Compliance Challenges in "Rep as PM" Accounts

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In recent years, fintech is advancing daily, professional research is offered to firms through various channels including clearing firms and custodians, and a seemingly ever-expanding array of model portfolios is available through various channels. Many investment adviser representatives ("IARs") at registered investment advisers ("RIAs") have concluded that their most efficient use of time is to gather assets and service client relationships, delegating the actual investing decisions to professionals who devote all of their time to it. Even so, a high percentage of firms permit their IARs to directly manage their clients' assets in "Rep as PM" accounts.[1]

The hallmark of Rep as PM accounts is that the IARs directly manage client accounts - selecting the securities to trade, typically on a discretionary basis, often based on their own research and due diligence, rather than relying on one or more models or third party managers. Some firms may provide guardrails, such as: requiring IARs to use firm-approved capital markets assumptions and model portfolios but permitting them to tweak the models, limiting IARs to use firm-approved asset allocation parameters, securities or types of securities, or mandating the type or scope of due diligence to be conducted. Other firms have looser or no constraints on how accounts are managed, the types of investments permitted, the tools used, or even the underlying assumptions or asset allocations for the accounts. Some IARs employ teams of analysts to conduct due diligence or subscribe to research services, while others simply conduct the research themselves. This article identifies some of the compliance risks inherent in the Rep as PM business model and offers some solutions for firms to consider.[2]

Potential Risk: IAR risk tolerance may not align with the rest of the firm

The investment objectives and risk tolerances should be defined uniformly at each firm so that clients are not misled or confused, and supervisors can identify outliers, even in Rep as PM accounts. At firms that allow maximum flexibility for their IARs, one IAR's idea of a conservative risk tolerance may resemble other accounts that are coded as moderate or aggressive. Drastic dispersions in the level of risk in clients' accounts not only create regulatory risk surrounding the clarity of firms' disclosures, but claimants' counsel can also use the discrepancies to buttress claims that the firm did not act in the client's best interest.

Compliance and Supervision Suggestions:

- Firms should consider requiring all IARs to use the same asset allocation models for all programs, including Rep as PM accounts, to prevent clients with the same investment profiles from having widely different account allocations.
- If firms permit IARs to design their own allocations, they should review their disclosures to indicate that IARs in the Rep as PM program do not use the methodologies and resources that the firm has adopted for other programs/accounts, which may lead to more disparate results than more traditional approaches (or whatever specific considerations are appropriate for that firm). Firms should consider including these disclosures in client agreements which get signed, not merely in the Form ADV and RBI disclosures (for dually registered firms).
- Firms should regularly review Rep as PM accounts for outlier positions, performance and allocations and require IARs to provide written explanations as to why the positions and allocations are appropriate for the selected strategy.

1. For some years, particularly after SEC adopted the "Merrill Lynch Rule" in 1999 which permitted broker dealers ("BDs") to charge fee-based compensation, some RRs also acted as managers of their customers' assets in Rep as PM accounts. This continued even after the DC Circuit Court of Appeals invalidated fee-based brokerage in *Financial Planning Association v. Securities and Exchange Commission*, 482 F.3d 481 (D.C. Cir. Mar. 30, 2007). After the adoption of Regulation Best Interest, however, brokerage firms should be cautious about allowing RRs to use Rep as PM accounts because providing ongoing investment advice or discretion may require the firm and RR to be registered under the Investment Advisers Act of 1940. Additionally, use of the title of portfolio manager by RRs might be considered misleading under the Disclosure Duty of Regulation Best Interest.

Even though this article focuses on IARs, to the extent that RRs do make independent decisions in their retail investor accounts, many of the concerns and proposed approaches identified in this article apply to such accounts as well.

2. The suggested approaches may not be appropriate for all firms, and firms may be compliant with the regulatory duties without adopting any of these particular suggestions. In the BD context, the same breadth of practices exists, although the RRs would likely not be exercising discretion on a regular and ongoing basis.

- Firms should consider using tools that risk rate accounts/portfolios as a whole, not just individual allocations or positions, to identify potential discrepancies between clients' stated risk appetites and portfolio compositions, particularly if the firms do not require their IARs to adopt specific asset allocation models.

Potential Risk: IARs are not considering reasonably available alternatives at the platform, program and security level

The best interest duty applicable to all IARs under the RIA's fiduciary duty includes an obligation that IARs not put their own interests ahead of their clients. Inherent in this duty is the requirement that IARs do not rely on stale information about the securities and strategies they recommend or the reasonably available alternatives to such investments/strategies.[3] As new offerings become available through the firm, IARs who have invested considerable time into identifying the features of various platforms, custodians, models, asset allocations and/or securities may have a tendency to rely on their previously reviewed approaches without considering new options. Prospects and even existing clients may be disadvantaged if there are newer, more cost effective means to achieve the same goals or which provide other advantages that would benefit the client (such as tax overlays, ESG options, etc.). The IARs' reluctance to put the time into learning about the features of new offerings is an example of putting their own interests (not conducting additional work) ahead of the clients' interest (in using the best available options designed to achieve investment objectives).

Compliance and Supervision Suggestions:

- Firms may want to develop tools that readily demonstrate the differences between platforms, custodians and programs and require all IARs and supervisors be trained on the features of the newer offerings.
- If warranted, firms can require IARs to document why using an older platform/program/custodian which has higher costs is in the best interest of existing and new clients. This can be included as part of the client onboarding process and annual reviews.
- Supervisors can compare portfolios of clients with similar investment profiles across different programs to see if some consistently cost more or underperform.
- Firms can consider sunsetting older offerings for new clients (along with appropriate disclosure to existing clients utilizing such platforms/programs).

Potential Risk: IARs may be not selecting the lowest cost share classes for client accounts[4]

For IARs that use mutual funds in Rep as PM accounts, firms should supervise that IARs are selecting the best share class currently available to the client, which may be different from the share class most recently used by the IAR as mutual fund complexes introduce new share classes at irregular intervals. Some firms rely on tools or rules that reside in trading systems that have been prepopulated with a single share class for each mutual fund. Some Rep as PM accounts can bypass these controls, either because IARs construct portfolios by entering particular tickers instead of populating asset allocations from a list of prescreened options, or because the filters bypass the Rep as PM programs. Further, some firms work with their subadvisers or platform managers to conduct ongoing reviews of existing share classes in models to identify ones which should be converted, and Rep as PM accounts may not be scoped into those reviews.

3. As Regulation Best Interest also imposes a duty to consider reasonably available alternatives prior to recommending investments to retail investors, this risk applies to BDs as well.
4. Share class selection may be a larger issue for RRs than for IARs since many funds have more share classes available for brokerage accounts than for advisory accounts.

Compliance and Supervision Suggestions:

- Firms should review their controls to identify and monitor share classes to confirm they apply to all account and program types, including Rep as PM programs. Further, firms should test these controls in each type of account (subadvised accounts, Rep as PM, UMA, different custodians, etc.) to assess that there are no inadvertent loopholes which permit the use of higher cost share classes.
- Firms should consider limiting IARs to using preapproved mutual fund share classes or requiring back up (such as the excerpt from the prospectuses showing the available share classes) upon the purchase of other mutual funds shares and at periodic intervals thereafter.

Potential Risk: IARs may lack the time/expertise to conduct ongoing due diligence

Well balanced portfolios need to have a sufficient number of positions, which may tax the IARs' capacity to stay on top of all of them. If IARs are selecting scores of securities for clients, are they truly conducting ongoing diligence into all of them? If they have fewer positions, are they actually customizing their client portfolios? Also, even IARs who focus on specific niches will land in some situations that exceed their expertise. For example, IARs with a focus on value stocks may find themselves out of their depth when an issuer becomes subject to a special situation or alleged fraud.

Compliance and Supervision Suggestions:

- Firms can require IARs to maintain research files on the strategies and securities employed in client accounts, and supervisors can periodically review them to see that, among other things, IARs are conducting due diligence not only upon incepting the positions but at reasonable intervals and upon material market events that impact the positions. Further, supervisors can look at whether the research reports and other due diligence items obtained by IARs are actually being reviewed and incorporated into the decision making processes, not merely accumulated. IARs should be conversant in all of the positions in their clients' accounts.
- Compliance can test that the supervisors are monitoring the IARs' due diligence files.

Potential Risk: The supervisors and back office staff are not familiar with the IARs' strategies

If an IAR's approach involves using complex or novel products or strategies not otherwise offered through the firm, has there been a reasonable onboarding process? For example, do any firm supervisors have sufficient expertise to supervise the strategy? Are the firm's current practices for meeting its best execution duties sufficient? Will new trading partners be needed? Do existing trading systems handle the best execution duties? Will the current valuation practices apply? Are there unique liquidity considerations?

Compliance and Supervision Suggestions:

- All new or materially modified products and strategies introduced to a firm should be run through a meaningful due diligence process, including IAR-introduced products/strategies. A new product committee (or some version thereof) should consider the investment, trading, operations, compliance, conflicts, supervision, fees and other costs, and other aspects of each new security type/strategy and decide whether the firm agrees to take them on, whether new systems, supervisory skills, internal controls, disclosures, policies and procedures or tools are needed to equip the IAR to provide advice on behalf of the firm on that type of security and for the firm to supervise it.

- Even after the product/strategy is approved, IARs can be required, on an ongoing basis, to compare how their strategies, underlying assumptions and expectations as to how such strategies would perform under a variety of market conditions to the actual performance. Supervisors and compliance can review these periodically.
- The firm can require supervisors be trained on the strategies used. For example, if an IAR employs options strategies, the supervisor can be trained as a FINRA Options Principal/Series 4 (even if the supervisor does not actually take the test). For more novel strategies, other resources for training should be identified.
- Firms should have at least one supervisor and a back up who are familiar with the strategy/product before it is employed in client accounts. This is particularly important before onboarding IARs who have clients utilizing strategies that are new to the firm.

Potential Risk: The firm lacks the tools to supervise the strategies

Although this is not limited to Rep as PM accounts, the problem can be exacerbated because of the great variety of strategies being employed. If the IARs are managing assets on a household basis, do they (and the supervisors) have the tools to review allocation, risk and level of activity at that level? What about the level of trade activity to support an ongoing fee – if some accounts are inactive but others have trades, can the firm monitor this? This is a particular issue if a household includes Rep as PM accounts and other types of accounts. If the IAR is using an algorithm/AI, can the firm develop confidence in the process? Style drift may be a concern if accounts do not automatically rebalance.

Compliance and Supervision Suggestions:

- Firms' investment management agreements should clearly indicate which accounts are being managed on a household basis and identify the implications – such as some accounts may be more concentrated in riskier assets, others may have infrequent trading, etc.[5]
- Firms should invest in tools that enable them to review account activity, costs and performance at a household level, if applicable.
- Firms that lack such tools may want to require the IARs to provide supervisors aggregated information on trade activity, costs and performance on a periodic basis.
- Firms can require access to, or at least evidence of, reviews conducted of any third party tools used to generate investment decisions in client accounts.
- If IARs use their own portfolio management or performance software, firms can require that they be provided access. See also the risks regarding data security too.

Potential Risk: Documentation

There are a number of different risks relating to documentation. Are the IARs using proprietary investor profile tools which replace or supplement the ones used by the firm? Are they relying on third party research? Do they use their own CRMs? The SEC Staff may expect these records to be retained based on the March 2022 Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors in which it emphasized multiple times that "[i]t is the staff's view that it may be difficult for a firm to assess periodically the adequacy and effectiveness of its policies and procedures or to demonstrate compliance with its obligations to retail investors without documenting the basis for such conclusions."[6]

5. BDs should consider tailored disclosures to their retail investors that identify whether investment objectives will be met in each account separately or as part of a group of accounts and identify which accounts will be treated collectively for purposes of an investment objective.
6. The language varies slightly in each instance but not the substance of the Staff's expectation that both BDs and RIAs document the clients' profiles to support the basis for their recommendations/trades in client accounts.

Compliance and Supervision Suggestions:

- Firms should make sure that IARs maintain records on the firm's systems, even if they also have their own set retained elsewhere. Compliance can test this.
- It is often effective to train the IAR support staff in recordkeeping requirements so that the firm has access to the required records.

Potential Risk: Data Privacy

Even if the firm has copies of the required records, if the IARs use third party vendors, confidential client information may be retained in a manner not consistent with the firm's privacy policy and data security protections.

Compliance and Supervision Suggestions:

- As part of the IAR onboarding process, firms can review what service providers are used and assess whether they meet the firm's data security requirements.
- IARs can be required to identify and provide data security documentation for all of the third parties they use in connection with their account management as part of the firm's annual risk assessment.
- Firms should consider maintaining lists of all of third party vendors who have access to confidential client information and scope them into the firms' ongoing service provider oversight programs.

Potential Risk: Proxy Voting

If there are some positions that are not widely held at the firm, firms may need to monitor that IARs are adhering to the firm policies, disclosures and recordkeeping requirements. This is particularly important if the IARs' votes do not align with the recommendations of the proxy advisory firms used by the firm.

Compliance and Supervision Suggestions:

- Firms should make sure their policies, procedures and client disclosure reflect the actual practices for all account types.
- If firms prohibit IARs from voting or advising on proxies, they can survey their IARs periodically about their proxy practices to determine they are in compliance.
- If firms have authority to vote proxies, they should test that they have access to the required records.

Potential Risk: Unique Conflicts of Interest

IARs who can invest client assets in any securities, select any outside manager, use any custodian or vendors, etc., may have conflicts of interest that do not apply to other IARs.

For example, personal trading of the IAR and their specific support personnel may be at risk for front running and/or the misuse of MNPI if firm policies and procedures don't properly consider Rep as PM activities. Or, IARs may use subadvisers with whom they have some affiliation or receive some benefits.

Compliance and Supervision Suggestions:

- Firms' risk assessments should consider whether IARs have any special relationships with any of their vendors. Do they have affiliations with or get marketing support from custodians or third party managers? Are some of their vendors associated with them?
- If IARs have specific conflicts, firms should consider if disclosure is required under Item 5 on the Brochure Supplement (ADV 2B). Even if not required by the instructions, firms may need to supplement the standard disclosure documents so that clients are alerted to the specific conflicts applicable to them.
- If IARs trade in smaller-cap or less liquid securities in their own and client accounts, firms may want to supplement existing personal trading procedures and supervision.

Potential Risk: Misleading Advertising

The performance data and areas of expertise in firms' marketing materials, as well as the "significant investment strategies or methods of analysis" identified in Item 8 of the firm's ADV 2A, may not apply in Rep as PM accounts. Unless firms highlight this for clients, however, they are unlikely to be aware of the inapplicability which may be misleading. Also, IARs may want to create their own performance track records which may not meet all of the requirements of the marketing rule.

Compliance and Supervision Suggestions:

- If parts of the firm's marketing materials or the ADV 2A are inapplicable to the clients in Rep as PM accounts, firms can clearly indicate that in an addendum to the Investment Management Agreement or program description delivered to the client.
- Firms can consider additional compliance testing (such as part of an existing branch office review process) to review custom marketing materials, social media postings, performance track records for proper calculation and records to support them, etc. Firms can conduct additional training on the performance calculation and related recordkeeping components of the marketing rule should be provided to IARs with their own track records.

Conclusion

From a risk management and compliance perspective, there are several important considerations for firms to evaluate and develop consensus across firm leadership when offering Rep as PM accounts. This article is not exhaustive but is intended to provide firms a solid road map of issues to consider as part of those reviews. ■