Sea change coming in asset management

Is the traditional broker-dealer business model for investing on the way out? This writer thinks that's the case.

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Significant change is sometimes initiated and sometimes thrust upon us. The financial services industry is experiencing a bit of both.

Since the creation of U.S. stock markets more than a century ago, brokerage firms have dominated the industry as the chosen vehicle Americans used for managing their investments. Even with advances in technology and easy access to market information, the majority of stocks, bonds and mutual funds still are purchased through a commissioned broker-dealer.

However, in recent years, there has been an industry shift, as more investors choose to manage their money with fee-based, registered investment advisers who assume fiduciary responsibilities for clients. Since 1998, the assets under management by this group have grown to 36 percent, and the growth is even greater among high-net-worth individuals.

As the founder of a referral-only firm that operates as a registered investment adviser, I have experienced this shift first hand. People tell us they prefer a fee-based relationship that carries with it a fiduciary responsibility. My firm, like all registered investment advisers, is required under the Investment Advisors Act of 1940 to disclose conflicts of interest and give advice that is suitable for the client -- in other words act as a fiduciary.

Now there are many high-quality and well-intentioned professionals in the brokerage industry. But the broker-dealer model does not necessarily translate into the optimal situation for individual investors. This is evidenced by increasing customer complaints, growing compliance departments and public fights over conflicts of interest. A big factor is that most investors do not realize the difference between a registered investment adviser (fiduciary) and a broker-dealer (salesperson).

In April, the Securities and Exchange Commission (SEC) attempted to establish a more level playing field concerning the regulation of the financial planning industry by mandating a standard disclosure that must be included in all client documents for fee-based accounts that continue to be operated by brokers (holders of a Series 7 license). This disclosure is an attempt to help the client understand the difference between when their broker is *selling* (acting as a broker) or *advising* them regarding a financial product. This can be very hard for clients to understand and leads to the question: Why not just advise your clients as a fiduciary?

The broker-dealer firms, whose profitability depends heavily on the highest-producing brokers, are finding themselves between the proverbial rock and a hard place. Some brokers who see the value in these regulations are moving from the traditional broker-dealer model and embracing the fiduciary role of a registered investment adviser. In the past year, there's been a significant rise in advisers registered with the SEC.

Meanwhile, virtually no new traditional broker-dealer firms have formed in the Twin Cities in the past five years. Yet it's now common to see new firms utilizing the registered investment adviser model.

An example of this trend locally is Piper Jaffray & Co. In August, Piper Jaffray in effect exited the brokerage business by selling its Private Client Services branch to UBS, which it will continue to operate using the traditional broker-dealer model. Other former Piper brokers chose to move their business to other firms, such as Merrill Lynch. Before the sale, still other brokers had chosen to shift to the fee-based registered investment advisory model.

Another factor supporting change is the growing awareness of how some brokerage firms, such as Charles Schwab, TD Waterhouse and Fidelity, have evolved to support the independent registered adviser model. Collectively these firms are challenging the value of the larger broker-dealer firms.

History has shown that such events can foreshadow major changes.

In his book, "The Tipping Point," Malcolm Gladwell asserts that changes often occur because of the efforts of a few individuals. Although these few might be the catalyst for change, an undercurrent of desire for change also must be present. That desire is alive and growing in the financial services industry.

There are a number of factors that could tip the financial services industry: the SEC's new disclosure standards; high-net-worth clients and mega brokers abandoning the broker-dealer model, and industry leaders, such as Schwab, continuing to act as proponents of the registered investment advisory model.

The financial services industry is a very old business that has done things the same way for a long time, and not necessarily always in the best interest of the investor.

Yet inside the current business model are exceptional professionals who can be agents of change. Hanging on to the current broker-dealer model because it's been around for 125 or more years is not good policy.