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Multi-Style Portfolios

Morgan Lewis
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MSPs: What are they?

- Variant of wrap account or “separately managed account” (SMA)
- MSPs integrate multiple investment styles into a single account or strategy, offering greater diversification and less market risk
- Sponsor usually acts as the “manager of managers” or “overlay manager” selecting
 - Investment styles
 - Portfolio (or “sleeve”) managers
 - Allocations to sleeve managers for an account
- Minimums usually start at \$100k and are targeted at the “high-end” retail investor

Generations of MSPs

- ① Integrated multiple disciplines from the “house” manager into single account
- ② Integrated multiple disciplines from single investment complex for distribution in other sponsor’s programs
- ③ Integrated multiple unaffiliated managers, assembled in a model portfolio, employing overlay manager to coordinate trading of various managers
- ④ Integrated input of multiple unaffiliated managers in “dynamic” allocation & adds risk/tax management by coordinating trades across the managers or “sleeves”

Two Common Structures

- Allocation
 - Each sleeve manager manages part of the client's assets
 - Overlay manager coordinates trades
 - Sleeve managers required to trade through overlay manager's desk
 - Sleeve managers required to give overlay manager real-time trade information
 - Overlay manager is responsible for monitoring compliance with client investment guidelines & restrictions, watching for wash sales & other oversight functions
- Model
 - Each sleeve manager provides the overlay manager with investment models and periodic updates
 - Overlay manager customizes the model to client's account and implements it through trades with its affiliated broker-dealer
 - Sleeve manager does not maintain individual accounts or have associated reconciliation, compliance & recordkeeping burdens

Allocation of Responsibility

- Allocated functions
 - Functional tasks
 - Regulatory tasks
 - Rule 3a-4 compliance
 - ADV delivery
 - Privacy notice delivery
 - Proxy disclosure *and* voting
 - Trading and maintenance of records
 - Maintenance of performance records
 - AML compliance
- Tangled workflow & communications
 - Email, fax, XML, FIX
 - Monitoring issues
 - Trade error issues
 - NSCC's proposed Separately Managed Account Service

Typical Overlay Manager Responsibility

- Higher than in traditional wrap fee arrangement
 - Conflicts among disciplines & managers
 - Double concentration
 - Wash sale issues
 - Tax recognition issues from periodic rebalancing
 - Differences in fees paid to sleeve managers create self dealing concerns
 - Disclosure
 - Retirement account issues

Disclosure issues

- MSPs are not the same as standard managed accounts
- The differences should be noted to clients

Performance Presentation Issues

- Who owns the performance?
- Can a sleeve manager advertise its model performance, subject to *Clover*?
- Whether one can show long term performance when there isn't any?

Distribution & Sales Practices

- Increasing sales through intermediaries
 - From wire houses to smaller firms & financial planners
 - Co-advisers versus solicitors
- Sales loads/termination penalties
 - Constellation Financial, SEC Staff No-Action letter (January 9, 2003)
- Fee differential issues
 - Especially where fee varies for same strategy between
 - Affiliated versus unaffiliated managers
 - Different programs offered
 - Disclosure and suitability

Special Issues with Models

- Legal relationship between model manager & clients
 - Client or 3rd party beneficiary?
- ADV delivery issues / Showing sleeve manager performance
 - Will delivery foster impression of client relationship?
- Timing of model updates
 - How often?
 - Affect on investment opportunities of other clients?
 - Ability to delay
 - Issues under proposed SEC rules for dissemination of holdings information
- Trade sequencing issues



Additional Compliance Responsibilities

- Ensuring the overlay manager is rebalancing when it is supposed to
- Looking at over-concentrations of securities
- Reviewing trade allocation issues

Plus Typical Wrap Fee Issues

- Investment Company Status - Rule 3a4
- Disclosure Obligations
- Advertising Issues
- Suitability issues
- Recordkeeping Requirements
- Performance presentation issues
- Administrative issues
- Trading issues for portfolio managers
- Retirement account issues
- Focus in SEC exams

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