What is an Investment Adviser?

Legal Definition. "Investment adviser" is a legal term that appears in the Investment Advisers Act of 1940, the federal law that governs investment advisers. Generally, this law defines an investment adviser as someone who, for pay, is in the business of advising others on investing in stocks, bonds, and other securities.

What Investment Advisers Do. Investment advisers provide professional advice to their clients regarding investments in securities. Investment advisers typically have the authority to make investment decisions on behalf of their clients, including which securities to buy or sell (referred to as "discretionary authority") consistent with each client's objectives and guidelines. The adviser's authority may also extend to deciding which additional investment advisers to retain on behalf of its client to manage all or a portion of the client's investments.

Spelling and Titles. The word "adviser" is often spelled "advisor." There is no difference in meaning between the two terms. The Investment Adviser Association prefers to use the spelling Congress used when it passed the Investment Advisers Act. "Investment adviser" is a broad legal term that encompasses a wide range of businesses. Other terms that investment advisers frequently use to describe themselves include "investment counsel," "investment manager," "asset manager," "wealth manager," "money manager," or "portfolio manager."

Clients. There are a wide variety of clients that employ the services of investment advisers. Clients fall into two broad categories: individuals and institutions. The first category includes: individuals, trusts, families, and groups of families. The second category includes: corporations, private pension plans, public pension plans, educational institutions, endowments, foundations, mutual funds, hedge funds, investment partnerships and other pooled accounts, banking institutions, and state and local governments.

Investment Strategy and Style. Investment advisers use a number of different investment styles and strategies, such as growth or value. Some specialize in investments in stocks (also called "equities"), some specialize in bonds (also called "fixed income"), while others manage portfolios that consist of investments in stocks, bonds, and cash. Some advisers tailor investment portfolios for each client. Other advisers strictly adhere to one or more centrally managed portfolios that reflect a specific investment strategy, style, or model. Clients sometimes retain several advisers with different investment strategies and styles to diversify their portfolios.

Size of Firm. Investment advisers range from small businesses to large corporations. Most investment advisers are small businesses that offer more discrete services and cater to a certain type of individual or institutional client. Some investment advisers are global businesses that employ thousands of people, serving both individual and institutional clients and offering a very broad range of services and products. The popular press often equates investment advisers with mutual funds. While some investment advisers manage mutual funds, statistics indicate that the vast majority of investment advisers are small businesses that have nothing to do with mutual funds. For more information, please see *Evolution - Revolution: A Profile of the U.S. Investment Adviser Profession*, available in the Reports & Brochures section.

Advisory Contract. Investment advisers enter into a written agreement with each client that outlines the adviser's responsibilities. The advisory contract typically identifies the services the adviser will provide, the assets or accounts it will manage, a description of the adviser's fees, and various other terms and disclosures.

Fees. Investment advisers are usually compensated based on a percentage of assets under management, not on a transactional basis. This structure promotes a long-term relationship between client and adviser and helps to align the interests of the adviser with each client. Investment advisers, however, may employ a variety of other compensation arrangements, including hourly or flat/fixed fees for selected services, or performance fees based on the performance of the assets in the client's account. The adviser's fee generally is separate from and does not include brokerage commissions, dealer spreads, and other costs associated with the purchase or sale of securities; custodian fees; interest; taxes; and other account expenses.

Custody of Client Assets and/or Securities. Investment advisers, unlike most brokers, typically do not maintain physical custody of client assets or securities. Instead, the client specifies a particular custodian (such as a bank, broker-dealer, or other financial institution) where the client's assets will be held. The client will receive periodic written statements from the custodian listing all holdings and recent transaction activity. In addition, an investment adviser will generally provide periodic account statements and supplementary reports to each client.

Registration. If an investment adviser has at least $100 million in assets under management, manages a mutual fund, or meets certain other requirements, it must register with the SEC by filing a document called Form ADV. Investors can review the information that investment advisers file with the SEC by visiting: www.adviserinfo.sec.gov. Form ADV, Part 1 includes useful information about the adviser, including its address, phone number, number of employees, nature of business, types of clients, assets under management, compensation arrangements, advisory activities, other business activities, affiliations, private funds (if any), custody, participation or interest in client transactions, ownership information, key executives, control persons, and disciplinary information (if any).

An investment adviser is also required to file with the SEC and deliver to clients and prospective clients Form ADV, Part 2A (also called a brochure), a narrative document that includes additional information about the investment adviser's advisory business, fees and compensation, performance-based fees and side-by-side management, types of clients, methods of analysis, investment strategies, and risk of loss, conflicts of interest, disciplinary information, other financial industry activities and affiliations, code of ethics, participation or interest in client transactions and personal trading, brokerage practices, review of accounts, client referrals and other compensation, custody, investment discretion, proxy voting, financial condition, and financial information if the investment adviser requires or solicits prepayment of over $1,200 in fees per client six months or more in advance.

An investment adviser is also required to maintain and deliver to clients Form ADV, Part 2B (also called a brochure supplement), a document that includes additional information about the investment adviser's employees who provide advisory services to the client, including educational background, business experience, disciplinary information, other business activities, additional compensation and supervision.

SEC Oversight. SEC-registered investment advisers are subject to inspections (also referred to as examinations) by the SEC. This means the SEC may visit with the adviser and will request and examine documents that relate to how the adviser discloses risks and potential conflicts of interest, trading activities, and other business practices, including communications with clients.

Regulation. The Investment Advisers Act is a law Congress passed in 1940 that authorizes the SEC to register and regulate investment adviser firms. Investment advisers are subject to rigorous regulatory requirements. For example, all SEC-registered investment advisers are required to have a written policy in place relating to the following subjects: insider trading, privacy, proxy voting (if the adviser has the authority to vote client proxies), and code of ethics. In addition, all SEC-registered investment advisers must develop and implement other written policies and procedures that are reasonably designed to prevent violations of the Investment Advisers Act. All investment advisers are required to appoint a Chief Compliance Officer.

Disclosures and Qualifications. Advisers are required to provide certain disclosures in Form ADV, including information about their risks and strategies, ownership of the firm, services they provide, fee rates, potential conflicts of interest, and disciplinary actions. Unlike some other professions, there is no qualification examination for investment advisers. However, many investment advisory personnel have earned professional designations such as Chartered Financial Analyst (CFA), Certified Financial Planner (CFP), and Chartered Investment Counselor (CIC). You should check other designations that advisers may use to make sure they are meaningful. Investment advisers are required to outline the educational and work experience, disciplinary history, other business activities, additional compensation and supervision of their investment professionals in Form ADV, Part 2B. This part of the form is not publicly available on the SEC's web site; therefore, clients and prospective clients should ask advisers for this document and for any other details of their investment professionals' educational, investment, and work experience.

Fiduciary Duty. Investment advisers owe a fiduciary duty to their clients. As such, an investment adviser stands in a special relationship of trust and confidence with its clients. As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients. The parameters of an investment adviser's fiduciary duty depend on the scope of the advisory relationship and generally include the following duties: (1) to place the interests of clients first at all times; (2) to have a reasonable basis for its investment advice; (3) to seek best execution for client securities transactions where the adviser directs such transactions; (4) to make investment decisions consistent with any mutually agreed upon client objectives, strategies, policies, guidelines, and restrictions; (5) to treat clients fairly; (6) to make full and fair disclosure to clients of all material facts about the advisory relationship, particularly regarding conflicts of interest; and (7) to respect the confidentiality of client information. This fiduciary duty differs from the suitability obligations that govern brokers.

Public Disclosure. In recent years, much more information has become widely accessible to the public regarding investment advisers. As noted above, the SEC maintains a public web site that allows anyone to review information the adviser has filed with the SEC (Form ADV, Part 1 and Form ADV, Part 2A). The web site is located at: www.adviserinfo.sec.gov.

Confused About Financial Service Providers?

Much confusion exists regarding various service providers in the financial services industry. This confusion is partly the result of terminology. Many financial services firms use the same or similar terms to describe a broad range of services. For example, some brokers or brokerage firms use such terms as "financial consultant," "financial advisor," or "investment consultant" – despite the fact that they may not in fact perform investment adviser activities. As mentioned above, investment advisers may use terms such as "investment manager," "asset manager," "investment adviser," or "advisor."

Confusion also is caused by the fact that some firms engage in more than one financial service activity. For example, a brokerage firm, in addition to its primary business of executing securities transactions, also may provide investment adviser services to certain clients or accounts (and may also be a registered investment adviser). For many people, it may not be readily apparent which type of service is being performed (or what laws or regulations govern such activities). Investors should ask questions of financial service providers to determine whether the provider would suit the investor's needs. For additional information, download Cutting Through the Confusion: Where to Turn for Help with Your Investments, or go to the Reports & Brochures section of our Website.

How to Select an Adviser

Identify Your Investment Goals

You should first identify your investment goals and then choose an investment adviser who is most capable of helping you meet those goals. If you are an individual investor, your investment adviser should understand your goals and your particular financial situation and make recommendations that are suitable for you. Some important factors to consider in defining your goals include age/time horizon, income, taxes, wealth, and risk tolerance.

Considerations Regarding the Services You Are Seeking

You should consider what level of investment services and advisory services you need. For example, some advisers provide clients with a pure investment management relationship while other advisers provide clients with sophisticated financial planning and advisory services in addition to investment management services. You should consider the nature of the client relationship that you would like with an investment adviser, including the level and form of communication you would like to maintain with the adviser. Decide whether you will give your adviser discretionary authority over your investments or merely provide you with investment suggestions for you to follow.

Questions to Ask

After identifying your investment goals, you should interview investment advisers to decide which one would best be suited to help you achieve your goals. Asking detailed questions will help you determine your comfort level with the prospective adviser on both a personal and professional level. Some questions you might ask include:

1. Are you a fiduciary, i.e., are you required by law to place my interests ahead of your own at all times? Are you willing to acknowledge your fiduciary duty in writing?
2. How are you paid? Do you make more money if I buy a particular stock, bond, or mutual fund over another investment? If so, would you still recommend this investment and why? Does your firm hold prize contests for sales?
3. What products and services does your firm offer? Are recommendations of products and services limited? If so, why?

4. What are the potential conflicts of interest surrounding the investment advice that you will give me? What policies have you instituted to avoid or at least mitigate any such conflicts?
5. What is your investment philosophy? How does your investment philosophy differ from other investment adviser firms?
6. How often will we meet? How often will I receive written reports about my portfolio?
7. What happens when you place an order for my account? Could I get a better price (cost and/or commission) if you sent my orders to a different market or broker to be executed?
8. Describe your typical client. May I contact your long-term clients as references?
9. How long has your firm been in business? What are the qualifications of the investment and professional personnel in the firm?
10. With respect to the person who will manage my account, what experience do you have, especially with people in my circumstances? Where did you go to school? What training do you have in the investment management field? What is your recent employment history? What other firms have you been registered with? What is the status of those firms today? What licenses do you hold?
11. Where does your firm invest its own money? Is it invested similarly to that of your clients?
12. Have you ever been disciplined by any government regulator for unethical or improper conduct or been sued by a client who was not happy with the work you did? How many lawsuits or arbitration cases have been filed against you and against your firm? What were the outcomes?
13. Can you provide me with a copy of the registration documents that you filed with the SEC? For registered investment advisers, ask for a copy of Parts 1 and 2 of their Form ADV. For investment adviser representatives of the adviser, ask for a copy of their Form U-4.

For further information, please contact the IAA:

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