Editorial Advisors Corner: Risk Management Update April 2015 – Regulatory Pitfalls Regarding Fee Based Accounts

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Are fee based accounts in the best interests of your clients?

Does your firm monitor the accounts it manages for the appropriateness of fees charged in relation to trading activity and client suitability? You should since the Securities and Exchange Commission ("SEC"), through its National Examinations Program, is continuing to look at how investment advisory firms are addressing this issue.[1]

Fee based accounts have become more prevalent in the financial services industry over the past twenty years as investors have favored the concept of paying for advice and management for an ongoing asset based fee.

Noting one size does not fit all when it comes to fee selection, the SEC is taking a hard stance against the practice known as "reverse churning" (putting clients into fee based accounts that have low level trading strategies). The SEC believes that this practice may be especially prevalent in wrap fee programs, as the single wrap fee is inclusive of transaction costs. In other words, the less trading in the wrap accounts, the more profit received by the wrap sponsor. To demonstrate its intentions to continue to combat this practice, SEC published the following in its 2015 SEC National Examination Priorities letter:

> "Financial professionals serving retail clients are increasingly choosing to operate as an investment adviser or as a dually registered investment adviser/broker-dealer, rather than solely as a broker-dealer. Unlike broker-dealers, which typically charge investors a commission or mark-up on purchases and sales of securities, investment advisers employ a variety of fee structures for the services offered to clients, including fees based on assets under management, hourly fees, performance-based fees, wrap fees, and unified fees. Where an adviser offers a variety of fee arrangements, we will focus on recommendations of account types and whether they are in the best interest of the client at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such relationships."

This is not a new position for the SEC. Notably, in a report published in 1995 by the SEC's Committee on Compensation Practices ("Tully Report"),[2] they called fee based arrangements a "best practice," but also stated that accounts with low trading activity might be better suited for a commission-based arrangement.

The SEC takes the position that placing clients in accounts with inappropriate fee structures is considered a violation of an advisory firm's fiduciary duty under Section 206 of the Investment Advisers Act of 1940. They therefore expect advisers to have processes in place to help ensure that the types of fees charged to clients are suitable.

It is particularly important for dually registered firms (*i.e.,* firms registered as both an investment adviser and broker/dealer) to have good controls in place, since they offer both fee based and commission based accounts. In 2003, FINRA issued Notice to Members 03-68[3] detailing its expectations when it comes to fee selection stating in part:

> "members should then consider whether the type of account is appropriate in light of the services provided, the projected cost to the customer, alternative fee structures that are available, and the customer's fee structure preferences."

Since the release of that Notice to Member, FINRA has taken action against a number of firms regarding the improper assessment of fees.

Compliance Tips for Ensuring Appropriate Fee Structures

Firms can address this issue in several ways, most notably through their policies, supervisory procedures, and client disclosures. The following protocols are provided to assist firms in implementing a compliance process that will help ensure that the types of fees charged remain in the clients' best interest:

- Adopt written procedures governing how and when client accounts will be reviewed to detect low trading activity
- Implement technology (software programs) that performs automated account reviews for inactivity and provides exception reports and/or alert emails
- Obtain necessary client information that may include but is not limited to: investment objectives, trading experience, account size, and risk tolerance, to determine appropriate fee structure
- As part of the account opening process, have supervisory personnel perform quality control reviews to help ensure the fee structure selected appears appropriate prior to opening accounts
- Provide disclosure (via Form ADV Part 2A) to clients regarding the types of fees charged by the firm and the conflicts surrounding the fee arrangements – for wrap accounts, this should include disclosure noting the fact that clients may be paying more for wrap fee based accounts than they would if they paid for the services separately
- Perform periodic testing of client accounts to compare fees charged with investment activity and services provided – for wrap accounts, determine if wrap fees charged are materially higher than what the fees would be if charged separately

Conclusion

The SEC and FINRA continue to question firms during exams about their processes for determining, both initially and ongoing the appropriateness of fees structures selected for clients. Therefore, CCOs should ensure that their firm has adequate procedures and controls in place to address these issues.

For more information, or to learn about how CCLS may be of assistance, please contact us at (619) 278-0020.

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ENDNOTES

1 *See* SEC Exam Priorities for 2015 at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf

2 *See* Tully Report at https://www.sec.gov/news/studies/bkrcomp.txt

3 *See* FINRA Notice to Members 03-68 at http://www.finra.org/sites/default/files/NoticeDocument/p003079.pdf