InteractiveBrokers

SPOTLIGHT ON

Considerations for advisors affiliated with broker-dealers

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INTRODUCTION

Broker-dealers are ranked among one of the most common affiliates of an adviser. The affiliation between an adviser and a broker-dealer creates a number of conflicts of interest and risks that the adviser must both disclose and continuously monitor.

An investment adviser is considered to be affiliated with a broker-dealer where the firms are "related by common ownership or common control."[1] Affiliated investment advisers and broker-dealers may be distinct standalone firms[2] or a dually registered, "Hybrid" firm[3] (i.e., a single legal entity registered as both an investment adviser *and* a broker-dealer).

While these types of relationships and even transactions between the affiliated firms are permitted under the Investment Advisers Act of 1940 (the "Advisers Act"), they can present a number of challenges.

CONFLICTS OF INTEREST

A. Legislative Requirements.

In instances where an investment adviser is affiliated with a broker-dealer, the investment adviser is faced with additional compliance considerations as a result of the inherent conflicts of interest caused by the close relationship.

Investment advisers, broker-dealers, and their financial professionals have incentives to put their interests ahead of the interests of their retail clients and customers. The federal securities laws do not preclude broker-dealers or investment advisers from having conflicts of interest that might adversely affect the objectivity of the advice they provide; however, firms and financial professionals have obligations regarding their conflicts. Investment Advisers are required to eliminate, or, at a minimum, fully and fairly disclose

[1] Investment Company Act of 1940 § 2(a)(3)(c), 15 U.S.C. §80a-2(a)(3)(c) (2020); See also, 17 C.F.R. § 248.120(a).

[2] In this case one firm serves the client's advisory needs and another firm serves the client's brokerage needs.

[3] In this case a single firm serves the client's advisory *and* brokerage needs.

conflicts of interest clearly enough for a client to make an informed decision to consent to such conflicts and practices, or reject them.[4]

The Investment Advisers Act of 1940 (the "Advisers Act") does not strictly prohibit advisers from using the services of an affiliated broker-dealer or executing transactions themselves, where the investment adviser is a hybrid firm. However, advisers must meet a number of additional requirements, depending on the facts and circumstances, including:

- Full disclosure - The anti-fraud provision of the Advisers Act requires advisers to provide full and fair disclosure to all clients and prospective clients concerning the adviser's business, including their brokerage practices;
- Authorization for principal and agency cross transactions; and
- Compliance with applicable exemptions for ERISA accounts.

B. Affiliated Transactions.

An affiliated transaction is a transaction in which the adviser or an affiliated person, individual or entity, is engaged in a transaction with a client on a principal or agency basis and has some financial interest in the trade. In the case where the affiliate is a broker-dealer, the investment adviser places client brokerage orders with a registered broker-dealer that is an affiliate of the investment adviser.

Principal and Agency Cross Transactions. These are transactions that are arranged by the investment adviser and/or affiliated broker whereby the adviser/affiliated broker has both an order to buy a certain security and an order to sell the same security from two or more different clients/customers of the adviser or broker-dealer. In such situations, the orders can be placed into the open market for execution or the firm may decide to handle the transaction internally either through a principal trade or a cross trade. The adviser or broker may find it advantageous for many reasons to trade the orders opposite each other instead of going to the open market.

Principal Transactions. Section 206(3) of the Advisers Act governs principal transactions prohibiting an adviser from engaging in principal transactions, including riskless transactions, unless prior to the completion of the trade, the adviser: (1) discloses to the client in writing the capacity in which the adviser is acting (provides the client adequate disclosure regarding its role in the transaction) and (2) obtains the client's consent to the transaction.[5]

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[4] See *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail communications and Restrictions on the Use of Certain Names or Titles*, Exchange Act Release No. 83063. Investment Advisers Act Release No. 4888. April 18, 2018., Securities and Exchange Commission, 99, n.225 (Apr. 18, 2018).

[5] Investment Advisers Act of 1940 Rule, 17 C.F.R. §275.206(3)-1 (2020).

Specifically, the disclosure must include: (1) the adviser's original purchase price for any security it sells to a client; (2) the price the adviser expects to receive on the resale of any security it buys from a client; and (3) the price at which a security could be bought or sold elsewhere when the price would be better for the client.[6] *The disclosure obligation and consent requirements cannot be satisfied through prospective, blanket consent from clients.* In addition to the disclosure requirements, an adviser engaged in principal transactions is still subject to the general fiduciary duty. An adviser must determine whether a principal transaction is in the best interest of the client.

Agency Cross Transactions. Under Section 206 of the Advisers Act and the applicable rules[7], an investment adviser must not engage in agency cross transactions unless it: (1) provides written disclosure and receives client consent prior to the completion of each agency cross transaction or (2) obtains prospective, blanket consent in compliance with the requirements of Rule 206(3)-2.

An agency cross transaction occurs where a hybrid investment adviser or an investment adviser using an affiliated broker-dealer, executes a transaction between an adviser client and a brokerage client for a fee.[8] Section 206(3) of the Advisers Act requires an investment adviser to provide written disclosure and obtain the client's consent before the settlement of each transaction. Rule 206(3)-2 provides a safe harbor from the trade-by-trade disclosures requirements of Section 206(3), permitting an adviser to obtain prospective, blanket consent from clients for such transactions. Advisers must meet the following requirements under Rule 206(3)-2 to make use of the safe harbor:

- Provide full disclosure to the client of the nature of the transactions, the conflicts of interest involved, and the compensation to be received;
- Obtain prospectively from the client consent in writing to engage in agency cross transactions;
- Send written confirmation of each trade to clients describing the terms of the transaction and total compensation received by the adviser or any affiliated broker-dealer[9];
- Send at least annually a written summary of all agency cross transactions to the impacted clients; and

[6] Investment Advisers Act of 1940 Rule, 17 C.F.R. §275.206(3)-3T (2020).

[7] Investment Advisers Act of 1940 Rule, 17 C.F.R. §275.206(3)-2 (2020); see also Investment Advisers Act of 1940 Rule, 17 C.F.R. §275.206(3)-1 (2020).

[8] 17 C.F.R. §275.206(3)-2 (2020).

[9] The disclosure document and each confirmation conspicuously disclose that consent may be revoked at any time. See Agency Cross Transactions for Advisory Clients, Advisers Act Rel. No. 589 (May 31, 1977) (adopting rule 206(3)-2).

- Avoid recommending the transaction to both the buyer and the seller.[10]

It is important for an adviser to ensure that the usage of an affiliated broker-dealer is fully disclosed. Account commissions and portfolio turnover rates should be monitored closely for churning behavior. An adviser should be reviewing the executions received from an affiliated broker to ensure consistency with the disclosures made to the investment adviser's clients.

In addition to the requirements of Section 206(3) and Rule 206(3)-2, investment advisers are subject to the fiduciary duty obligations under the Advisers Act. As such, investment advisers must also ensure that the transaction is in the best interest of the customer. Investment advisers must also disclose that they engage in agency cross transactions in their Form ADV.

C. Use of an Affiliated Broker-Dealer.

Typically, the use of an affiliated broker-dealer occurs in two contexts:

(1) A transaction where the affiliated-broker dealer acts on behalf of the adviser's client, while a second unaffiliated broker-dealer executes on behalf of the other side; and

(2) An agency cross transaction, in which the affiliated broker-dealer is the only broker-dealer involved in the transaction, executing for both sides.

Generally, an adviser should not execute client transactions on an agency basis, if registered as a broker-dealer or through an affiliated broker-dealer unless the adviser: (1) discloses to clients that the adviser (or its affiliate) will receive compensation for acting as broker and (2) obtains best execution for the transactions.[11] As a fiduciary, an adviser is obligated to disclose all material conflicts of interest to clients. The use of an affiliated broker-dealer raises a number of questions and conflicts, including but not limited to:

- *Is the affiliate obtaining best execution?*
- *What is the rationale for sending orders to the affiliate?*
- *Is the use of the affiliate in the best interest of the client?*
- *Are the commission rates being charged in line with industry rates? and*
- *Is the account trading more frequently than it would otherwise be resulting in more commission revenue to the affiliate*?[12]

[10] *Id*.

[11] 17 C.F.R. §275.206(3)-1 (2020); 17 C.F.R. §275.206(3)-3T (2020).

[12] Joseph McDermott, *Modern Compliance: Best Practices for Securities & Finance*, 417 (2015).

The Advisers Act does not prohibit advisers from using the services of an affiliated broker-dealer to execute transactions or from executing transactions themselves, in the case of dual registrants, on behalf of client accounts "provided full disclosure is made to clients and best execution is obtained."[13] The necessary disclosure is typically made through the adviser's Form ADV, Investment Advisory Agreement, and/or offering documents for investment vehicles.

Depending upon the type of client, an adviser's use of an affiliated broker-dealer may also be subject to additional requirements. For example, if the client is a:

(1) registered investment company - an adviser must adhere to the requirements of Rule 17e-1 under the Investment Company Act;[14] or

(2) pension plan subject to ERISA - an adviser must comply with the Prohibited Transaction Class Exemption 86-128.[15]

In situations where a client has given an investment adviser the authority to "direct client brokerage", the investment adviser has the discretion to direct client transactions to the broker of the investment advisers choosing. These circumstances give rise to a conflict of interest stemming from the potential revenue an affiliated broker-dealer may receive should the investment adviser direct client transactions to the broker-dealer. The investment adviser must always disclose[16] to clients:

- The existence and terms of practice regarding brokerage transactions, and the effect of such practices on commissions;
- The effect of client directed brokerage on the adviser's ability to obtain volume discounts, negotiate commissions or achieve best execution for some transactions;
- The potential for disparities in commission charges; and
- The potential conflicts of interest. [17]

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[13] *See, e.g., In re Tilden Loucks & Woodnorth, LLC*, Investment Advisers Act Release No. 3494 (Oct. 29, 2019) (adviser sanctioned for charging increased commission rates on client trades through an affiliated broker-dealer and failing to seek best execution without providing adequate disclosure).

[14] 17 CFR § 270.17e-1 (2020).

[15] Thomas P. Lemke, Gerald T. Lins, *Securities Law Handbook Series: Regulation of Investment Advisers*, §2:101 (2018 ed.).

[16] The investment adviser must provide corresponding disclosures in Form ADV Part 2A Item 12, and the IMA as well as policies and procedures in place to address the use of directed brokerage.

[17] *See In re Mark Bailey & Co.*, Advisers Act Release No. 1105 (Feb. 24, 1988).

Additionally, an investment adviser must disclose that there is a risk that it may not always be able to obtain best execution or state that they direct trades "subject to best execution".

Investment advisers may use an affiliated broker-dealer to execute client transactions, but it does raise a of conflict of interest that must be disclosed[18] to clients.[19] Specifically, a conflict exists to the extent that the investment adviser recommends the execution of the client transactions through the affiliated broker-dealer given that the affiliated broker-dealer receives commissions in connection those transactions. One of the most significant risks associated with this type of arrangement is that it may incentivize the investment adviser and/or affiliated broker-dealer to route all client transactions through the affiliated broker-dealer regardless of whether or not it would be the "best execution" of the client's transaction(s). The investment adviser should implement policies and procedures designed seek best execution and manage the conflict.[20]

D. Other Conflicts

Investment advisers affiliated with broker-dealers should consider the following key topics when managing their conflicts of interest:

1. Best Execution

An integral element of an investment adviser's fiduciary duty to its clients is the obligation to "seek to obtain 'best execution' of client transactions, taking into consideration the circumstances of the particular transaction"[21] where the adviser has been given the authority to "direct client brokerage"[22]. This requires that the

[18] Disclosed in Form ADV Part 1A Item 7 and Part 2A Item.10

[19] *Applicability of the Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services*, Advisers Act Rel. No. 1092, 17 (Oct. 8, 1987) ("Release 1092") ("Additional disclosures would be required, depending on the circumstances, if the investment adviser recommends that his clients execute securities transactions through the broker or dealer with which the investment adviser is associated.")

[20] *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Exchange Act Rel. No. 23170*, 14* (Apr. 28, 1986).

[21] Office of Compliance Inspections and Examinations, *Compliance Issues Related to Best Execution by Investment Advisers*, 1 (July 11, 2018) available at, https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf.

[22] "When an adviser has the responsibility to select broker-dealers and execute client trades." Office of Compliance Inspections and Examinations, *Compliance Issues Related to Best Execution by Investment Advisers*, 1 (July 11, 2018) available at, https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf.

investment adviser execute securities transactions on behalf of the client "in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances."[23]

2. Wrap Accounts

Standalone investment advisers affiliated with broker-dealers and dually registered/hybrid firms should pay close attention to the level of trading activity in client Wrap accounts.[24] In a typical Wrap Fee program, the broker-dealer acts as a sponsor for a money management program which encompasses investment management, brokerage, custody, and proxy voting services among others. In a bundled Wrap Fee program, the client pays the broker-dealer a single all in fee for all of the program's services. A bundled fee Wrap program is seen as a way to manage the incentive for account churning, however, it does create a circumstance where there is an increased risk and opportunity/incentive of reverse churning.

It is common for investment advisers affiliated with a broker-dealer and dually registered firms to offer Wrap programs through which the transactions of the adviser's clients are executed by the affiliated broker-dealer in tandem with the advisory services offered by the adviser.

Conflicts arise due to the fact that, under this model, the broker is not paid direct commissions for each trade and thus there is a disincentive for the adviser to manage the client's account as actively as they would for a non-wrap account where the broker receives commission on each transaction.

It is important that the firm disclose this fact to clients and develop clear policies governing the suitability factors used to recommendation a Wrap accounts to clients as opposed to a traditional account as well as procedures designed to aid the firm in monitoring the trading activity in Wrap accounts.

a. Churning. Churning occurs where a broker-dealer trades excessively in a customer's account with the goal of generating trading commissions. A bundled Wrap Fee program caps the commissions that can be earned by the broker-dealer, thus eliminating the possibility for additional commissions through increased trading.

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[23] *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Exchange Act Rel. No. 23170 (Apr. 28, 1986).

[24] Wrap fee programs make available a combination of investment management and brokerage services in exchange for a single fee (e.g., 1% of assets under management).

b. **Reverse Churning.** Reverse churning occurs where a broker-dealer fails to engage in trading on behalf of a client's account that would have otherwise been made had the client been paying separate commission for each trade. As discussed above, this is a risk particular to bundled Wrap fee programs, where the commissions are capped, and the broker-dealer does not receive a payment for each trade. As such, there is a disincentive for the broker-dealer to focus on trading these types of accounts even when more trading is in the best interest of those clients. This could result in the broker-dealer neglecting bundled Wrap fee accounts in favor of accounts where the broker-dealer is paid a fee on each trade. Broker-dealers with bundled Wrap fee programs should continuously monitor the level of trading activity in these types of account.

c. **Best Execution.** Typically, the broker-dealer sponsoring the Wrap Program also serves as the executing broker-dealer for trades made in those accounts, thus raising concerns about whether best execution of trades is being obtained. An adviser must weigh the benefits associated with the cost of the transaction through the sponsoring broker-dealer against the broker-dealer's expertise. In instances where the sponsoring broker-dealer does not have the requisite expertise or capabilities for certain types of securities transactions, the obligation to achieve best execution may require the adviser to use another broker-dealer (following disclosure to the clients).

Takeaways

The 2020 SEC Exam Priorities listed the examination of firms dually registered as or affiliated with broker-dealers as an examination priority. The SEC stated it would focus on whether these firms maintain effective compliance programs to address the risks associated with best execution, prohibited transactions, fiduciary advice or disclosure of conflicts regarding such arrangements. While these annual exam priorities do inform the Office of Compliance Inspections and Examinations ("OCIE")' examinations, the selection of the firms to be examined and the risk areas of focus are determined using a risk-based analysis, which depends on the type and nature of its business.

OCIE uses dozens of risk factors in its risk analysis. Pursuant to this risk analysis and associated algorithm, each SEC-registered investment adviser is assigned a numeric risk score. One of the risk factors used in the algorithm, which ultimately leads to the firm's risk score and determines the likelihood and frequency of it being examined by OCIE, is the firm's affiliation with a broker-dealer. **Therefore, affiliation with a broker-dealer not only broadens the compliance considerations and burdens for an SEC-registered advisor, but it also increases the likelihood that OCIE will visit the firm for a routine examination.**