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UNDERSTANDING THE HYBRID PRACTICE

Considerations for Advisors in Transition

Schwab Market Knowledge Tools®

This white paper is part of the Schwab Market Knowledge Tools (MKT) series, an ongoing program of industry research reports, white papers and guides from Schwab designed to keep investment advisors on the forefront of trends and competitive challenges facing the industry today. The MKT program delivers the kind of relevant and timely information needed for future business planning. This series of reports is based on the leadership position of Charles Schwab & Co., Inc. ("Schwab") in the registered investment advisor (RIA) marketplace (more than 6,000 advisors and over 20 years as of this printing).

EXECUTIVE SUMMARY

Advisors interested in transitioning their practice are faced with a large set of considerations. As with any strategic decision, the choice is fundamentally one of philosophy. What kind of practice—advisory or brokerage—is the right one for you and your clients? What business model can provide the breadth, flexibility and expertise required to deliver on your unique value proposition? What does your practice look like today, and how do you want it to evolve?

This paper is designed to help advisors understand the considerations they face when choosing the hybrid practice model, which allows them to conduct both brokerage and advisory business, and to assess the potential benefits and trade-offs that come with the different hybrid choices. The paper covers the following topics:

- Growth trends and drivers in the hybrid market segment
- The features of different hybrid practice models
- Compatibility with a firm's business philosophy and objectives
- The potential impact on a firm's client offerings
- Implications for the structure and management of the compliance function
- The economics of different types of hybrid approaches, as well as how they compare with other models

INTRODUCTION

The hybrid practice model lets advisors maintain both advisory and brokerage business, and it's become an increasingly common option for advisors in transition. Evaluating opportunities within the hybrid channel comes with some of the same basic considerations any advisor would face when transitioning their practice. But because the hybrid option involves dual registration and a dual revenue structure, it also introduces a unique set of considerations to the transition.

Investigating the hybrid channel raises important questions about business objectives, service models and economics. Gaining a solid understanding of the fundamental business and regulatory structures of different hybrid practice models is a critical first step. At a high level, there are two practice models within the hybrid channel:

- The semi-captive hybrid model, in which the advisor joins a corporate RIA of an independent broker-dealer (IBD)
- The dually registered hybrid model,[1] in which the advisor starts or joins an independent registered investment advisor (RIA) firm

Because hybrid advisors conduct both brokerage and advisory business, firms within the hybrid channel operate under two regulatory structures: the U.S. Securities and Exchange Commission (SEC) or the applicable state securities regulatory authorities, and the Financial Industry Regulatory Authority (FINRA).[2] A more detailed description of the dually registered and semi-captive hybrid models and the corresponding regulatory responsibilities can be found in Exhibit 3 on page 6.

The hybrid channel opens new possibilities for designing the client offer. There are different options for compliance management. And, with respect to overall economics, different hybrid choices offer different cost and revenue structures.[3]

1. According to the Cerulli Associates' report Advisor Metrics 2009: "Dually registered advisors are affiliated with a broker-dealer in addition to maintaining an RIA registration separate of their broker-dealer. Those advisors that operate as an IAR [investment advisor representative] under a broker-dealer's corporate RIA do not qualify as dually registered. Dually registered advisors often split client assets between their broker-dealer and their service agent."
2. Practicing within the hybrid channel requires multiple registrations: As an investment advisor representative (IAR) of an RIA registered with either the SEC or the applicable state securities regulatory authorities for advisory business, and as a registered representative (RR) of an IBD that is registered with the SEC and applicable states, and is a member of FINRA for brokerage business.
3. All definitions and licensing information in this chapter come from the Cerulli Associates report Advisor Metrics 2009.

Hybrid growth drivers are many and diverse

The hybrid model continues to attract advisors in transition. In particular, growth in the dually registered hybrid model is adding momentum to the overall trend toward independence. In fact, it is one of the fastest-growing segments of the advisory business.

In terms of number of firms, advisor headcount and assets, growth of RIA firms with dually registered advisors has outpaced that of RIA-only firms. From 2004 to 2009, net headcount at dually registered hybrid firms grew at a compound annual growth rate (CAGR) of 14.7 percent, nearly three times that of RIA-only firms, which grew at a CAGR of 5 percent. During the same period, headcount in nearly all broker-dealer (BD) channels experienced flat to negative growth. (See Exhibit 1) Also during the same period, both dually registered and RIA-only firms experienced strong asset growth of 9.5 percent and 8.3 percent CAGR, respectively.[4]

These trends are expected to continue for the next several years. Between 2009 and 2014, market share in terms of advisor headcount is expected to increase at firms with dually registered advisors and RIA-only firms at the expense of other channels. (See Exhibit 2) According to Cerulli Associates, headcount market share at firms with dually registered advisors is expected to increase 3.5 percent, from 4.2 percent in 2009 to 7.7 percent in 2014. During the same period, headcount market share at RIA-only firms is expected to climb 4.2 percent, from 5.9 percent to 10.1 percent. In contrast, other channels are expected to see flat to negative growth in share.[5]

A NOTE ON TERMINOLOGY

For the purposes of this paper, *advisory* is defined as business for which an advisor, acting in the capacity of an investment advisor representative (IAR) of an RIA, typically charges a fee as a percentage of assets under management. Some wirehouse advisors or those affiliated with an independent broker-dealer (IBD) may consider advisory business to include fees from mutual fund revenue—for example, trailers paid as a share of the 12b-1 fees the broker-dealer (BD) receives from the mutual fund—or fees from other investment vehicles such as variable annuities. In these instances, the advisor is conducting business as a registered representative of a BD. Therefore, we classify this business as *brokerage* in the paper.

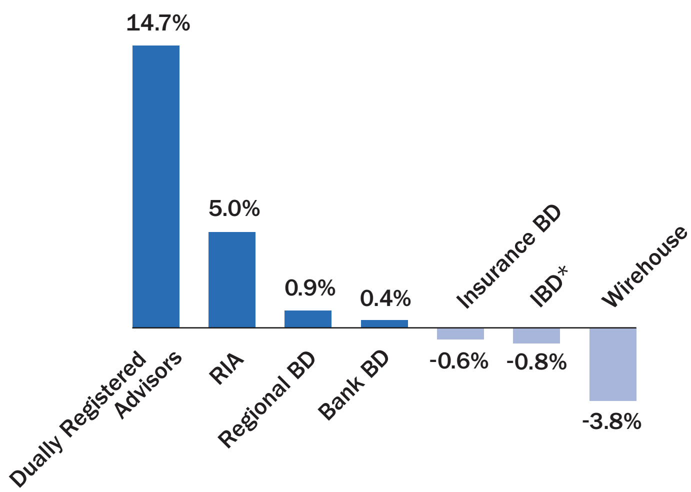
For ease of reference, this paper relies on commonly used industry terms and usage relating to the hybrid practice model, hybrid channel and hybrid advisors, such as the terms *dually registered* and *semi-captive*. These terms have developed over time as industry shorthand for various characteristics of advisors and their practices, such as firm affiliation, regulation, compensation and employment. However, use of these common industry terms can be imprecise, and by themselves, they may be insufficient to describe applicable regulatory structures, relationships and other characteristics. See Appendix A for a glossary of terms used in this paper.

The rapid growth is supported by trends both within advisors' practices as well as external forces in the market.

4. Cerulli Quantitative Update: Advisor Metrics 2010. Cerulli Associates, 2010.
5. *Ibid.*

EXHIBIT 1: HISTORICAL GROWTH RATE IN ADVISORS PER CHANNEL

Compound annual growth rate from 2004–2009



*IBD refers to semi-captive hybrid advisors.
Source: Cerulli Quantitative Update: Advisor Metrics 2010

Internal practice drivers

Advisors choose a hybrid model for several different reasons—both client-focused and business-focused. The primary reasons relate to business model flexibility, such as the ability to offer a broader set of solutions for clients. Secondary reasons have to do with business management and are mostly related to economics and autonomy.

Generally, advisors interviewed for this report cited multiple reasons for choosing a hybrid practice. Overall, it allows them to:

- Offer a broader solution set to help meet clients' financial planning needs
- Execute on core elements of their philosophy, with an expanded selection of alternative investments, structured products, private placements, annuities and insurance products
- Access market segments whose primary needs are for brokerage offerings, such as corporate retirement plans
- Control how the core client offering is designed and which providers are selected
- Stay flexible in a rapidly changing industry
- Preserve income, e.g., by maintaining trails from legacy brokerage business
- Attract hybrid advisors in transition as a way to grow the firm
- Meet client needs with an overall sensitivity to pricing. This may, for example, include taking a portion of a markup on fixed income rather than charging an asset-based fee.

External market drivers

In addition, several industry drivers are supporting the rapid growth of the hybrid model:

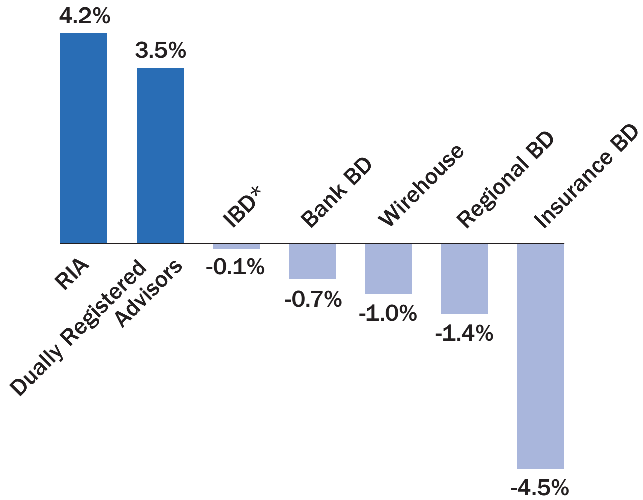
- **Open architecture.** The industry's shift toward an advice-driven model has created a more product-agnostic culture with less focus on proprietary products.[6] Advisors can now more easily blend advisory and brokerage offerings in whatever way best meets clients' needs. Major wirehouses have even been encouraging financial advisors to grow their advisory assets under management (AUM).[7]
- **Competitive pressure.** IBDs are under competitive pressure to increase AUM and want to meet their advisors' desire for advisory fee solutions. In response, many IBDs have loosened advisor restrictions and encouraged the growth of advisory business.[8]

6. Helen Kearney, Donna Mitchell and Lee Conrad, "Uncertainty Changes the Rules," *On Wall Street*, February 26, 2009.
7. Dan Jamieson, "Wachovia to unveil deferred-comp program," *InvestmentNews*, February 5, 2007; and Darla Mercado, "Merrill boosts bonus program," *InvestmentNews*, December 26, 2006.
8. Kristen French, "The Best of Both Worlds," *Registered Rep.*, March 1, 2006.

- **M&A activity.** Consolidators are increasingly active in the RIA business. These companies provide back-office support in exchange for a percentage of revenues or a minority stake in the acquired firm. To be competitive with acquisition targets, consolidators need to be flexible and open to different models, including the hybrid model.
- **Soft-landing firms.** There has been a steady increase in the number of firms offering advisors in transition a "soft landing." These firms provide back-office, compliance and other support systems, easing the transition to independence. Such firms may also maintain IBD relationships or establish their own BD to accommodate brokerage business and maximize their appeal to prospective advisors.[9]
- **Turnkey infrastructure.** IBDs and soft-landing firms have made significant investments in creating turnkey solutions for hybrid advisors, including flexible technology platforms that offer an integrated experience across brokerage and advisory assets.

EXHIBIT 2 : PROJECTED NET GAIN OR LOSS IN HEADCOUNT MARKET SHARE

2009–2014 Estimate



*IBD refers to semi-captive hybrid advisors.
Source: Cerulli Quantitative Update: Advisor Metrics 2010

Combined, these trends make a strong case for a continued sea change toward growing the advisory portion of a hybrid advisor's business. This change continues to fuel the steady growth of the hybrid model, and more specifically, the dually registered hybrid model.

Choosing between different hybrid practices—or not

Ultimately, choosing the hybrid channel and a particular hybrid practice model will depend on an advisor's philosophy and what is right for his or her clients. Some advisors prefer to sidestep the hybrid channel altogether, choosing the fully independent advisory RIA model.

This choice relieves advisors of having to maintain two separate registrations and manage compliance with two sets of rules. It also means they are not required to answer to an IBD for compliance procedures and oversight. (These areas are discussed in more detail on pages 14–15.) Moreover, there is the philosophical question of whether advisors would rather be paid on advice alone, avoiding any perceived conflict that comes with brokerage business. Finally, an advisor's brokerage business may not be large enough to justify the overall expense of maintaining it.

9. For more information, please refer to Schwab's 2010 MKT report Recruiting Advisors Turning Independent.

EXHIBIT 3: COMPARATIVE OVERVIEW OF ADVISOR PRACTICE MODELS

FULL AFFILIATION Broker-Dealer Advisor	**HYBRID ADVISOR**	**FULLY INDEPENDENT** Registered Investment Advisor
Employee of the broker-dealer (BD)	Employee or independent contractor of an Independent broker-dealer (IBD)	Fully independent; employee or owner of RIA
Conducts brokerage business as a registered representative (RR) of the broker-dealer	Conducts brokerage business as an RR of the IBD	Does not conduct brokerage business
Conducts advisory business through the BD's RIA	Conducts advisory business through the IBD's corporate RIA or an independent RIA	Conducts advisory business through an independent RIA
Receives brokerage or advisory compensation through a share of the BD's brokerage revenue	Receives brokerage compensation through a share of the IBD's brokerage revenue; may receive full share of advisory revenue	Receives full share of advisory revenue; takes on business risk of organization
Single compliance structure conducted by the BD	Dual compliance structure conducted by the IBD and RIA	Single compliance structure conducted by the RIA

TYPICAL HYBRID PRACTICE MODELS

Semi-Captive		**Dually Registered**
Advisor usually is not ready or does not want to move to an advisory-only practice.	**Typical Profile**	Advisor usually plans to conduct mostly advisory business or transition to advisory only.
Advisor is an employee or an independent contractor of the IBD.	**Employment**	Advisor starts or joins an independent RIA firm and is an independent contractor of the IBD.
Advisor is an RR under the IBD and an IAR under the IBD's corporate RIA.	**Registration**	Advisor is an RR under the IBD and an IAR of the independent RIA.
Some IBDs offer phantom stock or other equity substitutes. Book of business may be less portable and more difficult to value.*	**Equity and Ownership**	Principals of RIA firm own direct equity.
IBD fee schedule typically applies to both brokerage and advisory assets.	**Fees and Compensation**	IBD fee schedule applies to brokerage business; some IBDs levy an administrative charge on advisory assets.
IBD chooses the custodian(s) for both advisory- and brokerage-based client assets.	**Asset Custody**	Advisor can typically choose the custodian(s) for advisory client assets, and IBD chooses the custodians for brokerage-based client assets.
IBD manages all functions, including both advisory and brokerage business.	**Compliance and Supervision**	Advisor responsible for advisory business functions; IBD responsible for brokerage business and has some responsibility for advisory business.
IBD manages, and sometimes restricts, advisory and brokerage investment options.	**Product Selection**	Advisor may have more flexibility with choosing advisory services and investment options; IBD may restrict availability of brokerage options.
IBD typically provides turnkey infrastructure and support, including CRM, performance monitoring, operations, etc.	**Infrastructure and Support**	Advisor may leverage IBD turnkey infrastructure or choose to use third-party vendors to assemble a customized platform.

* More information about equity and ownership can be found in Schwab's 2010 MKT report Establishing an Effective Owner Compensation Plan.
Note: A glossary of terms is provided in Appendix A.

Advisors who do choose a hybrid practice should investigate the cost, administrative impacts and other factors before deciding between the different types of hybrid practices. The semi-captive model may offer some advantages by providing a more familiar structure for advisors in transition. But, there are also significant potential costs involved in added fees that apply to different parts of the business. There may also be more restrictions on products, services and revenue models—any or all of which may impact how an advisor runs his or her practice. Further, changing practice models—from semi-captive to dually registered, for example—can require re-papering clients, which can be disruptive for an advisor's business.

CONSIDERATIONS FOR EVALUATING THE HYBRID CHANNEL

When considering a transition, advisors face many fundamental decisions about their future, and the hybrid channel opens new choices in many key practice areas. But choosing a hybrid model can have wide-ranging impacts on the client offering and economics of their practice. So, it is important that advisors understand the potential implications across their entire business.

This chapter addresses considerations in five key practice areas:

1. Business objectives and value proposition
2. Investment philosophy and access to investment choices
3. Infrastructure and service model support
4. Regulatory and compliance
5. Economics and ownership

Consideration #1: Business objectives and value proposition

An advisor in transition is faced with many decisions about objectives, identity, mission, ideal client, investment approach and a range of other philosophical issues. Decisions in each of these areas will have specific implications for whether the hybrid model will work for a given advisor.

- **Business objectives.** It is critical that hybrid advisors think through all the areas listed above, paying specific attention to potential benefits and constraints within each type of hybrid practice. Robert Reby, founder of the dually registered hybrid firm Robert J. Reby & Company, Inc., summed it up this way: "First of all, they better spend a lot of time in the business-planning process and ask themselves, What do I want to look like when I'm done?" This decision is critical. Once the business is established, changing practice models can be difficult.
- **Equity ownership.** One of the most fundamental considerations for any advisor in transition is ownership and entrepreneurship. According to Reby, "The biggest transition is one of mindset. Do you have an equity mindset?" He adds, "Most advisors are very success-driven, but that's not the same thing as being entrepreneurial."

  For hybrid advisors, entrepreneurship and an equity mindset are critical to making the right choice between starting an independent RIA, joining an existing independent RIA or joining an IBD's corporate RIA. If their long-term goal is to own their own firm or conduct an advisory-only practice, a dually registered model may be a better choice than a semi-captive model. Equity ownership is discussed in more detail on page 16.

- **Firm value proposition.** What is my firm's value proposition, and what kind of offering is necessary to support it? This is the first question advisors should ask themselves when considering a transition. Within this context, the hybrid channel can provide continuity for advisors who maintain both brokerage and advisory business, if continuity of their offering is what they need to deliver on the firm's mission and brand promise.

  For example, many advisors within both the money management and wealth management sectors may have different reasons for maintaining a dual registration. A money manager may maintain a dual registration to advise on and invest in fixed income products for their clients while being compensated through receipt of a portion of the markup from their BD, rather than charging an asset-based advisory fee. For wealth managers, dual registration may help facilitate delivery on the brand promise and business model by providing expanded access to solutions such as annuities and insurance, alternative investments, structured products, and private placements. In this regard, evaluating the hybrid option ties directly back to an advisor's core identity and philosophy.

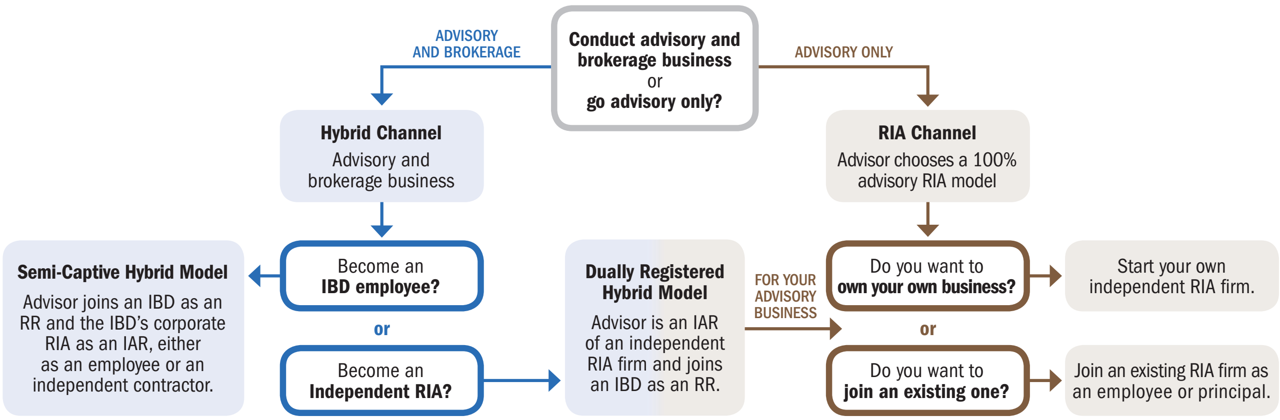
  Francis Hoey, founder of the dually registered firm Hoey Investments, Inc., says his firm does the vast majority of its business on the advisory side as a money manager. But he finds that clients are increasingly concerned with guaranteed income in retirement, a need that can be filled with a broader selection of annuities and similar products. He says, "Business development is really driven through the RIA. But the dual registration is there to meet clients' needs that are outside of the RIA model."

SETTING YOUR OBJECTIVES

Determining whether the hybrid approach—and which hybrid model—is right for you requires a process of self-assessment and setting objectives, not just for how you run your business today, but for how you want it to look years from now.

- What is your investment approach (e.g., model portfolios), and how actively do you trade or rebalance?
- What type and mix of investments do you plan to manage? For example, alternative investments, private placements, mutual funds, individual stocks, options, restricted stock, insurance.
- What percentage of your revenue/assets will be advisory-based versus brokerage-based?
- Do you want to retain your brokerage business, or will you be sunsetting that business over time?
- In which parts of your business do you expect to see the most growth?
- What type of support will you need and most value? For example, compliance, reporting, practice management, investment proposals.
- What is your target income, and how much are you willing to reduce your payout in return for support or other services?

EXHIBIT 4: BUSINESS MODEL DECISION POINTS FOR ADVISORS IN TRANSITION



- **Local market opportunity.** Advisors should also consider their local market. Is there enough of one kind of client or prospect for the advisor to specialize in a single offering, or is a broader offering necessary to build the practice?

  Alex Brown, a partner with the dually registered hybrid firm Genovese Burford & Brothers, says, "In a larger market, you can really just be providing one offering and still have a lot of prospects. In a smaller community like this, our business was built on taking care of many aspects of a client's financial situation."

- **Business fit.** For advisors who do not want to start their own independent RIA, and who would rather join an existing firm or an IBD's corporate RIA, it is important to know what kind of advisor that firm may be looking to recruit. Just as recruiting firms may have AUM targets for joining advisors, hybrid firms often have targets for business mix, such as minimum levels of advisory business. The mix can vary quite a bit, so it is important to know the target mix of the recruiting firm.

- **Business flexibility.** As the advisory business continues to change and practice models continue to evolve, advisors may want to consider whether they want to rely on a single practice model. According to Fran Hoey of Hoey Investments, "When you do something like go independent, it's very important to enter into a model that you're comfortable with. And this business is changing so fast that, for me, being 100 percent wedded to one specific approach is beyond my comfort zone. It's easier to keep all options open by maintaining dual registration than to have to go back and get it again."

- **Practice growth.** If an advisor intends to start his or her own RIA and grow the business by adding advisors, then the hybrid channel may be an appealing option. According to Mark Penske, CEO of the independent firm United Advisors, LLC, "Without having the broker-dealer and RIA capabilities coupled together, we would be missing out on a lot of advisor acquisition opportunities in the marketplace."

Consideration #2: Investment philosophy and access to investment choices

Investment philosophy is just as important as business philosophy when it comes to assessing hybrid options. Selection of, and access to, an expanded array of alternative investments, structured products, initial public offerings and guaranteed income products like annuities can be more limited in the advisory space compared with what is available on brokerage platforms. Executing an investment strategy may require the broader set of choices and investment instruments a brokerage platform can make available.

Access to a wider selection of investments and providers can complement the control and flexibility the hybrid advisory model provides. Hybrid advisors interviewed say the synergies are most apparent in wealth management and retirement planning, where access to a broader range of options can play a key role in meeting clients' needs.

For example, when it comes to retirement planning, Robert Reby, of Robert J. Reby & Company, Inc., believes in a "three-legged stool" approach: Social Security, investment income and guaranteed income. "Since traditional pensions have gone away for a lot of people, we look at replacing that with some other form of guaranteed income you can't outlive, like an annuity," he says. After nearly a year of due diligence, his firm incorporated annuities into its process. "It's brokerage, but we need it because it's an inherent part of our approach, which is to minimize the chance of a client outliving their money," he says.

The right mix for your practice

Because of an IBD's oversight responsibilities, many IBDs restrict advisors' investment choices for brokerage and advisory business, especially for semi-captive advisors. Independent RIAs working under the dually registered hybrid model may have more flexibility in choosing advisory solutions, though their BD may provide some oversight.

Some IBDs under the semi-captive model may also require new advisors to use existing model portfolios or other approved investments where they have already conducted due diligence. Others, like United Advisors (a soft-landing firm), may require advisors who join the firm to use the firm's model portfolios while also offering independent affiliates working under the dually registered model the freedom to run their own model portfolios.

LESSONS LEARNED

Business objectives and value proposition

- Business considerations play an important role in making the right choice among available hybrid options.
- The advisor's core mission and philosophy should be primary drivers in the hybrid decision, along with:
  - Key external drivers, including the needs and demographics of ideal clients, as well as an assessment of potential market opportunities
  - Investment approach—for example, does the advisor's approach require brokerage-based products for effective implementation?
- Tangible business goals and drivers such as growth by acquisition, equity ownership, flexibility and fit should be carefully weighed against other variables.

According to United Advisors' Mark Penske, "Advisors think they want access to everything, and at some level from a client perspective, you should be able to do that." But, he says too much can be overwhelming, especially for wirehouse advisors, who generally have had their former firm's due diligence committees managing the selection process for them. He sees most advisors in transition sticking closely to what they know, and he counsels them that "It's OK to get used to the new environment first, and then as you grow and gain confidence, you can explore all the other investment choices out there."

Advisors whose investment approach includes active rebalancing of client portfolios should consider the higher potential fee impact of the hybrid model. IBD ticket charges tend to be higher and can potentially raise the cost of rebalancing, creating tension between cost containment and executing the advisor's rebalancing strategies.

The key takeaway is that if investment choice is important—and if it's a central consideration in choosing the hybrid channel and the semi-captive model in particular—then understanding any potential restrictions in advance is critical to making a choice that best suits the advisor and his or her clients.

Consideration #3: Infrastructure and service model support

For advisors in transition, infrastructure and service model support can be key components of the decision-making process.

Systems and support

Any transition brings a range of new operational and service model considerations, especially in the area of systems and technology, including customer relationship management (CRM), performance reporting, asset allocation, rebalancing, trade order management, and data input and reconciliation. Hybrid advisors will have a choice among the following:

- Packaged tools and support offered as part of an IBD platform
- Packaged solutions from custodians, independent vendors and technology management firms
- Custom-built solutions for their own RIA or for an independent RIA they might join[10]

Exhibit 5 outlines the services and capabilities a newly independent advisor will likely be considering. The depth of capability and integration of different solutions can vary dramatically, and very few firms offer a full spectrum. An important rule of thumb is that turnkey solutions are generally the easiest but least flexible option.

Some key infrastructure considerations include:

- **IBD platforms.** With some IBD platforms, hybrid advisors can get access to a turnkey infrastructure solution, and some IBDs now allow advisors to choose what they most want from a menu of services, which can help manage costs. The drawback is that the advisor is wedded to the systems and configurations the IBD has chosen; there may be little flexibility to customize.

10. Various approaches to managing these issues are covered by reports in Schwab's MKT series, including: A Case for Starting or Joining a Registered Investment Advisory Firm; Best Managed Firms: The Business of Serving Clients; and Getting The Most Out of Your CRM Investment.

- **Outsourced platforms.** A second option is to find an outsourced solution that more closely meets the advisor's needs, including potentially using the back-office capabilities of a soft-landing firm. Non-IBD outsourcing options can offer more choice, in addition to the ease and efficiency of a turnkey solution. But these outsourced solutions, though potentially more tailored, are often bundled in the same way as IBD platforms and may face similar limits in flexibility.
- **Custom-built platforms.** Advisors can choose among different technologies to build their own platform solution. This strategy offers the greatest choice in terms of flexibility, vendor options and integration strategies to support specific business goals and client needs. The trade-off is that it can have higher near-term costs and may require more time and resources to manage.

Ultimately, advisors need to consider their firm's unique value proposition: How much will the service model depend on customizing communications, reporting and other facets of the client experience? What kinds of portfolios will the firm be managing? What kind of systems will best support the firm's investment philosophy and the services it provides to clients? Such questions will help advisors focus on what kind of technology and support they will most need and value.

Service model

In addition to technology and systems support, advisors interviewed for this report highlighted several areas that advisors in transition should keep in mind when considering the hybrid model, including the following:

- **Brand.** According to hybrid advisors, client communications such as statements, trade confirmations, etc., from IBDs and/or the IBDs' clearing firms tend to prominently feature the IBD's brand; sometimes it even overshadows the advisor's own brand. Because of the frequency and nature of client correspondence, brand recognition can be an important consideration. The advisor should understand and be prepared to tell the IBD's brand story to clients.
- **Service quality.** Advisors should weigh cost along with service quality when evaluating vendors and partners. In the hybrid model, dually registered advisors may have to conduct two levels of due diligence: one on the custodian selected for advisory

EXHIBIT 5: SERVICES AND CAPABILITIES

Considerations for advisors in transition

Client Management	Client relationship management Client profiling and proposals Asset allocation modeling
Investment Management	Research Rebalancing Trade order management Portfolio management
Performance Monitoring	Data aggregation Reconciliation Performance reporting
Operations	Billing Compliance tools Back-office support
Business Development	Marketing tools Websites Email communications

business and one on the IBD. Advisors who join an IBD's corporate RIA may only need to conduct due diligence on one company, but the advisory and brokerage operations may function separately.

- **Interaction with service providers.** For semi-captive advisors, the IBD may restrict interaction with third-party providers such as investment or technology providers. It is common practice to require advisors to address service issues via the IBD's internal staff, letting the IBD contact the relevant third party on the advisor's behalf. This added administrative layer can provide additional recourse for advisors in the event of problems. However, working through an intermediary can also slow down the resolution process. Advisors should obtain details of the IBD's problem resolution process as part of their due diligence.

Consideration #4: Regulatory and compliance[11]

The hybrid practice model requires operating under a dual-compliance structure: first, that of the RIA firm for which the hybrid advisor is an IAR, and second, that of the IBD for which the hybrid advisor is an RR. The regulatory structure breaks down as follows:

- The RIA, through which the hybrid advisor conducts his or her advisory business, is regulated primarily by either the SEC or the applicable state securities regulatory authorities.
- The IBD is regulated primarily by FINRA, a self-regulatory organization; however, the SEC and states also have regulatory jurisdiction over the IBD.

In addition to regulating the IBD's brokerage business (including that of the hybrid advisor), FINRA's rules also extend to the advisory activities of the IBD's representatives, including reporting, client communications and sales for the entire firm.

This is a key point: Any IBD the hybrid advisor associates with has an obligation to supervise the advisor's advisory business, as well as the advisor's brokerage business. This is the case regardless of whether the advisor maintains an independent RIA or is doing business through the IBD's corporate RIA. Working with the IBD's compliance department is a fact of life for hybrid advisors, no matter which hybrid option they may choose.[12]

Some advisors express deep frustration with IBD compliance oversight, while others see it as a potential benefit. According to Mark Penske of United Advisors, "Ultimately, if you are going to operate in a dually registered capacity, you need to embrace compliance. IBDs take a hands-on approach, and it can frustrate some people, but they are paid to be a second set of eyes on things, and I think it's an added benefit."

An overview of IBD compliance oversight

Advisors interviewed for this report offered the following key insights into IBD compliance management and dual supervision:

- **Variation among IBDs.** In general, respondents said that there was little variation in the oversight regimen of a single IBD (i.e., whether you join the IBD's corporate RIA or are affiliated through an independent RIA). Some did report, however,

11. This report is general and for informational purposes only. It is not intended as legal or regulatory compliance advice. Readers are urged to consult their own legal counsel and compliance advisors.

12. Advisors should be aware that the Dodd-Frank financial regulatory reform law enacted in 2010 has required studies and future rule making that could significantly change the regulatory landscape for advisors, brokers and hybrids. For example, the SEC is to conduct a study assessing any gaps in regulation between investment advisors and broker-dealers. In addition, the law has raised the AUM an RIA must have to register with the SEC from $25 million to $100 million. For many advisors transitioning to independence, this will mean that, to start their own RIA, they will be required to register with the applicable state securities regulatory authorities and will not be eligible to register with the SEC instead.

that there can be variations between IBDs, in both overall philosophy and day-to-day implementation in terms of processes, procedures, response times, etc. So, it is important to understand each IBD's overall compliance approach and process before choosing the best fit.

- **Working with IBDs.** For advisors coming from a wirehouse environment, respondents suggested that IBD compliance would not likely be much of a change from what they are already used to. "They are used to that type of compliance environment, so it is really a lateral move for them," says Matt Cooper, partner and managing director of the independent firm Beacon Pointe Wealth Advisors, LLC.

  The key challenge, according to respondents, is that given their supervisory standard, IBDs sometimes view common client communications as solicitations of trades. For example, a newsletter about portfolio rebalancing that includes the names of specific funds might be viewed as a solicitation to trade, in addition to a portfolio report. The question of whether a communication is providing information or soliciting trades appears to be most important for advisors with the vast majority of their assets on advisory platforms. They stated that working with IBD compliance on the nature of advisory business comes with the territory for hybrid advisors.

- **Process efficiency.** A large part of the frustration with IBD compliance, according to respondents, was logistics and turnaround times. Some said that compliance review can take weeks and that it hampers their ability to communicate with clients and implement marketing programs.

  Mark Penske of United Advisors suggests that, when dealing with IBD compliance, hybrid advisors need to be very programmatic: "I think advisors get frustrated because they develop a communication and want it to be out tomorrow. But it can't be. You need to have proper procedures in place, plan as much as possible in advance, and work efficiently within the parameters set out by the broker-dealer."

Choosing an RIA compliance model

IBD supervision for hybrid advisors is a given. IBDs manage compliance for all brokerage business and retain some oversight for the entire book of business (including advisory), even for independent RIAs.

However, hybrid advisors have two options for managing the RIA compliance function:

- **Semi-captive hybrid model.** By choosing this model, the advisor allows the IBD to assume direct management of all compliance functions, including RIA compliance.
- **Dually registered hybrid model.** When an advisor starts an independent RIA or joins an existing firm, the RIA firm assumes responsibility for managing the RIA compliance function and having its own chief compliance officer. The IBD still manages the compliance function for its brokerage business, and has some oversight responsibility for advisory business.

Advisors should note, however, that choosing the semi-captive model just to avoid managing the RIA compliance function can carry many potential restrictions on the practice and costs to the business, all of which need to be factored

LESSONS LEARNED

Compliance

- Compliance regimens can vary between IBDs; get to know the firm's approach before signing on.
- Working with IBD compliance is part of the relationship for advisory hybrid advisors.
- Plan communications and marketing initiatives as far in advance as possible, so you can work within the IBD's review parameters.
- Associating with an IBD's corporate RIA in order to avoid managing the RIA compliance function can subject the advisor to restrictions and added expenses for things like investment products and ticket charges.
- External legal counsel, or outside consultants, can help advisors improve the efficiency of the internal compliance management process.

into the decision. For example, semi-captive advisors can face restricted access to investment products, as well as higher administrative charges on advisory assets (as much as 15 percent of revenues), account fees, wire fees, ticket charges and other expenses, which can significantly impact the payout.

Managing your own compliance

While the prospect of managing RIA compliance on your own can seem daunting to many advisors in transition, the hybrid advisors we interviewed said that it is not burdensome. Many advisors have found that retaining outside legal counsel or compliance consultants familiar with their business model can assist them with their overall responsibilities and streamline the process. In many cases, these resources range from assisting firms with their compliance manual to day-to-day compliance procedures and annual review requirements.

According to Fran Hoey of Hoey Investments, who recently launched his own RIA, "The learning curve was huge. Most wirehouse advisors don't even know what an RIA is, or that they probably are already working under a corporate RIA."

But he says hiring a law firm to walk him through the process and help manage ongoing compliance functions put his mind at ease: "Now, I literally have a checklist of everything I need to do. And even though I was nervous about doing compliance on the RIA side, it has proved to be pretty easy."

Consideration #5: Economics and ownership

The economic considerations facing hybrid advisors are similar to those facing any advisor in transition, though choosing a hybrid model can add a unique twist to the basics, like equity ownership, as well as several other considerations related to independence. In addition to the primary consideration of what is best for clients, advisors considering the hybrid channel should consider:

- **Equity ownership.** Do you have an equity mindset, and will you want to monetize your practice at some point in the future?
- **Income preservation.** How much existing brokerage business income do you want to retain?
- **Future income goals.** What level of income do you hope to achieve?

- **Future income mix.** How important will brokerage products be in serving the best interests of your clients as your investment philosophy evolves over time?
- **Personal investment.** How much time and effort are you willing to invest to achieve the income you want?

Taking a broad approach to assessing long-term and short-term goals, as well as implicit trade-offs, will help advisors decide on the right practice model. In our interviews and research, we gained the following insights into the economics of practicing within the hybrid channel:

- **Hybrid vs. advisory only.** Even though there can be a slight economic advantage in operating expenses for the pure advisory-only model, factors related to business philosophy and the structure of the client offering are more important in the hybrid model.
- **Payout calculation.** Calculating potential payout is perhaps the biggest challenge for advisors considering the hybrid channel. The key decision is between joining an IBD's corporate RIA, and starting or joining an independent RIA. Here, economic questions relate to charges and fees that can reduce the gross payout, including:
  - *Charges on RIA (advisory) assets.* As discussed earlier, IBDs often levy an administrative charge to compensate for oversight on advisory assets. This is typically charged as a percentage of advisory revenue. Such charges are commonly 5 percent or less for dually registered hybrid firms, but can be as much 15 percent for semi-captive advisors.
  - *Administrative fees.* IBDs typically charge administrative fees based on total assets in each account. These fees can have breakpoints for larger accounts, but that means the fees hit small accounts disproportionately hard.
  - *Ticket charges.* Ticket charges can be a large concern or a small one, depending on how actively the advisor trades. For advisors who do regular tactical reallocations, these charges can be substantial. It is a good idea to calculate approximate ticket charges based on historical trading patterns to see what the potential impact would be on the payout.
  - *Revenue restrictions.* Semi-captive advisors may also face restrictions on their revenue structure—such as limits on retainer fees, asset management fees or planning fees. It is important that advisors have a clear idea of their offering so they can identify the potential impacts of choosing the semi-captive hybrid model.

LESSONS LEARNED

Economics and ownership

- Pure RIA and hybrid RIA practices may have similar operating expenses, so the choice between them should be more about an advisor's aspirations and business philosophy.
- Hidden fees and expenses can affect payout—advisors need to understand all the potential charges that may affect the payout.
- To get a realistic figure for potential payout, advisors should do an estimated calculation based on a year's worth of actual trading and investment management data.
- Personal investment is critical; offloading compliance, systems and technology or other practice management issues to an IBD carries costs to the business, as well as trade-offs.
- Equity ownership is a fundamental consideration when deciding between starting an independent RIA, joining an existing independent RIA or joining an IBD's corporate RIA.

- **Equity ownership.** The final, and perhaps most fundamental, economic question for any advisor in transition relates to securing equity ownership in the practice. Many advisors in transition will face a similar question of whether or not they want to start their own business or join an existing firm.

  With respect to selecting the most appropriate hybrid model, this is a critical choice. If owning and running a business is important to an advisor, the best option could be the independent RIA model or the dually registered hybrid model, i.e., starting an independent RIA as a principal with dual registration as an RR of an IBD. If running a business is less appealing, joining an independent RIA or going the semi-captive hybrid route by associating with an IBD's corporate RIA may be more appropriate, understanding that these choices may bring financial and operational restrictions.

  Advisors holding equity actually own a business entity that can be monetized and/or sold. In the semi-captive model, advisors may not own a legal entity that can be sold, and therefore they may be required to apply a discount to a book of business that does not come with the firm attached.[13]

13. For more information about firm valuation, refer to Schwab's 2010 MKT report Transition Planning: Valuation and Deal Structure. More information about owner compensation can be found in Schwab's 2010 MKT report Establishing an Effective Owner Compensation Plan.

CONCLUSION

As the financial advisory business continues to evolve, advisors may expect more choice and flexibility in how they structure and operate their practices. Each choice has merits, and also comes with trade-offs.

The best choice for a specific advisor will depend on the needs of current and target clients, as well as the advisor's professional objectives, such as where they want to be in five years. With respect to the hybrid channel specifically, key considerations include:

- The degree to which brokerage and advisory product diversification is important to the advisor's philosophy and management approach
- Long-term and short-term revenue goals
- The freedom to choose business partners and vendors for their service quality, cost, reputation and long-term financial stability
- The strategies that will be used to grow the business
- Equity ownership, and whether it is a long-term financial and business objective

Ultimately, there may not be a typical or ideal hybrid model. Rather, just as with any investment decision facing an advisor, the process of weighing priorities, risks and rewards will yield the right decision for each individual. We found that hybrid advisors choose this practice model for a variety of reasons and benefits that suit their unique situation, and more importantly, with a goal of serving their clients in the most appropriate way.

For more information or assistance, contact your Schwab representative or call 877-314-7821.

APPENDIX A: GLOSSARY

Below is a glossary of common terminology used throughout this report. These definitions have developed over time as industry shorthand to describe compensation and employment practices for hybrid advisors.

Advisor	An individual investment professional, as opposed to a firm, who provides investment advice to clients, perhaps along with other investment services such as brokerage. (See hybrid advisor, on page 21.)
Advisory business	In this report, advisory business is defined as business for which an advisor, acting in the capacity of an investment advisor representative (IAR) of an RIA, typically charges a fee as a percentage of assets under management. That RIA may be independent of or affiliated with the broker-dealer where the individual advisor is a registered representative in order to conduct the brokerage part of his or her hybrid practice.
Brokerage business	For purposes of this paper, brokerage business is defined as business conducted by a registered representative of a broker-dealer to provide clients with brokerage services and incidental advice that is within the brokerage exemption from the Investment Advisers Act. Brokerage business can also include compensation outside of commissions, including fees from mutual fund revenue—for example, trailers paid as a share of 12b-1 fees the broker-dealer receives from the mutual fund—or fees from other investment vehicles such as variable annuities.
Broker-dealer (BD)	In this report, we use this term to refer to firms engaged in the business of effecting transactions in securities for the accounts of others (broker) or for its own account (dealer). Broker-dealers must register with the Securities and Exchange Commission (SEC) and be a member of a self-regulatory organization, usually the Financial Industry Regulatory Authority (FINRA).
Consolidator	These companies provide back-office support in exchange for a percentage of revenues or a minority stake in the acquired firm.
Corporate RIA	A registered investment advisor that is owned by an independent broker-dealer.
Financial Industry Regulatory Authority (FINRA)	The most common self-regulatory organization (SRO) of which BDs are members. FINRA administers the registration and licensing of individual brokers or RRs, through Form U-4 and the Series 7 qualification exam, among other things.

Hybrid advisor	An advisor whose practice includes both investment advice rendered as an investment advisor representative of a registered investment advisory firm, as well as brokerage services, which may include advice, as a registered representative of an independent broker-dealer.
Independent RIA	A registered investment advisor that is not owned by a broker-dealer, bank, insurance company or other large financial services firm. Independent RIAs are generally owned by the principal individual advisors who run them and act as independent advisor representatives of a firm.
Independent broker-dealer (IBD)	A broker-dealer that is not affiliated with a commercial or investment bank or investment company but may be affiliated with an insurance company.
Investment advisor representative (IAR)	An advisor who is employed by, or otherwise associated with, and renders investment advice to clients on behalf of a registered investment advisor.
Registered investment advisor (RIA)	For purposes of this report, a firm (not an individual) that is registered as an investment advisor with either the SEC or the applicable state securities regulatory authorities. While an advisor (individual advisory professional) can register as an investment advisor, the vast majority of them are investment advisor representatives of RIA firms and need not register as RIAs themselves.
Registered representative (RR)	An individual professional who is employed by, an independent contractor of, or otherwise associated with (i.e., an "associated person" of) a broker-dealer and is engaged in the securities business of the firm, often interacting with clients.
Securities and Exchange Commission (SEC)	The federal regulatory authority in the United States with jurisdiction over securities markets and businesses, including registered investment advisors and broker-dealers, as well as self-regulatory organizations, such as FINRA.
Soft-landing firm	These firms provide back-office, compliance and other support systems, easing the transition to independence.

APPENDIX B: METHODOLOGY

As part of our research, Schwab interviewed six independent advisory firms—including semi-captive and dually registered hybrid firms—to gain insight into the issues and considerations related to choosing the hybrid practice model. In addition to this firsthand information, we used our own knowledge and expertise gained from years of consulting with advisory firms and advisors transitioning their practice.

APPENDIX C: FIRMS INTERVIEWED

We thank the firms listed below for their participation and the insight they shared during interviews for this project.

Beacon Pointe Advisors, LLC	**Newport Beach, CA**
Gateway Advisory, LLC	**Westfield, NJ**
Genovese Burford & Brothers	**Sacramento, CA**
Hoey Investments, Inc.	**West Chester, PA**
Robert J. Reby & Company, Inc.	**Danbury, CT**
United Advisors, LLC	**New York, NY**