Product Decisions Without Promised Internal Review May Lead to SEC Sanctions

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Don't fall into the trap of adding or dropping investment products to satisfy clients or business affiliates without conducting the internal reviews promised in Form ADV and marketing materials. Such actions may at the time seem like a way to keep key stakeholders happy, but it is a recipe for an SEC investigation and possible enforcement action.

Even players that should know better make this mistake. Merrill Lynch Pierce Fenner & Smith, a subsidiary of Bank of America and a long-time registered SEC adviser and broker-dealer, found itself with this problem. It paid almost $9 million as part of a recent settlement to resolve charges that, because of a conflict of interest involving a third-party manager, it did not follow its own procedures when it reversed an internal recommendation to drop products available to more than 1,500 retail advisory accounts that had invested approximately $575 million in them.

"By failing to disclose its own business interests in deciding whether certain products should remain available to investment advisory clients, Merrill Lynch deprived its clients of unbiased financial advice," said SEC New York Regional Office director Marc Berger. "Retail clients must feel confident that their advisors are eliminating or disclosing such conflicts and fulfilling their fiduciary duties."

According to the agency, the conflict of interest involved Merrill Lynch's involvement with the third-party manager – a U.S. subsidiary of a foreign multi-national bank – of the products in question. Merrill Lynch allegedly, at the request of the third-party manager, put on hold an internal recommendation to drop these products and replace them with new investment products before Merrill's governance committee planned to vote on the recommendation.

The third-party manager, according to the SEC, sought to prevent termination and contacted senior Merrill executives, asking them to consider the broader business relationship between the two companies. "Following those communications, and in a break from ordinary practices, the governance committee did not vote and chose to defer action on termination," the agency said.

The result

The products were kept on hold until December 2013, the agency said. By that time, the new team put in place by the third-party manager "had demonstrated to the satisfaction of [the due diligence unit] that it had successfully managed the products," and, as it turned out, "the products performed similar to, and in some cases, better than the replacement products that the [due diligence unit] had proposed."

"On December 17, 2013, the governance committee approved removing the products from hold and reinstated the products to the platforms as open to new accounts," the SEC said. "From January 2013 through December 2013, Merrill earned approximately $4.03 million in fees from the platforms' investment advisory clients based on the value of their investments in the products."

Yet the SEC's point here was not whether the products continued to do well, but that Merrill Lynch violated its own process – and that is what the firm got in trouble for, as well as for not having what the agency considered sufficiently specific written policies and procedures governing the process.

Merrill Lynch was found to have willfully violated Section 206(2) of the Advisers Act, which prohibits fraud, as well as Section 206(4) and its Rule 206(4)-7, the Compliance Program Rule, which requires advisory firms to adopt and implement reasonable written compliance policies and procedures. The firm agreed to pay approximately $4.03 million in disgorgement, plus approximately $807,000 in prejudgment interest, and a civil money penalty of approximately of $4.03 million.

"We promptly enhanced our policies and procedures to ensure the confidentiality of recommendations in the future," a Merrill Lynch spokesperson said in response to the settlement.

Settlement thoughts

The settlement "is a great illustration of the importance of the due diligence and the governance functions," said Hoguet Newman Regal & Kenney partner and former federal prosecutor Ilene Jaroslaw. "You've got to protect the integrity of due diligence deliberations from the business side of the house."

"There's no point blaming third-party companies from trying to influence an investment adviser's decisions," she said. "They are going to do what's right for their businesses. That's why the investment adviser must implement strong compliance policies and procedures to prevent this from happening."

But did Merrill Lynch really do anything wrong in terms of its clients? "What I get out of all this is nothing worse than the U.S. subsidiary asking Merrill's business people for an opportunity to show that the due diligence team got it wrong in recommending that the fund be terminated," said Stern Tannenbaum partner Aegis Frumento. "This was a reasonable request, and it was reasonably granted, because on the face of it the due diligence team did get it wrong [emphasis Frumento]."

The due diligence team, he said, "basically said the new management team might not know how to manage smaller retail portfolios because all they had done before was manage large institutional portfolios. It was a stupid call, one that management and the governance committee had every right to be skeptical of, and that the U.S. subsidiary was right to push back against it."

"So when the SEC says that Merrill departed from normal practice when the governance committee deferred action for further study, it basically is saying that the governance committee should, despite its mandate, just rubber stamp whatever the due diligence team says it should do, however dumb it may be," Frumento said. "That is just the opposite of the proper exercise of fiduciary responsibility. "

"How ironic," he said, "that if the SEC had been running Merrill like it says in this settlement it should have been run, its customers in fact would have been worse off."

The platform, policies and disclosures

From 2012 through 2013, clients on Merrill Lynch platforms who were invested in the firm's products paid a fee to the firm, but could only select from the products on those platforms, the SEC said. Merrill Lynch was responsible for a number of management functions, including identification of third-party investment managers, performance reporting, and advice and guidance.

In both its Form ADV brochures, as well as in its marketing, the agency said, Merrill Lynch made clear how its selection and evaluation of third-party management investments worked. Quoting from the brochures, the SEC said that the firm's due diligence unit, "'uses a multi-factor process for identifying and selecting style [investment] managers and funds, that incorporates quantitative, qualitative [and] objective and subjective components,'" and provided a list of factors that would be considered.

"Clients relied on Merrill to use these disclosed investment quality factors in determining which investments are available on the platforms and did not expect that Merrill would evaluate investments based on other business interests," the agency said.

Here's how the SEC said the process was supposed to work: "A material change in any product on the platforms – such as replacing the product's portfolio manager – would result in due diligence conducting an in-depth review of the product. If, through the due diligence process, due diligence analysts concluded that the product should be offered alternatives, the analysts would prepare a termination recommendation and supporting documentation . . . for approval through a due diligence governance process. If the committees in that process approved of the termination recommendation, it would move forward to the governance committee. . . . , [which] was ultimately responsible for deciding whether the products should be offered alternatives."

While that was Merrill Lynch's process in these circumstances, "no written policy or procedure governed this process," the agency said.

The recommendation

The external third-party manager in the spring of 2012 notified Merrill Lynch's due diligence unit that it was replacing the long-time manager for the products and moving portfolio management responsibilities from a single manager to a team based in a different location, according to the settlement order. The due diligence unit then placed the products on hold, meaning that no new accounts could invest in them, and began an in-depth evaluation of the products and the new team's ability to manage them, the SEC said.

"In December 2012, the due diligence analysts concluded that the products should be terminated and replaced by other products on the platform," the agency said. "The analysts prepared supporting documentation and provided it to the due diligence governance committees."

Those committees approved the termination recommendation later that same month. The recommendation was scheduled to be heard at the next meeting of the governance committee in January 2013.

Enter the third-party manager

A Merrill Lynch employee responsible for the operational aspects of the platforms, identified in the settlement order only as "Employee A," learned of the recommendation and its scheduling on the governance committee's agenda, the SEC said. That employee then notified the third-party manager. He did so, according to the settlement order, because "there were operational and timing issues relating to removing the products from a third-party managed diversified portfolio on Merrill's platform a few days after the governance committee meeting."

"Upon learning of the termination recommendation, the [third-party manager] immediately put into place a so-called 'plan of action' to prevent the termination by, among other measures, having executives at various levels at the [third-party manager] contact Merrill," the agency said. A third-party manager officer, identified in the settlement order as "Officer A," then scheduled a call with a senior executive at Merrill Lynch, according to the settlement order.

That call occurred on the morning of January 10, the SEC said. "According to an internal [third-party manager] email from Officer A regarding the call, Officer A 'stress[ed] the size and importance of the relationship, the thoughtful near year transition plan, the quality of the [new team] and extensive resourcing which drove [the transition] decision, and [their] commitment to the space.' Officer A also discussed their respect for 'the importance and autonomy' of the due diligence teams but said that they were 'disappointed' that they had not had the opportunity 'for a more thorough vetting and onsite [due diligence] and so were surprised to hear that [they were going to be terminated].'"

Following the call, according to the settlement order, the Merrill Lynch senior executive spoke to another firm senior executive who was also a member of the due diligence unit. After some internal back-and-forth at Merrill Lynch, the order continued, the termination recommendation, which had not yet been reviewed by the Merrill governance committee, was placed on hold.

The SEC, in the settlement order, quotes a due diligence employee email to another firm executive, in which the due diligence employee allegedly wrote, "'Here is a first. An external manager telling an internal product staffer what can go on an internal governance agenda,' to which the recipient responded, '[A]stonishing.'"

When the governance committee met on January 16, according to the settlement order, the due diligence analyst's presentation was cut short "in a break from ordinary practices." In a further break, the SEC said, "no vote was taken. The full governance committee was not informed of the communications with the [third-party manager]."

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