



Reverse Churning: Don't Fall Asleep at the Wheel

By Ben Coulter and Rhett Owens

INTRODUCTION

It is obvious that broker-dealers and their registered representatives, and investment advisors, must be careful in making recommendations to clients. But the recent increase in regulatory interest relating to inaction in a client account should also give pause to members of the securities industry. Specifically, the U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) have begun to focus their attention on "reverse churning," a claim alleging that a registered representative or investment advisor has breached the fiduciary duties owed to a client by moving an under-traded account from a commission to a fee-based compensation structure solely for the purpose of generating revenue from that account or by failing to make trades in an account that would have otherwise been made had the account been commission, instead of fee-based.¹

BACKGROUND

Traditionally, registered representatives and investment advisors have had to be careful in advising a client that a trade or transaction was suitable, an analysis dependent on the client's investment objectives, age, other investments, time horizon, tax status, willingness to accept risk, and other factors. Under this advisory model, registered representatives and investment advisors were subject to criticism and liability for "churning," a practice where the volume of trades in a client account or the speed of those trades, i.e. how long the purchased positions are held, suggest that the ulterior motive of the registered representative or investment advisor in recommending those transactions was to generate fees rather than improve the outlook of the client. The inherent conflict of interest at issue in instances of churning is self-evident: a registered representative or investment advisor paid by commission based on activity within an account has an interest contrary to, or at least inconsistent with, the client's interest because the advisor will be paid regardless of whether or not the trade is successful.

This commission incentives problem, and the reaction to it over time, have led to the near uniform establishment, as a best practice within the securities industry, of requiring that each trade recommended be approved by the client, and that such approval be well-documented. The other

¹ See, e.g., Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 Wis. L. Rev. 1059; Daniel Nathan & Lauren Navarro, *SEC Intensifies Scrutiny of Fee-Based Accounts and Reverse Churning*, Dec. 20, 2013, available at <http://media.mofo.com/files/Uploads/Images/131219-SEC-Intensifies-Scrutiny.pdf>; see also Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisors*, 55 Vill. L. Rev. 701, 740 n. 241 (2010) (defining "reverse churning" as "lack of trades in an account that otherwise would have been made had the client been paying separate commissions for them.") (quoting Thomas P. Lemke & Gerald T. Lins, REGULATION OF INVESTMENT ADVISERS § 2:116 (2010)).

effect of the prevalence of churning claims, and the attendant increase in the necessity of documenting client approval of such transactions, has been the creation of an incentive for brokers to move their clients to fee-based accounts. In other words, because commission-based accounts require more action to document and justify commissions paid, there is an incentive for brokers to move their clients to accounts which require less day-to-day oversight. This incentive also exists with respect to accounts in which there is relatively little trading.

INCREASING REGULATORY INTEREST IN "REVERSE CHURNING"

Recent announcements by the SEC, combined with the seemingly inevitable move toward a unified fiduciary standard for broker-dealers and investment advisors,² make it clear that members of the securities industry should be increasingly diligent in an effort to foreclose potential liability arising from inactivity in a client account.

For example, on March 6, 2014, Andrew Bowden, Director of the SEC's Office of Compliance Inspections and Examinations, spoke concerning actions involving conflicts of interest (in particular, the rise of fee-based advisory accounts at dual registrants³) and the potential conflicts of interest arising from such compensation structures.⁴ With respect to fee-based advisory accounts, Bowden specifically addressed three situations about which the SEC is particularly concerned: (1) accounts in which securities are purchased and portfolios are designed in commission paying brokerage accounts and then transferred to a fee-based wrap account in which the same trades could have been initiated without paying commissions; (2) accounts that consist primarily of cash or cash equivalents that are transferred to fee-based wrap accounts in which the fees are higher but the investments do not change; and (3) accounts that are fee-based accounts in which few if any transactions are made.⁵

Bowden's speech came on the heels of a similar speech given by SEC Chairwoman Mary Jo White on October 22, 2013.⁶ In her speech, White specifically identified reverse churning as an area that the SEC was targeting through Risk Analysis Examination, or the use of quantitative analysis of trading activity by clearing firms or broker dealers over an extended period of time (one to two years) to identify problematic behavior.⁷

FACTORS SUGGESTING AN INCREASE IN "REVERSE CHURNING" LITIGATION

A number of factors, in addition to the SEC's increasing interest in reverse churning, suggest that claims arising from issues associated with fee-based accounts are likely to increase.

First, there has been dramatic growth in the amount of assets in fee-based accounts. Recent reports show that the assets in fee-based accounts grew 28.4% in 2009, 20.6% in 2010, 8.3% in 2011 and

² See, e.g., Dave Michaels, *Fiduciary Standard for Brokers Backed by SEC Advisory Panel*, Bloomberg, Nov. 22, 2013, available at <http://www.bloomberg.com/news/2013-11-21/sec-panel-to-propose-higher-standard-for-brokers-retail-advice.html>.

³ Registered as both broker-dealers and investment advisors.

⁴ <http://www.sec.gov/News/Speech/Detail/Speech/1370541260300#.U7MikfMo4dU>

⁵ *Id.*

⁶ <http://www.sec.gov/News/Speech/Detail/Speech/1370539960588#.U7MktvMo4dU>

⁷ *Id.*

18.5% in 2012.⁸ Those numbers, when combined with the increased regulatory interest in reverse churning, and other compliance issues associated with fee-based accounts, suggests the inevitability of an increase in reverse churning claims.

Second, FINRA's recent amendments to its suitability rule (FINRA Rule 2111), as read in conjunction with its "Know Your Customer Rule" (FINRA Rule 2090), require that a member or associated person have "a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer based on information obtained through reasonable diligence of the member or associated person to ascertain the customer's investment profile." Under FINRA Rule 2111.03, the term "investment strategy" is to be "interpreted broadly" and includes an "explicit recommendation to hold a security or securities," an interpretation confirmed by guidance recently issued by FINRA.⁹ These rules provide a client dissatisfied with their account's production with an argument that their broker-dealer or registered representative breached FINRA's suitability rules by failing to take action with respect to that client's account.

Third, the Dodd-Frank Wall Street Reform and Consumer Protection Act authorized the SEC to create a uniform fiduciary standard applicable to retail financial advice and SEC Chairwoman White has recently indicated that the implementation of such a uniform standard is a top priority.¹⁰ While the specifics of such a uniform standard may be currently unresolved, any rule harmonizing the general fiduciary duty of an investment advisor with the more limited duties of broker-dealers will necessarily mean greater scrutiny for the actions of broker-dealers.

Finally, as discussed above, there is simply more regulatory interest with respect to the issue of reverse churning, as is evidenced by the the SEC and FINRA's recent announcements that they will focus on reverse churning in fee-based accounts.

CONCLUSIONS

Given the inevitable rise of reverse churning claims, broker-dealers, registered representatives and investment advisors should take action to attempt to foreclose reverse churning claims. First and foremost, firms should ensure that its account supervision and documentation system is as detailed as possible. Recent enforcement decisions by FINRA have made it clear that firms will be held accountable if there is no account supervision and documentations system in place; a FINRA arbitration panel will likely come to a similar conclusion. And while this supervision and documentation system should obviously record critical fundamental information about the nature of advisor-client contact regarding the account, i.e. the number of times a client has been contacted over a given time period, the system should also document critical factual details regarding these advisor-client interactions, including, but not limited to, whether the client asked specific questions regarding his or her account; whether decisions to purchase or hold securities were mutually decided after the provision of appropriate guidance by by the financial advisor; and whether the client asked

⁸ Daisy Maxey, *SEC Targets 'Reverse Churning' by Advisers*, Wall Street Journal, Feb. 24, 2014, available at <http://online.wsj.com/news/articles/SB10001424052702304610404579403251590760602>.

⁹ FINRA Regulatory Notice 12-55 (December 2012).

¹⁰ Mark Schoeff, Jr., *SEC's Mary Jo White's top priority: uniform fiduciary standard*, Investment News, Feb. 21, 2014, available at <http://www.investmentnews.com/article/20140221/FREE/140229975>

specific questions about the fee structure applicable to the account. Moreover, specific to reverse churning claims, it is critical that a financial advisor document in sufficient detail the decision to transfer a commission-based account to a fee-based account. The bottom line is this: the more detailed a documentation system records the more ammunition a financial advisor will have when a reverse churning claim is asserted.

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