge a "wrap fee" (i.e., an AUM fee) for this service, arguing that the wrap fee was a different form of "commission," and hence it should not require the firm to be held to a fiduciary standard. The SEC allowed these wrap fee accounts, as long as the broker satisfied two conditions: 1) any advice provided must be solely incidental to the brokerage service; and 2) any advertisements and other forms governing the accounts must state that

the account is a brokerage account and not an advisory account, and that the broker-dealer's interests may not always be the same as the customer's.

However, the Financial Planning Association challenged the SEC ruling, and in 2007, the D.C. Federal Court of Appeals ruled that it was inconsistent with the Investment Advisor Act. So, brokerage firms may not charge account fees based on AUM unless they assume a fiduciary standard.

### Who Do You Trust?

Trust is a key element in any relationship between an investor and a financial professional.

In a good relationship, the investor:

- Trusts that the professional is tech-

- nically competent,
- Trusts that the professional understands the individual's needs and circumstances, and
  - Trusts that the professional is ethical and of good character.

If you are seeking investment advice from a financial professional, you can attain such a relationship with

either a broker or an investment advisor. There is no certification that can assure someone that a professional will use good judgment, is truly interested in the client, or is trustworthy, and there is no compensation structure that ensures one advisor is more honest than another.

Nevertheless, it is important to

understand the different standards and compensation structures under which various professionals operate. A wise investor also understands the potential conflicts of interest that all financial professionals face.

You should only make your decision regarding who to hire after evaluating all of these issues. ▲

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**Harold Evensky, CFP, is president of Evensky & Katz, a Miami-based wealth management firm and an adjunct graduate professor in the financial planning program at Texas Tech University. William Reichenstein, Ph.D., CFA, holds the Pat and Thomas R. Powers Chair in Investment Management at Baylor University in Waco, Texas. He may be contacted at [Bill\\_Reichenstein@baylor.edu](mailto:Bill_Reichenstein@baylor.edu).**

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