GOING HYBRID

Understand your options when building a hybrid RIA platform for your practice.

KEY TAKEAWAYS

Is the hybrid RIA platform right for your practice?

What does hybrid mean? What are the options for structuring a hybrid RIA?

What do you need to consider when selecting a firm for your commission-based business and/or a custodian for your RIA business?
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EXECUTIVE SUMMARY
In the past, the dually (RIA and broker/dealer) registered hybrid practice model was largely used as a transition strategy toward operating a fee-only RIA enterprise. Today, however, the hybrid RIA business model has evolved from a means of transition to a rapidly expanding business model. For example, while the number of RIAs grew at an 8.4% compounded annual growth rate from 2004 to 2010, hybrid RIAs have outpaced the overall RIA channel with 15.2% compounded annual growth rate over the same period.

“Hybrid RIA” includes several different models and alternatives from which to choose. Operating as an independent RIA requires assuming more responsibility and liabilities than operating as a financial advisor employed by a wirehouse or regional firm. However, this added responsibility may lead to the opportunity for much greater satisfaction and rewards.

A key component to transitioning to a hybrid RIA practice is selecting the right custodian for your clients’ accounts. This key decision is about much more than simply procuring an account custody and a trading system. You’ll also want robust client management technology tools, direct access to expert operations support personnel, access to technical experts in areas like estate planning and taxation, availability of turnkey account solutions and a dedicated practice transition team to help you transfer client assets to your selected custodian and to start operating efficiently as soon as possible. This white paper provides you with insights into the hybrid RIA models available today, as well as guidance to assist you as you investigate these opportunities and select the best hybrid arrangement for you and your investment advisory practice.

“The majority of dually registered advisors appreciate the flexibility to operate under either a fee-based or commission-based relationship built on the needs and preferences of their clients.”

– CERULLI ASSOCIATES
“The news that RIAs are making significant headway in the 401(k) arena comes as no surprise to industry leaders. RIAs and dually registered advisors have grown so fast because they are providing the types of services that plan sponsors are seeking.”

- RIABIZ.COM

INTRODUCTION:
WHAT IS THE HYBRID MODEL?
The hybrid solution is a growing alternative in the RIA channel. With a hybrid model, also known as a dually registered platform, financial advisors may: 1) provide fee-based advisory services as an RIA representative, and 2) conduct commission-based business by registering with a broker/dealer. The hybrid platform is gaining popularity as a flexible business model that empowers financial advisors by providing technology, investment products, educational programs, support services and compliance assistance through their custodian and/or broker/dealer relationship.

An advisor establishing a hybrid RIA firm must comply with two regulatory structures: the U.S. Securities and Exchange Commission (SEC) (or applicable state securities regulatory authority for firms with less than $100MM in assets) investment advisor regulations and the Financial Industry Regulatory Authority (FINRA) regulations imposed on member broker/dealers (for commission-based business only).

RIA HYBRID MARKET TRENDS
In the past, the dually registered hybrid model was largely used as a transition strategy toward complete independence. Financial advisors would temporarily straddle the two worlds of the RIA and broker/dealer to continue receiving trail commissions while they built a fee-based business. Today, however, the hybrid strategy has evolved from merely a rite of passage to a common, legitimate business model.

While advisors continue growing their fee-based businesses, they are less inclined to sever relationships with a broker/dealer. In fact, surveys by Cerulli Associates reveal that only 17% of dually registered advisors are willing to drop their broker/dealer affiliation.

Over the last several years, the movement of advisors away from wirehouse firms has continued to drive the growth of the RIA. According to Cerulli Associates, client assets in the RIA channel totaled $1.9 trillion in 2010, a 16% increase over the prior year.¹

Most notably, the hybrid sector has grown faster than the overall RIA channel. While the number of RIAs grew at an 8.4% compounded annual growth rate from 2004 to 2010, hybrid RIAs have grown by a 15.2% compounded annual growth rate over the same period – as illustrated in the accompanying graph on the next page.

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As advisors are moving into the RIA channel, recent Cerulli research also indicates their clients are moving with them.

**Asset mix**

According to Cerulli Associates, hybrid RIA advisors in 2011 held an average of 75.8% of their assets under management as fee-based assets. The accompanying table represents the asset breakdown by type.

**HYBRID RIA ASSET BREAKDOWN**

<table>
<thead>
<tr>
<th></th>
<th>Mixed</th>
<th>Retail</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commission assets at firm</td>
<td>13.1%</td>
<td>11.9%</td>
<td>12.1%</td>
</tr>
<tr>
<td>Fee assets at firm</td>
<td>18.8%</td>
<td>11.0%</td>
<td>12.2%</td>
</tr>
<tr>
<td>Fee assets at RIA</td>
<td>68.1%</td>
<td>77.2%</td>
<td>75.8%</td>
</tr>
</tbody>
</table>

Cerulli Associates reports that dually registered advisors hold an average of three-quarters of their total client assets under their RIA registration, with the remainder nearly equally divided between fee and commission assets held through their broker/dealer affiliation. Thus Cerulli concludes that today’s hybrid investment advisor is first and foremost a fee-based RIA who retains affiliation with a broker/dealer in order to maximize flexibility in product offerings for clients and to maintain stronger revenue streams. Product lines such as annuities, new issue securities, non-traded REITs and mutual funds with 12b-1 fees currently do not work in a traditional RIA fee-based model.  

HYBRID BENEFITS AND RESPONSIBILITIES

The owner of an RIA firm who previously was an employee financial advisor with a broker/dealer is required to perform many of the administrative and compliance tasks previously performed or provided by the broker/dealer. This means the owner of an independent RIA business organization must take on greater responsibility, but in most cases this additional workload commitment may lead to greater satisfaction and financial benefits.

For example, depending on the model of practice selected, RIAs may receive up to 100% of the investment advisory fees charged to their clients. The list at left details some of the key benefits and responsibilities shared by RIAs utilizing a hybrid platform for business.

HYBRID CHANNEL MODELS

The hybrid RIA channel offers different operating models from which to choose. While many are similar, be sure to investigate key differences such as licensing requirements, compliance responsibility and what is required to produce client statements.

Every firm will not offer different types of hybrid models. In fact, most firms offer only one or two models with specific parameters that work optimally with their back office. While there is an enormous amount of flexibility associated with becoming a hybrid RIA, be sure to explore various firm options to find the best structure for your business and financial objectives.

Ultimately, the goal is to find the hybrid model that works best for you and your clients – and that may involve a trial-and-error process. Ideally, you want to work with a custodian who offers multiple options with the flexibility to switch from one model to another without having to change partners.

The following are general descriptions of the various types of hybrid RIA platforms available today.

BENEFITS AND RESPONSIBILITIES AT-A-GLANCE

Benefits
• Retain 100% of advisory fees; realize tax benefits of business ownership
• Capitalize on multi-custodial/multi-firm approach for complete client solution
• Select office location, décor, office hours, staffing
• Control business decisions, including business structure, marketing strategy and client service/reporting procedures

Responsibilities
• Compliance within SEC/state guidelines
• Register independent RIA via ADV form, file updates and disclosures, manage client account reporting
• Manage branch/office expenses, staff compensation and benefit plans
• Manage business decisions, including structure, marketing, technology integration, and client services
Semi-captive
The so-called “semi-captive” hybrid RIA affiliates with an independent contractor broker/dealer as an independent financial advisor and conducts a mix of commission and fee-based business. Investment advisory business may be conducted through the broker/dealer’s affiliated corporate RIA, or the advisor may choose to establish his or her own independent RIA.

With this hybrid RIA alternative, securities clearance and custody of assets are provided through the same broker/dealer for investment advisory and commission-based clients. Generally, the advisor retains a high percentage (80%-95%) of advisory fees and commission revenues.

With all business transacted through the same back office, there are consistent client statements for investment advisory and commission-based accounts. Advisors are not solely responsible for compliance activities but are expected to operate investment advisory and commission-based services pursuant to the broker/dealer’s policies and procedures. Semi-captive hybrid advisors manage their own office organization and are responsible for all office expenses. These expenses include rent, office furniture, equipment and supplies, selecting and compensating staff, creating an employee benefits package and all other aspects of running an independent business. Generally, independent contractor broker/dealers provide assistance to new semi-captive hybrid advisors with all these matters through professional guidance and, in many cases, recommended suppliers or outsourced solutions.

The independent semi-captive advisor may offer all product lines available through the broker/dealer and may access technology platforms, service associates, research and other value-added resources.

Semi-Captive “Select” Pricing Option
Some firms may offer an additional pricing option for advisors with $100 million or more in discretionary client assets under management. Under this option, the advisor affiliates as an independent FINRA-licensed financial advisor and chooses to offer clients a mix of commission and fee business similar to the semi-captive model. Also, select hybrid RIA participants may either conduct investment advisory business as a representative of the broker/dealer’s affiliated RIA or through their own independent RIA.

Trade execution, clearance, account custody and account statements for all client assets remain with the same broker/dealer. However, under this pricing arrangement, advisors retain 100% of investment advisory fees on discretionarily managed client portfolios. They also receive 100% payout on investment advisory consulting or financial planning fees.

Advisors manage their own business and are responsible for all office expenses, staff compensation, supervisory oversight fees, marketing and other aspects of running an independent advisory business. Hybrid select advisors enjoy the same support and assistance that the independent contractor firm provides to other advisors affiliated with the firm.

Finally, a high percentage (85% to 90%) of commission-based revenues generated by advisors under this option will be paid by the independent broker/dealer, including trail commissions on mutual funds, annuities or other packaged products held in non-advisory accounts.
Unaffiliated

Moving further from the semi-captive model is the “unaffiliated” hybrid model. This is also described as the traditional or original RIA hybrid business model. In this model, a participant establishes, registers and then manages an independent RIA entity and affiliates with a third-party independent “RIA friendly” broker/dealer to continue offering commission-based investment products and services. For those advisors focused primarily on their fee-based business, this model provides an avenue to continue adding trail revenue from legacy business. This approach provides a helpful bridge for advisors with long-term aspirations to shift to a fee-only model.

The unaffiliated hybrid provides the option to place client accounts with multiple custodians for trade clearance and custody or only one account custodian to simplify client account management, support and administration through one system and one set of procedures.

Each advisor is solely responsible for ensuring all RIA business is conducted in compliance with applicable state and federal regulations as well as meeting all regulatory filings and annual registration requirements applicable to his or her RIA entity.

Independent RIAs who are FINRA-registered with a non-affiliated independent contractor broker/dealer may offer all products available through the broker/dealer and, generally, will be provided access to technology platforms and commission-based account support through the broker/dealer’s service departments. The advisor is subject to the supervision of the independent broker/dealer under FINRA rules. Typically, the independent firm charges a compliance or supervisory fee for this service.

TRADITIONAL (FEE-ONLY) RIA

The traditional, fully independent RIA operates as a “fee-only” investment advisor for services provided to clients. Client accounts are placed with a custodial firm. Multiple custodians are generally permitted, offering fee-only advisors open-architecture and flexibility in managing client relationships. This traditional fee-only RIA model typically holds itself to a fiduciary standard.

Giving an advisor complete control over his/her practice, the RIA owner/advisor builds and manages the independent RIA business organization and is responsible for ensuring that all business is conducted in compliance with all applicable federal and state investment advisor regulations.

Because fee-only RIAs are not required to hold a Series 7, FINRA regulations and continuing education requirements are not applicable. However, the RIA firm is required to register with the SEC ($100 M+ in AUM) or state securities authorities (less than $100 M in AUM).

Most RIA practices (71%) are structured as team-based operations, while sole practitioners are more prevalent in the retail space. As an RIA, advisors have complete freedom to specialize their advisory practice, develop a personal brand and offer the range of products and services that meet their clients’ needs (with no pressure or incentive to sell proprietary products).

RIAs generate their primary revenue via advisory services, for which they retain 100% of fees. The RIA firm determines whether fees are based on AUM, by the hour or other flat-fee arrangement.

1 Practice Structure by RIA Channel, 2011
## Hybrid Models at a Glance

<table>
<thead>
<tr>
<th>Feature</th>
<th>Semi-Captive</th>
<th>Semi-Captive Select Pricing</th>
<th>Unaffiliated</th>
<th>Fee-Only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advisory fee payout</td>
<td>85%-90%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Consulting fee payout</td>
<td>100% (advisor-owned RIA)</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>12B-1 revenue retention on shares in advisory accounts</td>
<td>Advisor/Custodian</td>
<td>Advisor/Client</td>
<td>Custodian</td>
<td>Custodian</td>
</tr>
<tr>
<td>12B-1 revenue retention on shares in advisory IRA accounts</td>
<td>Client</td>
<td>Advisor/Client</td>
<td>Custodian</td>
<td>Custodian</td>
</tr>
<tr>
<td>Responsible for office management and expenses</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Responsible for RIA regulatory compliance</td>
<td>Yes (advisor-owned RIA)</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>No (corporate RIA)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Affiliate with third-party broker/dealer</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Ability to use multiple custodians</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Affiliation fee</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Supervisory fee</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
CHOOSING A CUSTODIAN

The key to a successful hybrid or traditional RIA practice is choosing resource and service partners that complement your business. To help assess what support and services you want from an account custodian and/or independent broker/dealer, a great way to start is to establish a list of duties, client service resources and technology tools. When complete, your list should provide you with a guide to use in your due diligence review of service providers. This will help you evaluate potential partners in the hybrid RIA market and help you select those with strengths in the areas required for your practice to succeed.

While the primary responsibilities of the custodian are to provide a trading platform and execution services for brokerage assets, custodial firms often provide many more benefits for an RIA. The simplicity of operational processes as well as easy access to thorough client account information by the RIA will simplify and enhance the success of the RIA and satisfaction of the RIA’s clients. Year after year, research confirms that the quality and timeliness of service is the No. 1 reason investment advisors change providers.

Services provided by a custodian or an independent contractor broker/dealer business partner for an RIA should include:

- Execute transactions for client accounts
- Hold client assets in safekeeping
- Process settlement of security sales and purchases
- Deduct and remit RIA fee billings on client accounts
- Facilitate timely cash transfers and distribution transactions
- Produce and distribute consolidated client account statements
- Provide client account data in a user-friendly format to populate RIA-owned software systems
- Offer business management consulting services
- Provide guidance in the screening, selection and employment of staff associates
- Provide securities research and market data service
- Provide marketing support
- Provide and support portfolio trading systems
- Client lending facilities
- Trust services
- Provide HNW consulting services and wealth management service
Given the timely nature of portfolio management by an RIA, it is paramount that a custodian performs responsively and proficiently. When a client has a question about a particular transaction, it is up to the custodian to provide quick and accurate information about each transaction to the investment advisor.

A KEY PHILOSOPHY TO SEEK OUT IN A CUSTODIAN

A key philosophy to seek out in a custodian is whether or not it views RIAs as clients to whom it must be responsive to maintain their business. As such, an RIA can change custodians and/or cherry-pick which services to use. Some larger custodians offer a variety of programs and resources to help support and grow your practice.
The following overview describes specific types of resources and tools that custodians may offer RIAs or hybrid RIAs. Pay careful attention to what each custodian and broker/dealer you consider is capable of providing. Along with your own custodian services checklist, use this guide to help you select those that offer the type and quality of support to optimize your practice’s design and service in the future.

**Technology**
Moving toward a more independent model of business should not mean giving up the technological tools and support you’re accustomed to using. Many custodians today offer comprehensive technology platforms featuring customer relationship management (CRM) software, trading tools, financial planning software and portfolio performance reporting. RIA clients should also be provided secure, user-friendly online access to real-time account information.

**Open architecture**
As an RIA, you may want to offer your clients a wide spectrum of investment services and choices to enhance and expand your relationship. If this is important to your business plan, an “open architecture” organization that doesn’t promote proprietary products should provide what you seek for clients, consistent with fulfilling your fiduciary responsibility to act in the best interest of your clients.

**Performance monitoring & reporting**
A custodian should provide consolidated, easy to use portfolio performance monitoring and reporting tools with multiple client report options.

**Marketing**
One of the perks of independence is the ability to build your own brand image. Some custodial firms provide extensive assistance to RIAs with branding that eliminates the necessity of selecting and hiring a separate marketing agency. It’s important to evaluate the scope and quality of marketing services offered through each custodian you evaluate. Many offer assistance in creating printed materials, a web presence, social media support, public relations guidance and other marketing support.

**Compliance**
An owner of an independent RIA has responsibility for regulatory compliance. Some custodians help new RIA owners develop written RIA compliance standards and procedures, as well as keep RIA partners informed about changing rules and regulations so compliance is maintained as changes occur.
CONCLUSION

As a hybrid RIA advisor, you’ll have control of your business, be able to act in the best interest of your clients and retain up to 100% of your investment advisor fees. If you are a financial advisor who personally manages client portfolios as a primary value provided to your clients, and are primarily fee-based, you are a prime candidate to consider a hybrid RIA business model or traditional RIA business model. There is a spectrum of hybrid RIA platforms and service providers available today, and they vary considerably in the structure and support capabilities provided.

If you desire to run a completely independent business practice without losing the scope of services and support offered through a full-service broker/dealer, transitioning to a hybrid RIA may very well be the right choice for you.

A key component to transitioning to a hybrid RIA practice is to select the right custodian and independent broker/dealer partner. It’s not just about procuring account custody or clearinghouse services. You’ll also need robust resources, turnkey solutions, integrated technology solutions and a dedicated, experienced transition team. You need the appropriate technology and client service tools to build a strong practice and the independence to make your own decisions. In short, you need to seek out the right combination of resources and services to make a meaningful and rewarding difference in your future.

Once you make the transition to a hybrid RIA, it’s your business to grow and expand. As it grows, you’ll build equity in your business that will be there for you in retirement while also building a legacy for your beneficiaries and successors.