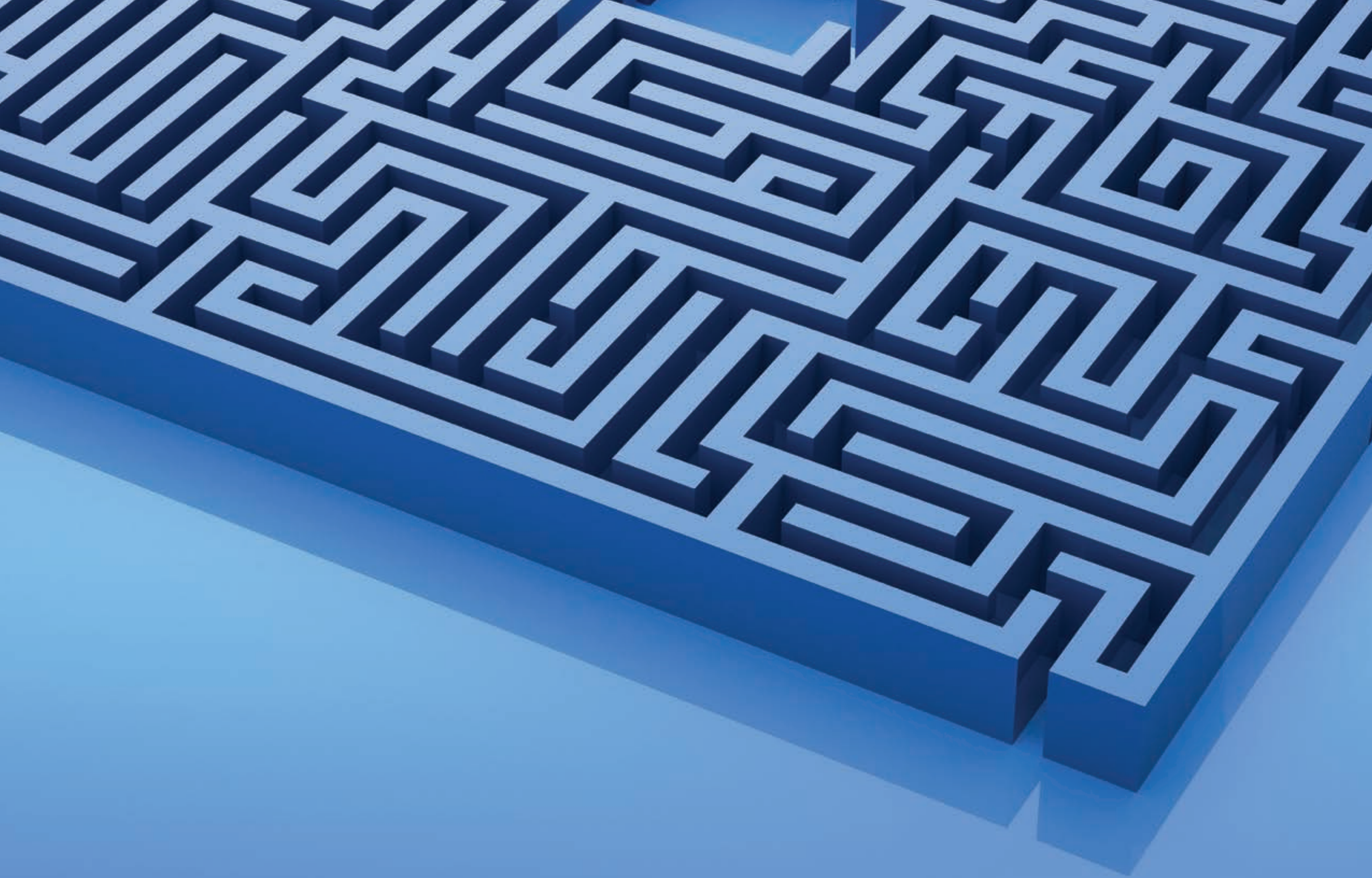

FINANCIAL
SERVICES
INSTITUTE

RIA GUIDEBOOK

JANUARY 2021

Background and Purpose

The financial services industry continues to evolve and assets continue to shift from commission to advisory. Understanding the business models, economics, market trends, culture and platforms that support the investment advisors leading this change is important. The FSI Investment Advisory Services Council has prepared the following RIA Guidebook for leaders of member firms. Information includes key considerations when contemplating expanding advisory support services to financial professionals.

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FINANCIAL SERVICES
BUSINESS MODELS & ECONOMICS

Financial Services Business Models & Economics

Introduction to Affiliation/Business Models

Different affiliation models are available to financial professionals to choose from and these models are important to understand how to serve clients effectively. With clients and regulations demanding transparency of fees, and levels of competition remaining as strong as ever, the industry continues to see a compression of fees and margins. Independent broker-dealers (IBDs), clearing firms, RIA custodians and product manufacturers all continue to experience pricing pressures while revenue opportunities lessen and expenses rise.

However, advisory fees charged by an investment adviser representative (IAR) to clients have remained steady for over a decade. Even with costs coming down and fees remaining flat, advisors are still applying pricing pressure to the industry providers with the expectations of greater flexibility, better client experience and the ability to maximize the value of their business. When an advisor cannot find these key components, they consider alternative providers.

Independence is about choice and profitability. When an advisor identifies a solution that allows them to provide choices without an abundance of restrictions in marketing, technology, fee structures and products, and within a pricing structure that allows the business to maintain strong profitability, it is less likely the advisor would consider a disruption of their business for a new affiliation structure (this structure often comes in the form of establishing their own RIA).

In this RIA Guidebook, we explore the IBD in the evolving landscape of the advisor. What types of advisors should an IBD focus on to grow their business? How might an IBD shift their model to provide the proper amount of support for their fee-based advisors? Would expanding their business models give them an advantage to compete or beat the other options advisors can choose from in today's dynamic landscape?

Cost is Only a Factor in the Absence of Value

Consider the factors that are driving advisors to "independence" and the services offered by different types of financial services firms. When reflecting on the reasons investment advisors leave an IBD, there are a few key factors that surface. Many investment advisors search for providers that offer services that are actually core services of the IBD such as technology, access to clearing and custodial services and compliance support. When you layer on the fears or concerns an investment advisor has about establishing their own RIA, they are almost all associated with the services the IBD had been providing, and often at a reasonable fee. So, if the argument from the IBD is that they provide all these services already, it begs the question as to why so many investment advisors don't see the value. It could be argued that many IBDs (especially larger firms with hundreds or thousands of advisors) have lost the individual touch or community of their many advisor segments. Though the RIA space is beginning to evolve into larger, national organizations, the core culture of the RIA is that of personalization, flexibility and community. IBDs, whether through expanding their business models or spectrum of affiliation types need to return to their roots and consider segmented service and solutions to specifically address the needs of smaller cohorts of advisors and their teams.

As referenced in the chart on the next page, more than three-quarters of IBD advisors who prefer the RIA model cite a 100% payout, greater marketing flexibility and increased financial value for their practice as factors for their preference.

IBD Advisor Reasons for Preferring RIA Model, 2020

	IBD Advisors Who Prefer the RIA Model		
Reason for Preferring RIA Channel	**Not a Factor**	**Moderate Factor**	**Major Factor**
100% payout	10%	38%	52%
Greater marketing flexibility	19%	45%	36%
Increases financial value of practice	20%	44%	36%
Current BD not adding enough value in relation to cost	19%	48%	34%
Flexibility regarding fee levels and structure	24%	45%	31%
Regulatory oversight is less burdensome for RIAs	23%	46%	31%
Flexibility to select technology systems	26%	43%	31%
Paying for unused services offered by current BD	30%	40%	30%
Ability to take discretion over client accounts	34%	39%	27%
Appeal of independent model to clients	27%	48%	25%
Increased opportunity to acquire other RIAs	35%	40%	25%
Operate exclusively as a fiduciary	51%	30%	19%
Ability to build custom model portfolios	49%	43%	9%

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute and the Financial Planning Association® (FPA®)

An RIA Custodian is Just a Broker-Dealer

When you think about the movement towards independence, one of the decisions a breakaway advisor will make, as a new small business owner, is that of the custodian for the safety and security of their assets. It is not so obvious, but important to consider that the RIA custodians are, at their core, a broker-dealer (BD) for the RIA community. The fact that they do not hold licenses or support commission business tends to cause most to consider them an RIA custodian alone, but make no mistake, they are BDs regulated by FINRA. The reason this is important is to further prove the fact that the IBD business model is not necessarily the problem, but rather the way in which a firm delivers its services. However, that is not to say an expansion of a business model should not be considered in today's environment of choice for investment advisors. In fact, it may be table stakes at this point. During the time in which this guidebook is being prepared, the winners in the recruiting space are offering multiple ways for advisors to affiliate.

Dual-Registered Model (Registered Rep of BD, IAR of Corporate RIA)

Overview

In the Dual-Registered Model, the advisor serves in two capacities. First, the advisor is a Series 7 or Series 6 registered representative of the firm's BD. The advisor is also an IAR, with a Series 66, Series 65 or comparable professional designation, of the firm's corporate RIA. This model differs from an advisor who is a registered representative of the firm's BD but has their own RIA, registered with either the SEC or an individual state. This model will be discussed in greater detail later.

A dually-registered financial professional, and the firm that serves them, has the flexibility to offer both investment products for a commission in a brokerage account and provide financial planning services for a fee and offer investment advice and discretionary or non-discretionary investment management for a fee.

Support Model

There is a wide disparity across firms as to the support provided to the advisor by the firm and in the current competitive environment where product, payout and technology have become somewhat commoditized. Advisor support is an area where firms can differentiate. Practice Development and Consultative Support are two broad areas where firms can distinguish themselves from the competition:

Practice Development – There is a wide range of practice development support offered by various firms. Some firms provide no support in this area, while others choose to outsource this function and steer advisors to a select list of independent practice management/development consultants and other firms to build out this service internally. For firms that choose to support this function internally, generally the support spans the following areas:

- Strategic Planning – Developing a Mission and/or Vision statement, defining the practice model, short- and long-term business planning, goal setting, firm culture, etc.
- Business Development – Marketing and business plans, client acquisition, social media strategy, client events, client segmentation and practice acquisition.
- Practice Management – This includes benchmarking the practice against other firms, business intelligence, financial management and forecasting/modeling.
- Operations – Establishing efficient processes, effectively integrating technology, defining the desired client experience, etc.
- Business Transition – Succession and business continuity planning.
- Organizational Design – Building a team with clearly defined roles and responsibilities, understanding and managing team dynamics, performance management and compensation, selecting and onboarding new team members.

Consultative Support – Like Practice Development, consultative support can take many shapes/forms. Generally, the support teams are structured to be both reactive and proactive in their support. This includes taking calls from advisors on product and strategy issues as well as proactively pushing out sales ideas, strategies, market updates as well as highlighting and training on income and estate tax changes. Generally, consultative support teams are organized by area of specialization (Insurance, Investment, Retirement, Financial Planning, etc.), but the best teams work collaboratively to uncover opportunities across all areas.

The following list provides a few examples of services that could be included in this model:

- Case Consultation – Assistance ranges from consultation with a single issue or product question to support for the development of a comprehensive financial plan. Generally, support teams are organized by product area and are positioned to answer specific advisor questions about products available on the platform, available advisory programs and assistance with financial planning strategies.
- Plan Development – Some firms provide an option for advisors to outsource their financial planning to the home office sales support teams. Firms may charge for this service or simply wrap it into their value proposition. In all cases, the goal is to drive greater adoption of a comprehensive financial planning process, grow sales and improve client outcomes.
- Technology – Although technology platforms have become somewhat of a commodity, advisor adoption and effective utilization represent an opportunity for firms to stand out. Effective support teams are available to respond to specific advisor questions, but also proactively put together training sessions and curriculums to build advisor proficiency. Technology will be discussed in detail in another section of this report but includes trading, CRM, reporting, planning, risk assessment, social media/marketing and more.

- Business Development – Helping advisors build and execute on a market plan, providing resources and opportunities to get in front of clients and prospects, and providing support on the strategy and tools used to build a digital presence encompass this area.
- Portfolio Construction – Portfolio construction assistance is often provided through the product manufacturers. However, this advice or guidance may be limited to the investment options of a fund company or influenced by an inherent conflict of interest. For this reason, some firms are choosing to build out this expertise internally to assist advisors with unbiased asset allocation assistance and security selection.

Compliance/Supervision

Regulatory compliance and the supervision of advisor sales practices are complicated under a dual registered model. FINRA is the self-regulatory organization for BDs and the SEC regulates the activities of the Investment Advisor and the activities of the Investment Advisor's IARs.

Dually-registered advisors, with the capacity to offer clients and prospective clients an advisory account, a brokerage account or both, may have a financial conflict as to how to appropriately structure the client relationship while mitigating this conflict. Educating clients about this conflict was one of the objectives of Regulation Best Interest and Form CRS. The dually-registered financial professional has to determine what is in the best interest of the client based on their individual circumstances. For example, should they buy and hold which would be better suited for a commission arrangement, or do they want on-going monitoring of their investment, which would be better suited for an advisory account? Recommendations that are driven by compensation considerations, as opposed to meeting the client's needs, will continue to come under regulatory scrutiny and dually-registered firms must have the policies, procedures and appropriate supervision in place to ensure that the ultimate client recommendation, when comparing all available alternatives, was in the clients best interest. In addition, the dually-registered firm must also be prepared to disclose any conflicts of interest which are often further complicated in a dual registration model.

Risk Factors

Although operating in a dual registration environment provides opportunities not available to firms choosing one model or the other, it also comes with complexity, cost and risk. One risk, as discussed above, is regulatory risk and the enhanced risk associated with operating under both FINRA and SEC guidelines and the fact that both the SEC and FINRA may perceive they have jurisdiction over both activities. Another risk is more of a business risk associated with shifts in the industry. This will be discussed in detail in the Industry Trends section of this report, but risk factors in this area include the shift toward advisory and the long-term need to maintain the BD side of the business. Supporting both can significantly increase complexity and expenses to support as it relates to technology, operations, supervision, advisor support and compliance. In addition, as advisors reach certain Assets Under Advisement (AUA) scale, certain advisors may feel they have "outgrown" this model and will choose to establish their own RIA.

Primary Economic Drivers

There are also multiple economic benefits of the RIA model and including the ability to generate revenue from multiple sources. Generally, all wealth management firms are attempting to get to approximately the same margin. In a dually-registered model, there are multiple levers a firm can pull to get there. These include, but are not limited to, the following: program/platform fees, brokerage fees, payout, affiliation fees, technology fees and self-clearing revenue. More details on economics will be covered later in the guidebook.

Conclusion

Operating as both a BD and as an investment advisor comes with a unique set of opportunities and challenges. Firms providing this environment must navigate the complexity of two regulators (FINRA and SEC), determine the level of support they provide advisors, balance associated costs while remaining competitive and drive profitability through a complex matrix of expenses and revenue opportunities.

Hybrid Model (Registered Rep of Broker-Dealer and IAR of Independent RIA)

Overview

The hybrid channel has proven to be a simplified way for financial professionals to create their own, or join an existing independent RIA, without giving up access to products and services they value most from the IBD, including compliance, practice management, recruiting and operations.

Financial professionals gain more control over their practice while still having a level of support for day-to-day operations. How much support depends on the preference of the financial professional, the BD they affiliate with, where they custody their RIA business and whether they create their own RIA or join an existing RIA.

In the Dual-Registered Model, the financial professional conducts commission-based business through their BD and advisory business through the BD's corporate RIA. The Hybrid Model, by contrast, is based on a financial professional conducting commission-based business through their BD and advisory business through their own unaffiliated RIA or by joining another unaffiliated RIA. Both have benefits and the decision depends largely on the specific needs of the financial professional and their clients.

High-Level Benefits

Some financial professionals relish the ability to create their own advisory practice from the bottom up with complete control over technology and procedures and processes.

Hybrid RIAs: Reasons to Retain BD Affiliation, 2020

Reason	Hybrid RIAs Who Plan to Retain BD Affiliation
Access to commission-based products (e.g., VAs, alternatives)	61%
Access to BD technology platform	48%
BD reduces operations burden	48%
BD's support allows more time for managing clients	45%
BD eases ongoing compliance burden	42%
Access to BD practice management support	27%
Access to home office investment research	21%
Concerned about the future of RIA regulation	12%
Access to home office recommended list of products	12%
Practice isn't large enough to operate as an RIA	6%

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute and the Financial Planning Association® (FPA®)

Recruiting

One often overlooked benefit of this model is leveraging their robust recruiting teams and a well-known brand name to build the practice by attracting the best talent. Independent RIAs, especially those just starting out, don't have the industry reputation or perceived reliability that can be a big benefit when hiring the best employees for their practice.

Business Support Model

Operational support and an established technology platform are the two most important services BDs provide to independent RIAs. Each can be correlated directly to the cost, both in money and time, of establishing the necessary functionality required to service clients. Expenses can include additional support staff, software licensing and time spent on operational procedures and RIA compliance instead of servicing clients.

Technology options include:

- Using the proprietary technology of the BD
- Using the technology of the RIA
- Using the technology of the custodian

If the BD is self-clearing, they can often provide a more integrated technology approach across both brokerage and advisory business when using their Corporate RIA. Otherwise, Hybrid RIAs may need to use multiple platforms or find some way to aggregate data into a customized system that meets their needs.

Hybrid RIAs: Importance of BD Services, 2020

Service	Not Important	Somewhat Important	Very Important
Back office and operational support	22%	35%	43%
Technology platform	29%	35%	36%
Compliance guidance on ADV filing and other RIA regulatory requirements	33%	39%	28%
Practice management support	37%	42%	22%
Continuing education	38%	43%	20%
Investment or economic research	46%	35%	19%
Practice acquisition support	48%	34%	18%
Conferences and events	48%	40%	13%
Model portfolios	64%	28%	8%
Rookie advisor training	71%	21%	8%
Recommended lists	59%	34%	7%

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute and the Financial Planning Association® (FPA®)

Compliance and Risk Factors

Compliance also can be a concern for Independent RIA financial professionals. Increased compliance responsibilities, financial litigation liability and regulatory liability cause many financial professionals to seek the regulatory support and backing of a BD (although the BD has limited regulatory responsibility for the RIA in this model) or other established advisory RIA rather than go it alone.

Custodians and IBDs also play an important role in educating financial professionals on the differences between corporate RIA affiliation, hybrid registration and full independence, including the extent of compliance guidance, oversight and consulting provided by the IBD.

Though a common concern, Cerulli's data show that financial professionals who recently switched firms typically retained most client assets after the move.

IBD Advisor Concerns About Opening an RIA, 2020

	IBD Advisors Who Prefer the RIA Model		
Concerns About Opening an RIA	**Not a Concern**	**Moderate Concern**	**Major Concern**
Assuming greater compliance responsibilities	12%	28%	60%
Greater regulatory liability when operating independently	8%	34%	58%
Losing clients during the transition	9%	48%	43%
Assuming greater operational requirements	16%	49%	34%
Assuming greater technology responsibilities	39%	28%	33%
Uncertainty about future of RIA regulation	24%	46%	30%
Inability to offer certain products (e.g., VAs, alternatives)	23%	47%	30%
Giving up BD's resources and support	24%	50%	26%

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute and the Financial Planning Association® (FPA®)

Primary Economic Drivers

There's no doubt that the Hybrid model is growing in popularity. Firm count in the hybrid RIA channel grew 2.6% from 2017 to 2018, compared to 1.4% in the independent RIA channel.[1] A large growth component may be attributed to a higher payout on the fees they charge clients. Larger payout means the ability to build equity and better monetize the practice when it comes time to sell.

Conclusion

While arguably one of the more complex models due to its expansive product and service offering to clients and the potential for multiple custodians, regulatory requirements and technology platforms, the Hybrid Model offers great flexibility and a way to transition to offering advisory services without losing commissions from a brokerage practice. Seasoned financial professionals might find the idea of increased control and independence appealing, but they must carefully evaluate the many logistical considerations and costs of this model.

IAR-Only of Corporate RIA

Overview

Over the past 25 years, the financial services industry has undergone a shift from commission compensation to advisory and planning fees. Several IBDs now accrue more revenue from advisory business than from commission accounts. Even though this shift has several benefits for both the independent BDs and their advisors, it also could become a threat to IBDs. As the industry evolves, many advisors may no longer find it necessary to partner with an IBD. Advisors that earn significantly more recurring advisory/planning fees than commission compensation start to question the value of maintaining FINRA registration and affiliating with a BD. IBDs seeking a strategy to retain advisors and their associated revenue should explore offering investment adviser representative-only (IAR-only) options under the BD's corporate RIA.

1Source- Cerulli Report US RIA Marketplace 2019

Business & Support Model

Most IBDs have invested time and money to develop their advisory programs. To be successful in this space, some may need to modernize their wealth management services, advisory offerings, service structure and culture. The support model needs to evolve across all aspects of the firm including operations, marketing, compliance and terminology/language used when dealing with IARs that are not affiliated with FINRA.

Effectively servicing IAR-only advisors may require a dedicated group with no possibility of clouding BD or FINRA related policies and rules with basic SEC requirements. Whether it is a dedicated service group or training existing home office staff, the operational structure needs to be geared to the SEC side. Staff that has been entrenched in a long history of BD structure and legacy needs to remove their FINRA hats when dealing with these advisors. The home office staff needs to be well-versed in the nuances of the advisory model and provide support and guidance tailored to this side of the business. Advisors need to see and feel the difference. If home office support, answers and guidance remain unchanged from a BD or FINRA perspective, the advisor will notice. IAR-only advisors view the world differently than their dually-registered peers. Processes, tools, paperwork and disclosures will need to adapt as the advisors operate exclusively under SEC regulations.

Offering a corporate IAR affiliation is the least disruptive option for financial professionals who want to do only fee business. The advisor can utilize the BD's infrastructure, advisory programs, operations, compliance, billing, third-party asset managers and financial planning agreements. It can be done without the burden of taking on any compliance maintenance and risk that would be required if they opened and operated an independent RIA. Advisors can operate exclusively as a fiduciary, eliminate FINRA nuances and retain access to the BD's full suite of services. The change for the advisor should be relatively simple. There are minor to little change for advisory accounts and minor to no disruption to the end advisory clients.

Compliance/Supervision

The BD's RIA is responsible for supervising all activities, investment advice and general business practices of their non-FINRA IARs operating under their corporate RIA. Providing compliance support and supervision comes with both opportunity and risk. The BD's compliance support model will need to evolve. To effectively provide compliance support and supervision to IAR-only advisors, the firm may need a dedicated advisory compliance group. Compliance staff that has been embedded in a long history of BD FINRA structure need to remove their FINRA perspective. Applying BD processes to a fee-only advisor will only create frustration.

Most IAR-only advisors value collaborative compliance support and guidance. Many policies, processes, procedures, compliance tools and disclosures need to be updated from a SEC regulations perspective. IBDs need to identify opportunities to provide additional flexibility and a specialized experience. For example, the firm's branch audit frequency could be reduced. The audit structure may need to change by eliminating all FINRA and BD references. There may need to be a dedicated advertising review team and slightly adjusted processes. Ensuring that the firm's compliance support evolves to provide a better experience for these IARs will contribute to an overall more cohesive experience.

Risk Factors

There is always risk with change, and IBDs trying to evolve to offer an investment adviser representative IAR-only option under the BD's corporate RIA is no different. Here are some of the associated risk factors:

- May require significant investment and organizational structure change.
  - IBDs may need to modernize their wealth management services and advisory offerings.
  - Distinct new support units (i.e. compliance, operations, etc.) requires investment.
  - Increased cost for adding additional staff as well as additional training.
  - Time and resources to adjust policies, procedures and tools for small initial adoption rate.
- Significant investment and cost to change brand and external marketing effort if the IBD plans to recruit and compete in the RIA marketplace.
- IT strategy may need to evolve to compete in marketplace.
- Need to explore using multi custodians to compete in marketplace. This impacts operational efficiency and economics.
- If the IBD does not make the full commitment or does change haphazardly, there is risk these advisors will feel misunderstood and explore leaving.

In addition, there is the risk that by failing to adapt to the changing landscape the IBD may lose their largest and most profitable fee-based practices. These advisors may explore other partnership options or leave to establish their own independent RIA.

Primary Economic Drivers/Revenue Levers

As your firm evaluates whether to offer an IAR-only option under the BD's corporate RIA, there are different economic factors that need to be considered. To be a compelling option in this market, the IBD may need to modify the cost structure and change their payout structure. Fee-only advisors may expect higher payouts. Consider the structure based on the platform and administrative costs of a non-FINRA advisor. Has the load been lessened? Advisory business tends to have lower margins than traditional BD business, but fee and planning revenue are more reliable. Firms need to examine all sources of revenue including sponsor and custodian economics.

As advisors become large enough to consider creating their own RIA, IBD's must make their IAR-only offering compelling enough to offset the cost savings of going directly to a custodian. IBDs need to add value beyond providing supervision services, such as offering more technology tools, planning support, investment management support and business consulting services.

Independent RIA (BD is essential service provider)

Overview

The Independent RIA model continues to be an attractive solution for financial advisors. Creating their own entity provides more control. Advisors considering the transition from the corporate RIA to an independent RIA are basing their decisions on factors such as lower costs, broader investment options, less restrictive compliance and greater M&A opportunity. Ultimately, BDs have several options in which to engage and partner with these RIAs for success and growth.

- Technology Provider – An integrated tech stack is essential to running any advisory business and many BDs have the expert support team to customize and build a seamless solution that RIAs can plug into. Smaller RIAs do not have the scale nor expertise to evaluate and implement these solutions themselves. BDs that offer an integrated technology solution which includes a host of options for CRM, financial planning, client portal, performance reporting, data aggregation, billing and compliance tools can partner with these RIAs in a meaningful manner.
- Platform Provider – As BDs continue to enhance their advisory platforms, whether built internally or by partnering with firms like Envestnet or Orion, they create the ability to offer these solutions to RIA firms. In doing so, they have removed the burden of billing, trading, platform maintenance, account opening and so much more for these RIAs. All these value-added services can be provided at a price point unattainable by the RIA. BDs may also provide reduced custody and clearing costs to RIAs. In doing so, this provides both parties with increased scale to further drive pricing down and potentially allowing the RIA to offload operational support to the BD.
- Resource Support or a la carte Solution – In many instances, RIAs are looking for several different solutions (i.e., compliance support, technology, platform support, operational support, etc.). Providing a menu of services where RIAs can improve on their weaknesses or enhance their capabilities is another avenue BDs can implement to support the independent RIA.
- Equity Ownership – Today RIAs are frequently positioning themselves for a private equity buyout, which delivers much-needed financial backing for growth. RIAs can leverage these private equity firms for M&A opportunities, increased marketing efforts or providing scale through other acquisitions. Inevitably, BDs have the same opportunity to partner with RIAs to provide the financial support needed to help the RIAs create their desired growth trajectory.

Compliance and Risk Factors

RIAs have the responsibility to ensure they are compliant with SEC or state regulatory guidelines. Lack of expertise and knowledge in advisory compliance increases the risk for the RIA and the advisors associated with the firm. Many RIAs choose to seek professional guidance and support from third-party vendors.

The bullets and statistics on the next few pages are taken directly from the **2018 SEC Annual Performance Report, SEC 2018-2022 Strategic Plan and 2020 Budget Request.** This information evidences the heightened regulatory focus on RIAs and advisory activity, which will also drive the amount of time and resources an unaffiliated RIA will need to devote to building and maintaining their own compliance program.

Percentage of investment advisers and BDs examined during the year

Description: Investment advisers and BDs are critical market participants in terms of their interactions with retail investors. This metric indicates the volume of advisers and BDs examined by the SEC or an SRO as a percentage of the total number of registrants. This metric includes all types of examinations: risk priority examinations, cause inspections to follow-up on tips and complaints, limited-scope special inspections to probe emerging risk areas, and oversight examinations of BDs to test compliance and the quality of examination by the Financial Industry Regulatory Authority (FINRA).

Fiscal Year	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018 Plan	FY 2018 Actual	FY 2019 Estimate	FY 2020 Estimate
Investment Advisers	9%	10%	10%	11%	15%	15%	17%	13%	16%
Broker-Dealers	46%	49%	51%	50%	48%	48%	48%	45%	47%

Responsible Division/Office: Office of Compliance Inspections and Examinations

Data Source: Tracking and Reporting Exam National Documentation System (TRENDS) (IA and BD SEC Data) and SRO Databases (BD SRO Data)

- The population of RIAs has grown significantly in recent years, as has the amount of assets those RIAs manage. More specifically, in just the last five years, the number of RIAs OCIE oversees increased from about 11,500 to 13,475, and the assets under management of RIAs increased from approximately $62 trillion to $84 trillion.
- RIAs' complexity, interconnectivity and dependency on a variety of market participants also continue to grow: more than 3,700 RIAs manage over $1 billion in assets; approximately 36% of RIAs manage a private fund; more than 55% of RIAs have custody of client assets; more than 60% of RIAs are affiliated with other financial industry firms; and approximately 12% of RIAs provide advisory services to a mutual fund, exchange-traded fund, or other registered investment company
- OCIE has increased its examination coverage of RIAs over the past several years from 10% in FY 2014 to a high of 17% in FY 2018. OCIE's coverage of RIAs in FY 2019, a year in which the RIA population continued to increase, and the SEC experienced a 35-day lapse in appropriations, was 15%.
- 2020 Exam Priorities include ADDITIONAL FOCUS AREAS INVOLVING RIAS AND INVESTMENT COMPANIES – specifically of note RIA Compliance Programs and Never Before and Not Recently Examined RIAs

Average months between opening a matter under inquiry or an investigation and commencing an enforcement action

Description: This metric captures the average number of months between the opening of an investigation and the filing of the first enforcement action arising out of that investigation. If the investigation was preceded by a matter under inquiry, the metric draws on the date of opening of the matter under inquiry. In conducting investigations, the enforcement program continually strives to balance the need for complete, effective and fair investigations with the need to file enforcement actions in as timely a manner as possible. While not all investigations result in the filing of enforcement actions, this metric provides information concerning the pace of investigations that do lead to such actions and supplements the previous goal, which measures the percentage of first enforcement actions filed within two years.

Fiscal Year	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018 Plan	FY 2018 Actual
Months	21	21	24	24	24	20	25

Target: Not Met

Analysis: In FY 2018, the average number of months between opening a matter under inquiry (MUI) or investigation and commencing an enforcement action was 25 months. Timeliness in filing actions is important because it can enhance the action's deterrent impact. At the same time, many of the division's cases are complex and can take extended periods of time to develop successfully.

Plan for Improving Program Performance: To address the issue of timeliness in investigations, the division is taking measures that include emphasizing expediency in quarterly case reviews, promoting best practices regarding efficiencies in various phases of the investigative process, leveraging data analytics capabilities and conducting training on tools that expedite investigations.

Responsible Division/Office: Division of Enforcement

Data Source: HUB Case Management and Tracking System for the Division of Enforcement

Total amount distributed within the fiscal year, and the number of Fair Funds from which those distributions came

Description: In its enforcement actions, the SEC may seek to return funds to harmed investors through disgorgement of ill-gotten gains or through the Fair Funds provision of the Sarbanes-Oxley Act. This provision permits the SEC to combine amounts paid as penalties with disgorged funds, or to create a Fair Fund from penalties only, to reduce losses to injured parties. This reflects the SEC's efforts to return funds to injured investors. This indicator identifies the total amount distributed within the fiscal year, and the number of Fair Funds from which those distributions came. This indicator may increase or decrease in dollar amount and number of distribution funds based on the number of SEC enforcement actions brought involving distributions, amounts ordered and paid in those actions and other factors. Due to the variation in reporting timelines established for each individual distribution, reported amounts are based on the agency's best available information. Reported amounts do not include those funds distributed through receiverships. Any funds not returned to investors are sent to the U.S. Treasury or the Investor Protection Fund established pursuant to Section 21F(g) of the Securities Exchange Act of 1934. Neither disgorgement nor penalties are used for the Commission's own expenses.

Fiscal Year	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018 Actual
Amount distributed (in millions)	$251	$424	$158	$140	$1,073	$794
Number of Fair Funds	22	28	34	35	32	26

Responsible Division/Office: Division of Enforcement

Data Source: HUB Case Management and Tracking System for the Division of Enforcement and Distributions Management System

There is also an increased risk of cyber fraud. As such, there has been a substantial increase in the examinations surrounding information security for both BDs and RIAs.

Number of examinations that request information related to an entity's information security

Description: Managing cyber and information risks is critical to the operation of the financial markets. As a result, the SEC's risk-based examination program will ensure that a portion of its exams each year will assess whether regulated entities are monitoring, managing and appropriately addressing these types of risks. The results of these important reviews will inform the SEC regarding industry developments and future work in this area. Overall, this metric reflects the continued focus of the SEC's examination program by measuring the number of examinations reviewing critical cyber and information risks.

Fiscal Year	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018 Plan	FY 2018 Actual	FY 2019 Estimate	FY 2020 Estimate
Number	Prior year data not available					N/A	N/A	150	300

Responsible Division/Office: Office of Compliance Inspections and Examinations

Data Source: Tracking and Reporting Exam National Documentation System (TRENDS)

Primary Economic Drivers

The independent RIA space continues to be an attractive solution for advisors due to the ability to keep a larger share of the fees charged to clients. As RIA firms grow and create scale within their firm, they can drive down pricing for technology and custodial costs. RIAs continue to position and structure their firms to be attractive to private equity buyouts or other liquidity events that can generate higher multiples in a sell or merger. Lastly, RIAs can attract other advisors through the offer of equity ownership and streamlined expenses.

Conclusion

The RIA channel continues to be one of the fastest growing models and is an attractive solution for advisors who wish to have greater control over their firm and direction of their business. With their scale, technology, compliance, platforms and operational support, BDs can partner with RIAs in a meaningful way to create opportunity for both entities to grow. Consider these stats:

- Independent RIAs represent 21% of total advisor headcount
- Independent RIAs represent 24% of total industry assets
- Independent RIAs are expected to control 30% of total assets by end of 2023

IBD Advisor Reasons for Preferring RIA Model, 2020

	IBD Advisors Who Prefer the RIA Model		
Reason for Preferring RIA Channel	Not a Factor	Moderate Factor	Major Factor
100% payout	10%	38%	52%
Greater marketing flexibility	19%	45%	36%
Increases financial value of practice	20%	44%	36%
Current B/D not adding enough value in relation to cost	19%	48%	34%
Flexibility regarding fee levels and structure	24%	45%	31%
Regulatory oversight is less burdensome for RIAs	23%	46%	31%
Flexibility to select technology systems	26%	43%	31%
Paying for unused services offered by current B/D	30%	40%	30%
Ability to take discretion over client accounts	34%	39%	27%
Appeal of independent model to clients	27%	48%	25%
Increased opportunity to acquire other RIAs	35%	40%	25%
Operate exclusively as a fiduciary	51%	30%	19%
Ability to build custom model portfolios	49%	43%	9%

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute and the Financial Planning Association® (FPA®)

PLATFORM OFFERINGS

Platform Offerings

Overview

As IBDs consider how they will serve investment advisors in the coming years, work must be done to create a comprehensive, fee-based platform. Much of what has already been discussed touches on the rationale including the potential for attrition based on a variety of factors. Building and maintaining a flexible, innovative platform will keep advisors loyal and happy. Though not an exhaustive list, IBDs who take a thoughtful approach in the following areas will be successful.

Investment Management Platform Options

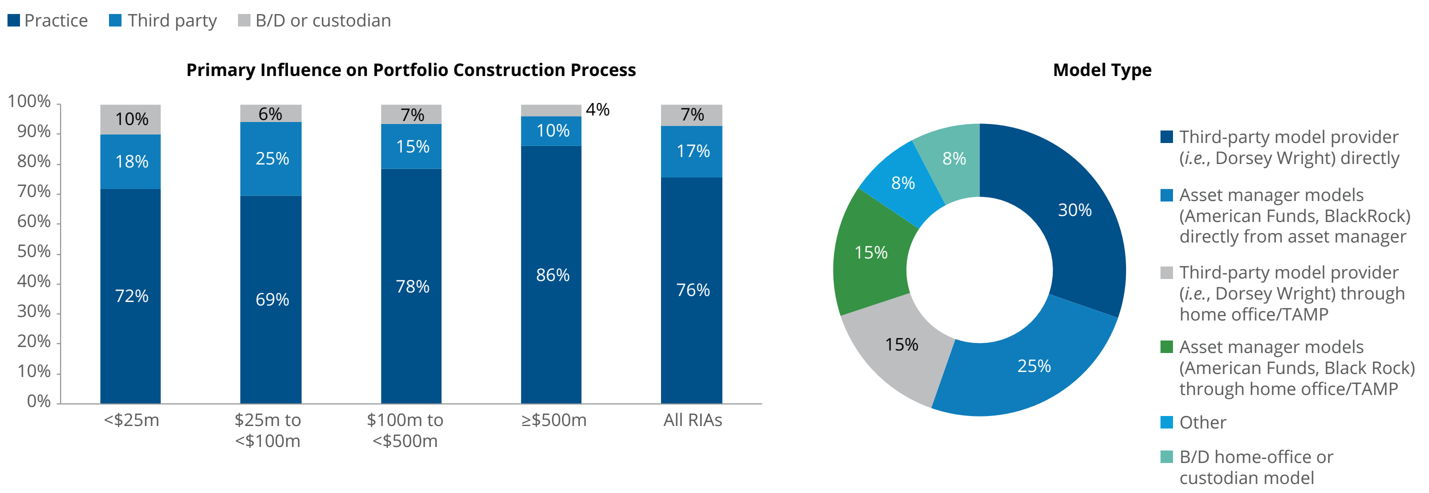
- Multiple or Single Custodian
- TAMP Partnerships
- Direct Access to Third-Party Managers
- Proprietary In-House Solution
    - Plug and Play Models
    - Research
    - Discretionary Asset Management
- Subscription Services
- Wrap and Non-Wrap Advisor Managed Account Structures

Exhibit 6.01

Portfolio Construction Dashboard, 2019

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute (formerly IMCA), and the Financial Planning Association® (FPA®)

Analyst Note: Responses for model type include only advisors who indicate that they start with or use models provided by a third party, B/D, or custodian.



- More than three-quarters (76%) of all RIAs report that they primarily rely on their practice during the portfolio construction process.
- RIAs who use models, fully or as a starting point, most commonly directly leverage third-party models (30%) and asset manager models (25%).

Product/Service Menu

- Mutual Fund Share Classes Allowed
- Alternative Investments
- Fee-Based Variable Annuities
- HSAs, 529s, 401ks
- Charitable Options
- Lending Solutions
- Financial Planning
- Retirement Plans

Investment Product Use, 2020

	Channel		
Product Type	**Independent RIA**	**Hybrid RIA**	**All RIAs**
Mutual funds (including liquid alternatives)	78%	92%	84%
ETFs	82%	85%	83%
Individual equities	80%	80%	80%
Money markets, deposit accounts, cash	63%	68%	65%
Individual fixed income	65%	64%	64%
Variable annuities	23%	65%	42%
Other insurance products	23%	55%	37%
Alternatives (excluding liquid alternatives)	24%	40%	31%
Separate accounts	18%	35%	25%

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute and the Financial Planning Association® (FPA®)

Technology

- Tech stack must include:
    - Fee Billing
    - Reporting and Aggregation
    - Modeling, Rebalancing, Block Trading
    - Financial Planning
    - CRM
    - Risk Assessment
    - Proposal Generation
    - Client Portal
- Offering Structure
    - Supported Enterprise Tools
    - Discount
    - Are certain systems required?
    - What can the advisor self-select?
    - Maximize integrations for a streamlined user experience

Miscellaneous

- Branding
- Due Diligence
- Referral Arrangements
- Education/Training

PERSPECTIVE: SHIFTING FROM AN IBD TO RIA

Perspective: Shifting from an IBD to RIA

Overview

Once a firm is knowledgeable about the options and economics, there is an opportunity to consider whether they should make changes to their business model or introduce new affiliation opportunities for investment advisors. Before introducing new service offerings, it is important to consider what actions the home office would need to take to roll out changes successfully.

Firms that have successfully deployed a fee-only, modernized corporate RIA, or hybrid RIA model have implemented significant changes within their firm including their culture, marketing, language, platform and technology availability. An outline of considerations for firms to consider are listed below.

Marketing

When firms first introduce additional affiliation models, they may first think about marketing to a new market. However, firms may also want to consider marketing to their existing financial professionals.

Action Items for Consideration:

- Plan an awareness campaign regarding business models and differences for each
- Provide education opportunities on IAR and/or RIA affiliation options

Once the firm is comfortable knowing they have solutions to meet the needs of their current financial professionals, including the correct supervision and risk management policies, they may want to consider proactively marketing their affiliation models to a new market.

Action Items for Consideration:

- Attend industry conferences such as Schwab Impact, Pershing's INSITE Conference, IWI, T3, etc.
- Advertise in trade magazines geared to RIAs such as Financial Planning, Financial Advisor and Investment News
- Create an email campaign that leads RIA prospects to the firm's website where statistical data can be measured for effectiveness so targeted follow up action can ensue
- Hire RIA-focused recruiters and/or partner with third-party recruiters who are up-to-speed on the firm's offering and ideal profile
- Have key leadership publish articles, participate in panel discussions and join industry organizations to position the firm as an advisory expert

Supervision

There are distinct differences in the supervision responsibilities of firms for dually-registered financial professionals versus those who are unaffiliated with FINRA. The firm should take time to review the supervision requirements for each affiliation model and make changes to the process and policies for each scenario.

Action Items for Consideration:

- Regulatory Supervision – Review FINRA NTM 94-44 and NTM 96-33 to determine the FINRA supervision requirements for dually-registered IARs and registered representatives
- Risk Management – Firm should consider additional reviews they may need from a risk management perspective if investment advisors will be covered by their E&O or there is perceived liability for their advertising, correspondence, social media posts or outside business activities
- Fee-Only Corporate – SEC requires supervision/oversight of all IAR activities (SEC 1940 Act; Reg BI)
- IAR of Independent RIA (not FINRA licensed) – There is no regulatory responsibility for BD or platform provider to review, but the firm could choose to review some actions such as background checks, complaint history and firm history for risk management

Hiring RIA Talent

In order to deliver the expected services and technology to investment advisors, the firm should consider whether they have knowledgeable subject matter experts or if they will need to hire additional staff. The teams supporting RIA business should be familiar with RIA platforms, speak the right language and have cursory knowledge of the BD. A few positions to consider include:

- Focused Advisory Compliance
- RIA Recruiters and/or Business Development
- Dedicated RIA Service Team
- RIA Custodian Liaison

When hiring for these positions, consider how their support will vary from that of the BD and ask questions related to those aspects. While FINRA rules are black and white, SEC/State rules have some degree of ambiguity (suggestions or general language rather than prescription required action). A rigid mentality may not be the best personality fit for supporting advisory business. It is also important to consider the language they use. Do they describe active management as market timing? What term do they use to denote advisor-managed accounts? The words they use will be a key indicator of their experience and perspective. Adding RIA subject matter experts to the home office team will ensure support is provided efficiently and accurately. They will know how to best serve the target audience with minimal confusion about FINRA rules and BD terminology. Consider licenses such as the FINRA Series 65, 66 and the CFP designation when hiring RIA support staff.

RIA Language Considerations

Words matter, especially in the financial services industry. When shifting your business perspective to an advisory mindset, work to incorporate the fee-based terminology that applies. By eradicating BD terms and selecting the appropriate advisory ones, understanding and value are demonstrated to the IARs with whom you partner. Though not exhaustive, below are a few impactful examples to consider.

Instead of *Suitability*: Risk Tolerance or Investment Objective

- Suitability Standard – Requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable based on a client's personal situation or investment profile along with an understanding of the potential risks and rewards of the recommended security or strategy
- Risk Tolerance – The degree of variability in investment returns that an investor is willing to withstand. Time horizon of a financial goal may impact how much risk a client is willing to take. An aggressive investor or one with a high-risk tolerance is willing to risk losing money to get potentially better results. Conversely, a conservative investor or one with a low risk tolerance prefers investments that maintain his or her original investment. Often, advisors may ask a series of questions to help assess risk tolerance.
- Investment Objective – A set of goals that an investor has for their portfolio that helps determine the optimal strategy or portfolio mix for achieving those goals, usually determined by using a questionnaire. Risk tolerance and time horizon are two key components, but other factors like taxes, transaction costs, liquidity needs and total wealth (social security, expected inheritance, pension/retirement income) are also considered. Investment objectives can change over time due to major life events, so it is important to re-evaluate periodically.

Instead of *Rep as PM*: Advisor as Portfolio Manager
Instead of *Registered Representative*: Investment Advisor Representative

- Registered Representative – A registered representative is a person who works for a brokerage company and serves as a representative for clients trading investment products such as stocks, bonds and mutual funds. Registered representatives are also known as brokers. A registered representatives can buy and sell securities for clients. They are primarily known as transaction-based service providers. To carry out these transactions a registered representatives must be licensed to sell the designated securities. They must also be sponsored by a firm registered with the Financial Industry Regulatory Authority (FINRA). To become licensed as a registered representatives for a sponsoring firm, a person must pass the Series 6 or 7 and Series 63 securities examinations administered by FINRA.
- Investment Advisor Representative – An IAR refers to a licensed and authorized person who works for a Registered Investment Advisory firm. The primary responsibility of an IAR is to provide investment-related advice as a financial advisor or planner. IARs receive compensation by charging fees typically as a percentage of assets under management (AUM). IARs must be properly registered with an RIA and in most cases hold a professional designation or complete licensing exams such as the Series 65 or 66.

Instead of Managed Money: TAMP, Third-Party Investment Manager, SMA (as appropriate)

- Turnkey Asset Management Program (TAMP) – A TAMP offers a fee-account technology platform that advisors use to oversee their clients' investment accounts. TAMPs are designed to save time and allow advisors to focus on client-facing activities while providing asset management tasks like investment research and portfolio allocation. TAMPs may offer technology, back-office support and tasks like investment research. Envestnet is an example of a TAMP.
- Third-Party Investment Manager – Third-party investment management is used when advisors want to delegate investment management tasks for all or a portion of their fee-based book. Advisors outsource this function to gain efficiency or to provide in-depth expertise for certain client scenarios (i.e., options). Managers may be accessed directly or through platform providers such as TAMPs. They typically take on discretionary investment management and may do so through a co-advisory, sub-advisory or solicitor's arrangement. Federated Investment Management is an example of a Third-Party Investment Manager.
- Separately Managed Account (SMA) – A SMA is an investment portfolio owned by an investor and managed by a professional investment firm. Most separate accounts are managed by registered investment advisors (RIA). SMAs are increasingly targeted toward more affluent retail investors and come with a wrap fee of 1%–3% per year of assets under management. SMAs offer more customization in investment strategy, approach and management style providing direct ownership of securities and tax advantages over mutual funds. A SMA is typically a single strategy approach (i.e. small cap value) as opposed to a comprehensive asset allocation. Gannett, Welsh and Kotler Equity Dividend Plus is an example of a SMA.

Other Terms to Clarify

Certain terms may carry varying definitions depending on the messenger or the regulatory body that applies (ex: SEC, States, ERISA). Be sure the team is on the same page when discussing these:

- Hybrid – A hybrid practice is registered with an RIA and a BD. This dual registration allows financial professionals to operate both a fee- and commission-based practice. A hybrid financial professional can offer a broad range of advice-driven strategies and solutions providing sound guidance on all aspects of a client's financial position, including wealth management and inter-generational transfer.
- Fiduciary – A person or organization who holds a legal or ethical relationship of trust to act in the best interest of the principal whose assets they are managing while avoiding or disclosing and mitigating conflicts of interest. Advisors under the fiduciary standard have a responsibility to put their client's interests above their or their firm's interests (a higher level of accountability than the suitability standard).
- ERISA Fiduciary Standard – Provides discretionary or non-discretionary investment recommendations regarding the management or administration of a qualified plan. The primary responsibility of a fiduciary is to run the plan solely in the interest of participants and beneficiaries for the exclusive purpose of providing benefits and paying plan expenses. Fiduciaries must act prudently and diversify the plan's investments in order to minimize the risk of large losses. In addition, they must follow the terms of plan documents to the extent that the plan terms are consistent with ERISA.

FINAL THOUGHTS AND NEXT STEPS

Final Thoughts and Next Steps

The FSI Investment Advisory Services Council has prepared this Guidebook to draw awareness to the continuously changing state of the financial services industry. Each firm must determine if changes are needed to enhance their advisory offerings and consider the downstream impact of those changes or lack thereof. The RIA market continues to grow and attract the next generation of financial professionals and clients; to ensure long-term success, your platform must evolve to meet their needs.

As mentioned throughout the Guidebook, the Council encourages advisory program providers to take these steps:

1. Analyze historical data to identify trends and opportunities
2. Review the models and economic factors of each to determine what works best
3. Consider a revamp of language, culture and technology with an RIA perspective to attract advisors that are good fits
4. Reach out to strategic partners and subject matter experts for insights and statistics
5. Confer with your industry peers to gain perspective

As you analyze, consider and learn, we hope you'll find meaningful ways to enhance your advisory offering. The RIA market is evolving and FSI members should continue to change in tandem to meet or exceed the expectations of the financial professionals with whom you partner.

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