

# Client Alert

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## SEC Intensifies Scrutiny of Fee-Based Accounts and Reverse Churning

By Daniel Nathan and Lauren Navarro\*

The SEC is crunching a lot of data these days, and it apparently intends to use some of that data to identify “reverse churning.” Reverse churning is the practice of placing a client who trades infrequently in a fee-based, rather than a commission-based, account. Chair Mary Jo White recently identified this as a problem that the SEC can detect through its quantitative analytics.

Based upon the SEC’s and FINRA’s past regulatory and enforcement focus in this area, we recommend that firms review their supervisory systems and procedures to ensure that they are adequate to identify possible instances of reverse churning before the regulators do. Evaluation of the appropriate use of fee-based accounts is very likely to be an SEC exam priority in the coming year.

### THE SEC’S ENHANCED USE OF DATA

At the annual meeting of the National Society of Compliance Professionals (NSCP) in October, White reported that the SEC’s examination program continues to improve the implementation of a risk-based strategy that focuses on entities and business practices that the SEC believes pose the greatest risks to investors and markets.<sup>1</sup> She pointed to the Risk Analysis Examination (RAE), which uses quantitative analytics to examine clearing firms and large broker-dealers. She said that the examination staff may require such firms to download all transactions cleared by a firm over the prior year or two, and the RAE subjects the data to a broad range of queries designed to identify problematic behavior.

Chair White reported that in one recently completed exam, the RAE team collected and analyzed over 400 million transactions, and she stated that she expects that future exams will analyze more than twice that many. Armed with this data, the RAE team is – and has been – able to identify a wide range of problematic behaviors including reverse churning, as well as unsuitable recommendations, misrepresentations and inadequate supervision.

### THE PROBLEM: REVERSE CHURNING

Fee-based accounts may be desirable when they align the interests of the client and the firm in building assets in an account. Fee-based accounts also may offer some clients a greater variety of services, such as long-term financial planning and money management. Conversely, in a transactional or commission-based account structure, brokers are incentivized to make trades, even at the expense of a client’s best interests.

However, fee-based accounts (also known as asset-based, or “wrap-fee” accounts) also ensure a stream of revenues to broker-dealers from clients that are less active traders or that have relatively small account balances (e.g., less than

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<sup>1</sup> Chair Mary Jo White, Remarks at National Society of Compliance Professionals National Membership Meeting (Oct. 22, 2013) *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370539960588#.Uq4WqJMVw>.

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\$50,000). For these clients, an annual fee might not make economic sense.

In short, fee-based accounts may not be the best fit for certain clients if annual fees end up costing more than the trading commissions that would have accrued in accounts that show little to no activity. The practice of putting – or leaving – customers in fee-based accounts despite a low level of trading or assets that does not justify the fee, is known as “reverse churning.”

## REGULATORY CRACKDOWN: FINRA AND SEC GUIDANCE AND ENFORCEMENT REGARDING FEE-BASED ACCOUNT SUPERVISION

In 2003, FINRA’s predecessor, the NASD, reminded members that they must have “reasonable grounds for believing that a fee-based program is appropriate for a particular customer, taking into account the services provided, cost, and customer preferences.”<sup>2</sup> The NASD directed members to implement supervisory procedures to require periodic review of fee-based accounts to determine if they remain appropriate for customers owning them. Absent unusual circumstances, the NASD stated, these reviews should be conducted annually. The NASD also explained that just because a customer would have been billed less in a commission-based account is not conclusive evidence that the fee-based account was inappropriate; however, such a finding should cause the member to give careful scrutiny to the cost issues.

Firms offering fee-based accounts are required by FINRA rules to develop and implement a supervisory system and written supervisory procedures reasonably designed to monitor their fee-based accounts and the activity in them. Such supervision is necessary to determine if the fee-based account structure remains appropriate for customers, taking into account the services provided, cost and customer preferences.

From 2007 to 2009, FINRA was more active in disciplining violations of this obligation. In general, the FINRA cases in this area allege a failure to supervise. In some instances, FINRA also found violations of its fair pricing rule. In addition, FINRA sanctioned some firms for improperly double-charging clients with fee-based accounts, that is, charging clients the annual fee in addition to a transactional or commission-based fee for the same asset. The following FINRA/NASD cases illustrate the regulator’s focus in this area:

- In one case, FINRA found that a broker-dealer failed to establish and maintain a supervisory system to determine whether fee-based accounts were more economical for the customer than standard commission-paying accounts. As a direct result of this lack of supervision, the firm allowed roughly 19 customers to continue in fee-based accounts without determining whether they were appropriate for the customers. For two years, no trades were conducted in 16 of these accounts, but the firm received about \$73,853 in fees. Moreover, although the firm required a minimum of \$50,000 to opt into the fee-based structure, many of the customers had less than \$25,000 for at least one year during the review period. Until 2005, the firm had no review process in place once an account was opened, so if a customer did not conduct any trades in an account this inactivity was never reviewed by a principal. In addition to other penalties, this firm was fined \$50,000 for its violation.

<sup>2</sup> See Notice to Members 03-68 NASD Reminds Members that Fee-Based Compensation Programs Must be Appropriate, *available at* [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=2703](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=2703)[http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=2703](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=2703).

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- In another case, FINRA found that as a result of a firm's failure to establish and maintain an adequate supervisory system to monitor its fee-based brokerage business, approximately 594 customers conducted no trades in their fee-based accounts for at least two years. These same customers paid the firm about \$1.9 million in fees. In addition, about 620 customers held assets that remained below the \$50,000 benchmark and averaged less than \$25,000 for at least one full year during the review period. FINRA fined the firm \$2 million.
- In a similar case, the only supervisory procedure involved review by a principal of the decision to open a fee-based account, but this review was found to be essentially meaningless. From February 2001 through June 2005, approximately 847 of these accounts had no trades during two or more consecutive calendar years, but were charged \$2.6 million in fees during the years of inactivity. FINRA fined the firm \$1.2 million.
- In another case, FINRA found that a firm failed to specify benchmarks for customers for whom fee-based accounts would be appropriate, and did not adequately monitor such accounts to ensure that they remained appropriate on an ongoing basis. As a result, during a three-year period, the firm opened over 2,644 wrap-fee accounts without adequately evaluating whether such accounts were appropriate or economical for its customers. Subsequently, the company failed to adequately monitor these accounts. As a result, FINRA found that in at least thirty-six accounts no trades were made for at least eight consecutive quarters. Nevertheless, these accounts were charged over \$129,000 in fees during these quarters. FINRA also found that the company failed to establish a supervisory system designed to protect its wrap-fee customers from being assessed both a transactional fee and an annual fee. Specifically, in 932 cases, the firm double-charged customers both a commission and a fee on the value of the asset purchased. The firm was fined \$700,000 for these violations.

The SEC has also tightened scrutiny on fee-based accounts and double-charging. For example, in one case the agency found that a broker-dealer/investment adviser had charged undisclosed fees to wrap-fee clients. In effect, the clients who maintained fee-based accounts were subjects of duplicative commissions. The SEC found that the firm committed fraud by charging both wrap fees and commissions. In another matter, clients in wrap-fee investment advisory programs contracted with the firm to pay one "wrap" fee for advisory, execution, clearing and custodial services except as specifically provided in their written advisory agreements. However, the SEC found that in at least 5,764 separate transactions, the firm charged commissions on a transactional basis in addition to the wrap fees.

At least one federal court has found that brokerage firms offering wrap-fee accounts owe customers a fiduciary duty. The Tenth Circuit, in *Geman v. S.E.C.*, held that in shifting client assets to a fee-based structure, a firm must act as a fiduciary and justify the annual fee.<sup>3</sup> In other words, if a firm wants to move a client into a fee-based account, it must be able to justify the move as economical.

### COMPLIANCE: TOUGHER REGULATION CONTINUES

The SEC's continuing interest in reverse churning and double-charging, and its use of new examination and investigation tools, together suggest that the future will see more investigations and enforcement actions against firms who place

<sup>3</sup> *Geman v. S.E.C.*, 334 F.3d 1183, 1189 (10th Cir. 2003) (holding that the brokerage firm owed its wrap-fee customers a fiduciary duty, even if it was not acting as an investment advisor with respect to transactions at issue, because customers' response to firm's promotional material, which included statement that firm would provide brokerage, advisory, and custodial services in return for customers' payment of "all-inclusive" fee, calculated as a percentage of a customer's assets under management, established an agency relationship, thus invoking fiduciary responsibilities).

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clients in a fee-based or 'wrap-fee' system. Monitoring accounts to ferret out reverse churning has proven difficult for firms in the past, since spotting inactivity might be more challenging than detecting excessive trades (known as "churning"). However, given Chair White's remarks to the NSCP, it seems that the SEC and its staff are willing to do what it takes to find and remedy these violations.

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