



PROTECTING THE INTEGRITY OF IDAHO FINANCIAL MARKETS SINCE 1905

**Idaho Department of Finance  
Guidance Statement  
2020-01-SB**

**INVESTMENT ADVISER FEE CONSIDERATIONS FOR ILLIQUID  
PRODUCTS**

**ISSUE DATE: JULY 1, 2020 (Replaces Guidance issued August 8, 2017)**

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**I. Background**

This Guidance is intended to assist state registered investment advisers (IAs) and their representatives (IARs) in addressing fees and related disclosures associated with an IA's recommendation or advice execution concerning illiquid securities. For purposes of this communication, illiquid securities are investments that have no ready public aftermarket and may or may not have limited liquidity provisions through the sponsoring organization or a stand-alone securities issuer. Examples of such products include, but are not limited to, private placement securities, and other non-traded securities such as REITs, BDCs, direct participation products, life settlements and similar securities.

Beyond this communication, the Department will continue its research on this matter and industry may receive a request for information regarding related practices so that we might establish what the industry "norms" are for Idaho registered investment advisers. Furthermore, the Department will continue to address these issues as they arise during both routine and special examinations.

**II. Important Considerations**

There is increasing concern among regulators that IAs placing significant client assets into illiquid securities are not only putting clients at greater risk, but that they are charging an ongoing fee for an asset that they truly are not able to "manage" due to the illiquid nature of the product.

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## Securities and Exchange Commission (SEC)

In recent years, the SEC has continued to refine its concerns and views regarding what is now known as “reverse churning.” Reverse churning is the placement of clients in a fee-based account when their account activity demonstrates that they would be better served by being in a commission/transaction-fee based account. Reverse churning and related fee issues were noted in 2015, 2016 and 2017 as a priority in the SEC’s examination program.

Developments at the federal level that address the conflicts of interests associated with investment advisers and their clients are instructive. The SEC has noted the following as the obligation of all federally regulated investment advisers. This is also applicable to state regulated investment advisers who have a fiduciary duty to their clients:

*As a fiduciary, an investment adviser owes its clients undivided loyalty, and may not engage in activity that conflicts with a client's interest without the client's consent.... An investment adviser must disclose all potential conflicts of interest between the adviser and its clients, even if the adviser believes that a conflict has not affected and will not affect the adviser's recommendations to its clients. This obligation to disclose conflicts of interest includes the obligation to disclose any benefits the adviser may receive from third parties because of its recommendations to clients.<sup>1</sup>*

*As a fiduciary, an adviser has an obligation to obtain "best execution" of clients' transactions. In meeting this obligation, an adviser must execute securities transactions for clients in such a manner that the clients' total cost or proceeds in each transaction is the most favorable under the circumstances<sup>2</sup>.*

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<sup>1</sup> “General Information on Regulation of Investment Advisers,” U.S. Securities and Exchange Commission, Division of Investment Management, March 11, 2011. <https://www.sec.gov> (July 1, 2020).

<sup>2</sup> Ibid.

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In addition, as of June 30, 2020, broker-dealers and their agents must comply with the SEC’s Regulation Best Interest (Regulation BI) under the Securities Exchange Act of 1934. Regulation BI establishes a “best interest” standard of conduct for broker-dealers and their agents.

### **The Financial Industry Regulatory Authority (FINRA)**

FINRA has direct regulatory authority over member broker-dealers, as well as some corollary influence over captive investment advisers. In addition to overseeing its members’ compliance with Regulation BI noted above, FINRA has also previously voiced views that, when considered together, address reasonable fees, illiquid products and clients’ best interests.

*It is generally inconsistent with just and equitable principles of trade – and therefore a violation of Rule 2110 – to place a customer in an account with a fee structure that reasonably can be expected to result in a greater cost than an alternative account offered by the member that provides the same services and benefits to the customer.<sup>3</sup>*

*Other areas of priority in 2016 will include...firms' monitoring of excessive concentrations and recommendations, particularly regarding complex, speculative or illiquid products.<sup>4</sup>*

*Firms must consider the overall needs and objectives of the customer when determining the benefits of a fee-based account... [S]taff does expect members to ensure that advisory products and services are appropriate in nature for a customer and that charges for such services are reasonable.<sup>5</sup>*

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<sup>3</sup> “NASD Reminds Members that Fee-Based Compensation Programs Must Be Appropriate,” *Notice to Members 03-68*, Financial Industry Regulatory Authority. <https://www.finra.org> (July 1, 2020).

<sup>4</sup> “FINRA’s 2016 Focus: Supervision, Liquidity and Securities Firms’ Culture,” *News Release*, January 5, 2016, Financial Industry Regulatory Authority. <https://www.finra.org> (July 1, 2020).

<sup>5</sup> “Fee-Based Account Questions & Answers,” *Frequently Asked Questions*, Financial Industry Regulatory Authority. <https://www.finra.org> (July 1, 2020).

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### **State Securities Regulators**

State securities regulators continue to express concern that clients with over-concentrated portfolios of illiquid products may be charged unreasonable fees due to the IA's limited ability to effect any practical management over the illiquid products.

State securities regulators concur that advisory clients are entitled to receive:

- a) Unbiased recommendations that are in the client's best interest.
- b) Clear disclosures regarding conflicts and third party formal or informal compensation agreements.<sup>6</sup>
- c) Disclosure of the special risks of owning illiquid securities products, to include the concentration risk associated with holding an excessive amount of illiquid securities.
- d) Clear disclosure of fees the investment adviser charges its clients.

### **III. Department of Finance Concerns**

Idaho Code §30-14-502 expressly prohibits IAs and IARs from engaging in fraudulent or deceptive acts, practices or courses of business that would operate as a fraud or deceit. The statute and the Rules Pursuant to the Idaho Uniform Securities Act can be found on the Department's website at:

<http://www.finance.idaho.gov/StatutesAndRules.aspx>

In the area of fees and related disclosures, Rule 104.12, .34 and .35 essentially make it a dishonest or unethical practice to not properly disclose third party fees and commissions, to charge a client an advisory fee for rendering advice when a commission for executing the transactions will be received by the adviser, or to charge unreasonable fees in connection with the services being offered. Additionally, under Rule 104.36, it is a dishonest or unethical practice when an adviser fails to properly disclose any material conflicts of interest "which could reasonably be expected to impair the rendering of unbiased and objective advice...."

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<sup>6</sup> This includes disclosure of sponsor "marketing" compensation and/or marketing expense reimbursement.

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**1. Suitability/Concentration Issues** – High concentrations of any one type of product (e.g. illiquid securities) raises the possibility that such concentrations may be inappropriate when considering the liquidity risks and the product specific risks. There are many state regulators, including Idaho, that impose investor suitability standards (net worth and income requirements) upon issuers of securities in this category. Additionally, over exposure to any one asset class (e.g. financial stocks in 2007) presents risks that must be assessed and managed. Overconcentration of investor funds in illiquid assets or in any one asset class presents significantly higher potential risks and returns.

While we recognize that certain products are not publicly traded, we have some concern where there are similar products available that have a public market. In these situations, we may question the motivation and rationale used in placing a client in an illiquid security when a similar, publicly traded security is available.

**2. Unreasonable Fees** - The Department’s concerns regarding unreasonable fees are not new and they are shared by other state regulators. Investment advisers are acting as fiduciaries when providing advice to clients. In our view, it appears that some advisers may not be meeting their fiduciary obligation in recommending securities that require long-term ongoing advisory fees, long holding periods, or are considered illiquid. Below is a hypothetical example that may help to demonstrate the issue:

*Consider a securities client and an advisory client each of which has 40% of their assets placed in three non-traded income products that do not anticipate a liquidity event for 4-10 years. The securities representative will receive a one-time commission of 6%, yet the adviser may charge 2% of the value of the investment as an “asset under management” for the full 4-10 years or beyond in some cases. Essentially the investment adviser may receive a fee greater than that received by a broker-dealer agent for selling the same product to their clients. This hypothetical practice does not appear to comport with an investment adviser’s fiduciary duty to its client.*

*In the above scenario, such a circumstance would lead us to question whether such practices violate the Idaho Uniform Securities Act and related rules regarding dishonest or unethical practices.*

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**3. Other Fee Considerations** - Two other issues are also of concern relative to fees. First, establishing market-based valuations for illiquid products can be difficult, but necessary where ongoing fees will be charged. Otherwise, the fee calculations will be flawed and improper.<sup>7</sup> Secondly, while an adviser may periodically meet with a client and stay abreast of developments with the illiquid securities held by the investor, these activities, by themselves, likely do not support a claim that the IA is actively managing the illiquid securities.

The Department will be looking at these issues in more depth in the future to develop more directed policies in these areas and to assess whether legislation or further rule making is warranted.

**Contact** - You may direct comments or requests for additional information regarding this Guidance Statement to:

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<sup>7</sup> "DPP and Unlisted REIT Securities," *Regulatory Notice 15-02*, April 11, 2016, Financial Industry Regulatory Authority. <https://www.finra.org> (July 1, 2020).

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