NSCP NATIONAL MEMBERSHIP MEETING

Current issues with Wrap Accounts

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Current issues with Wrap Accounts

- Model account programs
- Distribution issues
- Investment company status
- Administering client restrictions
- Suitability issues
- Disclosure obligations
- Advertising issues
- Avoiding liability for others' conduct
- Recordkeeping
- Performance presentation issues
- Administrative issues
- Trading issues
- Retirement account issues
- Focus in SEC exams

Model account programs

- Relationship between model manager and clients
- ADV delivery issues
- Trade sequencing issues
- Performance presentation issues
- Applicability of research analyst rules

Distribution Issues

- Sales loads
- Sales through intermediaries
  - From wire houses to smaller firms and FPs
  - Solicitors

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
      - Bar on any company deriving more than X% of revenues or profits from sin businesses
  - Closely scrutinize client written investment policy statements

Administering client restrictions

- Create a formal process & a committee to oversee it
  - Establish acceptable restrictions
  - Periodically review client requests
  - It 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

Disclosure Obligations

- Disclosure Obligations of Wrap Sponsors
  - Contents of Wrap Fee Brochure
    - Cover Page
    - Table of Contents
    - Fee Information
    - Information on Portfolio Managers
    - Client Information
    - Permitted Client Communication with Portfolio Managers
    - Investment Strategies of Wrap Sponsor's Portfolio Managers
    - Other Form ADV Information
  - Brochure Delivery
  - Updating
  - Sponsors of Multiple Programs
  - Applicability to Mutual Fund Asset Allocation Programs

Disclosure Obligations

- Portfolio Managers
  - Identity of wrap programs in which the adviser participates
  - Differences between services provided to wrap fee versus non-wrap fee customers
  - Proxy policy
  - Amount of the portfolio manager's share of wrap fees – no longer required
  - Brochure delivery
  - Delegation of responsibility for brochure delivery and recordkeeping

Advertising Issues

- SEC Advertising rules apply
- NASD now informally saying Rule 2210 applies
  - 10/2/03 position on "related performance" in broker provided ads for hedge funds
  - Sound basis / balance requirements under Rule 2210

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 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
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 issues

- Special issues with multi-discipline accounts
  - 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

Avoiding liability for others' conduct

- Sponsor liability for portfolio manager's conduct
  - Limited focus on portfolio manager diligence
  - "Ancient" case law
  - Broader concerns underscored by adviser-subadviser cases
    - *Legg Mason Fund Adviser* case (9/01)
- Portfolio manager's liability for sponsor's conduct
- Portfolio manager's liability for other's conduct
  - Evolving structures complicate issue
  - Sponsor's tactical reallocation
  - Involvement of others
    - New subadviser/overlay models
    - Financial planning & CPA firms that sell a sponsor's wrap program

Recordkeeping Requirements

- Concerns
  - ADV delivery
  - Privacy notice delivery
  - Trading records
  - Performance records
  - AML
- Process
  - Specify responsibility in contract
  - Access by portfolio manager to sponsor's records
  - Certification to portfolio manager on compliance with delivery requirements
    - Provide date if requested
  - Portfolio manager - maintain trading data
  - Performance records - For marketed composites, how much backup information must be kept

Performance presentation issues

- Who's performance is it?
  - AIMR's concept of "firm
  - Multi-discipline accounts
- Who's responsible for
  - Calculating it
  - Keeping records
- Filling gaps
  - Linking wrap performance to past performance
  - Using an index as a proxy for past performance
  - Using model performance
    - Greater security concentration
    - ADRs for foreign securities
- Use of gross numbers by wrap sponsors
- Proposed AIMR guidance statement on wrap fee performance (being revisited)
  - Portfolio managers are ultimately responsible for performance calculations
  - "Firm" concept
  - Use of institutional and wrap track records
  - Responsibility for underlying records
  - Net-of-fee presentations

Administrative issues

- Fails or errors from communication lapses
  - Insufficient funds
  - Margin sale by sponsor because of call on another account
- Fee issues
  - Deductibility issues
  - Contribution issues for IRAs and other retirement accounts
- Personal securities trading issues
  - How does a manager apply personal trading “blackouts” when it is always trading – as clients are coming into the program every day?

Trading issues for portfolio managers

- Best Execution in the choice of brokers
- Trading conflicts
  - Firms managing wrap & non-wrap business are often forced to break up orders
  - Many firms rotate orders to ease sequencing issues
    - Does this place institutional orders at the mercy of wrap orders?
    - Problem exacerbated where large wrap orders take time
  - “Signaling” problems
  - Step outs ease the problem, but many sponsors unwilling to accommodate them

Trading issues for broker-dealer sponsors

- Starts with same issues in ordinary brokerage
  - *Marc Geman* enforcement case
- Agency-Cross Transactions
- Principal Transactions
  - Morgan Lewis letter (4/97): Sponsor may trade as principal if not acting as adviser in a trade
    - Trade initiated by portfolio manager
    - Sponsor does not influence portfolio manager's trading
  - Concerns remain with ERISA accounts & MDA programs
- Discretionary Trades by Exchange Members
- Limit Order Protection
  - NASDR interpretation letter (7/97): Sponsor may trade ahead of unexecuted customer limit order directed to other broker if needed to adhere to principal trade limits
- Trade confirmation suppression
  - SIA letter (8/99)

Retirement account issues

- Conflicts when sponsor
  - Offers both affiliated and third-party managers
  - Re-deploys assets across multiple managers (e.g., in MDA program)

Retirement account issues when offering affiliated & third-party managers

- Obstacles
  - Recommendation by sponsor raises self-dealing concerns
  - Even asset allocation recommendation may raise concern if affiliated manager is the sole manager for an asset class
  - Concerns stem from sponsor's fiduciary status
  - Concerns greatest for retirement accounts governed by ERISA type prohibited transaction rules where disclosure of conflicts will not cure
  - DOL has not to date adopted class exemptions covering wrap arrangements that help

Retirement account issues when offering affiliated & third-party managers

- Possible workarounds – with disclosure
  - Limit the affiliated manager alternative to non-restricted retirement accounts
  - Ensure that the sponsor does not act as a fiduciary in recommending managers – but this is tough
  - Create a separate single-manager program for restricted retirement accounts
    - that offers an affiliated manager as the only option, and
    - where sponsor does not recommend the program

Retirement account issues when sponsor's re-deploy assets across multiple managers

- Differences in fees paid to portfolio managers create self dealing concerns
- Fee leveling alternatives

Focus in SEC exams

- Situations where the sponsor has replaced or recommend replacement of a manager
- Whether the sponsor requires managers to make payments, provide services or throw other business to the sponsor to partake in the program
- Sponsor's due diligence of manager performance data and background
- Execution quality
- Manager executions through other brokers
- Timeliness of manager allocation instructions
- Trade errors and resolution
- Complaints

Focus in SEC exams

- Confirmation of trades
- Prompt investment of available cash
- Approach to investment restrictions
- Use of other brokers

Focus in SEC exams: Warning signs

- Failure to adhere to client restrictions
- Large number of trade errors
- Unreasonably long delays in starting to invest client accounts
- Blowing out securities at out inception then repurchasing them shortly afterwards
- Dispersion in performance of program accounts in relation to manager's performance elsewhere

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