



THE MONEY MANAGEMENT INSTITUTE

Legal/Regulatory Affairs Conference for General  
Counsels & Chief Compliance  
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# Suitability, Individualization and Rule 3a-4 Issues

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# Suitability, Individualization and Rule 3a-4 Issues

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- 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 3a4
  - Individualization
  - Administering Client Restrictions

# Suitability Issues

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

# OCIE's Summer Mini Sweep

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- The entity (Registrant or the sponsor) responsible for determining the suitability of the wrap-fee program for the client.
- A description of any information Registrant receives from each wrap-fee sponsor regarding the suitability of the wrap-fee program for each client.
- For each wrap-fee program in which Registrant participates, a description of the information Registrant obtains regarding each client's financial status, investment objectives, risk tolerance, etc.
- Copies of all requests, including requests via email, from any wrap-fee program sponsors for any background or other information about Registrant, its services, or any of its portfolio managers or other personnel.
- Copies of any information the wrap-fee sponsor provided to Registrant regarding the types of investment advisory services the sponsor wanted to include in its wrap-fee program and/or why the sponsor determined Registrant would be appropriate for inclusion in the program.
- A detailed description of the circumstances surrounding any instance in which Registrant withdrew from participation in a wrap-fee program [or] a sponsor removed Registrant or any member of its staff from a wrap-fee program.
- A description of any affiliation or relationship, other than the wrap-fee program, between Registrant and any of the wrap-fee program sponsors.

# Suitability Issues: Five Dimensions

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1. Is the portfolio manager suitable for the program?
  - “Reasonable basis” / Diligence varies
  - “Say what you do” approach reflected in Schedule H
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 SMA 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

- NASD & NYSE Focus on Fee-Based Brokerage Accounts
  - NASD 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 NASD, members must
    - Have reasonable grounds 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 where
    - Member discloses that a potentially lower cost account is available
    - Member has documented & can demonstrate the customer chose for reasons beyond cost

# Suitability: Special Issues with MDAs

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- Sponsor tactically allocates or rebalances among disciplines & managers
- Does more frequent involvement heighten a sponsor's suitability obligations?
- Who is responsible for conflicts among disciplines & managers?
  - Double concentration
  - Wash sale issues
- Tax recognition issues from periodic rebalancing

# Investment Company Status - Rule 3a4

- 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

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- 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



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