

# The Rapidly Changing Landscape of Defending Dually Registered Independent Advisors/Broker-Dealers

## Moderator:

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## Session Participants:

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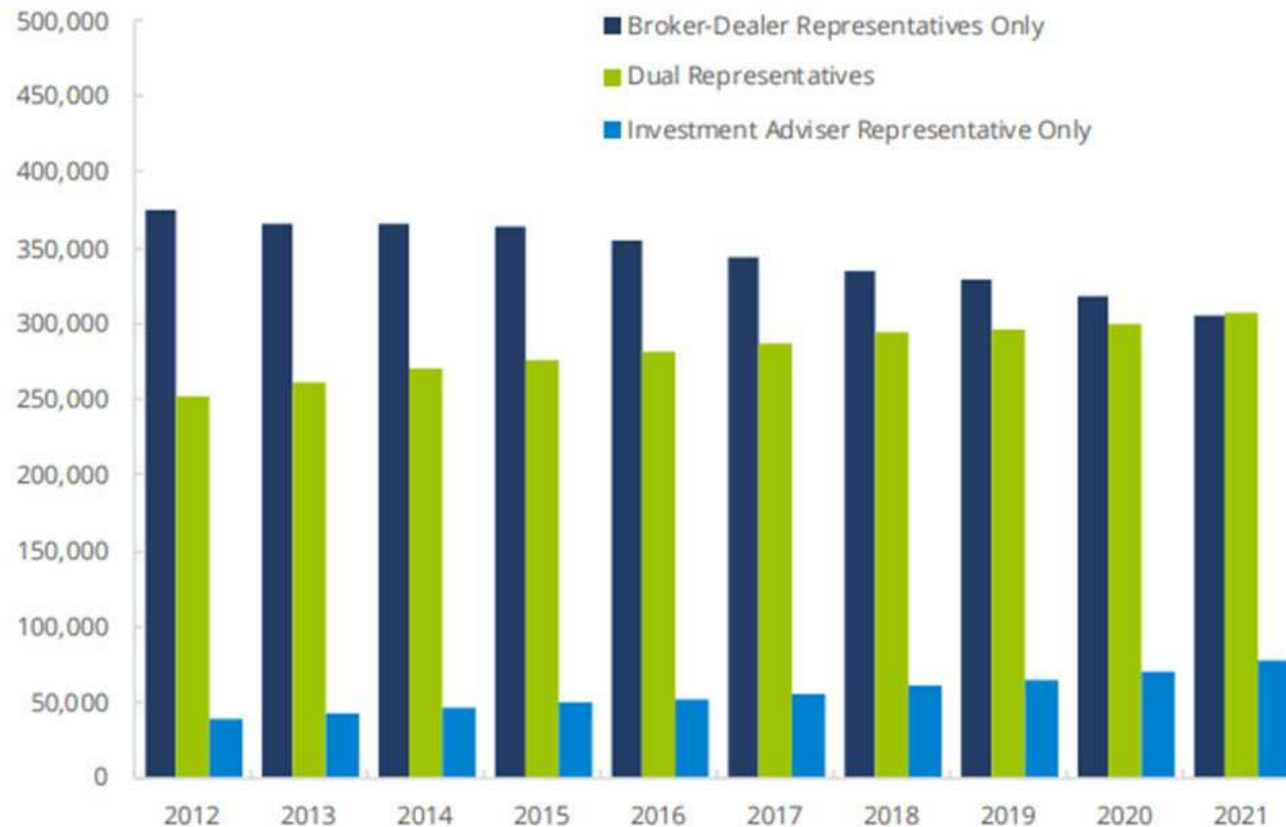
# What is Dual Registration?

- Dually Registered Advisor/Financial Professional or “Hybrid Advisor”
  - Individual who is a both registered representative with broker-dealer and an investment advisor representative of an RIA
- Dually Registered Firm or “Hybrid Firm”
  - Registered broker-dealer firm where same entity is also an RIA
- Can offer both transaction and fee-based services
- Dual registration intent
  - Purpose of investment advisor is to act as fiduciary in the *active management* of a client’s assets
    - Monitoring the account to ensure previously purchased products are still in line with disclosures/objectives
    - Actively trading in the account
  - Purpose of broker-dealer traditionally is to facilitate trading for its clients
    - Role is more in line with making a recommendation and facilitating the trade

# New Trends

Figure 1.5 Securities Industry Registered Individuals by Type of Registration, 2012–2021<sup>1,2</sup>

(Count as of year-end)



- FINRA Report 2021 shows number of dual registrants as of the end of 2021 exceeded the number of solely registered broker-dealer representatives for the first time in 10-year period.
- 307,500 dual registrants, 305,000 representatives solely registered as brokers, and about 77,500 investment advisors registered with the SEC or state governments

# Hurdle Number One: How to Structure the Client Relationship

- SEC Staff Guidance March 2022
- Legal Standards
  - Investment Advisor: fiduciary (duty of care and duty of loyalty)
  - Broker-Dealer: act in the best interests of the client (Reg BI)
- How to determine whether the investor's objectives are met with one platform over the other?
  - Standard: have a reasonable basis to believe it's in the client's best interest
    - Limitations on account types and products should be disclosed and considered
    - Disclose costs and fees
- What policies and procedures are in place to help advisor decide which platform to use?
  - Has the advisor been trained properly?

# Investor Onboarding and Disclosures

- Need to disclose to client capacity under which advisor and/or firm is acting
  - Default: assume both standards apply
- Ensure policies and procedures are in place on how to disclose which capacity is applicable to investors
- Form CRS (Customer/Client Relationship Summary)

# Practices to Assist Firms

- Avoid compensation thresholds that disproportionately increase compensation through opening of certain account types
- Policies and procedures that minimize incentives
- Supervisory procedures to monitor recommendations
- Specific language in account opening agreements

# Sample Language for RIA Investment Management Agreement

- As detailed in its Brochure and the Form ADV Part 2B supplement for the Wealth Manager(s) responsible for Client's Accounts, most of FIRM Wealth Managers are registered representatives with broker dealers that are not affiliated with FIRM. Under applicable regulatory requirements, a broker dealer may be required to review transactions resulting from the investment related activities of its registered representatives that occur away from the broker dealer. In order for such broker dealers to meet their regulatory obligations, FIRM needs to share information about Clients with such broker dealers. Client authorizes FIRM and each Custodian to share information regarding Client, and to direct Client's Custodian to share such information, with such broker dealers.

# Hurdle Number Two: How To Supervise?

- Applicable Investment Advisers Act of 1940 Rule
  - Rule 206(4)-7 RIA is required to conduct annual compliance review
- Applicable FINRA Rules
  - Rule 3270: Prohibits OBA without prior notice to firm
  - Rule 3280: Prohibits trading away without prior notice to firm
    - Proposed Regulatory Notice 18-08 or Rule 3290: dual registration would not trigger supervisory responsibilities for firm
  - Rule 3110: Firm must maintain a system to supervise
    - Written procedures, supervisors, branch offices
  - Rule 3120: Annual Audits
- Notice to Members
  - NTM 94-44: recommends broker-dealers supervise those who participate in private securities transactions and receive compensation away from firm
  - NTM 96-33: recording keeping systems to ensure adequate supervision



# Regulation Best Interest Considerations

- SEC FAQ on Care Obligation, April 2023

## Special Considerations: Recommendations and Advice by Dual Registrants

**20. I am a dually licensed financial professional working at a dually registered firm, and some of our retail investors have both brokerage and advisory accounts with us.**

- a. How do I know which standard applies when providing advice and recommendations to such investors?**
- b. Do I need to consider whether a brokerage or advisory account is more appropriate for an investment or investment strategy when providing recommendation or advice to a retail investor of a dually licensed financial professional?**

# Recommendations on Record Keeping

- NTM 96-33 suggests broker-dealer:
  - Develop recordkeeping system that captures RIA transactions
  - Provide adequate supervision over RIA transactions (suitability reviews)
  - Develop additional books and records on document retention
    - Name of advisory clients (determine who are also clients of broker-dealer)
    - Copies of agreements
    - Duplicate confirmations
    - Correspondence files
    - Exception reports
    - Suitability reviews

# Are Broker-Dealers Required to Supervise?

- Are member firms required to supervise the work dually registered advisors are conducting at the RIA?
  - Unfortunately, it isn't clear
  - Broker-dealer will get roped in anyways
  - Notice of members encourage such supervision
- Recent important decisions
  - AWC from Cetera: \$1 million fine  
"Failed to establish, maintain and enforce a supervisory system and written supervisory procedures reasonably designed to supervise certain private securities transactions conducted by their dually-registered representatives."
  - State of Massachusetts action against Purshe Kaplan  
Alleging the firm failed to supervise certain transactions of its dually registered advisers
  - Common thread is whether the broker-dealer was placed on notice of heightened supervision requirements or regulatory inquiry by SEC

# Recommendations Reviewing Supervision

- Reviewing recommendation for account type
  - Has advisor obtained sufficient information?
  - Supervisor review of reasonable basis for account type/program
- E-Mail monitoring with overall supervisory platform
- Annual exams of RIA
- Inquire into regulatory inquiries and responses
- Joint supervision agreements

# Hurdle Number 3: Compliance

- FINRA rules much more exact and rule-based and RIA rules are principle-based and defined in the industry by best practices
- FINRA Rule 3120, broker-dealers are required to have in place a system of policies and procedures that annually test and verify firm supervisory controls procedures
  - Firms must also create or amend Written Supervisory Procedures identified as necessary by this testing.
  - Goal is to cover the lowest common denominator
    - Guard rails are up to catch even the bad apple advisors
- Investment Advisers Act of 1940 Rules 206(4)-7 – RIA is required to conduct annual compliance review
  - Can hire a third party as compliance personnel
    - Can structure compliance as RIA sees fit more room for interpretation and exposure

# Hurdle Number Four: Where's the Coverage?

- Gaps in coverage between broker-dealer and RIA
- What types of coverage should broker-dealers have to protect RIA clients
  - Broker-dealer E&O and cyber coverage
- **MAKE SURE EVERYONE HAS INSURANCE**

# Four Main Take Away Points in Defending Cases Involving Dually Registered Advisors

- (1) Is there a reasonable basis for the type of client relationship and the product?
  - Was the advisor self motivated or did he act in client's best interest?
- (2) Did the broker-dealer supervise the actions of the RIA?
  - Did the broker-dealer know of regulatory concerns and/or was the broker dealer placed on notice of heightened requirements?
  - The broker-dealer can't bury its head in the sand
- (3) Did the broker-dealer and RIA meet compliance requirements?
- (4) The broker-dealer should require the RIAs they work with have adequate E&O insurance

# CLE CREDIT CODE

**CODE WORD: SUPERVISION**