

ACA Insight

The weekly news source for investment management legal and compliance professionals

“The problem is not that the advisers moved into the brokers’ space, but that the brokers moved into the advisers’ space.”

Industry Representatives Seek Changes to SEC’s Proposed Standards of Care

Harmonize rules for investment advisers and broker-dealers. Impose federal licensing and education requirements on advisory firms. Require advisers to provide clients with account statements. Codify advisory firms’ fiduciary duty in a rule.

If these possibilities from the SEC’s standards of care package proposed in April give you concern, you can take solace knowing that some major industry heavy hitters share them, and have some other concerns, as well. The **Investment Adviser** [continued on page 2](#)

Advisers Bullish About Future Business Prospects

Nearly 80 percent of advisers expect to grow their workforces over the next 12 months. Fifty-seven percent with individual clients think their assets under management will grow over the next three years, while 59 percent with institutional clients expect the same.

If that outlook sounds bright and sunny, that’s because most investment advisers are positive about their future business outlooks, according to the *2018 Executive Outlook Survey*[®], a joint project of global research and consulting firm **Cerulli Associates** and [continued on page 4](#)

Refund Unearned Advisory Fees as Contracts and Policies Stipulate

Advisory firms receiving requests from clients to refund their advisory fees need to do so on time and in accordance with their advisory contracts, policies and procedures, and other disclosures. Failure to do so, whatever the reason, may draw attention from SEC examiners and possibly the Division of Enforcement.

Just ask **Beverly Hills Wealth Management**. The California-based investment adviser with \$142 million in assets under management on July 20 reached a settlement[®] with the SEC over the agency’s allegations that the adviser not only improperly failed to refund unearned advisory fees when requested, but failed to disclose its precarious financial condition to clients.

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Industry Representatives

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Association, which represents SEC-registered advisers, and the **Investment Company Institute**, which represent funds, in the past few days joined other asset management stakeholders in sending comment letters to the Commission before it considers adopting final rules.

The Commission on April 18 proposed two rules and an interpretation that would, among other things, create a best interest standard for broker-dealers, provide an “interpretation” on the existing fiduciary duty for advisers, require advisers and broker-dealers to provide a specific short-form disclosure to retail investors, and would limit how the term “adviser” or “advisor” can be used by broker-dealers (*ACA Insight*, 4/23/18[Ⓞ]).

Commissioners voted 4 to 1 in favor of the proposals, but several of them made clear they were voting yes only to get the proposals before the industry and the public for comments. Most of the commissioners said they want changes. The changes desired may cause problems for SEC chair **Jay Clayton** as he attempts to satisfy different schools of thought in coming up with a compromise that will be adopted.

Past, present and future

Looking at the push for standards of care on a larger canvas, it is part of an effort to create what some have labeled a “fiduciary rule” for broker-dealers that would raise their level of client responsibility to something similar to what advisory firms have complied with for years. The Department of Labor in recent years adopted, an ERISA-based Fiduciary Rule for financial institutions that would affect only those firms working with retirement investments, but that Rule was vacated by a federal appeals court earlier this year.

The Trump Administration then moved the ball to the SEC, which proposed the rules now being considered, and which associations and others are commenting on.

“It is really going to be hard for the SEC to adopt final rules here,” said **Proskauer** partner and former SEC Division of Investment Management deputy director

Robert Plaze. “There are all kinds of things that can be included in a proposed rule, just to get it before the public. For example, one commissioner may have wanted a particular provision but was unable to get agreement from the other commissioners, which resulted in a request for comment on that approach in the proposing release. The commissioner may have been mollified and voted to propose the rule with the hope that his or her views would prevail. At the adoption stage, this technique is not available to work out disagreements and the chairman might lose that commissioner’s vote if the rulemaking has not moved in his direction. That’s what makes adoption of a rule much more difficult than a proposal. One senses reading the release that there were a number of comment requests designed to smooth over differences.”

Further, he noted, the Commission is currently short one commissioner, since **Michael Piwowar** resigned last month. It will likely be short another commissioner come December, when **Kara Stein** is scheduled to leave. That will leave Clayton with fewer commissioners from which to fashion a three-vote majority for adoption of any rules.

“Chairman Clayton is focused like a laser beam on this subject,” said **Pickard Djinis & Pizarri** partner **Mari-Anne Pizarri**, who wrote a comment letter[Ⓞ] to the SEC herself. “It is an issue that has been put off because it is too difficult, so I give him credit for tackling it. If the SEC ends up not doing something, it will look bad.”

Will the Commission ultimately adopt some kind of rule, given the strong points of view on the subject? “Some form of a Best Interest Rule may be adopted, but first, the SEC has to stop and figure out what the problem is,” Pizarri said. “The problem is not that the advisers moved into the brokers’ space, but that the brokers moved into the advisers’ space.” The first step, she said, is to “figure out the boundaries of the broker-dealer exception under the Advisers Act.”

“As an overarching principle, we oppose harmonization for its own sake, and believe that new regulatory burdens should not be imposed on investment advisers unless there is a very good reason to do so,” she said in her firm’s comment letter.

Support, but . . .

Both the IAA and the ICI, in their comment letters, initially express support for the agency's attempts to address the standard of care issue. "The Commission's package of proposals take important steps toward strengthening the standard of conduct for broker-dealers and reducing investor confusion," the IAA said. The ICI, in its letter, said that it "strongly support[s] the SEC . . . taking the lead to ensure that retail investors, regardless of whether they are investing for retirement or other important goals, are afforded strong protections when they receive recommendations from a broker-dealer or an investment adviser."

Beyond that, however, both associations, as well as others writing letters, bring up issues about some of the proposed rules and proposed changes.

The IAA actually issued two comment letters, one¹⁰ on August 2, raising concerns about the SEC possibly imposing "unnecessary and ill-fitting" broker-dealer regulations on advisers, and the other¹¹ on August 6, in which it raises concerns about the rest of the SEC's proposed package, including:

- Regulation Best Interest, which require a broker-dealer making a recommendation to a retail customer to act in the best interest of that customer, without putting its own interest ahead of the customer's;
- Form CRS (Client Relationship Summary), which would require advisers and broker-dealers to provide retail investors with a four-page disclosure highlighting the key differences in the principal types of services offered;
- Restrictions on how broker-dealers may use the titles "adviser" or "advisor;" and
- An interpretation of certain aspects of the Advisers Act "to reaffirm – and in some cases clarify" them.

"We have real concerns about whether these rule proposals as written will achieve their intended goals, or whether they will actually increase investor confusion," said IAA president and CEO **Karen Barr**.

The ICI, in a statement accompanying its August 7 com-

ment letter¹², said in regard to the SEC's proposed interpretation of an adviser's fiduciary duty, that the Commission should "refine its interpretation to make it more consistent with existing law by, among other things, "recognizing key differences between institutional advisory relationships and the retail advisory relationships that are the focus of the SEC's interpretation." It also called for the agency to drop pursuing the idea of applying broker-dealer rules, such as licensing requirements, to advisers, noting that the SEC has yet to explain why doing so would be necessary.

Specific concerns

In its August 3 letter on the SEC's request for comments on "enhancing" adviser regulation, the IAA said that instead of thinking about applying broker-dealer rules to advisers, the SEC should focus on "raising the standard of conduct for brokers to match investors' expectations regarding the advice they receive."

Specifically, the IAA, in its statement accompanying the letter, said that the Commission needs to recognize the following:

- **Advisers and broker-dealers have different business models.** "Given those differences, financial responsibility rules are inappropriate and unnecessary for advisers. Broker-dealer financial responsibility rules are intended to protect customers and creditors from losses and delays that can occur when a broker-dealer fails. But investment advisers' activities do not present these risks. Most significantly, investment advisers do not hold client assets and the insolvency or failure of an adviser does not put client assets at risk."
- **Account statements are not necessary.** "A requirement for advisers to provide account statements would be duplicative," as advisory firm clients already receive such statements from custodians, and the custodial account statement or an invoice from the adviser specifies the advisory fees clients pay.
- **Federal licensing and continuing education requirements for advisory firm personnel are not necessary.**

Such personnel who engage with retail clients “are already subject to state licensing and qualification requirements. The Commission has not explained why a second layer of licensing and qualification is warranted.” Beyond that, the IAA said, there is already a range of compliance requirements that advisory staff must meet, as well as training to help them comply with existing laws, regulations and fiduciary obligations.

In its release accompanying its August 6 comment letter on the SEC’s proposals involving standards of care, among the points the association made were the following:

- **Proposed Regulation Best Interest.** As currently written, the IAA said, the Rule would apply “only in the limited context of, and at the time of, a specific investment recommendation.” Instead, it said, “all advisory activities” that broker-dealers provide retail clients, including ongoing monitoring for purposes of recommending investment changes, should be covered either by this regulation or by a fiduciary standard. The association also repeatedly made the point that it believes the Commission should better define advice that is “*not* [emphasis IAA] ‘solely incidental’ to brokerage services.” That definition constitutes a safe harbor allowing broker-dealers that fall within it to avoid meeting Advisers Act regulation.
- **Proposed Form CRS.** While the IAA said that helping investors understand the type of financial professional they are dealing with and what to expect from the relationship, “we believe that, as proposed, Form CRS may exacerbate the investor confusion it is intended to address.” The association suggested that the association submit the proposed form to investor testing before adopting it. The IAA also said that the Commission should provide an “educational comparison” between advisers and broker-dealers, as well as other financial professionals, on its website, rather than requiring firms to include disclosures about other firms’ services.
- **Proposed Advisers Act interpretation.** “We do not believe it is necessary or beneficial to codify the fidu-

ciary duty in a rule,” the association said. “This well-established, principles-based duty has successfully served as the bedrock principle of investor protection of clients of investment advisers for more than 75 years.”

As for the ICI, it said that in regard to the SEC’s proposed interpretation of an adviser’s fiduciary duty, the agency needs to refine its interpretation to make it more consistent with existing law by:

- **Clarifying the scope and applicability of an adviser’s fiduciary duty,** “recognizing key differences between institutional advisory relationships and the retail advisory relationships that are the focus of the SEC’s interpretation;” and
- **Confirming that the existing standard under the Advisers Act for a client’s consent to conflicts is** “whether the adviser has provided full and fair disclosure of material conflicts and obtained informed client consent.”

Advisers Bullish

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the **Investment Adviser Association**. This year’s survey, conducted in the first quarter of 2018, questioned the IAA’s membership base on a variety of business expectation metrics, including profitability measures, budgeting expectations, technology initiatives and investment strategies.

“Currently, no firms anticipate decreasing their overall headcount over the next calendar year,” the survey said, while “nearly 80 percent of firms anticipate increasing the number of talent.” It noted that the staffing expectations in this regard were higher than in last year’s survey, which reflected answers to questions asked in the fourth quarter of 2016. The reason for this, according to a discussion of key survey findings included with this year’s survey results, “presumably reflect[s] optimism about firms’ business prospects and the economy.”

In addition to growing staff and AUM, other themes that stood out from the survey results are an emphasis on hiring new talent as retirements, as well as mergers and

acquisitions, take hold, and the continued importance of cybersecurity.

The survey results should provide some “thought leadership and peer benchmarking” to both IAA member firms and other advisory firms, said Cerulli Associates director **Donnie Ethier**. For instance, the projected growth in advisory firm size, whether from recruiting talent, securing more clients, larger clients, or both, is that the risk of cybersecurity is likely to grow. As firms achieve greater scale, they often need to tap third parties for expertise and service, which have their own cybersecurity issues, he said.

“The Cerulli/IAA report is a useful tool for asset managers who wish to gain a broader view of how other firms are prioritizing strategic, technology, employment, and other business issues,” said **Ropes & Gray** counsel **David Tittsworth**. “While there are certainly a variety of concerns, the basic prognosis is that asset managers expect to grow their businesses by pursuing smart talent, business, strategic and cost-effective strategies. The hiring concerns are critical – and the report notes that nearly half of respondents are reporting that they are within 15 years of retiring. Succession planning must be a high priority for these firms if they expect to continue to grow and thrive.”

Growth findings

Following are some specific results from the survey in regard to advisory firm growth:

- **Growth in staff.** Breaking down the “nearly 80 percent” growth result further, the survey reports that 64.7 percent of respondents expect their headcount to increase by 1 percent to 10 percent over the next 12 months, while 14.7 percent expect a more than 10 percent increase. The survey found that 20.6 percent expect their staff size to remain the same.
- **AUM growth.** Here’s how the relative optimism about AUM broke out among firms with individual clients, institutional clients and defined contribution clients: Twenty-one percent of advisers managing individual clients expect their AUM to go up by more than 10 percent, while 28 percent of advisers managing

institutional clients expect that result, and 12 percent of firms with defined contribution clients believe that will be the case. Thirty-six percent of advisory firms with individual clients anticipate an AUM increase of 1 percent to 10 percent, while 31 percent of firms with institutional clients, and 18 percent of firms with defined contribution clients, expect that result. As for those who expect AUM to stay just where it current is, count 27 percent of advisers managing individual clients, 34 percent of advisers managing institutional clients, and 47 percent of advisers managing defined contribution clients in that camp.


- **Growth plans in 2018 compared with 2016.** Where will the AUM growth come from? “Virtually all expect to accomplish this by way of organic growth,” the survey reported, something that it said Cerulli finds to be a common characteristic in the entrepreneurial environments of most registered investment advisers. The research firm said it “anticipates that new business lines, including digital advice platforms and automation tools, will have a greater impact than many currently expect.”

Investments, opportunities and threats

A number of the survey questions related to where advisers planned to invest client dollars, as well as the opportunities and threats they see ahead.

- **Industry opportunities and threats over the next two years.** The biggest opportunity voiced by respondents was the incorporation of what is known as environmental, social and governance (ESG) criteria and socially responsible investing (SRI). Forty-three percent of those answering this question said it was an opportunity, compared to 33 percent categorizing it that way in the previous survey. The 2018 findings also found that 54 percent of respondents were neutral on the subject, while 3 percent saw it as a threat.
- **External factors.** Trends and events occurring internationally also brought response. Topping the list was cybersecurity, with 63 percent of firms saying they were “very concerned” about it and 34 percent saying they were “moderately concerned.” The next

highest-ranked topic under “very concerned” was a “potential significant market crisis” (26 percent), followed by “international relations, e.g., North Korea” (23 percent); “fee compression” (20 percent); “competitive pressure to invest in new technology” (20 percent); the “U.S. regulatory environment” (14 percent); and the “non-U.S. regulatory environment” (9 percent).

- **Technology investments.** How do advisory firms plan to prioritize their investments in technology? It will be no surprise that 51.4 percent ranked improvements in cybersecurity as their highest priority, with 40 percent listing it as a moderate priority. The next highest priority after cybersecurity that was listed was improving data management and analytics, which drew 31.4 percent, followed by updating older technology, which drew 25.7 percent; maximizing resource allocation and distribution opportunities (such as client segmenting and predictive analytics), which drew 17.1 percent; and improving digital content (such as through mobile devices), which drew 14.3 percent. 

Refund

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Specifically, according to the SEC’s administrative order instituting the settlement, Beverly Hills Wealth Management, in April 2016 withheld prepaid, unearned advisory fees totaling \$131,000 from 63 departing clients who requested terminating their advisory relationship because those requests, which arrived by email and regular mail, lacked a “wet signature.” Such a stance by the firm was “contrary to the disclosures made to clients in both Form ADV Part 2A and its advisory contracts,” the SEC said.

Further, the agency charged, between March 2013 and April 2018, Beverly Hills Wealth Management and its founder and CEO, **Margaret Mulligan Black**, “continually omitted material facts and made false and misleading statements regarding [the advisory firm’s] financial condition in firm brochures.” The firm failed to let clients know that it was insolvent and unable to repay its loans during this period, the agency said.

“Advisory firm managers are fiduciaries running a business. Financial matters should be carefully monitored in order to prevent financial problems cascading to the point of insolvency. An adviser should not have to make a Hobson’s choice between the client’s interests or a creditor’s,” said **Scarinci Hollenbeck** partner **Paul Lieberman**.

That said, he asked, “Realistically, what investment adviser is going to make the required financial disclosures in a timely manner that they are insolvent, and thereby trigger a race to the door of both clients and firm staff?”

“The settlement is a good reminder of just how important it is for advisers to follow the terms of their own agreements and also only make accurate and truthful statements in their ADV filings,” said **Tesser Ryan** partner **Gregory Ryan**. “It makes the point that the agency will act against advisers in enforcing regulations which are designed to assure investors that custodians of their funds are forthcoming and truthful in their ADV filings and that advisers will honor contractual obligations to their clients.”

The firm, financial health and refunds

Beverly Hills Wealth Management as of March 2018 had 168 clients, consisting predominantly of high net worth individuals, as well as institutional clients, pension plans and charities, the SEC said. Under its advisory agreement, clients would prepay their advisory fees at the beginning of each quarter, meaning that if a client terminated its relationship with the adviser before the quarter ended, it would need to be refunded a portion of the advisory fee for that quarter.

Beverly Hills Wealth Management experienced this type of situation. Two of its financial advisers, who together managed more than \$160 million in client assets, left the firm on April 1, 2016. Then, between April 11, 2016 and June 1, 2016, those two financial advisers forwarded 63 client termination letters to the advisory firm. “The financial advisers sent the letters by USPS, as well as by email,” the agency said. “The departing clients physically signed most of the termination letters, but signed some of them electronically.”

Both the advisory firm’s adviser agreement and its March 28, 2016 firm brochure stated that Beverly Hills Wealth Management would refund the unearned portion of an advisory fee “after receiving ‘written notice’ of termination from the client,” the SEC said. “An original signature was not required for an effective termination under either the advisory agreement or the firm brochure.” Clients were to receive the pro-rated refunds after five business days, according to the adviser’s advisory agreement, the administrative order says.

Further, Beverly Hills Wealth Management’s compliance manual, dated April 2016, made clear that a client could notify the advisory firm of its termination “by a variety of methods, including mail, email and even orally.”

Despite these requirements, Beverly Hills Wealth Management “did not refund the prepaid advisory fees” Instead of adhering to the five-day requirement, Black directed all the clients to submit another termination letter with an original or wet signature.”

That apparently made some difference. In July 2016, after receiving new termination letters, the advisory firm refunded \$46,000, or about 35 percent, of the unearned fees, the SEC said. “Moreover, the firm did not refund the client’s fees until more than three months after it received the first termination letters.”

Enter the SEC

By this point, according to the settlement order, examiners from the SEC’s Office of Compliance Inspections and Examinations were visiting the adviser, and brought up the unearned advisory fee issue. What’s more, Division of Enforcement staff had requested documents.

“It took several more months for Beverly Hills Wealth Management to refund the remaining money to the clients, which had to be recalculated because [the adviser] and Black initially used the wrong termination date,” the SEC said.

The remaining approximately \$85,000 in unearned advisory fees was refunded in September 2016 – although the settlement order notes that, “importantly, this came after the examination staff sent the firm a deficiency letter, and the enforcement staff met and followed up with the firm regarding the status of the remaining funds.”

Disclosure issues

Aside from the issue of refunded unearned advisory fees, the advisory firm settled charges that between March 2013 and April 2018, it “omitted material facts and made false and misleading statements in 13 firm brochures regarding its financial condition that was rea-

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sonably likely to impair [the adviser’s] ability to meet contractual commitments to its clients,” the SEC said.

Specifically, according to the SEC, from at least March 2013 through April 2018, Beverly Hills Wealth Management could not pay its expenses through its operating income and “experienced cash shortages in the last month of each quarter. . . . To cover the shortage, as well as the costs associated with hiring new financial advisers, Black, on behalf of [the advisory firm], borrowed a total of \$675,000 from several individuals in 2013, and \$50,000 in 2014.”

The advisory firm, by 2014, was in default to its creditors for \$700,000 in principal and, by the end of December 2017, an additional \$75,000 in interest, the agency said. As of 2017, the SEC said, Beverly Hills Wealth Management “had a negative net worth of \$1,498,279.”

Violations and sanctions

Both Beverly Hills Wealth Management and Black, as part of the settlement, were found to have willfully com-

mitted violations of Sections 206(2) of the Advisers Act, which prohibits fraud, and Section 207, for making an untrue statement of material fact in any registration application or report.

In addition, the advisory firm was found to have willfully violated Section 204(a) and its Rule 204-1(a) (2), requiring that Form ADV be amended promptly when information in it becomes materially inaccurate, and Section 206(4) and its Rule 206(4)-7, the Compliance Program Rule, for failing to adopt and implement written compliance policies and procedures. Black was found to have willfully aided and abetted and caused Beverly Hills Wealth Management’s violation of these two sections and rules.

Both parties were censured. Beverly Hills Wealth Management was ordered to pay a civil money penalty of \$100,000, and Black was ordered to pay a civil money penalty of \$50,000. An attorney representing both parties, when reached, chose not to comment on the settlement. ☞

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