Selecting an Investment Company

By Gene C. Sulzberger

From the casual observer's perspective, U.S. investment management firms may all look alike. However, there are important differences that investment consumers should be aware of when selecting an investment firm.

The three common types of investment institutions serving individuals with investable assets in the United States are broker/dealers (BD), registered investment advisory firms (RIA) and trust companies. Within these institutions, one would be working with a registered representative (RR) at a broker/dealer, an investment advisor representative (IAR) at an RIA, or a trust officer at a trust company.

Where a client's assets are custodied is an important question that needs to be part of any conversation with an investment firm. Custody provides an investor a place to store assets with little risk. Assets in custody are protected by the SEC Customer Protection Rule – meaning that, even if the custodian or the investment firm fail, investors' assets remain secure and separate from the custodian or investment firm's own assets. Custodial institutions normally charge custodial fees for their services.

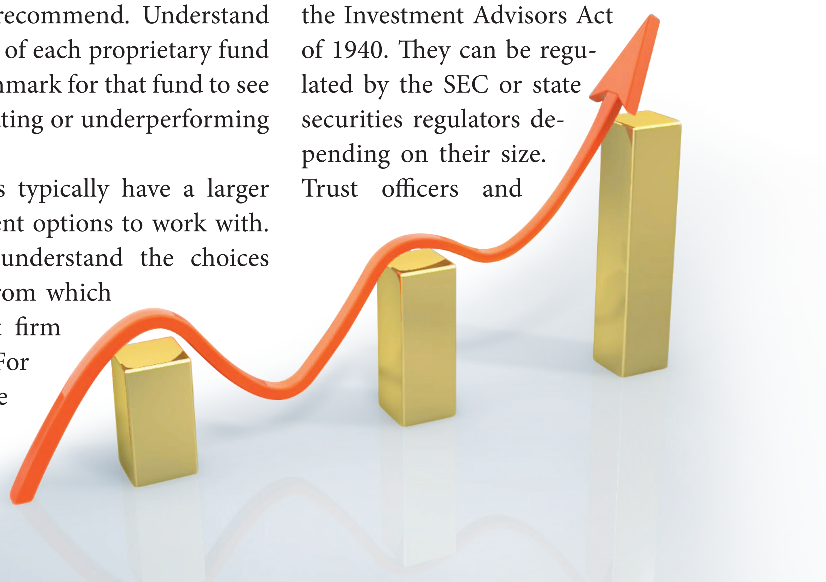
The larger trust companies and brokerage firms usually have their own custody divisions for safekeeping of their investment clients' assets, or they may use third-party providers. Generally, RIAs custody the assets of their clients with large, third-party national custodians, such as Pershing, Schwab and Fidelity. Understanding the custody environment of the investment firm one chooses and the costs for this service are important. The third-party custodial relationship your investment firm has is a check and balance highly recommended in light of publicized investment frauds of the past few years and helps protect against fraud.

Understanding the investment product options of the investment firm is also highly valuable. A number of sizeable trust companies are focused on their own proprietary investment products. Some of these funds perform well, whereas other funds may not. Reviewing the prospect uses of these proprietary funds is a task most people do not like to perform, but it is something I recommend. Understand the performance of each proprietary fund against the benchmark for that fund to see if the fund is beating or underperforming the benchmark.

BDs and RIAs typically have a larger pool of investment options to work with. Clients should understand the choices they have and from which their investment firm has to choose. For example, is there a large selection of actively managed and indexed funds that the firm works with, or restricted to just a few funds? Can clients purchase individual securities? What kinds of alternative investments can the client invest in and how does the firm exercise due diligence on these funds?

How the investment firm and advisor are compensated is another crucial question to ask. RIAs and trust companies generally receive their compensation through a fee, typically a percentage fee of the assets under management. BDs and their RRs are typically compensated through commissions, front or back end loads and/or fees. BDs may depend on transactions for a large part of their income, but can also continue to receive fees from mutual funds sold. Investors should make sure they understand the different types and levels of fees that are being charged and whether this can influence how the portfolio is managed or structured.

This leads to, in my opinion, the most important distinction between each type of investment firm – the legal responsibility the firm and the advisor owe the client. RIAs and their officers have fiduciary relationships with their clients as required by the Investment Advisors Act of 1940. They can be regulated by the SEC or state securities regulators depending on their size. Trust officers and



Gene C. Sulzberger is president of Sulzberger Capital Advisors, a registered investment advisor in Miami. He works with U.S. and international clients, helping them meet their wealth management goals. Gene is a CERTIFIED FINANCIAL PLANNER™ and a registered trust and estate practitioner (TEP). He is also an attorney who previously practiced law in the area of trust and estate planning. He has over 20 years of experience in financial services and financial planning. Gene can be reached at (305) 573-4900 or gene@sulzbergercapital.com.

trust companies also have a fiduciary relationship with their clients as required by the state laws that govern trust companies. The fiduciary standard is built on a duty of loyalty meaning that the fiduciary cannot put his personal interests before the duty to his client. A fiduciary is the highest standard of client care under the law.

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BDs and their RRs are held to a different legal standard called the suitability standard. They are required to recommend suitable investments to their clients per the rules of conduct of their regulatory organization, known as FINRA, and the SEC. As stated earlier, RRs can be paid a commission and/or some form of additional compensation on sales of investment products, which could influence behavior. If one product pays a higher commission than another product, that RR may be more inclined to recommend the higher commissioned product to his client. Reputable brokerage firms should have policies and procedures in place to monitor such behavior and hold it in check. A key distinction is that an investment advisor or trust company typically focuses on a client's entire portfolio and a BD may focus on the individual securities transactions from where their commissions arise.

FINRA has instituted an overhaul of the suitability standard provisions that took effect in July 2012. Significant aspects to this revision are the requirements of brokers to perform reasonable diligence on products, understand these investments and have a reasonable basis to think that a security or investment strategy is suitable. It adds the investor's age, investment experience, time horizon, liquidity needs and risk tolerance to the list of factors that affect a suitability determination. In regulatory and professional circles, there are discussions about whether to elevate the standard of care of BDs to that of the fiduciary standard, but this has not happened yet and has met considerable resistance.

In the end, when selecting an investment professional to work with, it is important to understand the type of firm a client is working with and the level of legal responsibility the investment professional has to the client. It is important to ask questions. Not all investment firms are alike and the investment options available can be quite different.