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ACA Insight

The weekly news source for investment management legal and compliance professionals

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SEC Proposes Broker-Dealer Best Interest Standard, Adviser Fiduciary Interpretation

The SEC on April 18 laid down its initial markers on the subject of standards of conduct for both broker-dealers and advisers – while making clear that it expects and welcomes changes.

The Commission, by a 4 to 1 vote at an open meeting, proposed two rules and an interpretation that would, among other things, create a separate best interest standard for

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Fees and Expenses: OCIE Wants Advisers to Focus on the Nuts and Bolts

Sometimes it's the basic things that get overlooked, like fees and expenses. When that happens in the asset management community, problems occur and examiners notice – which may be why the SEC's Office of Compliance Inspections and Examinations this month issued a Risk Alert offering an "Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers." Chief compliance officers would be wise to pay attention.

"OCIE's objective in publishing this Risk Alert is to encourage advisers to assess their advisory fee and expense practices and related disclosures to ensure that they are

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Discovery of Fraudulent Registration Offers No Relief from Rule Compliance

One might think that an advisory firm charged with misstating its assets under management in order to register with the SEC could take some solace in believing that it never had to comply with agency rules. After all, such an adviser might think, the Custody Rule, the Books and Records Rule, the Advertising Rule and other rules apply only to SEC registrants. But such an assumption would be a mistake.

One adviser found this out the hard way on April 5. That's when the SEC reached a settlement with Connecticut-based advisory firm **Clayborne Group** and its owner, founder and chief compliance officer **Dean Heinemann** for improperly registering

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SEC Proposes

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broker-dealers and provide a separate "interpretation" on the existing fiduciary duty for advisers. The SEC's proposals would also require advisers and broker-dealers to provide short-form disclosures to retail investors, and would limit how the term "adviser" or "advisor" can be used by broker-dealers.

"The big takeaways are that there is not one uniform standard for advisers and broker-dealers, as some had looked for, and that the new standard for broker-dealers is not a fiduciary rule," said **Stradley Ronon** partner **Lawrence Stadulis**.

The SEC proposals, which total more than 1,000 pages with more than 1,800 footnotes, are designed to at least partly address issues that have plagued advisers and broker-dealers for years. Perhaps chief among those questions is whether broker-dealers, long subject to a suitability standard in their dealings with clients, should be subject to a stricter standard, as advisers are.

The one certainty that came from almost all the commissioners' comments, as well as early industry reaction, is that the final version of these measures are likely to look quite different from what was proposed.

"There will have to be changes," said **Ropes & Gray** counsel **David Tittsworth**. "There will be hundreds of comment letters. The comments at the open meeting confirmed just how controversial this is."

"This was a good faith effort to get the ball rolling, from the SEC's perspective," said Stadulis.

The proposals

The new SEC proposals seek to address, to some extent, this issue and related topics. Here's what the Commission proposed:

- **Regulation Best Interest.** Under this proposed rule, a broker-dealer making a recommendation to a retail customer would have a duty to act in the best interest of the retail customer at the time the recommendation is made, "without putting the financial or other interest of the broker-dealer ahead of the retail customer," the SEC said. It would entail disclosure, care and conflict of interest obligations. One of the problems here, said **Eversheds Sutherland** partner **Michael Koffler**, is that the definition of "best interest" is not clear.
- **Investment adviser interpretation.** Under this proposal, the SEC "reaffirms, and in some cases clarifies, certain aspects of the fiduciary duty that an investment adviser owes to its clients." The point of the interpretation appears to be to "pull together the existing law, common law, court precedents and more in one place," said Tittsworth.
- **Form CRS relationship summary.** Under this proposed rule, advisers and broker-dealers would be required to provide retail investors with a "standardized, short-form (four-page maximum) disclosure [that] would highlight key differences in the principal types of services offered, the legal standards of conduct that apply to each, the fees a customer might pay, and certain conflicts of interest that may exist." Koffler suggested, however, that the very simplicity of the form may make it seem like advisers and broker-dealers do the same thing. "The more you make things look the same, the more you make it difficult for investors to distinguish between them."
- **Titles.** The SEC would restrict certain broker-dealers from using, as part of their name or title, the words "adviser" or "advisor," because of their similarity to "investment adviser." The concern, said the agency, is that the misuse of these terms "may mislead retail customers into believing their firm or professional is a registered investment adviser." Tittsworth suggested that this may not go far enough, that a more comprehensive measure would be one addressing all those who "hold themselves out" as providing investment advice, including those with titles like "wealth manager" or "financial consultant."

Changes and the Commission

The proposed measures from the Commission are likely to change, and at least three commissioners – including two who voted in favor of the proposals – made clear that, to varying degrees, they see the proposed rules and interpretations as far from ready and simply building blocks for further changes, following review of public comments. SEC chairman **Jay Clayton** set a 90 day period for public comment and review. He made this point in his opening remarks at the open meeting. "I am excited for us to take this significant step forward. The word 'step' is appropriate. Today, in short, we are framing the issues and proposing a comprehensive path forward on which we anticipate and welcome robust public comment."

Commissioner **Robert Jackson**, one of the two Democratic commissioners on the Commission, in explaining his vote in favor of the proposals, said that "I am mindful of the fact that, in light of recent decisions by the Administration and the courts, investors currently lack any meaningful protections from conflicted advice from brokers. And I believe that an open, public rulemaking process is the best way for us to be certain that our rules are giving investors the protections they deserve. For that reason, I am reluctantly voting to issue these proposals for comment—and look forward to continuing to work with our exceptional staff to improve them."

Commissioner **Hester Peirce**, one of the two Republican commissioners, who also voted in favor, expressed concerns regarding the clarity of the proposals. She said that she supported putting the proposals out for public comment, describing them as "an excellent start on the path to reform."

The other Democratic commissioner, **Kara Stein**, in what might be described as a blistering critique of the proposals, was the only commissioner to vote against them. "The proposals before the Commission today squander the opportunity to act in the best interest of investors. Instead, the proposals essentially maintain the status quo."

She continued, "Does this proposal require financial professionals to put their customers' interests first, and fully and fairly disclose any conflicting interests? No. Does this proposal require all financial professionals who make investment recommendations related to retail customers to do so as fiduciaries? No. Does this proposal require financial professionals to provide retail customers with the best available options? No."

The DOL and the SEC

The Department of Labor's ill-fated adoption of its own Fiduciary Rule, vacated by a federal appellate court on March 15 (*ACA Insight*, 3/26/18), was an attempt to address this problem for financial professionals with retirement clients.

The SEC's proposed interpretation for investment advisers differs from the DOL Fiduciary Rule and related DOL rules in "the manner by which conflicts of interest are addressed," said **Drinker Biddle** partner **Joan Neri**.

"Under the DOL rules," she said, "when a fiduciary to an ERISA plan or an IRA gives advice in which it has a conflict of interest, the fiduciary is required to either avoid or eliminate the conflict or rely upon a prohibited transaction exemption. The SEC's proposed interpretation makes clear that an adviser is required to eliminate the conflict or adequately mitigate it only in those cases where full and fair disclosure and informed consent are insufficient. In other words, not all conflicts need to be eliminated or mitigated under the SEC's interpretation."

Industry reaction

Given the size of the proposals, key associations welcomed the SEC's involvement in the process, but said they would need to study the specific measures before further commenting on them.

The **Investment Adviser Association**, in a statement issued shortly after the proposals were voted on, said that it "applauds the SEC for proposing a package of rulemakings designed to raise the standard of conduct for broker-dealers and address investor confusion. We share concerns expressed by the majority of commissioners about whether the proposals will actually achieve those objectives, which we view as crucial for investor protection. However, we are committed to working with the Commission to get this right."

"Regarding the proposed interpretation of the federal fiduciary standard for investment advisers, we believe the fiduciary standard has been well-established by law, regulation and judicial decision and is well-understood by market participants," the association contin-

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ued. "Therefore, we believe additional interpretation may be unnecessary or weaken the standard. We are pleased that, as the IAA urged, the SEC has provided an opportunity for comment."

It added that it found the proposal to restrict the misleading use of titles to be "a step in the right direction," but that titles are "only one piece of the total context of how services are marketed. We look forward to working with the Commission on this aspect of the proposal."

The **Investment Company Institute**, in its own statement, said that it "commends chairman Clayton for leading the Commission's efforts to address standards of conduct for financial intermediaries" and that it has "long advocated for the SEC to take the lead in this area. We look forward to commenting in detail once we have reviewed the package in its entirety."

Fees and Expenses

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complying with the Advisers Act, the relevant rules, and their fiduciary duty, and review the adequacy and effectiveness of their compliance programs," the SEC's examination arm said in releasing the Risk Alert. The Alert is based on fee and expense issues identified in deficiency letters from more than 1,500 advisers' exams completed during the past two years, the agency said.

"This is basic stuff, not mistakes that advisers should be making," said **Mayer Brown** partner **Adam Kanter**, "but OCIE does find these mistakes from time to time when examining advisory firms."

"The whole piece might be summarized as having the following theme: attention to detail matters," said **Dechert** partner **Michael Sherman**. "If you agree to charge a fee, value assets or allocate expenses in a certain way, the SEC is going to expect that you will do that. If you disclose in your private placement memorandum or in your Form ADV that you are going to do things a certain way, the agency is going to expect you to do things that way – even if another way would have been equally fine had that other way been agreed to and disclosed."

At the core of OCIE's findings is what appears to be inconsistencies between the terms of a client's advisory fees and expenses as detailed in its advisory agreement and described in its Form ADV and other materials, and what actually happens in practice. "An adviser that fails to adhere to the terms of these agreements and disclosures, or otherwise engages in inappropriate fee billing and expense practices, may violate the Investment Advisers Act of 1940, and the rules promulgated thereunder, including the anti-fraud provisions," OCIE said.

When this occurs, the SEC may bring enforcement action. In the Alert, OCIE identifies two examples of such actions: the May 10, 2017 **Barclays Capital** settlement, in which the agency found that the adviser allegedly violated Adviser Act Section 206(2) by incorrectly calculating advisory fees when it used a billing method that differed from the advisory agreements; and the January 13, 2017 **Morgan Stanley Smith Barney** settlement, in which the SEC alleged that the adviser violated Section 206(2) when it charged clients fees that did not reflect negotiated discounts.

"The disclosure that clients receive, especially regarding advisory fees and expenses, is critical to their ability to make informed decisions, including about whether to engage or retain an adviser," OCIE said.

The Risk Alert also notes that some advisers, in response to what OCIE found, have already "elected to change their practices, enhance policies and procedures, and reimburse clients by the overbilled amount of advisory fees and expenses." In addition, the examination agency said, some advisers have pro-actively reimbursed clients for incorrect fees and expenses.

"Advisers should consider how they can organize themselves to assure that they meet the Risk Alert's attention-to-detail expectation," Sherman said. For example, he said, this might include maintaining a "cheat sheet" of how various accounts are charged fees and expenses, as well as periodically reviewing contractual arrangements and disclosure documents to assure consistency and accuracy.

"Advisers should test periodically that they are charging fees, valuing assets and allocating expenses in a manner that is consistent with the relevant documentation," he said.

Disclosure findings

Kanter said that the common errors listed in the Alert that center on disclosure are among the more interesting. "They represent more of a fiduciary issue for advisers, more than a rote, 'You didn't do what you said you would do.'"

Nonetheless, he said, all the fee-and-expense mistakes listed in the Alert "are worth advisers looking at and including in their annual review. There could be a coding formula put into an adviser's billing system 20 years ago that, in fact, is wrong. The adviser may not have reviewed it to make sure it was right since then. It might be a good idea to periodically review the billing system versus the contractual language to make sure it's properly handled in the system. Just because you've been doing it for 15 years doesn't mean you've been doing it correctly."

The disclosure observations in the Risk Alert involved advisory fees. Specifically, according to the Alert, examiners observed advisers that:

- **Made a disclosure in Form ADV "that was inconsistent with their actual practices."** For instance, according to the Alert, there were "advisers that disclosed in the Form ADV a maximum advisory fee rate, but nevertheless had an agreement with a certain client to charge a fee rate exceeding that disclosed maximum rate."
- **Did not disclose certain additional fees or markups in addition to advisory fees.** Here, the Risk Alert said that examiners found advisers that did not disclose that they collected expenses from a client for third-party execution and clearing services that exceeded the actual fee charged for those services, and advisers that earned additional compensation on asset purchases for client accounts or that had fee-sharing arrangements with affiliates.

Following are some of the other fee-and-expense errors that examiners frequently found.

Fee billing based on incorrect account valuations

"OCIE staff has observed advisers that incorrectly valued certain assets in clients' accounts resulting in over-billed advisory fees," the Alert says. It noted that, since advisers generally assess fees as a percentage of the value of assets they manage in each client's account, "an incorrect account valuation will lead to an incorrect advisory fee being assessed to that client." OCIE then provided the following examples found by examiners:

- **Valuing assets in a client's account using a different metric than those specified in the client's advisory agreement.** An example here would be using the asset's original cost to value an illiquid asset, rather than valuing the asset based on its fair market value today.
- **Valuing a client's account using a different process than that specified in the client's advisory agreement.** An example OCIE provided here included using the market value of the account's assets at the end of the billing cycle, rather than using the average daily balance of that account over the entire billing cycle, as specified in the client's advisory agreement. A second example provided was including assets in the fee calculation "that were excluded by the advisory agreement from the management fee, such as cash or cash equivalents, alternative investments, or variable annuities," OCIE said.

Billing fees in advance or with improper frequency

According to the Risk Alert, OCIE staff has observed "issues with advisers' billing practices relating to the timing and frequency for which advisory fees were billed." Specifically, the examination agency found advisers that:

- **Billed advisory fees on a monthly basis, rather than on a quarterly basis, as stated in the advisory agreement or disclosed in Form ADV Part 2.** "Similarly, staff observed advisers that billed advisory fees in advance, despite the advisory agreement specifying that clients would be billed in arrears," the Risk Alert says.

- **Billed a new client for advisory fees in advance for an entire billing cycle, instead of pro-rating such charges to reflect that the advisory services began mid-billing cycle.** OCIE also noted examiners found advisers that did not reimburse a client a pro-rated portion of the advisory fees when the client terminated the advisory service mid-billing cycle, "despite disclosing that they would do so in Form ADV Part 2."

Applying the incorrect fee rate

"OCIE staff has observed advisers that applied an incorrect fee rate when calculating the advisory fees charged to certain clients," OCIE said in the Risk Alert. Specifically, according to the Alert, staff found some advisers that:

- **Applied a higher rate than what was agreed upon in the advisory agreement o**r double billed a client, and
- **Charged a non-qualified client performance fees based on a percentage of their capital gains "inconsistent with Section 205(a)(1) of the Advisers Act."** That section prohibits compensation for the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client, unless the client meets certain specified criteria. ☙

Discovery

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with the agency from 2012 through 2016. In the same settlement, the SEC also charged the advisory firm with violating Rule 206(4)-2, the Custody Rule, and Rule 204-2(a), the Books and Records Rule.

"Because Clayborne was registered with the Commission as an investment adviser, even though it was ineligible to be so registered, it was subject to the Custody Rule," the agency said in its administrative order instituting the settlement.

In other words, even though the adviser was improperly registered, it nonetheless did register, and during that period was therefore subject to the SEC's rules, said **Proskauer** partner and former agency Division of Investment Management deputy director **Robert Plaze**. "It's like driving on a toll road that you haven't paid to drive on. If you get a speeding ticket, you can't tell the police officer, 'You can't give me this ticket because I am not allowed to drive on this road.'"

The principle also works in reverse, he said. If an advisory firm should be registered with the SEC but is not, it is still subject to its rules that apply to registered advisers.

Why would an advisory firm that does not qualify for SEC registration want to do so, and thereby subject itself to agency oversight and rules? "A primary reason a smaller advisory firm would want to be registered by the agency may be to avoid having to register with multiple state regulatory agencies," said **Tesser Ryan** partner **Gregory Ryan**. "Once a smaller adviser obtains registration with the SEC, the adviser avoids the complex and cumbersome problem of having to deal with multiple sets of regulatory rules and procedures in the states in which they do business. It can be very cumbersome and expensive to an IA to register in multiple states."

In addition, he said, "custodians may also prefer investment managers to be registered with the SEC. These custodians are likely coming under pressure to perform due diligence on the advisers they do business with."

"Falsely inflating assets under management on Form ADV so that an adviser ineligible for registration may appear eligible is particularly dangerous," said **Mayer Brown** partner **Matthew Rossi**. "First, the SEC may perceive such a misrepresentation as a fraud on the agency itself. Moreover, when an illegible advisers registers, it unnecessarily subjects itself to a whole range of regulations and potential violations that otherwise would not apply."

The fiduciary tie-in

The settlement may be notable for other reasons, said **Stradley Ronon** partner **Lawrence Stadulis**. "The SEC, historically, has rarely brought enforcement actions against advisers for improperly registering under the Advisers Act, " he said. "Instead, it simply deregisters them on its own initiative after public notice."

"It is possible," he said, "that the SEC wants to clean house of improperly registered advisers in advance of its likely upcoming uniform fiduciary standard rule proposal (*ACA Insight*, 1/15/18). If the proposal is adopted, it will further widen the regulatory gap between state and registered advisers. Registration will carry with it an express federal conduct standard, which investors might misconstrue as a regulatory seal of approval. If so, Advisers Act registration may become even more coveted and necessary to successfully conduct business than it is today."

"It is possible that the SEC is concerned about this and is trying to get out the message that it will no longer simply deregister firms," Stadulis said. "After all, improper registration, in and of itself, arguably, is fraudulent to the extent advisers make false and misleading statements about their status to the SEC and the investing public. The practice is certainly at odds with a uniform fiduciary standard."

The firm and its registration

Heinemann formed Clayborne in 2005, and registered it with the Commission in January of that year, through the filing of an initial Form ADV, according to the agency's administrative order instituting the settlement. At that time, an adviser had to have AUM of at least $25 million to fall under SEC regulation. The settlement order makes no charge that Heinemann and Clayborne did not legitimately pass this marker.

As a result of the Dodd-Frank Act, however, the threshold for SEC registration was raised in July 2012 to $100 million. Clayborne filed a supplemental Form ADV in May of that year, stating that it had AUM of more than $100 million and repeated those representations in subsequent AUMs through 2016, the agency said.

In its Forms ADV filed with the Commission from 2012 through 2016, "Clayborne misrepresented its AUM, because during said period, approximately $100 million of its stated AUM was not continuously and regularly supervised and managed," the SEC said. As a result, during this time period, "Clayborne was ineligible to register with the Commission as an investment adviser because it did not have the requisite AUM, as defined in Form ADV."

A question of custody

Heinemann formed what the settlement order describes as "an investment fund or hedge fund" in April 2010. Managed by Clayborne, the fund conducted a private placement that August and raised $630,000 from seven investors, six of whom were clients of Clayborne, the SEC said.

“Because Clayborne maintained and had access to [the fund’s] client funds, Clayborne had custody of client funds with the meaning of Rule 206(4)-2,” the agency said. As such, he “never caused account statements to be provided at least quarterly to [the fund’s] clients for which it maintained funds or securities, as required by the Custody Rule.” In addition, he “never caused an examination by an independent public accountant to verify client funds and securities as required under the Custody Rule.”

Heinemann, as Clayborne’s CCO, “was responsible for Clayborne’s compliance efforts and knew or should have known that Clayborne failed to provide account statements or to arrange for an annual verification of client funds and securities by an independent public accountant,” the agency said.

Books and records

The SEC charged that the adviser “failed to make and keep certain books and records required by Commission rules relating to its investment advisory business.”

Violations and punishment

As part of the settlement, the SEC alleged that Clayborne willfully violated Section 203A of the Advisers Act by improperly registering with the Commission, and that Heinemann “willfully aided and abetted and caused Clayborne’s violations.” In addition, both Clayborne and Heinemann were charged with willfully violating Section 207, which prohibits the making of untrue statements of material fact in any registration application or report filed with the Commission.

Separately, Clayborne was charged with willfully violating Section 206(4) and its Rules 206(4)-2(a)(3) and (a)(4) for Custody Rule violations, and Section 204(a) and its Rules 204-2(a)(7) and (a)(10) for books and records violations. Heinemann was charged with having willfully aided and abetted, as well as caused, those violations.

Heinemann was suspended from the securities industry for 12 months, and ordered to pay a civil money penalty of $20,000. An attorney representing Clayborne and Heinemann, when reached, chose not to comment.

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