

Legal Risk Management Tip
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CONSIDERATIONS FOR ADVISORS WITHIN THE HYBRID MODEL

Over the past few years, more and more firms are diversifying services and products. In an effort to support this business development and attract new talent, broker-dealers (“BDs”) are permitting associated persons to affiliate with independent, non-affiliated investment advisory firms (“IAs”) and vice-versa, which allows the representative to conduct both brokerage business (as a registered representative or “RR”) through the BD and advisory services (as an investment adviser representative or “IAR”) through the IA. This also allows for greater prospective client development opportunities, which leads to revenue generation. However, with more diversity come greater compliance challenges that necessitate engagement of legal counsel during particular transactions. This legal tip will provide important information regarding challenges compliance officers have in overseeing the “hybrid” business model, with a case study involving special considerations for supervision of outside business activities and revenue flow.

A. What is the “Hybrid” Business Model

When discussing a hybrid business model, the basic concept is simple – a hybrid model is one that allows for a representative to associate with an IA while serving as an RR with an unaffiliated BD. Doing so allows the representative to receive a combination of fee-based and transaction-based compensation from their clients.¹ This is similar to, but distinct from, “dually registered” advisers who are RRs of a BD and also perform advisory services as an IAR under the BD’s corporate IA. With this model however, there are both unique regulatory and business challenges.

B. Case Study

Assume you are the Chief Compliance Officer (“CCO”) of a fee-only IA. The Chief Executive Officer comes to you and says, “Great news! We’ve just hired Ms. Smith as a new financial adviser of the firm. The exciting thing about Ms. Smith is that she also has her Series 7 license, and is eligible to sell investment products through an unaffiliated BD for which she’s currently a RR. I told her that she could keep her affiliation with the BD and start to market her ability to sell brokerage products to our clients. Ms. Smith did mention that she wants to run all revenues she receives, from both the BD and our firm, through a limited liability company (“LLC”) that she has set up for tax purposes. That’s not a problem is it?” Immediately you start searching for answers to the many questions this situation poses.

1. Compliance Considerations

Firms employing a hybrid practice face the daunting task of abiding by dual compliance programs under two different regulatory structures. The IA is regulated either by the SEC or by individual states, while the BD is regulated primarily by the Financial Industry Regulatory

¹ http://advisorservices.schwab.com/public/file/P-4002185/SAS_Trans_HybridMKT_WEB021011.pdf.

Authority (“FINRA”). Firms must be aware of and abide by regulations promulgated by all such regulatory bodies. While not a comprehensive list, below are some of the more pressing considerations the CCO will encounter.

i. Oversight by BD of Advisory Services

In developing a supervisory oversight program, BDs must comply with FINRA rules and regulations. In accordance with FINRA Rule 3270,² BDs are obligated to supervise the outside business activities of their RRs. As such, the BD has an obligation to supervise Ms. Smith’s advisory activities - regardless of whether she is part of a hybrid model serving as an IAR of an IA that is independent of the BD. To supervise her activities, the BD will require Ms. Smith provide the BD with several books and records in order to oversee her trading and other activities. This will include, but is not limited to, duplicate email transmissions and transactional reporting for Ms. Smith. Further, the BD will require copies of the IA’s disclosure documents to review such as Form ADV, Privacy Notice, advisory contract(s) and marketing materials. As the CCO, you will need to work closely with Ms. Smith and her affiliated BD to ensure that they receive such documents and data flow.

ii. Unforeseen Impacts to IA Compliance Program

In addition to those areas highlighted above, there are additional unforeseen impacts to the IA’s Compliance Program that must be considered as well. BDs that are FINRA members are subject to FINRA oversight of the activities of the firm as well as its associated persons. While advisory-only firms are not regulated directly by FINRA, the IA can find itself involved in a FINRA examination, or subject to FINRA requirements, due to the fact that an IAR of the IA also is an RR of a regulated BD. To exemplify this, let’s assume that Ms. Smith is selling a particular security to her clients that FINRA wishes to examine. FINRA will not only request documents from Ms. Smith vis-à-vis the BD, but also may ask to retrieve certain trading and communication books and records from the IA. It is also possible that FINRA could go onsite at the IA firm to perform a branch office examination, thus subjecting the office team to additional pressures.

In response, the IA should be proactive to ensure that internal controls are developed prior to onboarding the new advisor. For example, the IA should consider adopting its own internal policies and procedures to monitor outside business activities of and trades executed by the RR. By monitoring behavior patterns and trends, the IA is able to ensure that sales activities are not fraudulent and firm policies are not being circumvented. The CCO should weigh these factors and report up to the Senior Management team with findings and recommendations.

² Additionally, in accordance with FINRA Notice to Members 94-44 and 96-33, registered broker-dealers are required to oversee the trading activities of RRs. For more information, please see <http://www.finra.org/sites/default/files/NoticeDocument/p013792.pdf>.

2. Receiving Fees/Commissions

In this scenario, Ms. Smith requested that revenues generated by her be paid to her LLC, for which she is the sole member. While there are very little restrictions on the IA for paying advisory fees to Ms. Smith in this manner, the same is not true for the receipt of brokerage commissions from the BD. FINRA Rule 2040³ governs the payment of transaction-based compensation by BDs that are FINRA members to unregistered persons. Rule 2040 flatly prohibits any member firm or associated person from, directly or indirectly, paying compensation to an unregistered firm or unlicensed person, if the receipt of such compensation would cause the recipient to be subject to the broker-dealer registration requirements of the Securities Exchange Act of 1934 (the “Exchange Act”). SEC guidance states that receipt of securities transaction-based compensation is an indication that a person is engaged in the securities business and that such person generally should be registered as a broker-dealer. Thus, a BD is not able to issue brokerage commissions to Ms. Smith’s entity directly (assuming the entity is not registered with FINRA as a broker-dealer), but rather, such commissions must be made to her as an individual. This can have important liability implications for Ms. Smith as well as indirectly on the IA. Even though the BD is ultimately responsible for overseeing the payment of commissions, Ms. Smith is personally liable for failure to adhere to FINRA regulations. As CCO, you need to convey FINRA’s requirements to Ms. Smith and provide guidance on how she could transfer funds she receives as an individual to her personal corporate entity upon receipt. You should also ensure that branch office examinations for Ms. Smith evaluate the use of the corporate entity, including source of funds for revenue streams to help ensure regulations are not being circumvented.

C. Conclusion

Firms deciding whether or not to employ a hybrid business model should investigate the cost, administrative impacts and other factors before adopting such practices. While doing so creates the potential for increased opportunities, service offerings and revenues, it also exposes the firm to increased business and compliance risks. It is important to have a clear understanding of how to best address, minimize and/or mitigate these risks. It is recommended that anyone interested in occupying such a role work with independent counsel familiar with these models to ensure such risks and processes are properly addressed.

For more information on this topic, please contact us at (619) 298-2880 or at info@jackolg.com.

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³ For more information please see http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=11780.