IBDC

Conflicts of Interest and Sales Charge Disclosures for Dually-Registered Firms

Edward Zusman
Partner
Markun Zusman Freniere & Compton, LLP

Introduction

Conflicts of Interest and Sales Charge Disclosures For Dually-Registered Firms

- Conflict Of Interest Issues Dually-Registered Firms Face When Determining Pay For Transactions Or Services
- Failure of Applying Sales Charge Discounts For Eligible Accounts

Introduction

The Hybrid Firm

- "*As a fiduciary, an adviser has an obligation to act in its client's best interest and to disclose material conflicts of interest such as the receipt of compensation for selecting or recommending mutual fund share classes.*" (OCIE Risk Alert July 13, 2016)

- FINRA and SEC's prioritization of dually-registered firms as an emerging risk highlight regulators' concerns over financial conflicts of interest

- Dually-registered advisors are permitted to provide advice and recommendations so long as *all* conflicts are fully disclosed and advisor takes steps to assure client's consent is fully informed

Conflicts of Interest
Supervision of Advisory Activity

- Neither the federal securities laws nor the NASD Rules of Fair Practice mandate the supervisory system or structure

- Firms responsible for developing and implementing its own supervisory system for supervision of each registered representative, registered principal, and other associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations, as well as detect and prevent violations

Conflicts of Interest

Supervision of Advisory Activity (continued)

- "*[T]he records created and recordkeeping system used, together with relevant supervisory procedures, must enable the member to properly supervise the RR/IA by aiding the member's understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA's authority, and the suitability of the transactions.*"

  (NASD Notice to Members 96-33)

Conflicts of Interest

Supervision of Advisory Activity (continued)

- Key is mitigation of regulatory and litigation exposure, and maintaining culture of compliance and desire to achieve best practices goes a long way!

- Tips for mitigating exposure:

  (1) Maintaining adequate records documenting approval of outside business activity and or transactions, and outside securities transactions;

  (2) Integrating utilization of records into policies and procedures to maximize supervision of advisory activities of dual registrant;

  (3) Determining suitability of transactions recommended by registered person to advisory clients;

  (4) Staying informed of the continually evolving advisory industry, and continuing to learn about the impact it has on their supervisory processes

Conflicts of Interest
Structure of Client Accounts

Advisory *or* Brokerage account, that is the question!

- Dually-registered firms have initial hurdle of providing advisory versus brokerage account recommendations
  - Such firms must supervise activities of hybrid advisors when they act as representatives of the broker-dealer or the RIA
  - Broker-dealers must supervise the suitability of recommendations made by dually-registered financial professionals

Conflicts of Interest
Structure of Client Accounts (continued)

- To avoid scrutiny over structuring client accounts, hybrid firms must demonstrate:
  - Service recommendations to clients were properly supervised for suitability
  - Whether level of activity in accounts merit advisory fee, and clients' are receiving value-added services for advisor fees they are paying
  - Disclosure of all potential conflicts of interest in recommending investment products that generate revenue

Conflicts of Interest
Structure of Client Accounts (continued)

- Policies and Procedures in place for use in arriving at broker-only versus brokerage + investment advisory recommendations
- When structuring accounts, advisors must carefully weigh all applicable variables, especially clients' investment needs, strategies, and goals
- Account recommendations *must be client-focused*, not advisor-focused

Conflicts of Interest
Compensation and Oversight

- Firms must examine procedures to ensure adequate systems are in place to monitor advisors' potential unethical behavior

- Burden on firms to examine procedures and ensure adequate systems are in place to monitor potential unethical behavior

Conflicts of Interest
Compensation and Oversight (continued)

- The SEC "...*has highlighted the need for advisers making mutual fund share class selections to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act including those that govern their selection process.*"

  (OCIE Risk Alert July 13, 2016)

- Regulators are showing no hesitation in going after firms where advisors seek to increase compensation at their client's expense

Conflicts of Interest

Compensation and Oversight (continued)

- *In the Matter of Dion Money Management, LLC*, Adm. Proc. File No. 3-16702 (July 24, 2015):
  - Dion was fined $50,000 and agreed to amend disclosures to provide notice to its clients of the SEC's order for failing to adequately disclose compensation arrangement to clients where Dion received payments from third parties when client assets were invested in certain mutual funds.
- *Timothy Edward Daly*, AWS NO. 2009018310201 (June 4, 2012):
  - Mr. Daly was fined $97,500 and suspended for three months from association with any FINRA member for overcharging commissions and fees in connection with securities transactions, effectively charging clients twice for those transactions.

Conflicts of Interest
Reverse Churning

- Regulators expressed concerns over hybrid firms offering proprietary programs where client trades are placed by its broker-dealer, while investment management is provided by its RIA

- Regulators fear that such arrangements systematically marginalize clients, and may result in clients not fully receiving the promised active investment management service

Conflicts of Interest
Reverse Churning (continued)

- *In the Matter of Royal All. Associates, Inc., Sagepoint Fin., Inc. & FSC Sec. Corp.,* Respondents. (Mar. 14, 2016) Release No. 34-77362
  - Dually-registered broker-dealer and investment advisory firms — Royal Alliance Associates, SagePoint Financial and FSC Securities Corp. — agreed to pay more than $9.5 million to settle SEC charges that they acted negligently by failing to monitor advisory accounts on a quarterly basis to prevent reverse churning, in which the firms collected approximately $2 million in extra fees from selling clients mutual fund share classes that included 12b–1 fees — marketing charges that benefit the advisor or broker— despite availability of cheaper share classes.

Conflicts of Interest

Reverse Churning

(continued)

- *In the Matter of Raymond James & Associates, Inc.*, Respondent. (Sept. 8, 2016) Release No. 4525—
  - Raymond James paid $600,000 penalty for failure to establish policies and procedures necessary to determine the amount of commissions their clients were being charged when sub-advisers "traded away" with a broker-dealer outside wrap fee programs. The firm's financial advisors were unable to provide the magnitude of these costs to clients and did not consider these commissions when determining clients' account suitability, leaving clients unaware they were paying additional costs beyond the single wrap fee they paid for bundled investment services

Conflicts of Interest
Reverse Churning

(continued)

- *In the Matter of RiverFront Inv. Group, LLC*, Respondent. (July 14, 2016) Release No. 4453 –
  - RiverFront failed to adequately notify clients of additional transaction costs beyond the "wrap fees" paid to cover cost of bundled services. Brokers outside the wrap program sponsor were used to execute the majority of program trading, resulting in extra costs to clients. RiverFront agreed to be censured and pay a $300,000 fine, and must provide quarterly updates on its website for the volume of trades by market value executed away from sponsors and the associated transaction costs passed onto clients.

Conflicts of Interest
Bottom Line

- The SEC and FINRA are likely to continue prioritizing conflict of interest issues relating to compensation

- From the Dion, Raymond James, RiverFront, Royal Alliance, SagePoint, and FSC Securities matters, regulators are enforcing requirements to ensure high levels of transparency between the firms and clients are maintained, especially regarding firms' compensation schemes.

Sales Charge Discounts & Waivers
Investor Protection

- "*FINRA's commitment to investor protection is highlighted by the significant restitution component ... which reinforces that investors must be able to trust that their brokerage firm will offer the lowest-cost share classes available to them. When firms fail to do so, we will take appropriate action.*"

  - Brad Bennett, FINRA Executive Vice President and Chief of Enforcement

- The ongoing fines issued by FINRA underscore the need for firms to ensure customers are receiving all discounts and waivers to which they are entitled

Sales Charge Discounts & Waivers

Failure to Apply Eligible Sales Charge Waivers

- FINRA is issuing substantial sanctions and fines to dozens of firms that fail to provide customers with appropriate volume discounts or sales charge waivers.
  - Edward D. Jones & Co. L.P. (AWS No. 2015045354201)
  - Stifel Nicolaus & Co. (AWS No. 2015045163601)
  - Janney Montgomery Scott LLC (AWS No. 2015045368001)
  - AXA Advisors LLC (AWS No. 2015045369801)
  - Stephens Inc. (AWS No. 2015046029901)
  - Wells Fargo Advisors, LLC (AWS No. 2014042689901)
  - Raymond James Financial Services, Inc. (AWS No. 2015044309501)
  - LPL Financial LLC (AWC N0. 2015045270901)

Sales Charge Discounts & Waivers

Failure to Apply Eligible Sales Charge Waivers

(continued)

- *In the Matter of UBS Financial Services, Inc.*, Respondent AWC No. 2013038351701 (August 15, 2016)
  - UBS fined $250,000 for failing to waive certain fees for eligible mutual-fund customers. UBS charged customers over $277,636 to invest in mutual funds from September 2009 to June 2013.
- *In the Matter of Royal Alliance Associates, Inc.,* Respondent AWC No. 2012034450501 (December 2, 2015)
  - Royal failed to identify and apply sales charge discounts to certain customer's eligible purchases of UITs resulting in customers paying excessive sales charges of approximately $204,000

Sales Charge Discounts & Waivers

Failure to Apply Eligible Sales Charge Waivers

(continued)

- *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated*, Respondent AWC No. 2011029999301 (June 16, 2014)
  - Merrill Lynch fined $8 million for failing to waive mutual fund sales charges when it offered Class A shares, and ordered to pay $24.4 million in restitution to affected customers, in addition to $64.8 million the firm has already repaid to disadvantaged investors. Even after learning it was not providing sales charge waivers to eligible accounts, Merrill Lynch relied on its financial advisors to waive the charges, yet failed to adequately supervise the sale of such products or properly train or notify its financial advisors.

Sales Charge Discounts & Waivers

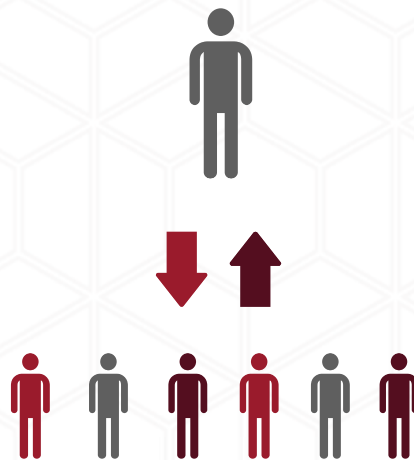
Accountability

- Firms must be accountable to policies and procedures
- To avoid "punishment" firms ought to:
  - inventory all available discounts for their products
  - set up system to provide the discounts, which includes adequate oversight to ensure system is working
  - conduct an analysis of their practices and procedures to identify weaknesses in the controls that have been established. Once these weaknesses are identified, it is recommended that firms develop an action plan to remediate any gaps that were discovered.

Sales Charge Discounts & Waivers
Bottom Line

- Based on FINRA's continued prioritization on regulating sales charge discounts, in conjunction with the slew of sanctions and fines distributed to firms, we anticipate FINRA to continue to hold firms accountable

Questions?



IBDC