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What Are the Opportunities and Risks Associated With **Operating a Hybrid RIA?**

One of the financial services models that has gained the most traction in the past decade is the hybrid RIA model. With this model, financial advisors can provide clients not only with brokerage products and services as a registered representative of a broker-dealer, but also investment advisory services as an investment adviser representative of an investment adviser (so-called dual-registered representatives). With a broader universe of brokerage and advisory services and products than is typically available through a stand-alone brokerage or advisory firm, dual-registered representatives can better tailor their advice to clients and simultaneously expand the universe of potential clients they can serve when operating through a hybrid RIA.

Nonetheless, the hybrid RIA model is often misunderstood. This is due, in some part, to the fact that the hybrid RIA is not a single uniform business model, but rather, multiple variations on the same model. Each type of hybrid RIA has its own unique opportunities and challenges, and we will delve into the factors that make each of these variations unique. We will also explain some of the unique compliance risks associated with operating under the hybrid RIA model.

INTRODUCTION

Although there are numerous iterations of the hybrid RIA model, there are three general structures along a spectrum of independence:

- The semi-captive model (providing the smallest degree of independence).
- The affiliation model (providing some degree of autonomy).
- The dual-registered firm model (providing the most independence to the operator).

THE SEMI-CAPTIVE MODEL

The semi-captive model is a structure whereby personnel associated with a broker-dealer can not only provide brokerage services as a registered representative of the brokerage firm, but also advisory services as an investment adviser representative of an investment advisory firm owned by the broker-dealer (the so-called corporate RIA). The representative typically does not own any equity in the corporate RIA nor have any authority to manage the affairs of the corporate RIA.

This model is well-suited to financial advisors who wish to provide more and better services to their clients. It allows them to focus their efforts on managing their practice and clients without having to manage (and without incurring the time and expense associated with managing) other aspects of a business, including the operational, compliance and finance functions. Typically, individuals who select to operate under this model are paid a percentage of the revenue they generate for both the broker-dealer and the corporate RIA.

Broker-dealers are increasingly offering this option to incentivize registered representatives to maintain their affiliation with the brokerage firm instead of launching their own advisory firm or joining another firm with an investment advisory practice.

Individuals operating under the semi-captive model are subject to supervision and oversight not only with respect to their brokerage services, but also with respect to their advisory services because they operate under the broker's corporate RIA. While certain brokerage firms will allow individual advisors to market their practices through their own brand names and/or websites, ultimately, the individual advisors are independent contractors of the corporate RIA, and the clients are clients of the corporate RIA, not the individual advisor. Therefore, individual advisors wishing to eventually monetize their business under this model or retain flexibility in moving their clients to another firm in the future should negotiate upfront with a firm offering this model to ensure the firm will not impose non-competition and/or non-solicitation covenants if the individual advisor wishes to eventually terminate its association with the firm. Depending on the circumstances, individuals exploring this model might also face limitations in the universe of services and products that are made available by the corporate RIA.

THE AFFILIATION MODEL

Under the affiliation model, an individual or team can launch their own advisory firm and maintain an affiliation with an unaffiliated brokerage firm where some or all of the advisory firm's personnel can also serve as registered representatives of the unaffiliated brokerage firm. In this model, the financial advisor does not own the brokerage firm, but rather still serves as an independent contractor of the unaffiliated brokerage firm. When operating through this model, an individual advisor or a team of advisors that launches the advisory practice maintains ownership and control over the firm and the advisory clients they serve. Nonetheless, clients served through the unaffiliated broker-dealer are customers of the broker-dealer.

Dual-registered representatives who launch their own RIA are typically compensated for rendering

advisory services through their equity ownership in the advisory firm and for brokerage services through the receipt of a percentage payout based on the revenues they generate for the brokerage firm.

Those who launch their own RIA are responsible not only for managing their own advisory practice, but also for management of the entire advisory firm, including the operational, compliance and finance functions. While some or all such functions can be outsourced, such services come at a cost.

The affiliation model is popular with advisors who want to launch an independent advisory firm and have clients with legacy brokerage or insurance assets (such as fixed or variable annuities) that may not be serviced through the advisory firm, and the adviser wishes to continue rendering services with respect to such assets through the affiliation with a brokerage firm to provide more holistic financial services to the client.

Those operating under the affiliation model are responsible for developing their own compliance program with respect to their advisory services and ensuring that dual-registered personnel comply with applicable state or U.S. Securities and Exchange Commission (SEC) rules governing the advisory business. With respect to the brokerage business, any dual-registered representatives remain subject to the broker-dealer's compliance program, including any applicable written supervisory procedures. Such procedures often include the requirement to submit outside business activities and private securities transactions for pre-approval (including affiliation with the advisory firm), the requirement to submit brokerage marketing materials for pre-approval, and the requirement to follow FINRA rules pertaining to communications regarding brokerage services.

Brokerage firms will also typically require that dual-registered representatives submit their email and other communications for monitoring by the brokerage firm, which could result in the broker-dealer having access to communications regarding the advisory services rendered by the dual-registered representative.

DUAL-REGISTERED FIRM MODEL

Under the dual-registered firm model, an individual or team can own a firm that operates both an advisory practice and a brokerage practice. The practices can either be operated through a single entity or through affiliated entities owned by the principals. In either scenario, the principals maintain ownership and control of the firm and both the advisory and brokerage clients. They also maintain the right to manage the advisory and brokerage business without supervision and oversight from an outside firm.

Nonetheless, advisors selecting this model have sole responsibility to manage the operational, compliance and finance functions of the advisory and brokerage business and to ensure that the dual-registered firm complies with both applicable state or SEC investment advisory regulations, as well as applicable FINRA and other rules pertaining to the brokerage business.

This model is well-suited for advisors wishing to maintain the most autonomy possible with respect to their business while offering clients both advisory and brokerage services.

REGULATORY CONSIDERATIONS FOR HYBRID RIAS

Hybrid RIAs have drawn scrutiny from the SEC in recent years because there are some unique compliance risks associated with operating under the hybrid RIA model.

For starters, the SEC is particularly keen on ensuring that dual-registered representatives operating under a hybrid RIA clearly explain when they are acting as an advisory employee and when they are acting as a registered representative of a broker-dealer. That's especially important given that SEC-registered firms are subject to two different standards of conduct – with SEC-registered investment advisers being subject to fiduciary duties of care and loyalty while broker-dealers are subject to Regulation Best Interest when it comes to serving retail customers . Practically speaking, it can be challenging for dual-registered representatives and firms to clearly and consistently communicate to clients when they are acting in an advisory capacity and when they are acting in a brokerage capacity, especially if they are serving clients in multiple capacities. The failure to clearly communicate the capacity in which a dual-registered representative is acting at all times can lead to client confusion and potential allegations of misleading the client.

The SEC has also highlighted potential concerns about various conflicts of interest that can cause a dual-registered representative to violate its fiduciary duty to its clients. Among other things, a firm that offers clients both advisory services and brokerage services must initially and periodically determine whether advisory services or brokerage services are appropriate for the client. In doing so, they must consider various factors, including the amount of monitoring and supervision being conducted on behalf of the client and the costs of such services. The failure to select the proper account type for the client can be viewed by the SEC as a violation of the firm's fiduciary duty of care owed to the client.

Similarly, a firm that offers wrap fee program services (i.e., an arrangement whereby both investment advisory and brokerage execution services are offered for a single fee) must initially and periodically thereafter determine whether the wrap fee program is appropriate for the client. In doing so, they must consider various factors, including, without limitation, the amount of trading being conducted on behalf of the client, as well as the costs of wrap fee program services. A firm that fails to conduct such analyses and to put clients in the proper account type can potentially be sanctioned for violation of its duty of care to its clients .

Dual-registered representatives must also be cognizant of recommending, as an investment advisory representative, investments where the firm or representative is entitled to receive compensation on the brokerage side in connection with the recommendation of such products (e.g., Rule 12b-1 fees or revenue share payments in connection with investments recommended) . Failure to make full and fair disclosure of such conflicts of interest and, where appropriate, to manage such conflicts, can violate an SEC-registered investment adviser's duty of loyalty owed to its clients. In addition, where the recommendation is made in connection with advice pertaining to certain retirement assets (including 401(k) assets or individual retirement account assets), such recommendations could violate the prohibited transaction prohibitions found in the Employee Retirement Income Security Act of 1974 ("ERISA") and/or Section 4975 of the Internal Revenue Code of 1986.

1 SEE COMMISSION INTERPRETATION REGARDING STANDARD OF CONDUCT FOR INVESTMENT ADVISERS, RELEASE NO. IA-5248 (JUNE 5, 2019).

2 SEE REGULATION BEST INTEREST, RELEASE NO. 34-83062 (APRIL 18, 2018).

3 SEE "OBSERVATIONS FROM EXAMINATIONS OF INVESTMENT ADVISERS MANAGING CLIENT ACCOUNTS THAT PARTICIPATE IN WRAP FEE PROGRAMS" (JULY 21, 2021).

4 SEE IN THE MATTER OF NPB FINANCIAL GROUP, LLC, ADMINISTRATIVE FILE NO. 3-19918 (AUG. 20, 2020); IN THE MATTER OF MADISON AVENUE SECURITIES, ADMINISTRATIVE FILE NO. 20872 (MAY 31, 2022).

Also, dual-registered representatives that recommend or select a brokerage firm with whom they are affiliated for the execution of transactions for which the representative is rendering advisory services should be particularly mindful of ensuring that the client receives best execution in connection with such transactions. The fiduciary duty of care applicable to investment advisers requires that the firm obtain best execution by seeking a broker-dealer that will execute the trade so that the total cost, proceeds and/or other value of the transaction is the most favorable to the client under the circumstances. Conflicts of interest exist when a dual-registered representative recommends a firm with whom they are affiliated to execute such transactions, and therefore, it is particularly important for representatives to ensure that clients receive the best execution (in terms of cost and price) in light of this conflict to avoid the appearance of impropriety.

Additionally, dual-registered firms must be cognizant of the potential custody implications if the dual-registered firm serves as the qualified custodian to maintain advisory client assets. In such scenarios, the revised Custody Rule requires that when the adviser or a related person acts as the qualified custodian for client funds and securities, the adviser must annually obtain, or receive from the related person, an internal control report. The report must be prepared by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board, and the report must include an opinion as to whether the custodian has controls that are suitably designed and are operating effectively to, among other things, safeguard client funds and securities .

Dual-registered representatives and firms must also be mindful of complying with appropriate FINRA rules. For instance, FINRA Rule 2040 generally

[5] SEE IN THE MATTER OF A.R. SCHMEIDLER & CO., INC., INV. ADV. REL. NO. 3637 (JULY 13, 2013); IN THE MATTER OF GOELZER INVESTMENT MANAGEMENT, INC., INV. ADV. REL. NO. 3638 (JULY 31, 2013).

[6] SEE RULE 206(4)-2(A)(6) UNDER THE INVESTMENT ADVISERS ACT OF 1940.

prohibits a brokerage firm and registered representatives from paying compensation to individuals who are not registered representatives for providing services that would otherwise require the recipients to be registered representatives of a broker-dealer. As such, hybrid RIAs must avoid situations where registered representatives of the broker-dealer are required to share their brokerage compensation with other members of the hybrid RIA who are not registered as registered representatives of the broker-dealer.

Also, dual-registered representatives of hybrid RIAs must be particularly mindful when recommending certain investments to their clients as certain such recommendations may require notice to – and in some circumstances, approval – from the broker-dealer. FINRA Rule 3280 prohibits an associated person of a broker-dealer from participating in private securities transactions unless the associated person provides notice to the broker-dealer and consent where the associated person will also receive selling compensation in connection with the transaction. For purposes of FINRA Rule 3280, a "private securities transaction" includes any securities transaction outside the regular course or scope of an associated person's employment with a broker-dealer, including, without limitation, new offerings of securities which are not registered with the SEC, with some exceptions. Where a dual-registered representative participates in a securities transaction is a highly factual determination, and so dual-registered representatives must be particularly careful when they recommend securities in which they have some involvement in connection with the offering.

CONCLUSION

In short, the hybrid RIA, in its various forms, can be a tremendous option for certain advisors, depending on their circumstances. However, advisors must clearly understand the opportunities and risks prior to choosing which path to follow.

Brightstar Law Group serves investment advisory firms by providing proactive business-minded solutions pertaining to corporate and securities law-related matters. Among other things, our firm offers counsel with respect to securities and compliance matters (including representation in SEC examinations), private fund formation, corporate formation and structuring, business transactions (including M&A and joint ventures), contract drafting and negotiation, employment law matters, operational due diligence, and succession planning. For more information, please visit brightstarlawgroup.com or call us at 917-838-7398.

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