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Defining the Roles in the Alternative Investments Industry

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In this article, we look at various players in the alternative investments industry and identify who they are and what they do. The many firms involved in the creation and management of alternative investments, including nontraded REITs, interval funds, nontraded BDCs and private placements, can fill more than one role, but working together they perform all the required functions to meet the needs of investors.

This article describes in brief the roles of:

- Transfer Agent
- Custodian
- Product Sponsor

It also describes the primary differences between:

- Broker Dealer
- Registered Investment Advisor (RIA)
- Financial Advisor (FA)
- Fee Only Financial Advisor

Transfer Agent

Transfer agents keep track of the individuals and entities that own stocks and bonds. Most transfer agents are banks or trust companies, but sometimes a company acts as its own transfer agent.

Founded in 2009, Blue Vault was built on the belief that transparency and education are essential ingredients of research. We are committed to providing access to valuable performance information that was once stored only deep inside financial statements and filings, and often difficult to obtain. It is our mission to provide the most in-depth and thorough research available on alternative investments, including nontraded REITs, BDCs, and Closed-End Funds, Interval Funds and Private Offerings to help educate financial advisors and help protect investors.

Transfer agents perform two main functions in the alternative investment environment:

- Issue and cancel certificates to reflect changes in ownership.
- Act as an intermediary for the company.

A transfer agent may also serve as the company's paying agent to pay out interest, cash and stock dividends, or other distributions to stock- and bondholders. In addition, transfer agents act as proxy agent (sending out proxy materials), exchange agent (exchanging a company's stock or bonds in a merger), tender agent (tendering shares in a tender offer), and mailing agent (mailing the company's quarterly, annual, and other reports).

In many cases, you can find out which transfer agent a company uses by visiting the investor relations section of the company's website or by searching for the S-11 for a nontraded REIT's public offering on the SEC website.

Custodian

A custodian is a financial institution that holds customers' securities for safekeeping in order to minimize the risk of their theft or loss. A custodian holds securities and other assets in electronic or physical form. Custodians generally tend to be large and reputable firms. A custodian is sometimes referred to as a "custodian bank."

In addition to holding securities for safekeeping, most custodians also offer other services, such as account administration, transaction settlements, the collection of dividends and interest payments, tax support, and foreign exchange. The fees charged by custodians vary, depending on the services that the client desires. Many firms charge quarterly custody fees that are based on the aggregate value of the holdings.

In cases where investment advisors are responsible for customer funds, the advisor must follow custody rules set forth by the Securities and Exchange Commission (SEC). The person or entity must be considered a qualified custodian, often limiting the options to banks, registered brokers, registered dealers, and certain other individuals or entities.

In the U.S., some of the largest custodian banks include the Bank of New York Mellon, JPMorgan Chase, State Street Bank and Trust Co., and Citigroup.

Product Sponsors

Alternative investment products such as nontraded REITs, nontraded BDCs, Interval Funds, unlisted Closed End Funds, Private Equity and Reg D offerings, all have asset management firms that design the product structures, select the investment types, file the public offerings with the SEC, and raise capital through the issuance of common shares. They make investments in real properties, joint ventures, variable interest entities, loans, mortgages and other credit instruments, and leverage the portfolios using debt. They make decisions about distribution rates, and ultimately, decide if, when and how the product should be liquidated.

Larger product sponsors such as Blackstone, Griffin Capital, CIM Group and others may have multiple product offerings across several alternative categories. For example, SS&C, a major provider of transfer agent and fund administration services, works with 70 investment management firms and over 510 different fund products, all within the retail alternatives sectors.

Product sponsors usually own a program's advisor firm, an affiliated separate legal entity, which is compensated by a variety of fees disclosed in the program prospectuses, which include asset management fees and may also feature acquisition and disposition fees, debt financing fees, and incentive-based fees related to a percentage of shareholder returns that exceed a specified hurdle rate. Typically, the advisor is responsible for sourcing, evaluating and monitoring investment opportunities and making decisions related to the acquisition, management, financing and disposition of assets in accordance with the fund's investment objectives, subject to oversight by the board of directors.

The management of a fund may be external, performed by employees of the advisor and compensated via the above fees, or may be internalized and managed by employees of the fund itself. The internalization of a fund's management can take place when the fund is of significant size or approaching a liquidity event such as a public listing.

Broker Dealer

A broker-dealer is a person or firm in the business of buying and selling securities for its own account or on behalf of its customers. The term broker-dealer is used in U.S. securities regulation parlance to describe stock brokerages because most of them act as both agents and principals. A brokerage acts as a broker (or agent) when it executes orders on behalf of its clients, whereas it acts as a dealer, or principal when it trades for its own account.

Broker-dealers fulfill several important functions in the financial industry. These include providing investment advice to customers, supplying liquidity through market making activities, facilitating trading activities, publishing investment research and raising capital for companies. Broker-dealers range in size from small independent boutiques to large subsidiaries of giant commercial and investment banks.

There are two types of broker-dealers: a wirehouse, or a firm that sells its own products to customers; and an independent broker-dealer, or a firm that sells products from outside sources.

There are over 3,700 broker-dealers to choose from, according to the Financial Industry Regulatory Authority (FINRA).

By definition, broker-dealers are buyers and sellers of securities, and they are also distributors of other investment products. As the name implies, they perform a dual role in carrying out their responsibilities. As dealers, they act on behalf of the brokerage firm, initiating transactions for the firm's own account. As brokers, they handle transactions, buying and selling securities on behalf of their clients.

Registered Investment Advisor (RIA)

A Registered Investment Advisor (RIA) is a person or firm who advises high-net-worth individuals on investments and manages their portfolios. RIAs have a fiduciary duty to their clients, which means they have a fundamental obligation to provide investment advice that always acts in their clients' best interests. As the first word of their title indicates, RIAs are required to register either with the Securities and Exchange Commission (SEC) or state securities administrators.

The Investment Advisers Act of 1940 defined an RIA as a "person or firm that, for compensation, is engaged in the act of providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications."

Which regulators advisors need to register with depends mostly on the value of the assets they manage, along with whether they advise corporate clients or only individuals. In general, advisors who have at least $25 million in assets under management or provide advice to investment companies are required to register with the SEC. Advisors managing smaller amounts typically register with state securities authorities.

Registering as an RIA doesn't denote any form of recommendation or endorsement by the SEC or state securities regulators. It means only that the investment advisor has fulfilled all the requirements for registration. For advisors who register with the SEC, the required information includes the advisor's investment style, assets under management (AUM), fees, any disciplinary actions, and, for a firm, the key officers. Other requirements include the RIA informing the SEC of any potential conflicts of interest that have arisen for them in their work, or that might do so in future.

Financial Advisor ("FA")

This is a broad term for a professional who helps manage an investor's money. Investors pay the advisor, and in exchange, they help with any number of money-related tasks. A financial advisor might help manage investments, broker the sale and purchase of stocks and funds, or create a comprehensive estate and tax plan. If the advisor is working with the public, they must hold a Series 65 license. In addition to that license, there are many other financial advisor credentials the advisor might hold, depending upon the services that are provided.

Financial advisor as a general term includes subsets of the financial advisor group, such as stockbrokers, insurance agents, money managers, estate planners, bankers, and more.

It's important to note that under the Department of Labor's new fiduciary rule, all professionals who give retirement planning advice or who create retirement plans are held to a certain legal and ethical standard.

Compensation for Financial Advisors and Their Incentives

The basic compensation models for advisors are:

- Advisors who only charge an hourly or a flat fee for the planning services they provide. Depending on the engagement they may provide limited or comprehensive advice.
- Advisors who charge based on assets under management (AUM), for example, 1% of the investment account value. The engagement may or may not include planning and/or other advice, which is usually secondary to the money management.
- Advisors who only receive commissions based on the sale of a product or a financial transaction, such as a stock trade. Advice or planning might be ancillary to the product sale (as with a stockbroker), or they might be a key part of services (as with a financial planner).
- Advisors who are compensated through a combination of fees, assets under management and/or commissions. The exact mix varies by advisor. Also known as "fee-based," this model allows advisors to offer clients a wider range of services as well as work with them to implement recommendations and monitor progress.

One of the major benefits of selecting a fee-only advisor is the freedom from the inherent conflict of interest that can arise when a significant portion of the advisor's income comes from selling the investor financial products. The concern is whether the advisor is recommending a certain financial product because it enhances his/her bottom line and if the products recommended are truly in the investor's best interest. Some registered reps and others who earn all or part of their compensation via commission may be required to favor products offered by their employer — which may or may not be the best vehicles for the investor's situation. Since fee-only advisors do not sell commission-based products, receive referral fees, or other forms of compensation, the potential for conflicts of interest is limited.

An advisor who charges a fee is acting as a fiduciary and legally required to act in the investor's best interest. Generally, an advisor is a fiduciary when he charges a fee for planning services and/or is investing money in an advisory account. Also, Registered Investment Advisors and Certified Financial Planners act as fiduciaries. In contrast, an advisor who only earns commissions is held to a lower standard and does not have to make the "best-interest" recommendation, but rather one that is "suitable" for the investor's needs.

Another benefit of using fee-only financial advisors is the opportunity for them to offer an objective second opinion. This is especially true if the advisor works with clients on an hourly, as-needed basis or perhaps will do a financial plan or financial review for a fixed project fee.

However, fee-only advisors might be costly. For example, if the fee-only advisor suggests that the investor purchase a product that the advisor does not sell, such as disability insurance, then the investor is paying the advisor as well as a commission to an insurance salesman.

For beginning investors or investors with smaller investment portfolios, the fee-only advisor must either limit the services he offers and/or charge clients a higher fee. For wealthy individuals who are willing and able to pay a substantial retainer, a fee-only advisor could be the right choice. But, for many individuals with limited resources or whose assets are tied up in qualified plans, the out-of-pocket costs for a fee-only advisor could get prohibitive.

No form of advisor compensation is totally conflict-free. Working with an advisor who is compensated via a percentage of the investment assets under management may create an incentive to keep as much of the client's portfolio under management as possible. ▲