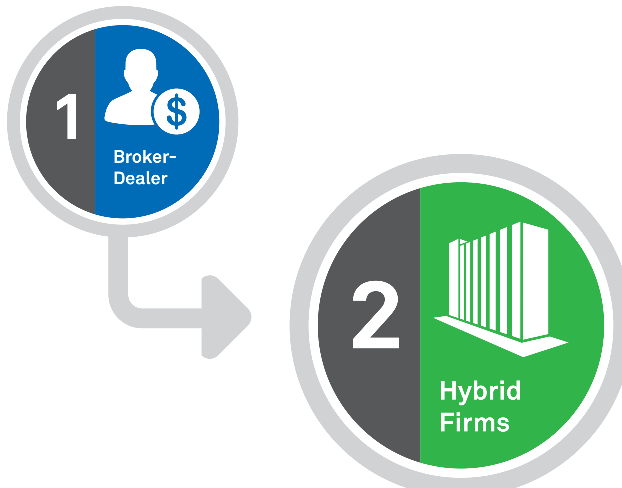
Conflicts in a Rapidly Changing Fiduciary Landscape

Part Two:

A Focus on Dually Registered or “Hybrid” Challenges



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In collaboration with Thomas Roberts, a member of Groom Law Group’s Fiduciary practice group

Identifying Emerging Compliance Concerns

Part one of this series reviewed the standards of care applicable to registered broker-dealers. It also discussed how good compliance practices require firm-level procedures for addressing potential conflicts between those standards of care and the way the firm or its representatives are compensated.

In part two, we take a close look at some of the unique concerns confronting the growing number of individuals and firms that have adopted dual registration or hybrid approaches to serving client needs.

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- Where the dually registered investment professional is representing a distinct broker-dealer and a distinct RIA, the client's brokerage and advisory needs are met by unrelated organizations.
- Where the dually registered financial professional is representing a hybrid firm, the same organization serves both the client's brokerage and advisory needs. Additionally, many hybrid firms offer wrap account programs, which make active investment management and brokerage available for a single fee.

Key Concepts and Definitions

Within the industry, the terms "dually registered" and "hybrid" are often used interchangeably. They describe services offered at different organizational levels (i.e., at an individual representative level vs. a firm level). They also apply to different organizational structures (i.e., by single entity firms or by dual or multiple entity firms that are commonly controlled). It is understandable then, that the terms are sometimes a source of confusion.

For clarity, we will use the following terminology:

- **"Dually Registered Advisor/Financial Professional" or "Hybrid Advisor"** means an individual (natural) person who is both a registered representative associated with a broker-dealer and an investment advisor representative of an RIA. This person may either be associated with a single, dually registered firm, with a broker-dealer and a registered investment advisor that are affiliated, or with a distinct broker-dealer and a distinct RIA.
- **"Dually Registered Firm" or "Hybrid Firm"** refers to a registered broker-dealer firm where the same legal entity or an affiliated legal entity is also a registered investment advisor.
- **"Distinct Broker-Dealer"** means a registered broker-dealer firm that is neither registered as, nor affiliated with, an RIA, but that may permit its representatives to function as hybrid advisors.
- **"Distinct RIA"** refers to an RIA firm that is neither registered as, nor affiliated with, a broker-dealer, but that may be represented by hybrid advisors.

Dual registration and hybrid models have become increasingly popular because they have a great deal of flexibility in serving client needs. A dually registered financial professional can serve clients by offering not only brokerage accounts, but also non-discretionary advisory services, discretionary asset management services or some mix of all three.

Hybrid firms and distinct broker-dealers that permit their registered representatives to function as hybrid advisors face unique challenges under the federal securities laws and FINRA rules. This is particularly complex since dually registered financial professionals and hybrid firms regularly encounter compensation-related conflicts of interest.

Key Terms

Dually Registered Financial Professional or Hybrid Advisor

An individual who is both a registered representative of a BD and an investment advisor representative of an RIA.

Dually Registered Firm or Hybrid Firm

BD firm where the same legal entity or an affiliated legal entity is also a registered investment advisor.

Distinct BD

A registered BD firm. May permit its representatives to serve as dually registered financial professionals.

Distinct RIA

An RIA firm. May be represented by dually registered financial professionals.

Additional compliance challenges under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code confront individuals and firms that provide investment management or non-discretionary advisory services to clients' qualified plans or IRA assets. As discussed below, hybrid firms may have a financial interest in receiving and retaining fund-related revenue streams that may be available to them as a broker-dealer (i.e., 12b-1 fees, service fees, and revenue sharing payments). These are based on investment management decisions or investment advice they or their affiliates provide as an RIA. These firms have a financial conflict that the Department of Labor (DOL) is seeking to address in recent proposals. *Importantly, the DOL's proposals would curtail the availability of these revenue streams to hybrid firms. Hybrid firm management and compliance personnel will want to carefully monitor the DOL's proposals and evaluate their potential impact on revenue streams available to the firm*.

On April 14, 2015, the DOL made available its long-awaited re-proposed regulation on the definition of "fiduciary" under section 3(21) of ERISA. The package of materials proposed by the DOL included:

- *A regulation re-defining who is a "fiduciary" by reason of providing investment advice to a plan or an IRA (the "2015 Proposed Regulation");*
- *Two new prohibited transaction class exemptions; and*
- *Amendments to several existing prohibited transaction class exemptions.*

For additional information on the 2015 proposal, visit http://www.dol.gov/ebsa/regs/conflictsofinterest.html.

Challenges Under the Federal Securities Laws and FINRA Rules

An Initial Hurdle: The Advisory Account Recommendations Versus Brokerage Account Recommendations by Dually Registered Financial Professionals

FINRA, the self-regulatory organization for broker-dealers, requires member firms to supervise the activities of hybrid advisors when they act as representatives of the broker-dealer. FINRA also oversees when they act as representatives of the RIA, even when the RIA is a distinct RIA. This supervisory responsibility manifests itself in different ways. First, the registered representative of the FINRA member firm must obtain the broker-dealer's consent to engage in the outside business activity of representing the RIA.[1] The approval must be in writing. This is because the representation of the RIA would be expected to give rise to the registered representative's receipt of compensation for outside activities involving securities transactions. Mere approval of the registered representatives serving as a dually registered representative is not enough. FINRA also requires that the broker-dealer supervise the suitability of recommendations made by a dually registered financial professional, including the suitability of a recommendation to establish an advisory relationship with a distinct RIA or a hybrid firm.

In 2013, the SEC cited dually registered and hybrid approaches as a new and emerging risk area that would be a focus of the Office of Compliance Inspection and Examination (OCIE).[2] The SEC explained:

> *Due to the continued convergence in the investment advisor and broker-dealer industry, [OCIE] will continue to expand coordinated and joint examinations ... of dually registered firms and distinct broker-dealer and investment advisory businesses that share common financial professionals.*
>
> *For example, it is not uncommon for a financial professional to conduct brokerage business through a registered broker-dealer that she does not own or control and to conduct investment advisory business through a registered investment advisor that she owns and controls, but that is not overseen by the broker-dealer.*
>
> *This business model presents multiple conflicts. Among other things, the staff will review how financial professionals and firms satisfy their suitability obligations when determining whether to recommend brokerage or advisory accounts, the financial incentives for making such recommendations, and whether all conflicts of interest are fully and accurately disclosed. In addition, the staff will review dually registered firms' policies and procedures to understand if such policies and procedures provide guidelines for when a financial professional makes a securities recommendation to a customer with a broker-dealer account versus an investment advisor account.*

1. NASD Rule 3040

2. *See* Office of Compliance Inspections and Examinations Examination Priorities for 2013, available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf

The SEC's remarks indicate a concern that dually registered financial professionals, who can offer clients a choice between an advisory account and a brokerage account or both, may have a financial conflict as to how to appropriately structure the client relationship.

As an example, a dually registered financial professional may recommend the pursuit of a client's goals through an investment in A shares of a mutual fund held in a brokerage account. This recommendation would generate up-front sales commissions. Alternatively, an advisory account arrangement could be established for the same client that would invest in no-load funds and under which the client would pay an ongoing, asset-based, advisory fee. A FINRA or SEC examiner may inquire about how the individual advisor arrived at his or her recommendation. Inquiries may be made as to whether the investor's objectives are best met through a buy and hold strategy, which would tend to suggest a brokerage account relationship, or through an advisory arrangement.

Recommendations that are driven by individual advisor compensation considerations, as opposed to meeting the client's needs, will likely be met with regulatory concern. SEC and FINRA examiners are also likely to ask about whether the broker-dealer, with responsibility for supervising the conduct of the dually registered financial professional, has policies and procedures in place for that individual to use in arriving at a brokerage only vs. brokerage and an investment advisory account recommendation.

Scrutiny may occur at multiple levels. First, with respect to the initial recommendation to the client regarding services, the firm will need to demonstrate that the recommendation of an advisory account was properly supervised for suitability.

Second, after an advisory relationship has been established and is ongoing, regulators may inquire about whether the level of activity in the client's account merits the advisory fee it is paying. Advisory arrangements for small accounts or for investors with a buy and hold orientation are likely to be questioned. In this respect, the firm will want to demonstrate that it has monitored its client relationships to ensure that client interests are being served and that clients are receiving value-added services for the advisor fees they are paying.

Third, where a suitable advisory arrangement has been established, a hybrid firm should be prepared to demonstrate that it has fully disclosed any conflicts of interest it may have in recommending investment products that generate revenue, such as 12b-1 or revenue sharing payments for its broker-dealer.

Scrutiny of Wrap Account Programs—"Reverse Churning"

Regulators are also likely to inquire about the level of trading activity in client wrap fee arrangements. Wrap fee programs typically make available a combination of investment management and brokerage services in exchange for a single "all in" annual fee (e.g., 1.5% of assets under management). Hybrid firms often offer proprietary programs under which client trades are placed by its broker-dealer, while investment management is provided by its RIA. Regulators have expressed concerns that the economics of these arrangements may cause hybrid firms to provide something less than the active investment management service that the client was promised. Because trading activity requires the firm to incur expenses, the profitability of a wrap fee account tends to increase if trading activity is minimized.

1 Demonstration that the recommendation of an advisory account, as opposed to a brokerage-only arrangement, was suitable and properly supervised for suitability.

2 Demonstration that the firm has monitored its client relationships to assure itself that client interests are being served and that clients are receiving value added services in consideration of the advisor fees they are paying.

3 Demonstration that the hybrid firm has fully disclosed any conflicts of interest it may have in recommending through its RIA the investment of client accounts in investment products that generate revenue, such as 12b-1 or revenue sharing payments for its BD.

The Investment Advisers Act of 1940 (Advisers Act) describes an investment advisor as: "anyone who engages in the business of advising others as to the value of securities or the advisability of investing in, purchasing or selling securities for compensation."

The SEC's remarks indicate a concern that dually registered financial professionals, who can offer clients a choice between an advisory account and a brokerage account or both, may have a financial conflict as to how to appropriately structure the client relationship.

In 2014, OCIE sent an information request to a number of hybrid firms concerning wrap program arrangements. Among the 21 questions were requests for;

- any analysis conducted by the firm to identify accounts with low levels of trading
- copies of trade blotters (i.e., purchases and sales journals) listing transactions in securities and other financial instruments for current and former clients
- firm policies and procedures for monitoring wrap accounts with high cash balances or low levels of trading
- the factors used by the firm to determine the suitability of wrap clients initially and on an on-going basis.

For clients with little or no trading activity, a firm may be challenged to justify its wrap fee and explain why the client, as a buy and hold investor, would not be better served through a traditional brokerage account arrangement.

Identifying and Disclosing Conflicts of Interest to Advisory Clients—the Conflicts Presented by Broker-Dealer Revenue Sources and Best Execution Concerns

Under the Advisers Act, a registered investment advisor is always obligated to serve the "best interest" of its clients and not to subordinate the interests of the client to its own. In other words, a registered investment advisor is obligated to always put client interests first.

Notwithstanding that general rule, for purposes of the federal securities laws, a registered investment advisor *is* permitted to render advice and make recommendations to clients in instances where it may have a conflict of interest so long as that conflict has been fully disclosed to the client and the client has consented to the advice relationship on a fully informed basis.[3] The legal basis for the exception is the notion where an advisor has made "full and frank disclosure" of its conflict of interest. The advisor's client then is positioned to evaluate the investment advisor's conflicting interests and to make an informed decision about whether the advisor can serve the client's interests in light of the advisor's own financial interests.

Advisory account relationships established by hybrid firms typically also involve a brokerage account with the same firm. In such instances, the sources of revenue available to the broker-dealer in connection with the account's holdings often give rise to a conflict of interest. With respect to mutual fund investments, for example, any revenue sharing arrangements that the broker-dealer may have with particular funds could provide a financial incentive to the firm's advisory arm to recommend funds based on those revenue considerations. Under such circumstances, it is important that the investment advisor identify the conflict to its clients and take steps to assure that the client has consented to the advice arrangement with full knowledge of the conflict.

A related issue involves the investment advisor's duty to clients to obtain the best execution of their transactions.[4] The term "best execution" is not itself defined under the Advisers Act, but has come to be defined over time through SEC enforcement actions alleging failure to achieve best execution. In essence, best execution is a duty to see that client trades are executed in a manner in which the client's costs and proceeds in each transaction are the most favorable available given the circumstances.

3. It is important to remember that disclosure of conflicts in the manner required by federal securities laws, by itself, is insufficient to avoid the prohibited transaction restrictions of ERISA and the Code that may apply to qualified plan and IRA client recommendations.

Typically, a best execution analysis requires consideration of both qualitative and quantitative factors. Quantitative analysis involves consideration of price and commission rates, while qualitative analysis involves factors such as the broker's ability to handle trades, financial stability, reputation and overall knowledge of the market. In 2013, the SEC brought a best execution enforcement action against a hybrid firm alleging a discrepancy between the firm's statements concerning its best execution policies and procedures and its actual practice.[5] The firm's Form ADV indicated that it would consider a list of factors and would conduct a comparative brokerage firm commission rate analysis. The SEC alleged that the firm always directed advisory client trades through itself as broker-dealer without considering other options for executing the trades, such as unaffiliated broker-dealers. Further, the SEC alleged that the firm misrepresented to clients that use of the firm's broker-dealer capabilities for trade execution would result in lower commission costs when in fact that was not necessarily the case. The firm agreed to pay a $500,000 fine as part of the resolution of the case.

Best execution is a duty to see that client trades are executed in a manner in which the client's costs and proceeds in each transaction are the most favorable available given the circumstances.

The SEC also brought a best execution enforcement action against another hybrid firm that resulted in more than $1 million in fines and penalties.[6] The firm served as broker-dealer for advisory client accounts and charged a stated commission rate per traded share, which was shared with the firm's clearing broker on an 80% to 20% basis. The firm later re-negotiated the basis on which commissions were split with its clearing firm to a 90%/10% basis, but was alleged to have failed to notify its clients of that change or to have undertaken a best execution review in light of the change. Based on these actions, a hybrid firm may want to consider conducting periodic reviews to evaluate whether its RIA business is obtaining best execution for clients through its broker-dealer, confirming the firm's adherence to its best execution policies and procedures, as disclosed to clients.

Many hybrid firms are already aware of questions securities regulators have raised concerning the hybrid model, which tend to largely concentrate on whether hybrid firms are properly calibrating their service model recommendations (i.e., brokerage or advisory) to individual client situations. Less well known, but of critical importance, are new compliance challenges that have emerged. Recently, the DOL has proposed changing the definition of the term "fiduciary," as well as the nature of the prohibited transaction exemption relief available, regarding employer-sponsored plan arrangements and IRAs. As discussed below, the DOL's proposals would curtail the ability of hybrid firms to receive 12b-1 fees and other forms of revenue sharing generated by wrap program assets involving IRAs.

4. *See, e.g., In re MPI Investment Management et. al.*, Investment Advisors Act Release No. 1876 (June 12, 2000)

5. *In the Matter of Goelzer Investment Management et. al.,* Investment Advisors Act Release No. 3638 (July 31, 2013)

6. *In the Matter of A.R. Schmeidler & Co., Inc.,* Investment Advisors Act Release No. 3637 (July 31, 2013)

The DOL's proposals would curtail the ability of hybrid firms to receive 12b-1 fees and other forms of revenue sharing generated by wrap program assets involving IRAs.

Challenges Confronting Advisory and Managed Account Programs at Hybrid Firms Under the DOL's Proposal

IRA assets often represent the largest source of hybrid firm investment advisory and managed account assets. However, hybrid firms have widely varying practices concerning the treatment of fund-related revenues available to their broker-dealer businesses in connection with their RIA's investment recommendations. To some extent, these variations in practice may be attributable to confusion about the degree to which, if at all, the prohibited transaction rules of ERISA are applicable to IRAs and whether exemptive relief from those rules may be available.

While IRAs are typically not subject to ERISA's prohibited transaction provisions, some firms and individual advisors fail to appreciate that IRAs are subject to the parallel provisions of section 4975 of the Internal Revenue Code.

For example, some in the industry have held the view that since IRAs are not subject to ERISA, the same revenue sharing opportunities available with respect to non-tax advantaged, or "retail" accounts should be equally available with respect to IRAs. An oft-heard, though not entirely accurate catch-phrase by some firms has been "IRAs aren't subject to ERISA, so we don't have to worry about prohibited transactions."

As noted above, in fact, IRAs have always been and remain subject to section 4975 of the Internal Revenue Code. Section 4975 of the code contains a set of prohibited transaction provisions that parallel those found in ERISA, including prohibitions against fiduciary self-dealing (e.g., using one's investment management authority to invest the assets of client account in funds that generate 12b-1 fees and revenue sharing to the hybrid firm's broker-dealer arm).

With respect to IRA advisory accounts, hybrid firms act as fiduciaries when recommending investments or exercising discretionary management authority over account assets. The investment of those assets in funds that generate 12b-1 fees, revenue sharing or similar payments to the hybrid firm's brokerage arm pose a conflict of interest. Recognizing this, some hybrid firms adhere to a practice of resolving such conflicts by rebating any revenue sharing back to client accounts or using such amounts to offset the client's account-level fees.

Many other firms accept revenue sharing payments generated in connection with IRA accounts that they advise either because they were unaware of the legal prohibitions against fiduciary conflicts under code section 4975 or because they concluded prohibited transaction exemptive relief from those legal prohibitions was available under one or more DOL class exemptions.

The DOL, which has the authority to issue prohibited transaction exemptive relief under both ERISA and the Code, decades ago issued two exemptions which provide a basis to support the common practice by hybrid firms of retaining 12b-1 fees and other revenue sharing streams generated in connection with client IRA wrap account programs.[7]

Prohibited transaction exemptions 75-1 and 86-128 provide relief from the conflicts of interest a fiduciary faces when the fiduciary engages in certain transactions with a qualified plan or an IRA. The fiduciary may take the position that if the firm meets the conditions of the class exemption, the firm can retain the 12b-1 fees and other revenue it receives.

The department's proposal limits or removes altogether the availability of this exemptive relief, depending on whether the advice relationship is non-discretionary or discretionary. The department's proposals have the potential to dramatically affect many hybrid firm revenue models.

For non-discretionary advice relationships, the DOL proposal would condition the availability to receive 12b-1 fees and other forms of revenue sharing upon satisfaction of the terms of a new "best interest contract" or "BIC" exemption. The conditions of the BIC exemption are numerous, highly technical and require the delivery of a "best interest" promise to clients which exposes the firm and its representatives to litigation risk.

In the case of discretionary advice relationships, under the DOL proposal, the receipt of 12b-1 fees, revenue sharing payments marketing fees, administrative fees, sub-TA fees and sub-accounting fees by hybrid firms with discretionary management authority over client IRA assets would be explicitly disallowed.

Hybrid firms and advisors will want to carefully monitor the progress of the DOL proposal. If it is adopted, hybrid firms will need to analyze the extent to which client relationships that involve the receipt of revenue sharing may require restructuring to avoid prohibited transactions.

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The Bottom Line

Rules governing acceptable compensation practices are fast-evolving. In this environment, firms that aren't prepared to address these dramatic changes will be at a disadvantage. The reality is that new regulation, such as the Department of Labor's proposed Conflict of Interest rule, has implications for all business models—and everyone needs to begin proper planning and compliance oversight.

7. *See PTE 86-128, Class Exemption for Securities Transactions Involving Employee Benefit Plans and Broker-Dealers,* 51 Fed. Reg. 41686 (Nov. 18, 1986), amended at 67 Fed. Reg. 64137 (Oct. 17, 2002); *see also PTE 75-1, Exemptions from Prohibitions Respecting Certain Classes of Transactions Involving Employee Benefit Plans and Certain Broker-Dealers, Reporting Dealers and Banks*, 40 Fed. Reg. 50845 (Oct. 31, 1975), as amended at 71 Fed. Reg. 5883 (Feb. 3, 2006).

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Updates and further information on this topic are available at www.groom.com.

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* Based on number of broker-dealer clients, *InvestmentNews* 2015

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