

DUTIES TO CUSTOMERS

DIFFERING LEGAL STANDARDS

- Registered Investment Advisors
 - Fiduciary Duty
- Registered Representatives
 - Suitability
 - Best Interest Standard

FIDUCIARY DUTY

- Imposed by Investment Advisors Act
- Duty of Loyalty
 - Best Interest of the Client
 - Best Execution
 - Advice and Monitoring over the Course of the Relationship
- Duty of Care
- Limited by scope of service agreed

FIDUCIARY DUTY DUTY OF LOYALTY

- Adviser must not place its own interest ahead of its client's interests. Depends on scope of relationship (Asset based fee vs. one-time plan)
- Full and fair disclosure of conflicts or potential conflicts
 - The appropriate level of specificity, including the appropriateness of stating that an adviser "may" have a conflict
 - Considerations for disclosure regarding conflicts related to the allocation of investment opportunities among eligible clients.
 - IA must deliver to retail investors, at or before investment advisory agreement, a relationship summary, including a plain English summary of certain of the firm's conflicts of interest, and would encourage retail investors to inquire about those conflicts

FIDUCIARY DUTY DUTY OF CARE

Best Interest of the Client

- Reasonable Inquiry into financial situation, level of financial sophistication, investment experience, and financial goals (“investment profile”)
- Update the client’s investment profile to reflect any changed circumstances (tax, marital status, retirement, etc.)
- Independently or reasonably investigate securities before recommending them to clients
- Cost
- Applies to all investment advice, including investment strategy, engaging a sub-adviser, and account type

FIDUCIARY DUTY DUTY OF CARE

Best Execution

- Total cost or proceeds in each transaction are the most favorable under the circumstances
- Not only cost. The “determinative factor” is not the lowest possible commission cost, “but whether the transaction represents the best qualitative execution.”

FIDUCIARY DUTY DUTY OF CARE

Advice and Monitoring over the Course of the Relationship

- Provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship
- Asset based fee vs. one-time plan. Depends on scope of relationship

SEC ON FIDUCIARY DUTY

- The SEC has been particularly focused on advisers recommending mutual funds to clients without adequately disclosing less expensive share classes. In February 2018, the Division of Enforcement announced its Share Class Selection Disclosure Initiative, under which the Division agreed not to recommend financial penalties against advisers which self-report violations of the federal securities laws relating to mutual fund share class selection and promptly return money to victimized investors. SEC has filed a number of actions against advisers which did not self-report such violations.

THOROUGHBRED FINANCIAL SERVICES,
LLC., ADMINISTRATIVE PROCEEDING FILE
NO. 3-18952

- Investment adviser and two of its investment adviser representatives have agreed to pay nearly \$1.7 million to settle charges that they improperly invested clients in more expensive mutual fund share classes that charged fees, known as 12b-1 fees, when less expensive share classes of the same funds were available without the fees.

REGISTERED REPS STANDARD

- FINRA Suitability (Historical Standard)
- SEC Best Interest (New Standard)

FINRA RULE 2111

- FINRA Rule 2111
 - ***A member or an associated person must 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 the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.

FINRA RULE 2090 KNOW YOUR CUSTOMER

- Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.

FINRA SUITABILITY RULES

- **Reasonable-basis obligation:** reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least **some** investors.
- **Customer-specific obligation:** reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile
- **Quantitative suitability:** reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile
 - Factors: turnover rate, the cost-equity ratio, and the use of in-and-out trading

FINRA RULE 2111 SUITABILITY STANDARD

- Reasonable basis to believe that a recommended securities transaction is suitable for the customer, based on the information obtained through the reasonable diligence of the firm or associated person to ascertain the customer's investment profile.
- A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance.

FINRA SUITABILITY REASONABLE BASIS

- Asking a customer for the information ordinarily will suffice.
- Absent "red flags" broker generally may rely on the customer's responses.
- A broker may not be able to rely exclusively on a customer's responses in situations such as the following:
 - the broker poses questions that are confusing or misleading to a degree that the information-gathering process is tainted,
 - the customer exhibits clear signs of diminished capacity, or
 - other "red flags" exist indicating that the customer information may be inaccurate.
- Better practice is to attempt to gain as much relevant information as possible before making recommendations

SUITABILITY

QUANTITATIVE SUITABILITY

- Excessive trading
 - Turnover rate: number of times that a portfolio of securities is exchanged for another portfolio of securities.
 - The cost-to-equity ratio: the amount an account has to appreciate just to cover commissions and other expenses. In other words, it is the break-even point where a customer may begin to see a return.
 - A turnover rate of six or a cost-to-equity ratio above 20 percent generally indicates that excessive trading has occurred.
 - Excessive trading becomes churning, which violates Section 10(b) of the Exchange Act, Rule 10b-5 and Rule 2020, when the registered representative acts with an intent to defraud or a reckless disregard for the customer's interests.

SEC ON CHURNING

- “We are diligently pursuing deceitful brokers who prey on their customers. Brokers need to ensure that the level of trading they recommend is suitable for their customers, and investors should be on the lookout for frequent trading in their accounts.”
- Antonia Chion, Associate Director in the SEC’s Division of Enforcement and Chair of the Enforcement Division’s Broker-Dealer Task Force.

GREGORY T. DEAN, LETTER OF ACCEPTANCE, WAIVER AND CONSENT NO. 2017052699901

- Excessive trading and churning
- Annualized turnover rate of 30.99 tto 92.12 and an annualized cost-to-equity ratio of 72.09% to 130.64
- \$1,834,832 in cumulative losses while generating more than \$715,930 in commissions, fees and margin interest charged to the customers.

Sanctions:

- Barred from association in all capacities with any FINRA member firm

MICHAEL ALLEN KAMPERMAN, LETTER OF
ACCEPTANCE, WAIVER AND CONSENT NO.
2016050400401

- Six years of unsuitable investments in the 401(k) and IRA retirement accounts of eight customers. Not suitable for customers
- High risk, speculative oil and gas energy sector securities.
- Recommended that one customer purchase and hold a leveraged inverse ETN, which was only meant to be held for one trading day,' in his 401(k) retirement account for nearly 16 months. Not suitable for anyone.
- \$407,000 in trading losses
- Eighteen-month suspension and \$20,000 fine

BEST INTEREST STANDARD

- Effective September 10, 2019
- Requires broker-dealers to act in the best interest of a customer when making recommendations for securities transactions or investment strategies to a retail consumer.
- May not place the financial or other interests of the broker-dealer ahead of the customer
- Disclosures regarding conflicts
- Reasonable diligence standard
- Policies and procedures to address conflicts
- Compliance policies

BEST INTEREST STANDARD COMPONENT OBLIGATIONS

- (1) providing certain prescribed disclosure before or at the time of the recommendation, about the recommendation and the relationship between the retail customer and the broker-dealer (“Disclosure Obligation”);
- (2) exercising reasonable diligence, care, and skill in making the recommendation (“Care Obligation”);
- (3) establishing, maintaining, and enforcing policies and procedures reasonably designed to address conflicts of interest (“Conflict of Interest Obligation”), and
- (4) establishing, maintaining, and enforcing policies and procedures reasonably designed to achieve compliance with Regulation Best Interest (“Compliance Obligation”).

BEST INTEREST STANDARD DISCLOSURE OBLIGATION

- Written disclosure of all material facts about the scope and terms of its relationship with the customer, including
 - Disclosure that the firm or representative is acting in a broker-dealer capacity;
 - Material fees and costs
 - Type and scope of the services, including any material limitations on the recommendations that could be made to the retail customer.
 - All material facts relating to conflicts of interest associated with the recommendation that might incline a broker-dealer to make a recommendation that is not disinterested, including, for example, conflicts associated with proprietary products, payments from third parties, and compensation arrangements.

BEST INTEREST STANDARD CARE OBLIGATION

- Must exercise reasonable diligence, care, and skill when making a recommendation to a retail customer.
- Must understand potential risks, rewards, and costs associated with the recommendation.
- Then must consider those risks, rewards, and costs in light of the customer's investment profile
- Reasonable belief that the recommendation does not place the broker-dealer's interest ahead of the retail customer's interest.
- Consider reasonable alternatives, if any, offered by the
- If series of investments can't be excessive

BEST INTEREST STANDARD CONFLICT OF INTEREST OBLIGATION

- Written policies and procedures addressing conflicts of interest associated with its recommendations to retail customers.
- Designed to identify all such conflicts and at a minimum disclose or eliminate them.
- Reasonably designed to mitigate conflicts that create an incentive for an associated person of the broker- dealer to place its interests or the interest of the firm ahead of the retail customer's interest.
- If material limitations on recommendations (e.g., offering only proprietary or other limited range of products), the policies and procedures must disclose the limitations and associated conflicts.
- Identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.
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BEST INTEREST STANDARD COMPLIANCE OBLIGATION

- Written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.
- Policies and procedures must address not only conflicts of interest but also compliance with its Disclosure and Care Obligations under Regulation Best Interest.

BEST INTEREST STANDARD FUTURE

- No history here on how SEC will enforce or apply
- SEC says no private right of action, but seems like would be applied in arbitration at least indirectly in addition to suitability
- Regulation has been challenged by seven states and D.C. (9/9/19)
- Have to see how it shakes out

OTHER ISSUES

- Fee based v. Commission based
- Reverse Churning
- Elder protections

FEE BASED ACCOUNTS

- May be more advantageous and cost effective
- Must be appropriate for customer
- Low activity account, may not be appropriate
 - Need to be aware of possible “reverse churning”

ELDER PROTECTION

FINRA Rule 4512 – Customer Account Information

- Permits “Trusted Contact Person”

FINRA Rule 2165 –Financial Exploitation of Specified Adults

- Permits “temporary hold” on account if financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted
- Contact Trusted Contact Person
- Written supervisory procedures required to use rule

Federal Senior Safe Act

- immunity to certain defined financial advisors and financial institutions who disclose “potential examples of financial exploitation of senior citizens.”

ELDER PROTECTION BEST PRACTICES

- Involve trusted contact person involved as early as possible with any signs of dementia or suspected fraud or abuse;
- Escalate to supervisors and supervisors to legal department;
- If the senior investor is always accompanied by someone, get them one-on-one to confirm that their true instructions are being followed
- Videotaping of meetings with senior investors (and their trusted advisor, if possible) that appear to have, or are confirmed to have diminished capacities;
- Age of clients on supervisory documents
- Heightened supervision for clients flagged for possible or actual dementia
- Red flag triggers for suspicious activity in senior investors' accounts

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