

RIAs may face ticking time bomb after SEC slams a \$1.9-billion RIA for neglecting 'orphan' accounts while charging fees, a problem that may be industrywide

Thousands of clients may be getting lost in the shuffle in the face of strong inorganic RIA growth -- an obscure problem until federal regulators gave Regal Investment Advisors the royal treatment, in part, for charging full fees and failing to disclose reduced service.

Author Oisin Breen October 26, 2021 at 3:39 PM



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Gary Gensler: There's a reason why the '33 Act was called the Truth in Securities Law.

Brooke's Note: *One reason people don't like doing business with large corporations is that so much can slip between the cracks. Consumers end up becoming their own watchdog. The giant cracks at wirehouses allowed the RIA business to spring up starting in the early 1990s. But now, the RIA business is looking more like a big business and its challenge, increasingly, will be to avoid taking on a corporate attitude of bottom-line convenience. What this article points to are SEC allegations of **reverse churning** by an RIA -- namely charging a fee where little is done to earn it. It's not a new topic. But it's been presumed that the SEC was willing to turn a blind eye. Indeed, in a bull market an advisor's neglect of*



The \$8-trillion RIA business should be on high alert after federal regulators discovered a time bomb that may be ticking in the compliance basement of firms across the industry.

The Securities and Exchange Commission (SEC) penalized Regal Investment Advisors, a \$1.9-billion Michigan RIA, nearly \$1 million for an offense its examiners either overlooked or failed to take into account.

"The issue is now clearly on the SEC's radar and ripe for an enforcement sweep," says Ari Sonneberg, partner and chief marketing officer for the Wagner Law Group in Boston.

"While with many orphaned accounts, there's less likelihood that someone might drop a dime to make a complaint, we're now looking at a proactive SEC that very well might be zeroing in on this very

issue," he explains, via email.

The federal regulator fined Regal Investment Advisors, in part, for its handling of "house accounts."

The term is shorthand for clients orphaned when an advisor leaves an RIA. Those accounts -- unbeknown to the investors -- lost full service but Regal continued to levy full fees.

"The SEC might be cracking open Pandora's Box. Regal will not be the last of this type of enforcement action," Sonnenberg says.



Ari Sonneberg: The issue is now clearly on the SEC's radar.

Kicking up a fuss

In broad strokes, the SEC is shining a brighter light on RIA firms that charge recurring fees to make sure they're also providing full service -- and whether it discloses inconvenient truths to its clients

"It's pretty basic that you can't collect a fee for doing nothing," says Scott MacKillop, founder and CEO of Denver TAMP, First Ascent Asset Management, via email. See: [After a 2018 cash scare, Scott MacKillop got a \\$1.5 million lifeline and -- boom -- RIAs rewarded his flat-fee TAMP with 1,000% AUM growth in 35 months](#)

It's also almost certain that RIA compliance officers are noticing increased SEC scrutiny, according Anders Jones, founder and CEO of remotely-based RIA Facet Wealth. Jones's RIA's [initial business model](#) involved buying at-risk orphan accounts and giving them a good home.



Anders Jones: There's definitely some 'I hope no

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hundreds of billions, of assets,*" he says.

"If the SEC really wanted to make a stink about this, there are a lot of examples. There's definitely some 'I hope no one notices' exploitation going on," he adds.

It's a case of accounts conveniently slipping between the cracks, MacKillop continues. "The [accounts] may not be large enough to reassign to an advisor or broker, so they sit untended. As Jones said, the [broker-dealers] hope no one notices," he explains.

Heart of the matter

Ultimately, the issue of poorly serviced orphaned accounts goes straight to the heart of the RIA value proposition. It centers on just how much an RIA has to do beyond managing investments to count as a fiduciary, says MacKillop.

"Most RIAs take their fiduciary responsibilities seriously and would not be looking for the minimum requirement. This is as much for competitive reasons as for legal ones.

"An advisor must be reasonably available for client questions and must affirmatively try to check in with the client at least once a year," he explains.

In most cases, "untended" does not mean uninvested. It mostly means advisors are not reaching out to clients to communicate, handhold or to monitor whether that client's circumstances have changed enough to warrant a reallocation of risk.

Indeed, in its Regal ruling, the SEC has told RIAs that it's not enough to simply act as investment managers. Even if investments perform, RIAs must maintain regular oversight, says Cataldo.

"Regal should be a reminder to compliance and operations staff," he adds.

Yet it's not as if an RIA needs to worry about the goal posts having shifted in some incomprehensively complex manner, says Brian Hamburger, CEO of Englewood, N.J. compliance consultancy, MarketCounsel, via email..



John Cataldo: Regal should be a reminder to compliance and operations staff.



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check."

Regal's Form ADV notes that clients would receive 'continuous and focused investment advice,'" he explains.

Holy mess

The SEC could also uncover an unholy mess if it starts pulling back the curtain, says Mac Bartine, CEO of Knoxville, Tenn. compliance outsourcer, SmartRIA, via email.

"On the large RIA side of things, as long as they're growing through M&A and [advisors] are moving around to find the greenest pasture, orphaned accounts will continue to be an issue, and RIAs will need to look closely at their contracts to understand how they should continue to manage those accounts," he adds.

Yet Max Schatzow, partner at Lawrenceville, N.J., law firm Stark & Stark is skeptical that such compliance failures are widespread -- even among hellbent rollups.

"I think firms with M&A strategy are miles out front on this issue. They know they need to fold acquired clients into the mix," he says.

Some 165 RIA transactions closed in the first nine months of the year, beating the 2020 record of 159, according to a report from San Francisco investment bank, DeVoe and Company. Over half the 64 RIAs sold in the third quarter of 2021 managed in excess of \$1 billion in client assets, the report states.

Truth matters

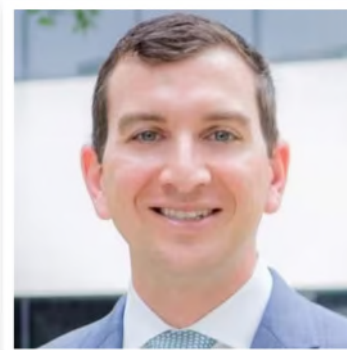
Indeed, SEC chair Gary Gensler recently warned RIAs that he expects them to do more than the bare minimum for their clients.

"If you're asking a lawyer, accountant, or adviser if something is over the line, maybe it is time to step back from the line.

"Remember that going right up to the edge of a rule or searching for some ambiguity in the text or a footnote may not be consistent with the law and its purpose," he told his audience at [FINRA's May annual conference](#).

"There's a reason why the '33 Act was called the Truth in Securities Law. Telling the truth matters," he continued.

FINRA-registered broker-dealers would seemingly be even more susceptible to scrutiny over neglect of orphaned accounts because there are so many that are so small, and brokers tend to move around.



Max Schatzow: Firms with M&A strategy are miles out front.

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A FINRA spokesperson confirmed it does not hold any oversight on fee-based 'house accounts.'

Storm front

Other Regal-type situations are out there that developed from the rash of growth and change in the industry, Hamburger says.

"Firms have trouble managing accounts that change in some way, or are otherwise not part of the normal review of the firm. There's actually more chance of fraud or fiduciary breaches," he explains.

For good reason, says Bill Singer, attorney and author of the [Broke and Broker blog](#), via email.

"When it turns out in some cases that the former stockbroker can't quite cut it as an investment advisor, the RIA is often left with a handful of relatively dormant accounts -- truly orphans. [The problem then is that] it's something akin to out of sight, out of mind," he explains.

The SEC's decision to take action could signal a shift in its attitude to orphaned accounts, adds Schatzow.

"We're probably talking about a few handfuls of firms across the country that might still have this problem. In the aggregate, it might be a few billion dollars in advisory accounts. I can't recall this issue ever resulting in an enforcement," he explains.



Scott MacKillop: It's pretty basic that you can't collect a fee for doing nothing.

Case in point

Regal Investment Advisors itself has made acquisitions [including Durand Capital Partners](#) in 2020.

The SEC [ruled](#) that Regal principals John Kailunas, 57, and Brian Yarch, 44, failed to adequately disclose their, and their company's interest in a subsidiary asset manager Durand Capital Partners**, whose services Regal recommended, in some cases as "independent."

Initially, Durand was owned by a former Regal advisor among several backers, including Kailunas, who took a 10% stake in the firm, according to the SEC. In 2019, Regal Holdings of America, owned by Kailunas and Yarch took over the remaining 90%.

The failure to disclose conflicts is "absolutely repeatable," too, says Hamburger



Mac Bartine: Is it going to be pretty? Possibly not.

"This is becoming a bigger issue as firms are purchased by roll-ups, or

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Failure to disclose

The SEC concluded that 2010-founded Regal, and its principals, breached the Investment Advisers Act of 1940 in their handling of client accounts when an advisor left the firm.

Regal levies a 270-basis-point annual fee for accounts up to \$500,000, which is on the high end of the spectrum of typical RIAs charges.



Brian Hamburger:
Orphaned accounts will
continue to be an issue.



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The fees slide to 225-basis- points for \$1 million or less and 200-basis-points for accounts over \$1 million, according to the fee schedule in the company's October 4 SEC filing.

Regal often failed to notify clients, despite continuing to levy fees, and transferred their accounts -- roughly 250 in total -- into a so-called 'house account,' from which Kailunas and Yarch received a share of fees, according to the SEC.

Some 81 house accounts received no advice, the regulator [reports](#).

As a result, the regulator ordered the firm and its principals to pay out \$946,774 in penalties and fee returns, after it failed to disclose conflicts of interest and poorly serviced orphaned clients in the 'house account'.

As part of its enforcement against Regal, the SEC also barred Yarch from serving as chief compliance officer for any firm under its oversight for three years. He held the role at Regal until July 2021.

~~Kailunas and Yarch both also agreed to non-prosecution of \$50,000 without admitting or denying the SEC's~~



any action ... They just sat back and collected fees," adds MacKillop.

AWOL

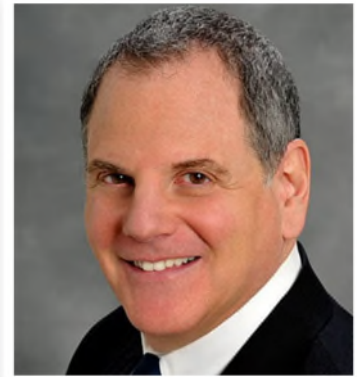
Indeed, until late 2019, Regal "lacked written policies and procedures" when transitioning client accounts after an advisor left the firm, if their accounts remained under its management, according to the SEC.

Instead, it relied on "informal" procedures that designated Regal's principals as the new managers of the 'house accounts.'

Kailunas and Yarch provided "varying levels" of advice to Regal house accounts, ranging from regular service to "no account reviews or client contact over a number of years," the SEC reports.

One client paid out \$7,600 in fees without receiving any advice for roughly three years, according to the regulator.

Since 2019, Regal's formal policy is to notify clients approximately 90 days after their advisor leaves the firm, and to waive fees for that 90-day period, although its adherence to the new policy has been mixed, according to the SEC.



Bill Singer: [Orphaned accounts can be] something akin to out of sight, out of mind.

Head scratcher

The SEC certainly caught Regal unmistakably way out over its skis, according to Alex Potts, president of \$18.7 billion AUM TAMP, Buckingham Strategic Partners, part of the \$52 billion AUM Buckingham Group, which includes an RIA.

"It's a bit mind bending," he says. "When a client terminates, we prorate back their fees, [and] de-link their custodial accounts . To not do this is way offside; it's easy to do it right."

At a mega RIA like Fisher Investments, which has thousands of advisors, it can be managed straightforwardly, says John Dillard, spokesman for the Camas, Wash. RIA with \$189 billion in managed assets, via email.



"When one of our investment counselors leaves the firm, the client



email.

"The most effective way is to build a fee suspension or a reassignment protocol into the advisor off-boarding process. This is the most logical touchpoint to the issue and it is how we handle it," he says.

RIA custodians want no part of this compliance discussion.

Charles Schwab Corp. and Interactive Brokers have yet to respond to a request for comment. Fidelity asserts it meets industry standards. Pershing declined to comment on how it manages accounts orphaned by RIAs.

** Jones' estimated numbers refer to the investment management industry at-large, including FINRA-regulated broker-dealers, which have to meet 'best interest' standards on commission-based sales, rather than the more onerous fee-based fiduciary standards the SEC adjudged Regal fell foul of. See: [New DOL fiduciary 'rule' unshackles broker-dealers](#).*

Dublin-native and Edinburgh-based Oisín Breen has spent seven years writing about finance, including five whirlwind years diving into the advisor world for RIABiz. A widely published and well regarded poet with two full collections under his belt, Breen is also an academic in English Literature with a deep fondness for his Scottish rabbit, Hessell. [@Breen](#)

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