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OCIE Training Session

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Wrap Fee Programs

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Overview

- Architecture of Wrap Fee Programs
- SEC Focus on Wrap Fee Programs
- Disclosure Framework for Sponsors and Managers
- Advertising and Marketing Issues for Sponsors and Managers
- Sponsor Due Diligence of Portfolio Managers
- Suitability, Individualization and Rule 3a-4 Issues
- Best Execution, Trading and Investment Opportunity Issues
- Recent Trends in Wrap Fee Products

Architecture of Wrap Fee Programs

Architecture of Wrap Fee Programs

- Brief History
- Participating Firms
  - Sponsors (Brokers, Advisers & Banks)
  - Portfolio Managers (Advisers & Banks)
- Covered Investments
- Allocation of Functions
- Client Fees
- Investment Company Status
- Disclosure Framework

SEC Focus on Wrap Fee Programs

SEC Focus on Wrap Fee Programs

- Overselling Customization
  - Wrap fee programs marketed as having tax-advantages but in reality do very little in the way of tax analysis
- Suitability Issues
  - Recommending wrap fee accounts when a mutual fund may offer the same (or similar) strategy for less
- Excessive Fees and “reverse churning” issues
- Manager Due Diligence & Conflicts
- Misleading Advertising
- Point of Sale Issues

Disclosure Framework for Sponsors and Managers

Disclosure Framework for Sponsors and Managers

- Form ADV, Part 2A
  - Transitioned sponsors from Schedule H to Appendix 1
  - Expanded brochure delivery requirements for wrap fee programs
  - Clarified brochure delivery requirements for wrap fee programs
    - Manager may delegate the task (not the obligation) for brochure delivery to the sponsor
    - Evidence of delivery may be retained in the offices of the sponsor, not manager, so long as records are produced promptly

Disclosure Framework for Sponsors and Managers

- Form ADV, Part 2B
  - Structure and allocation of advisory functions in wrap programs results in multiple brochure supplement delivery obligations
    - Formulating advice with direct client contact – sponsor role
    - Making discretionary investment decisions for client, even if no direct client contact – manager role
  - Exceptions to brochure supplement delivery obligations apply in wrap context

Advertising and Marketing Issues for Sponsors and Managers

Issues From the Sponsor’s Perspective

- Application of FINRA Rule 2210
  - Related Performance
  - Backtested Performance
  - Blended Performance
  - Target, Projected and Assumed Rates of Return
  - Investment Analysis Tools (FINRA Conduct Rule IM-2210-6)
  - Mutual and Hedge Fund Performance
  - Index Performance

Issues From the Manager’s Perspective

- CFA Institute Guidance Statement on Wrap Fee Performance
- Manager Reliance on Sponsor to Present Performance

Sponsor Due Diligence of Portfolio Managers

Sponsor Due Diligence of Portfolio Managers

- Disclosure Obligations to Clients
  - Disclose to Financial Advisor or directly to Client
  - Disclose “Watch List” status
  - Timing of disclosure
- Conflicts of Interest
  - Use of affiliated Managers
  - Managers that direct/step out trades to Financial Advisors/BD affiliates of Sponsor
  - Revenue sharing payments to Sponsor or affiliate, by mutual funds affiliated with Manager
  - Manager sponsorship of conferences, etc. for Sponsor’s Financial Advisors
  - Home office initiated programs and Manager assistance with branch office marketing
  - ADV/Investment Management Agreement Disclosures
- Policies and Procedures, Including Information Barriers
  - Manager selection process – Level of review (i.e. rely on Manager certifications?)

Sponsor Due Diligence of Portfolio Managers

- Use of third parties
- Differences across a Sponsor’s programs
  - Evaluation of same manager in different programs
  - Sponsor mergers – Managers recommended by predecessor firm, but not by acquiring firm
  - Inclusion in “No Due Diligence” programs of managers not recommended in other programs (and concerns with Financial Advisors recommending Managers in “No Due Diligence” programs)
- Due diligence on affiliated managers
  - Use of third party research firms to evaluate affiliated managers
  - Independence of third party firms retained to evaluate affiliated managers

Sponsor Due Diligence of Portfolio Managers

- Factors to Consider when Determining whether to Add, Suspend or Terminate Managers
  - Quality of Composite and Dispersion in Performance
  - Trading Issues
  - Legal & Regulatory Matters
  - Business operations (including size and longevity of Firm; quality of personnel; personnel changes; retention incentives for key personnel; and client servicing capabilities)
  - Investment Process and Implementation
  - Research Capabilities
  - Performance analysis (not necessarily the primary factor)
- Monitoring Obligations (Ongoing Due Diligence)
  - Process (periodic or ongoing)
  - Level of review (independent review of news and other documentation or reliance of manager representations
  - Communication of review (to Financial Advisors or directly to clients)

Dealing with Manager Terminations

- Probation/Watch List processes
- Manager terminations
  - Manager substitutions and authority/responsibility issues
  - Client requests to stick with terminated managers

Suitability, Individualization and Rule 3a-4 Issues

Suitability, Individualization and Rule 3a-4 Issues

- Suitability Issues
  - How to Gauge and Who is Responsible
  - OCIE's Summer Mini Sweep
  - Five Dimensions
  - The Bundled Fee & Undertrading
  - Special Issues with MDAs
- Investment Company Status - Rule 3a-4
  - Individualization
  - Administering Client Restrictions

Suitability Issues

- Lots of experience, limited guidance
- Where do suitability obligations come from?
- When do they apply?
- Whose job is it anyway?

Suitability Issues: Five Dimensions

1. Is the portfolio manager suitable for the program?
   - "Reasonable basis" / Diligence varies
   - '"Say what you do" approach reflected in Appendix 1
2. Is the program suitable for the client?
   - James Edmund Wilson no-action letter (9/89)
3. Is the chosen strategy suitable for the client?
   - "Out of category" requests
   - Non-Customized Wrap Fee Accounts versus Comparable Mutual Funds
4. Is the portfolio manager suitable for the client?
   - Client restrictions & ERISA accounts
   - Suspension & termination raise delicate issues
   - Clients who elect to stay with replaced managers
5. Is the portfolio manager's trading suitable for the client?

Suitability: The Bundled Fee

- FINRA & NYSE Focus on Fee-Based Brokerage Accounts
  - FINRA NTM 03-68:
    - *"Members must have reasonable grounds for believing that a fee-based program is appropriate for a customer given the services provided, cost, and customer preferences"*
    - *"It generally is inconsistent with just and equitable principles to place a customer in an fee-based account that reasonably can be expected to result in a greater cost than an alternative offered by the member that provides the same services & benefits"*
  - According to the FINRA, members must
    - *Have reasonable basis before opening to believe a fee-based account is appropriate*
    - *Disclose all material components of a fee-based program (e.g., fee schedule, services provided, and that the program may cost more than paying for services separately)*
  - Absent "inducement by the member," no suitability liability will arise if
    - *Member discloses that a potentially lower cost account is available*
    - *Member has documented & can demonstrate the customer chose for reasons beyond cost*

Investment Company Status - Rule 3a-4

- Individualized Management
  - Customer Contact
    - *At the opening of the account*
    - *Annually*
    - *Quarterly*
    - *Access to portfolio manager*
  - Customer Reporting
  - Indicia of Ownership - Right to:
    - *Withdraw cash/securities*
    - *Vote securities, or delegate authority to another*
    - *Receive confirmations and other documents*
    - *Sue as a security holder*
  - Reasonable Restrictions
- Current Focus on Rule 3a-4 & Industry Practice
  - ICI Petition
  - SEC Sweep

Administering Client Restrictions

- "Reasonable restriction" concept under Rule 3a-4
  - Limited guidance
  - SEC & ICI focus
- Tips - Only accept restrictions that can be administered practically
  - Industry classifications
- Impractical restrictions
  - Bars on stocks subject to 3rd-party social ratings that may be hard to monitor
  - Bars on stocks based on shifting criteria
- Accounts Requiring "Special Handling" (e.g., Foreign Accounts, Public Entities & State Pension Funds, Trusts & Guardianships, and Native American Tribes)
- Closely scrutinize client written investment policy statements

Administering Client Restrictions

- Create a formal process and a committee to oversee it
  - Establish acceptable restrictions
  - Periodically review client requests
  - If a client wishes to impose a new restriction, it should be taken under consideration by the committee and the portfolio manager – which may delay the acceptance of the client's account

Best Execution, Trading and Investment Opportunity Issues

Best Execution, Trading and Investment Opportunity Issues

- Buyside Challenges of Best Execution in Wrap Fee Program Trading
- Finding The Lesser Evil: Current Solutions In Wrap Trading
- Who Is Responsible for Best Execution in Wrap Trading?
- Challenges For Broker-dealers

Buyside Challenges of Best Execution in Wrap Fee Program Trading

- Broker selection: Is there a choice?
- Who gets disadvantaged, directed or non-directed clients?
- The disclosure of holdings and the risks of front-running
- Agency, cross, and principal transactions
- Investment opportunity issues

Finding The Lesser Evil: Current Solutions In Wrap Trading

- Trading Last
- Segregating WRAP Trading
- Rotation
- Stepping Out/Pro-Rata Allocations
- Other types of tradeaways

Who Is Responsible for Best Execution in Wrap Trading?

- Sponsor
- Portfolio manager
- Both

Challenges For Broker-dealers

- Agency, cross, and principal transaction rules
- Regulation T and "Letters of Free Funds"
- Discretionary trades with exchange members
- Limit-order protection
- Monitoring portfolio manager trading practices
  - Approach to trade allocation

Recent Trends in Wrap Fee Products

Recent Trends in Wrap Fee Products

- Development of Model Account Programs
- Migration to UMA Structures
- Use of Mutual Funds, ETFs and Hedge Funds
- Use of Variable Annuities

Hedge Funds in Wrap Fee Programs

- Types of hedge funds
- Marketing and private placement issues
  - Regulation D
  - FINRA advertising issues & risk disclosures
- Suitability issues
  - Due diligence
  - Layering of fees
  - Liquidity & complications in rebalancing
- Eligibility issues
  - Accredited investor/qualified purchaser issues
  - ERISA issues
- Reporting issues
  - Valuation
- Compensation issues

Variable Annuities in Wrap Fee Programs

- Regulatory Backdrop
  - FINRA Concerns & Proposed Risk Disclosure Document
  - Recent FINRA Enforcement Actions
- Suitability
  - Both at annuity contract level and the underlying fund level
  - Layering of fees and costs
    - *Surrender charges and IRS penalties*
    - *Sales charges*
    - *Fees (including mortality and administrative fees, investment advisory fees and charges for riders or special features)*
- Licensing and agent appointments
  - Finders fee issues

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