



THE MONEY MANAGEMENT INSTITUTE

Legal/Regulatory Affairs Conference for General
Counsels & Chief Compliance
June 6, 2006

New SMA Products

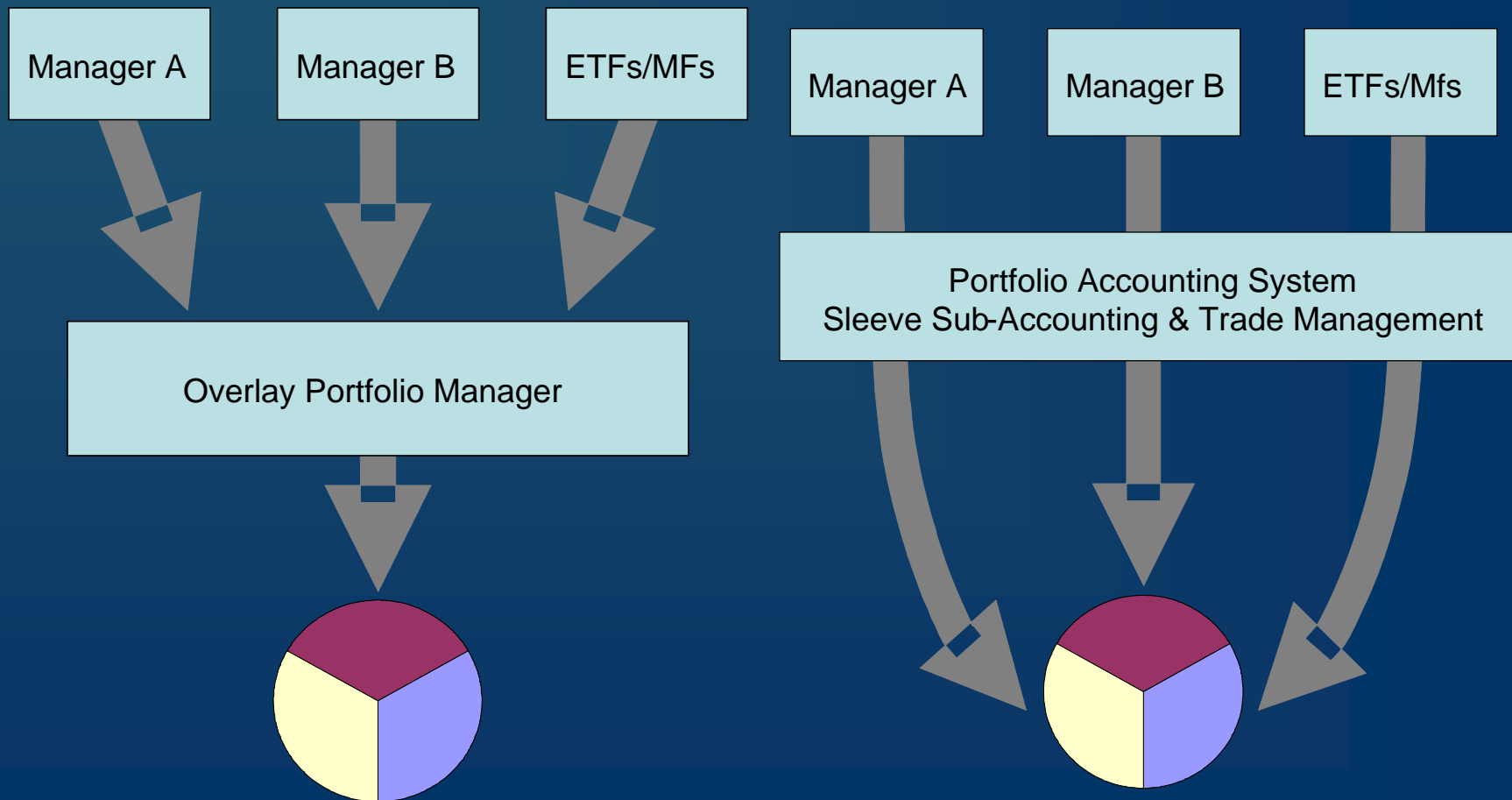
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New SMA Products

- Developments in UMAs: Special Suitability and Pricing Issues
- Use of Mutual Funds (fee & Fee Waived Funds), ETFs and Hedge Funds
- Use of Variable Annuities

Model Based UMA with Overlay Manager vs. UMA with No Overlay Manager



Model Based Programs: What are they?

- Model Portfolio – *n*. A list of recommended securities and their relative weights developed by the Model Provider to match a specified investment style
- How is the model distributed and updated?
 - Just the Model: A list of stocks with relative weights
 - Model Account/Model Trades: A series of trades in a hypothetical account
 - Other Recommendations
- Sub-Adviser vs. “Research Provider”
- Models can be used in UMAs or SMAs
- Model Provider does not:
 - Have (or need) client specific information
 - Have trading discretion
 - Provide individualized investment advice for clients

Model Based Programs: Investment Opportunity Allocation

- Fiduciary Standard – Equitable allocation of investment opportunities over time
- Timing of model updates
 - Frequency
 - Effect on investment opportunities of manager's other clients – trade sequencing
 - Disclosure Requirements

Model Based Programs: Client Third Party Beneficiary?

- **Why Focus on Third Party Beneficiary Status?**

“We believe that, for purposes of rule 204-3, a contractual relationship and the corresponding brochure delivery obligations exist between the client and the portfolio manager, even in the absence of a written contract. See, e.g., A. Corbin, Corbin on Contracts §§ 776-77, 781 (one vol. ed. 1952) (discussing third-party beneficiaries); Restatement (Second) of Contracts § 4 (1979) (discussing implied contracts).” National Regulatory Services, Inc., No-Action Letter, note 4 (July 22, 1992)

- **What is a Third Party Beneficiary?**

(1) Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and either (a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or (b) the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.

(2) An incidental beneficiary is a beneficiary who is not an intended beneficiary. Restatement (Second) of Contracts § 302:

- Case law allows for broad interpretation: Two Practical Factors:
 - Intent of the Parties – May include purported beneficiary’s (i.e., client’s) intent
 - Directness – Technically, it is not direct - How much can model portfolio be modified before implemented?

Model Based Programs: Client Perception and Disclosure

- What disclosure about Model Provider is required?

“It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly - (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client” - Advisers Act § 206
- What does the client perceive?
 - How is the source of the sleeve’s “alpha” presented to and selected by the client?
 - If Model Provider’s ADV is delivered?
 - If sleeve-level performance is shown in quarterly reports, in marketing materials?
- How to Clarify
 - Sponsor’s Schedule H (and/or Overlay Manager’s ADV)
 - Client Contract
 - Account Application – Model Provider Selection
 - Model Provider Profile

Selective Disclosure and SMAs

- Form N-1A: Item 4(f) Requires
 - Description of policies and procedures with respect to the disclosure of the Fund's portfolio securities to any person, including:
 - Conditions or restrictions on use
 - Frequency and lag time, if any
 - Conflicts of interest between fund and investment adviser's clients
 - Adviser's compensation
 - Who may disclose on behalf of fund
 - Fund director oversight
 - On going arrangements to provide, names of recipients
- "The Commission is not aware of any situation where the receipt of consideration by the fund's investment adviser or its affiliates in connection with an arrangement to make available information about the fund's portfolio securities would be a legitimate business purpose." SEC Release IC-26418 (April 16, 2004).

Selective Disclosure and SMAs

- Model vs. Management
 - Managing a client's account = disclosure?
 - Advice to a client = disclosure?
 - “Research provider” vs. sub-adviser
- When does management in the same or similar style = “disclosure of fund's portfolio securities”?
- SMA vs. UMA
- Restrictions on confidentiality and use

Pricing and Fee Differential Issues in UMAs

- Flat Fee versus Blended Fee
 - Suitability – UMAs with ETFs and Mutual Funds vs. ETF/Fund Wrap Account + SMAs
 - Unmanaged asset sleeves or “parking sleeves”
 - Stacked or Blended Fees
 - ERISA Issues
 - Disclosure

Sleeve-Level Performance in UMAs & Model Based SMAs

- Use of Sleeve-Level Performance in UMAs
 - Supervision of Managers/Overlay Manager
 - Client Reporting
 - Marketing and Product Selection
- Whose performance is it? - How to reconcile manager performance in marketing materials and account sleeve-level performance in client statements

Hedge Funds in SMA accounts

- Types of hedge funds
- Marketing and private placement issues
 - Regulation D
 - NASD 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
 - Sales loads
 - Placement agent fees

Variable Annuities in SMA Accounts

- Regulatory Backdrop
 - NASD Concerns & Proposed Risk Disclosure Document
 - Recent NASD 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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