BATES RESEARCH GROUP

Fee Selection and Reverse Churning

Overview and Practitioner Guidelines

Introduction

At the beginning of 2015, the U.S. Securities and Exchange Commission (SEC) announced that fee selection and reverse churning will be examination priorities this year.[1] Although the SEC did not expressly mention fee selection and reverse churning among its 2014 priorities, it had mentioned that an examination priority would be whether advisors fulfilled their fiduciary and contractual obligations in wrap fee accounts.[2] Such obligations include fee selection and reverse churning. FINRA did a sweep relating to reverse churning in 2003 and has already fined several companies.[3] FINRA has fined firms at least as far back as 2004 and for as much as $2 million plus another $2 million in restitution and additional undertakings for reverse churning.[4] Given the SEC's stepped up scrutiny and the fact that the SEC regulates FINRA, it seems imminent that FINRA will increase its scrutiny in this area as well.

It is likely that every firm offering fee-based accounts will have them scrutinized by regulators for fee selection and reverse churning during their next SEC and/or FINRA examinations. After warning firms that this will be a focus of their examinations, regulators probably will not be very lenient with penalties when identifying accounts and/or supervisory procedures that they perceive as problems. Accordingly, it would be prudent for financial firms to carefully examine their supervisory

[1] http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf
[2] http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf
[3] https://www.sec.gov/comments/4-606/4606-2861.pdf

[4] *Id.*

David Mahler

procedures in this area to see if they are adequate to withstand regulatory scrutiny and avoid unwarranted risk.

What is Reverse Churning?

As the name implies, reverse churning is in some ways the opposite of churning, which occurs when a registered representative recommends (or undertakes) transactions in an account that he controls for the purpose of earning transaction based commissions, not for the benefit of the client. Churning usually includes a high turnover ratio and high commissions as a percentage of the assets under management, although these indicators do not always mean that churning has occurred.

Reverse churning occurs in fee-based accounts when a fee is charged, but the financial firm does little or nothing in the account to earn that fee. Reverse churning virtually always includes a low turnover ratio.

What fee selection issues are there besides Reverse Churning?

The major related fee issue that regulators have identified is when a representative earns a commission on a transaction and then shortly thereafter moves the security purchased to a fee-based account. This has been characterized as a conflict of interest by FINRA,[5] and is sometimes called "double dipping." There are other potential issues that regulators may find with fee selections, but double dipping and reverse churning seem to be their major targets at present.

What are the risks to Broker-Dealers and Registered Reps?

As with most regulatory issues, broker-dealers need to consider potential regulatory and civil liability as well as reputational risks. The number of fee-based accounts has been growing rapidly in the last several years as financial firms have shifted much of their assets under management from transaction-based brokerage accounts to accounts where the fee is based on assets under management, performance, hourly rates or some other method that is not based on transactions.

In the introduction, we pointed out that one firm already paid a FINRA fine of $2 million plus $2 million in restitution and was required to perform other undertakings as a regulatory penalty. As the amount of assets in fee-based accounts grow, so does the risk of such accounts to financial firms, especially if there are not adequate supervisory controls. Regulatory penalties may get significantly larger.

We are not yet aware of any significant civil actions. Therefore, the analysis of what may happen in civil actions is based on what we believe likely will occur, rather than on precedent. Although reverse churning has been in the news lately because the issue has been raised by regulators, it does not seem like any financial institutions have taken a large reputational hit yet. However, when an issue

[5] http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf

becomes a regulatory focus, they sometimes take the opportunity to make an example of a firm to send a message to that and other firms if the opportunity presents itself, and this can become front page news. To many firms, the reputational risk can be the biggest downside to inadequate controls.

What can financial firms do to manage the risk?

Financial firms are not required to use a specific method to prevent reverse churning and other fee selection problems. However, there must be reasonable supervisory procedures in place to prevent such problems. Therefore, there are many ways to fulfill a firm's obligations rather than just one correct way. The best way to fulfill supervisory responsibilities may vary from firm to firm. Accordingly, suggestions in this section are meant to provide possibilities and are not meant as requirements. They are also not intended to be exhaustive. Each firm has to make decisions for itself and may well come up with good solutions that are better for its business model.

As a starting point, the SEC stated, "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."[6]

[6] http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf

Initial Fee-based Account Recommendation

At the inception of the account, it is important to determine what type of activity will occur in the client's account. As with any account, the first thing the representative should do is obtain information about the client. This should include usual suitability information and what the client's trading intentions are. The client may tell the representative what type of activity he intends if he will be maintaining a high degree of control over the account, or the representative may need to make his own determination if the client is mostly depending on the representative for recommendations.

After the representative has gathered adequate information to get an idea of what type of trading will occur in an account, he is then in a position to discuss types of accounts (*i.e.* transaction-based or fee-based). If one type of account is clearly better for the client, of course that one should be recommended. If more than one seems reasonable, then the representative can recommend any of the reasonable ones or explain the costs and benefits of each in a balanced manner to the client and let the client decide. If the representative makes the recommendation, he should explain the costs and benefits of the one he recommended over the other choices and get the client's approval.

At the very least, the information about the client must be documented. This falls into the standard "know your customer" rule. Although it may not be required, it is a good idea to document any discussion about the choice of accounts. That way, if the chosen account does not work out to be the best choice later due to some unforeseen occurrence, one can demonstrate that the circumstances were truly unforeseen and that the previous steps were properly taken. If the client chose an account that the representative did not recommend, then this should be documented and, even better, require written evidence from the client.

Supervision of the New Account

As part of the supervisory approval of a new fee-based account, the supervisor should review the information gathered and feel sure that a fee-based account is suitable for the customer. If he needs more information than what has been documented to make such a determination, he should have the representative get that additional information and document it. Any concerns a supervisor has may later be shared by a regulator or trier of fact.

The supervisor should look at the initial funding of the account to see if transactions were done in a transaction-based account and then promptly moved to the opened account. For example, if a client sent in money to a new transaction-based account and purchased stock, then a fee-based account is promptly opened and the securities are moved to the new account, this should raise a flag for double dipping. It is possible for accounts to do frequent business and for that reason decide to open up a fee-based account and then move the assets to the new account. In that case, there may be transactions before the transfer that do not indicate any problem. It is a judgment call on the part of the supervisor. The supervisor should look at the total circumstances and question himself as to how this will later look to a regulator examining the account.

Ongoing Activity And Monitoring

Monitoring by Representatives

It is a good idea for representatives to periodically monitor fee-based accounts to see if the trading that occurred is what was previously expected. If the amount of trading was significantly different than expected, then a reappraisal should be made about the suitability of the account. If the account is no longer in the client's best interest, a new discussion should be had with the client regarding better choices. It is best for such a discussion to be documented. If a client continues to want an underperforming fee-based account, it would be best to get that in writing from the client or at least to send a client correspondence confirming the conversation.

If a client has a fee-based account, the representative should not receive transactional commissions on trades where the securities will end up in the fee-based account, *i.e.* double dipping. Some examples are front-loaded mutual funds or mutual funds with 12b-1 fees meant at least in part to compensate the representative, annuities that compensate the representative, and direct participation programs that compensate the representative. These and other similar investments should be made outside of fee-based accounts.

A representative should not recommend transferring assets from a transaction-based account to a fee-based account shortly after completing a lot of transactions unless the account has a large amount of transactions on a continual basis. It is better to wait until the client is about to do additional transactions of a significant amount before transferring the assets to a fee-based account.

Monitoring by Supervisors

Firms need to have a supervisory system in place to monitor for fee selection and reverse churning. One way to do this is for supervisors to periodically review all fee-based accounts with the objective of detecting potential problems. This may work well in smaller firms or firms in which there are not a lot of fee-based accounts. However, as the number of fee-based accounts in a firm grows, this may not be practical. For those firms doing larger business in this area, reviewing exception reports is likely to be a more efficient process.

Most firms are very familiar with using turnover reports to detect churning. Similar reports would be a good tool to detect reverse churning as well. The major difference with a report to detect reverse churning rather than churning is that the report should flag low turnover ratios as opposed to high ones. An advantage of such a report is that the IT department likely will have less work to do than if they were creating a report from scratch. Likely, systems are already calculating turnover ratios in accounts for turnover reports, and IT only needs to adjust the output for another report with the low turnovers being presented rather than the high ones. Once this report is generated, someone needs to follow up and gather more facts about the accounts flagged. Just because an account is flagged does not necessarily mean that there is a problem. An account may normally have adequate activity to warrant a fee-based account, but could also have temporarily lower activity during a specific reporting period. There may be good reasons to believe that the account will have higher activity in the future. For example, an account that is frequently rebalanced within specified parameters may not have left those parameters during the monitored period but it is reasonably expected to be rebalanced frequently in the future. When it appears that an account will continue to have less activity than originally expected and the lower activity makes the present account less efficient than another type, the client should be contacted and a more suitable account recommended. After the facts have been gathered and corrective actions taken, if needed, the facts and resolutions should be documented and approved by a supervisor.

Another possible (but technically more difficult) periodic report is one that would calculate the hypothetical commissions and compare those to the fees being charged in the fee-based account. Such a report would flag accounts that have charged a significantly larger fee than the hypothetical transactional commissions. Again, once this report is generated, someone needs to follow up and gather more facts about the flagged accounts. Similar to the example above, the client should be contacted if the account type is no longer suitable, and the facts gathered and actions taken should be documented by the supervisor.

Another helpful report is one that would flag accounts where certain investments are transferred in. These investments could include front-loaded mutual funds, mutual funds with 12b-1 fees, or other investments with fees that are meant, at least in part, to compensate a representative. Again, once this report is generated, someone needs to follow up and gather more facts about the flagged accounts. Just because an account is flagged does not necessarily mean that there is a problem. For example, the client may have purchased the investment at another institution and the account was later transferred in. If the investment needs monitoring, the present representative is entitled to a fee for doing so. If the investment does not belong in a fee-based account, then the investment should be moved out of the fee-based account. After the facts have been gathered and corrective actions taken, if needed, the facts and resolutions should be documented and approved by a supervisor.

Most firms require supervisory approval to move assets from one existing account to another. When a supervisor is reviewing such a transfer from a transaction-based account to a fee-based account, he should check to see if the securities were purchased recently with an eye out for possible double dipping.

Conclusion

As the amount of money in fee-based accounts grows, so do the risks to financial firms. Regulators have signaled that they will be scrutinizing these accounts for fee selection and reverse churning. It is in the best interest of financial firms offering these accounts to have adequate procedures in place to limit their risks. We have made some suggestions above to help firms think about possible solutions. However, there are other potential solutions that may be just as good, if not better, for some firms. Each firm needs to tailor its approach to its own business. Firms need to monitor both their company's evolving activities and the changing landscape of regulatory activity in order to manage their risks.

David Mahler is an affiliate expert with The Bates Group based in Fort Lauderdale, Florida. David has spent approximately 35 years in the securities industry, the last 25 of which he has spent in senior legal and compliance positions, covering both retail and institutional investors. David has held CEO and CCO positions within the financial industry. David has also arbitrated approximately 40 cases for the NASD (now FINRA) and the Pacific Stock Exchange.

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Bates Group, LLC | 5005 SW Meadows Road, Suite 300 | Lake Oswego OR 97035 | Tel: 503.670.7772

http://BatesResearchGroup.com | research@BatesGroupLLC.com