People Handling Other Peoples' Money

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Good morning, and thank you, Scott [Weisman], for that kind introduction. *Before I begin, I'll remind you that the Securities and Exchange Commission disclaims responsibility for any statement or private publication by any of its employees, including me. The views expressed here are my own and do not necessarily reflect the views of the Commission, the Commissioners or of other members of the staff.*

I'm really pleased to be here with you today. It's not long ago that I participated in this conference as an attendee. As some of you may know, I worked in or around the industry for 24 years before joining the SEC. Like you, I enjoyed working with colleagues in a highly competitive, rapidly changing, business … trying to help our clients, employees, and owners achieve their objectives. I was also regularly examined by the SEC … but that's a story for another occasion.

Today, I stand before you on the other side of the podium, having spent the last 2 ½ years examining the market from a regulator's perspective, hopefully about to say something that will set the stage for the next two days or otherwise be of some use or interest to you.

My recent experience with the Commission has confirmed the complexity and adaptability of the market … a complexity and rate of change that can be fascinating, exhilarating, challenging, or frustrating … but that can also cause us to forget our fundamentals and to lose the forest for the trees. We can get lost in the many regulatory agencies, laws, rules, and regulations. Am I dealing with the SEC, the Fed, the OCC, the CFTC, the FCA, or others? How can I take advantage of SEC Rule 506(c) without losing my exemption under CFTC Rule 4.13(a)(3)?

We can also get lost in the accelerating pace of technological change. I received my first computer 7 years after graduating from law school, a time when e-mail wasn't widely used for business communications; financial advisors completed order tickets with a pen; and stocks traded in fractions. Today, just 20 years later, technology has transformed the industry … and you best not blink, or you may fall far behind. Market participants now clamor to receive news releases only hundredths of a second before their peers. We recently rolled out in OCIE a new trade analytic tool that will enable our examiners to quickly subject years' worth of your trading data to a battery of more than 50 tests.

Even though the complex and changing rulebooks, regulations, algorithms, and fiber-optic cables (going to lasers now) shaping the market today are interesting and important, they're not what I want to address today. I want to go old school. I want to go back to basics. I want to talk about *people*. More specifically, I want to talk about people handling other peoples' money. For, at its most simple, isn't that what the financial services industry is all about? … *people* handling other peoples' money?

Good People Trying to Do the Right Thing

I'll start by emphasizing that my time with the Commission has reinforced my understanding on the day I was sworn in: the overwhelming majority of the people in the industry … including, I suspect, everyone in this room … are trying to do the right thing by their clients, colleagues, owners, and … even, regulators. That's why you're here today.

It's not an easy task. Indeed, it's a very difficult task given some of the complexities and innovations we've touched on already. Yet, when OCIE staff engages with business leaders, lawyers, and compliance officers and identifies deficiencies or weaknesses in controls … whether we're addressing issues generally across the entire market or those specific to a firm … most make a good-faith attempt to remediate on their own.

We in OCIE therefore spend a lot of our time and resources trying to help the good people get it right. We are transparent. For the last two years, we've published our examination priorities to let you know the areas we'll be examining so you have the opportunity to self-evaluate and remediate. We have also been publishing Risk Alerts to flag areas where we have found noncompliance across firms, again giving you the opportunity to look into these issues preemptively in your organizations. We are hosting increasing numbers of outreach and "in-reach" events, where we share with you what we are seeing and what the law requires.

From Chair Mary Jo White on down throughout OCIE, the goal is not to play "gotcha!" We in OCIE are much more interested in seeing the many good people in the industry self-correct and succeed.

It is in this spirit — the spirit of helping good people do the right thing — that I want to continue and to speak with you about the three most common activities in which people engage when handling other peoples' money that may result in them having serious interaction with the Commission (not to mention clients and their lawyers, other regulators, and criminal authorities).

What are they? In trying to focus OCIE resources on the root causes of harm to investors and our markets, I've reviewed most exam results and enforcement actions in the investment advisor area for the last several years and beyond … and concluded that almost all of the serious problems we address arise because: (1) some people lie, cheat, and steal; (2) some people act recklessly; and (3) some people don't see, think, or act clearly or fairly because their judgment is clouded … or contaminated … by conflicts of interest.

And, like Rod Serling, I "present for your consideration," whether your legal, compliance, risk, and audit programs will be enhanced if you implement them to identify and deal effectively with these people and the problems they present within your organizations … whether you are a firm of 3, 30, 300, or 300,000.

Liars, Cheaters, and Thieves

We can dispense with the first vice quickly. The ways and means of man are many, but the methods used by some people to separate their brethren from their money are relatively unchanged. They lie, cheat, and steal.

I'm going to use some examples from Enforcement cases — not to be heavy-handed, but I'm limited in what I can say about examinations, which are non-public.

You may have seen that the Enforcement Division recently charged a Los Angeles-based attorney as the alleged architect of a fraudulent scheme that raised money through a boiler room operation. It is alleged that high-pressure salespeople persuaded more than 60 investors nationwide to invest a total of $1.8 million in a movie first titled *Marcel* and later changed to *The Smuggler*. Investors were allegedly falsely told that actors ranging from Donald Sutherland to Jean-Claude Van Damme would appear in the movie when in fact they were never even approached. Instead of using investor funds for movie production expenses as promised, the defendants are charged with spending most of the money on themselves. The SEC press release states that the investor funds that remain aren't enough to produce a public service announcement let alone a full-length motion picture capable of securing the theatrical release promised to investors.

While I believe that liars, cheaters, and thieves are a very small minority of the industry, the SEC spends a significant amount of time and resources trying to detect their bad behavior and to prevent them from harming investors.

You must also. From the moment you hire your second employee, or your 20^{th}, or your $2{,}000^{th}$, the odds increase that you have employed someone who will resort to bad acts to separate other people from their money.

My first boss in the industry ran our legal and compliance department, which oversaw well over one thousand employees. In a memorable, but earthy, metaphor, he used to declare, "We have it good. We get to work with smart people in an interesting business. We help our clients achieve their financial goals. Our employees make a good living and provide for their families. This is a great company. We (*and here he was talking about the leadership of the firm, not just the compliance team*) are like lifeguards at the community pool, watching the swimmers' heads bob in the water. Most are having fun, following the rules of the pool, but you just know that someone may be out there, peeing in the pool, ruining it for everyone. Our job is to find that person."

Indeed, this may be where our interests are most closely aligned. No one wants liars, cheaters, or frauds in their firms or in the industry.

Reckless People

OCIE also sees people who behave recklessly. They forget that they are fiduciaries and caretakers of their clients' money.

For example, you may have seen that the Division of Enforcement recently brought a settled case[1] against a firm that adopted practices that gave the firm's 60 employees total control of clients' funds without implementing any appropriate safeguards. The firm enabled its employees to access and to transfer client funds through the use of (1) pre-signed letters of authorization; (2) cutting and pasting client signatures on LOAs; (3) and retaining logins and passwords to access their clients' outside accounts.

Let me pause here and say, "I get it." The firm was likely trying to provide a service to its clients by enabling them to easily transfer funds. But, importantly, the record is devoid of any facts indicating that the firm had adopted reasonable controls to ensure that disbursements of client funds by pre-signed LOAs, or cut-and-pasted signatures, or remote log-in were actually authorized by the client. It was an accident waiting to happen.

It could have been a problem employee with a drug, alcohol, or gambling problem who was tempted to misappropriate client funds … or it could have been a client who tried to stick it to the firm and falsely claim that a withdrawal or series of withdrawals were unauthorized and there would be no record of the authorization. Someday, somehow, the absence of controls was going to bite the firm.

As it turned out, the inadequacy of the firm's controls was exposed when a hacker gained control of a client's email account and, posing as the client, emailed instructions for the firm to wire almost $300,000 to a foreign bank account designated by the hacker. The firm acted upon the hijacked e-mail without question or further inquiry, and the client's money was gone.

Identifying people behaving recklessly within your firms can be difficult. Financial services is fiercely competitive. You are trying to keep up. Resources are finite. And, depending on the size of your firm, people can sometimes roam out of your sight and over the hill before you realize they are no longer with the herd.

I therefore implore you to stay current on what's happening in your business and to continually probe and test to evaluate whether you have people within your organization who are rushing headlong into, or up to their necks in, activities in the absence of the kinds of controls that a fiduciary should have in place.

It could be new products … or new lines of business … or rapid growth … or acquisitions … or contractions and retrenchment … or bending over backwards to serve your clients. It is critical to identify and remediate any instances within your organization where people are handling other peoples' money in the absence of reasonable controls.

When OCIE staff and I look out into the industry today, one of the areas where we are beginning to conduct exams to assess the existence and effectiveness of controls is in the alternative mutual fund space. Increasingly, advisers to mutual funds are establishing and marketing funds that are labeled "alternative" and hold non-traditional investments or engage in complex trading strategies.

Alternative funds are the bright, shiny object. According to our Risk Analysis and Surveillance team, assets under management in alternative mutual funds rose 63% in the 12 months ending December 31, 2013, from $158 BB to $258 BB. At least 60 alternative funds launched in 2013, joining the 64 funds launched in 2012, and leaving investors with more than 400 funds labeled "alternative" in one form or another. At least one consultant estimates that alternative funds will comprise nearly 16% of total fund assets by 2022, up from about 3% in 2011.

There is certainly nothing wrong with alternative investments or alternative investment strategies, per se. Many investors have benefitted from their inclusion in portfolios.

But … and it's a big but … the use of hard to value and/or illiquid securities in an open end mutual fund, which requires daily valuation and offers daily liquidity, is fraught with risk. This is particularly true for advisers that may have experience with alternatives in private funds but are new to implementing them within the strictures of the Investment Company Act … and for advisers that may have experience with the Investment Company Act but are new to alternatives.

In short, daily valuation and daily liquidity require a tremendous amount of control and discipline. An adviser can invest up to 15% of an open end fund's assets in illiquid investments. That's 15% at cost … not at market. So, the percentage of a fund invested in illiquid alternatives can fluctuate above 15% … and if the market moves sharply downward … and investors start redeeming their shares en masse … the adviser must sell what it can to meet redemptions, and the percentage of the fund in illiquid investments can move even higher …

You get the picture. Alternative funds are the bright, shiny object … but they are a sharp object. If any of you have launched, or are considering launching, a mutual fund that uses alternative investments or strategies, I implore you to evaluate the reasonableness and effectiveness of your controls.

Conflicts of Interest

That brings us to conflicts of interest — the vice that is most difficult for the people within an organization to detect because they are often impaired by it. OCIE staff and I see instances where otherwise honest, hard-working people are blind to the fact that they are putting their interests ahead of their clients. We can come into such situations independently and unaffected by the same pressures and incentives as the adviser and see immediately that client money is being handled primarily for the benefit of the adviser, not the client … but the adviser will cling insistently to the notion that its heart and actions are pure.

There's an apocryphal story about Abraham Lincoln and conflicts of interest during the Lincoln-Douglas debates. (*I remember reading the story some years ago but could not find the original source when preparing these remarks, so I cannot attest that the story is true … but it has the ring of truth. If there are any Lincoln scholars out there who can point me to the source or confirm that it's merely legend, I'd appreciate you letting me know.*)

At any rate, as you know, Abraham Lincoln and Stephen Douglas engaged in a series of debates in 1858 on the issue of slavery. They alternated who went first. The leader was scheduled to speak for 60 minutes, and then the other would take the stage. One time, Douglas led off and expounded at length on "the great good of slavery." When it was Lincoln's turn to speak, Lincoln sauntered to the stage and simply held two gold coins in front of his eyes. He said, "You know, it's sometimes difficult for a man to see clearly with these in front of his eyes."

Now, I am not comparing conflicts of interest in the financial services industry to the deprivations of slavery, BUT, it does make my point. If gold was sufficient to blind peoples' vision to the horrors and injustice of human bondage, then it will certainly suffice to cloud peoples' vision when it comes to what investment to buy … or where to buy it … or how much to pay … or who, among several clients, gets a piece.

Conflicts are also interesting and insidious, because we see them at an individual, firm, and industry level. One person, a close group of people, or seemingly everyone in the entire system, can incrementally, over time, through the accretion of justifications, customs, and excuses convince themselves that they are entitled to money and opportunities that fairly belong to their clients.

Take a conflict at an individual level. In 2012, the Commission charged the founder, majority owner, and CIO of a Los Angeles based adviser[2] (that at its peak managed more than $10 BB) with allegedly unfairly allocating options trades. The complaint alleged that over a period of more than two years, the principal allocated almost 2,500 option trades more than an hour after their execution, enabling him to routinely cherry pick winning trades and allocate them to favored accounts (including his own). Even though the firm's policy manual required employees "to adhere to the highest standards with respect to any potential conflicts of interest with client accounts," here was not just a potential conflict, but an actual conflict ("Who gets these profitable trades?") that is alleged to have been consistently resolved in favor of the principal over a 27-month period at the expense of his clients.

OCIE also sees conflicts that appear to ensnare an entire firm's way of doing business. In 2012, the Commission settled charges against a Portland, Oregon based firm[3] that was receiving compensation for placing its clients in certain mutual funds. The firm, which managed nearly $2 BB (not insignificant), offered turn-key asset management services and back-office custodial support to about 60 advisers. The firm also created and offered proprietary asset allocation models to its advisor clients. The models used a variety of mutual funds, ETFs, and equity positions. From time to time, the adviser would change weightings, as well as the funds used, in the models. If the participating advisors acquiesced, then the changes were made across all of the advisor's client accounts.

In September 2007, the firm entered into an arrangement with a broker that agreed to pay the firm a percentage of AUM invested in certain funds. That arrangement included a scaling provision that increased the payout rate to the firm if it achieved higher levels of investment in the funds covered by the agreement. So, of all the thousands of funds available to the firm, it had a direct financial incentive to use certain funds, and to use them in increasing amounts, in the construction of the models that it offered to its advisory clients.

This actual (not theoretical or potential) conflict of interest was not disclosed to the firm's advisory clients or, in turn, their clients … leaving me to wonder … what was the firm thinking? How did they get comfortable with this arrangement? What rationalizations and justifications were required?

Incentives and conflicts and the human mind are powerful things. Indeed, individual and firm-level conflicts can sometimes snowball into "groupthink," or industry-wide conflicts.

Let's roll back the clock to 2003. The SEC commenced a series of examinations of mutual fund distributors and advisers to ascertain whether the distributors were receiving fund brokerage — compensation via commissions on transactions on the fund's behalf — as a form of undisclosed compensation for fund sales. By the end of these exams, a few things were apparent: (1) there were widespread instances in the industry where advisers were directing fund brokerage to distributors to compensate them for sales of fund shares; (2) in doing so, many advisers were not meeting their fiduciary duty to shareholders to allocate trades to attempt to obtain best execution — to the contrary, they were putting their interests ahead of their shareholders', (3) many advisers were doubly conflicted because they were using the shareholders' money (in the form of brokerage commissions) to offset or reduce the advisers' revenue sharing obligations, and if the advisers didn't direct sufficient brokerage dollars to the distributors, they had to make up the difference out of their own pockets; and (4) these arrangements and payments — which were material and not in the interests of shareholders — were not adequately disclosed (or disclosed at all) to investors or to fund directors.[4] The examinations resulted in an amendment to Rule 12b-1 in 2004 prohibiting the use of brokerage commissions to finance fund distribution, a number of enforcement actions, reimbursements of nearly $100 million and nearly $20 million in fines. Looking back on it, it's hard to conceive how something so malignant grew into a widespread industry practice.[5]

Can it happen again? When we look out into the industry today, one of the areas where we are actively looking for undisclosed and unmitigated conflicts is the trend among dually registered firms to move their clients' assets from commission-based brokerage accounts to fee-based wrap accounts that offer advice and no-commission trading for one bundled asset-based fee.

The dual-registrants we examine can pretty quickly explain why the migration to fee-based accounts is good for them. Their commission-based business is under pressure from decreasing trade volumes and declining commission rates. They can transform choppy, transaction based-compensation into a steadier, more reliable, and predictable revenue stream. They no longer have to make a sale to collect a fee.

And there may be compelling and legitimate reasons why the move to a fee-based advisory account is in the best interest of the client. The client may receive additional planning or consulting services. The incentive to recommend unsuitable transactions to generate a fee is removed, and the client may value the option to initiate a trade on her own without having to pay a commission.

And there's nothing wrong with earning a fee where advisers have such a valuable service to provide. Study after study shows that the average equity investor's return over long periods lags the broad-based equity index return by several percentage points because of behavioral biases and tendencies. The average investor sells when she should buy, and buys when she should sell … so guiding investors and helping them employ a disciplined investment strategy can be a valuable service.

But we see instances where the value proposition to clients is not clear:

- Securities are purchased, and portfolios are constructed or reconstructed, in commission-paying brokerage accounts at significant expense to the client, and then promptly transferred to a fee-based wrap account in which they could have done the same trades without paying commissions.
- Accounts that consist primarily or entirely of cash or cash equivalents earning a few basis points that are transferred into a fee-based wrap account charging up to nearly 3% of AUM … and continue to remain invested in cash.
- Accounts that sit in a fee-based account for years without effecting a single transaction, or effecting sell transactions only to generate proceeds to pay the asset-based fee.

I could go on … but suffice it to say the move into fee-based wrap accounts is a widespread practice. A lot of people have jumped into the pool. We fear that the rationalization that "everyone is doing it" may be adversely affecting peoples' thinking about how some of these arrangements are in the best interest of their clients.

If you didn't see it, the Commission published recently a good investor bulletin on the adverse impact of fees on investor returns over time.[6] The stakes for investors (and advisers), and the risk that the gold coins are clouding their vision, is high.

Conclusion

Over today and tomorrow, I hope you'll have the opportunity to examine the market and your business through the window of the many laws, rules, and regulations with which you must comply … and the window of the technological changes sweeping through the industry and your firms that you must navigate. But I also hope you will get back to basics and spend some time thinking about the people who work in the industry and in your firms. Most of them are good people, trying to do the right thing by their clients, colleagues, and owners.

But you will occasionally cross paths with someone who is simply trying to separate other people from their money through falsehoods or misappropriation … or who is handling other people's money recklessly and in the absence of a true fiduciary's reasonable controls … or whose incentives and thought process has left him (or them … and sometimes a whole bunch of them) conflicted and behaving in ways that put their selfish interests ahead of those they agreed to serve.

When attempting to identify and address these people, particularly people who are conflicted, please, on behalf of your clients, colleagues, and owners, think and act independently, rigorously, and objectively … constantly asking, "How is this product, or account, or course of conduct, in the best interest of our clients, who have given us their money, and whose interests we have agreed to put ahead of our own?"

And if and when you can't get a square answer to that question, that you can easily understand and explain to others, you've done it! You've identified who's peeing in the pool.

Thank you, and have a great conference!

[1] *In the Matter of GW & Wade, LLC*, Release No. 3706 (Oct. 28, 2013), *available at*: http://www.sec.gov/litigation/admin/2013/ia-3706.pdf.

[2] *SEC v. Aletheia Research and Management, Inc. and Peter J. Eichler, Jr.*, United States District Cou for the Central District of California, Civil Action No. 12-cv-10692-JFW-(RZx), *available at*: http://www.sec.gov/litigation/complaints/2012/comp22573.pdf.

[3] *In the Matter of Focus Point Solutions, Inc. et al.*, Release No. 3458 (Sept. 6, 2012), *available at*: http://www.sec.gov/litigation/admin/2012/ia-3458.pdf.

[4] *See*, *e.g.*, *In re Massachusetts Fin. Services Co.*, Advisers Act Release No. 2224 (Mar. 31, 2004), *available at*: http://www.sec.gov/litigation/admin/ia-2224.htm; *see also*, *e.g.*, *In re PA Fund Management LLC, PEA Capital LLC, AND PA Distributors LLC,* Exchange Act Release No. 50384, (Sept. 15, 2004), *available at*: http://www.sec.gov/litigation/admin/34-50384.pdf.

[5] "Pressures to distribute fund shares (or to avoid making payments for distribution out of their own assets) have caused advisers to direct more fund brokerage (or brokerage dollars) to selling brokers. The directed brokerage has been assigned explicit values, recorded, and traded as part of increasingly intricate arrangements by which fund advisers barter fund brokerage for sales efforts." SEC Release Amending Rule 12b-1, *available at*: http://www.sec.gov/rules/final/ic-26591.htm.

[6] "Investor Bulletin: How Fees and Expenses Affect Your Investment Portfolio," dated February 1 2014, *available at*: http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-how-fees-expenses-affect-your-investment-portfolio.

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