

Wrap Fee Programs and Separately Managed Accounts

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I. Introduction

Over the past thirty-two years, the wrap fee and separately managed account industry has developed and matured as program sponsors have, to their credit, accumulated over \$604 billion in assets as of September 2008.¹ Securities regulators have largely kept pace, starting with a skeptical if not critical view of wrap fee arrangements that has evolved into a more balanced approach that has allowed innovation around a basic regulatory framework. This relatively “hands off” approach by securities regulators reflected the fact that wrap fee arrangements have generated far fewer investor protection concerns and controversies than many traditional brokerage arrangements.

This outline discusses the principal regulatory framework for wrap fee and separately managed account programs under the federal securities laws, including under the Investment Advisers Act of 1940 (“Advisers Act”), the Investment Company Act of 1940 (“Investment Company Act”), and the Securities Exchange Act of 1934 (“Exchange Act”). The outline also discusses some of the current issues confronting participants in wrap fee and separately managed account programs.

Wrap fee programs are arrangements between broker-dealers, investment advisers, banks and other financial institutions (typically acting as sponsors of the programs) and affiliated and unaffiliated investment advisers (or portfolio managers) through which the customers of such firms receive discretionary investment advisory, execution, clearing, and custodial services in a “bundled” form. In exchange for these “bundled” services, customers pay an all-inclusive – or “wrap” – fee determined as a percentage of the

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¹ Money Management Institute Interim 3Q 2008 Data Flash, available at <http://www.mminst.org/downloads/2008/11/3q-2008-flash-10282008-104.pdf>.

assets held in the wrap fee account. SEC Rule 204-3, governing written disclosure statements of investment advisers, defines a wrap fee program as “a program under which any client is charged a specified fee or fees not based directly upon transactions in a client’s account for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and execution of client transactions.” See Advisers Act Rule 204-3(g)(4). Separately managed account programs are not defined by SEC rules and include wrap fee programs, as well as programs where the customers receive the same compliment of services in unbundled form.

II. Principal Regulatory Framework for Wrap Fee Accounts

A. “Investment Adviser” Status of Sponsors

Wrap sponsors generally are subject to investment adviser registration, although there could conceivably be circumstances in which investment adviser registration ought not to be required. SEC statements on the subject point more starkly at the need for registration. For instance, in the SEC’s 1995 release re-proposing Rule 3a-4 under the Investment Company Act <<http://www.sec.gov/rules/proposed/3a4.txt>> (“*Rule 3a-4 Reproposing Release*”), the SEC stated that a broker sponsoring a wrap fee program “generally cannot rely” on the broker exception from the definition of investment adviser in Advisers Act Section 202(a)(11)(C) because that exception is available only to a broker-dealer that provides investment advice that is “solely incidental” to its brokerage business and that does not receive special compensation for such investment advice. According to the SEC, “the staff is of the view that a [wrap fee program] generally is not incidental to a sponsor’s broker-dealer business and . . . the sponsor’s portion of the wrap fee is special compensation.” This principle was left undisturbed in the SEC’s 1997 release adopting Rule 3a-4 <<http://www.sec.gov/rules/final/ic-22579.txt>> (“*Rule 3a-4 Adopting Release*”) and the SEC’s 1999 rule proposal (and no-action position) clarifying the scope of the broker-dealer exception from the definition of investment adviser <<http://www.sec.gov/rules/proposed/34-42099.htm>>. In that 1999 rule proposal, the SEC stated that, even if broker-dealer sponsors do not have discretionary authority, the advice the sponsor provides on asset allocation or selection of portfolio managers could not be viewed as incidental to its brokerage services. The SEC re-affirmed this view in guidance in the release adopting (now vacated) Rule 202(a)(11)-1, stating that “advisory services provided by certain brokers in connection with wrap fee programs are not solely incidental to brokerage for the purposes of the broker-dealer exemption.” Release No. 34-51523 (April 12, 2005). In the wake of the D.C. Circuit’s decision in *Fin. Planning Ass’n v. SEC*,² vacating Rule 202(a)(11)-1, the SEC re-proposed an interpretive rule reinstating several interpretive provisions of the vacated rule to clarify that certain types of advice are not solely incidental to brokerage services. Advisers Act Release No. 2652 (September 24, 2007). Although the release did not make any mention of the application of the exception to wrap fee programs, that should not necessarily be taken to mean that the SEC has abandoned its previously held view that advisory services provided by sponsors of wrap fee programs are incidental to brokerage services.³

B. “Investment Company” Status of Wrap Programs

² *Fin. Planning Ass’n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

³ This statement was also made in an SEC guide to the regulation of investment advisers update through November 2006, prior to the D.C. Circuit’s decision in *FPA*. “The SEC staff has stated a broker-dealer that receives a ‘wrap fee,’ *i.e.*, a fee based on a percentage of assets that compensates the broker-dealer for both advisory and brokerage services, will receive ‘special compensation.’” The Regulation of Investment Advisers, by the Securities and Exchange Commission. Robert E. Plaze, updated to November 22, 2006. http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042006.pdf

The SEC and its staff have long taken the position that certain discretionary investment management programs fall within the definition of “investment company” and are subject to registration as such unless they are exempt.⁴ Specifically, in the *Rule 3a-4 Reproposing Release*, the SEC stated that under these programs: “[A] customer’s account typically is managed on a discretionary basis in accordance with pre-selected investment objectives. Customers with similar investment objectives often receive the same investment advice and may hold the same or substantially the same securities in their accounts. In light of this similarity of management, some of these Investment Advisory Programs meet the definition of investment company.”

The SEC and its staff’s position in this area developed over the course of more than two decades in which the SEC brought two significant enforcement cases and submitted two rule proposals. The area has come under increased scrutiny over the past two years, as the Investment Company Institute submitted a rule-making petition to the SEC that might scale back the scope of Rule 3a-4 and the SEC staff launched two examination sweeps to inform itself of practices in the area and possible concerns.

Rule 3a-4 has its origins in an enforcement action brought by the SEC in the early 1970s, which was followed by a study of small account investment management services conducted by the Advisory Committee on Investment Management Services (“Advisory Committee”). A number of the Advisory Committee’s recommendations were incorporated into the original Rule 3a-4 proposal in 1980, which would have provided a safe harbor for investment management services affording clients individualized treatment. The rule was not adopted at that time, however, due to public opposition. Thereafter, the SEC’s staff issued a series of no-action letters relating to investment management programs offered to individuals, in which the relief granted was based on the conditions of the proposed rule. Some twenty years later, in June 1995, the SEC brought its second enforcement action in the area, which was followed by the SEC’s reproposal of Rule 3a-4 later that year.

1. *Clarke Lanzen Skalla*

In *In the Matter of Clarke Lanzen Skalla Investment Firm, Inc.*, Advisers Act Release No. 1501 (June 16, 1995) (“*Clarke Lanzen*”), the SEC sanctioned an investment adviser and its principals for operating a mutual fund asset allocation program that constituted a *de facto* unregistered investment company. Under the *Clarke Lanzen* program, customers were provided with a choice of six different investment strategies, ranging from aggressive to defensive, each with a predetermined investment formula. Once a strategy was selected, the investment adviser invested customer funds in no-load mutual funds on the same basis for all customers who chose the same investment strategy. The investment adviser’s principals had investment discretion and made all investment decisions for program customers. The SEC found in *Clarke Lanzen* that the program violated the Investment Company Act because it failed to register as an investment company. While the SEC did not identify the specific factors that led to its conclusion that the program was an unregistered investment company, the program failed to meet many of the requirements of repropose Rule 3a-4. In particular:

⁴ A corollary of the proposition that a discretionary investment management program is an “investment company” is the concept that a customer’s interests in the program are “securities.” The SEC stated in the *Rule 3a-4 Reproposing Release* that such programs “can be deemed to be issuing securities for purposes of the Securities Act of 1933.” The release refers to *Clarke Lanzen*, discussed below, in which program interests were deemed unregistered securities. Rule 3a-4, as adopted, provides that “[t]here is no registration requirement under section 5 of the Securities Act of 1933 with respect to programs that are organized and operated in the manner described in rule 3a-4.”

- There were no records in the investment adviser’s files indicating that customers were contacted periodically to ascertain whether investments in their accounts continued to meet individual investment needs or goals;
- Customers did not receive fund proxies, prospectuses, semi-annual and annual reports for the mutual funds in which they were invested;
- Customers could not pledge, hypothecate or unilaterally request from the mutual funds the withdrawal of shares from their accounts; and
- Customers had no contractual right to instruct the adviser to refrain from purchasing particular mutual fund shares.

2. Proposed Rule 3a-4

The SEC first proposed Investment Company Act Rule 3a-4 in 1980. *See Individualized Investment Management Services*, Investment Company Release No. 11391 (October 10, 1980) (the “1980 Proposing Release”). The proposed rule would have provided a safe harbor from the definition of “investment company” for programs meeting the following conditions:

- The investment manager provides continuous investment advice based on each customer’s individual needs;
- A person who is authorized to make investment decisions for a customer’s account (i) interviews the customer regarding his or her financial situation and needs at the opening of the account and at least annually thereafter; (ii) attempts to determine, at least quarterly, whether there has been a change in the customer’s financial situation and needs; (iii) provides the customer with an account statement at least quarterly; and (iv) is reasonably available to the customer during normal business hours;
- Each customer maintains, to the extent practicable, every indicia of ownership of his funds, including the right to withdraw, vote, hypothecate and pledge the securities in his or her account and the right to receive a confirmation of each security transaction; and
- Each customer has the opportunity and authority to instruct the investment adviser to refrain from purchasing particular securities.

3. Intervening SEC Staff No-Action Letters

Following the initial proposal of Rule 3a-4, the SEC staff issued more than 20 no-action letters to persons requesting assurance that the SEC staff would not recommend enforcement action with respect to advisory programs not registered under the Investment Company Act. Each of these letters was conditioned on representations primarily based on the terms of the 1980 version of proposed Rule 3a-4.⁵

⁵ See, e.g., *Wall Street Preferred Money Managers, Inc.* (April 10, 1992); *Rauscher Pierce Refsnes, Inc.* (April 10, 1992); *Westfield Consultants Group* (December 13, 1991); *Atlantic Bank of New York* (June 7, 1991); *Morgan Keegan & Company* (October 2, 1990); *Jefferies & Co., Inc.* (June 19, 1989); *Strategic Advisers Inc.* (December 13, 1988); *Scudder, Stevens & Clark* (August 17, 1988); *Balliett, Blackstock & Stearns, Inc.* (August 19, 1987); *Shearson/American Express* (July 13, 1983); *Paley & Ganz, Inc.* (December 6, 1982).

a. Application of the 1980 Version of Proposed Rule 3a-4 to Novel Investment Advisory Programs

The SEC staff, in its June 14, 1995 letter to Benson White & Company, granted no-action relief to permit the operation of what was then a novel mutual fund asset allocation program that would not meet all the requirements of then proposed Rule 3a-4. See *Benson White & Company* (June 14, 1995). Under the proposed program, a participant's assets would be allocated between two or more mutual funds, in accordance with predetermined age-based asset allocation ratios. These ratios would be compulsory for virtually all participants. The investment adviser would determine the program's asset allocation policies and serve as investment adviser to the mutual funds. The staff's "no-action" response was conditioned, in particular, on the following representations by the investment adviser:

- The composition of each participant's account would differ unless the participants were in the same age bracket;
- Program participants would receive a prospectus for each mutual fund;
- Participants would approve any change to the asset allocation ratios before implementation;
- The investment adviser would reasonably be available to participants for consultation;
- Participants would receive required confirmations of securities transactions and quarterly statements containing a description of all account activity;
- Participants would be provided with current prospectuses, annual and semi-annual reports, proxies and any other required information and disclosures for each mutual fund;
- Participants would have the right to pledge and vote the securities in their accounts and to redeem all or part of their mutual fund shares at any time; and
- Participants would retain all rights under the federal securities laws to proceed directly against any mutual fund in which they own shares, and would not, by participating in the program, be obligated to join the investment adviser as a condition to proceed against a mutual fund.

Benson White is distinguishable from prior no-action letters for several reasons. First, prior no-action letters suggested that an asset allocation program sponsor (or another person) must interview participants regarding their financial circumstances when the account is opened and at least annually thereafter, and attempt to determine whether a participant's circumstances have changed at least quarterly. The staff concluded that participant contact is not mandatory given the unique nature of the program.

Second, prior no-action letters were conditioned on participants having the right to instruct the investment adviser to refrain from purchasing certain securities on their behalf. The staff stated that it continues to believe individualized treatment is a critical distinction between an investment company and an advisory program outside the scope of the Investment Company Act. Nonetheless, despite the lack of individualized treatment, given the totality of the circumstances and the unique nature of the program, including the participants' ability to consult with the investment adviser, the individual consent required before changing the asset allocation formula for participants' accounts and the retention of individual indicia of ownership of securities, the SEC staff agreed that the program need not be registered as an investment company.

Finally, earlier no-action letters created some confusion concerning the confirmation delivery requirement that must be met to avoid investment company status. Some letters required confirmations to be delivered to participants on a transaction-by-transaction basis while other letters permitted the delivery of monthly confirmations.

4. Reproposed – and Final – Rule 3a-4

The SEC reproposed Rule 3a-4 in 1995 and adopted the rule substantially as reproposed two years later in 1997. Like the earlier version, the adopted rule provides a non-exclusive safe harbor from the definition of investment company for investment advisory programs that comply with the terms of the rule. The rule states that it is “a nonexclusive safe harbor from the definition of investment company” and that it “is not intended . . . to create any presumption about a program that is not organized and operated in the manner contemplated by” the rule. (Nevertheless, any program operating outside the requirements of Rule 3a-4 will invite scrutiny.) Both the *Rule 3a-4 Reproposing Release* and the Rule 3a-4 Adopting Release state that the adoption of the rule does not affect the status of no-action letters previously issued by the Division of Investment Management with respect to investment advisory programs.

a. Rule 3a-4’s “Safe Harbor” Conditions. While the terms of the final rule generally followed the proposed rule, it was modified to reflect changes since the initial proposal in 1980. The conditions of the final rule are as follows:

(i) Management Based on Customer’s Circumstances. Each client’s account in the program is managed on the basis of the client’s financial situation and investment objectives and in accordance with any reasonable restrictions imposed by the client on the management of the account.

(ii) Customer Contact

(a) At the opening of the account, the sponsor⁶ (or other person designated by the sponsor) obtains information from the client regarding the client’s financial situation and investment objectives, and gives the client the opportunity to impose reasonable restrictions on the management of the account;

(b) At least annually, the sponsor or another person designated by the sponsor contacts the client to determine whether there have been any changes in the client’s financial situation or investment objectives, and whether the client wishes to impose any reasonable restrictions on the management of the account or reasonably modify existing restrictions;

(c) At least quarterly, the sponsor or another person designated by the sponsor notifies the client in writing to contact the sponsor or such other person if there have been any changes in the client’s financial situation or investment objectives, or if the client wishes to impose any reasonable restrictions on the management of the client’s account or reasonably modify existing restrictions, and provides the client with a means through which such contact may be made; and

⁶ The rule defines “sponsor” as “any person who receives compensation for sponsoring, organizing or administering the program, or for selecting, or providing advice to clients regarding the selection of, persons responsible for managing the client’s account in the program. If a program has more than one sponsor, one person shall be designated the principal sponsor, and such person shall be considered the sponsor of the program under this section.”

(d) The sponsor and personnel of the manager of the client's account who are knowledgeable about the account and its management are reasonably available to the client for consultation.

(iii) Reasonable Restrictions. Each client has the ability to impose reasonable restrictions on the management of the client's account, including the designation of particular securities or types of securities that should not be purchased for the account, or that should be sold if held in the account.

(a) Limited SEC Guidance

The SEC stated that whether a particular restriction is reasonable depends on all of the facts and circumstances, including the client's stated investment objectives, the difficulty of complying with the restriction, and the specificity and number of such restrictions. The fact that a restriction puts some administrative burden on the manager or may affect performance does not make it per se unreasonable. But, the SEC said that a restriction could be unreasonable if it is "clearly" inconsistent with the client's investment objective or is "fundamentally" inconsistent with the adviser's program. A group of restrictions may be deemed unreasonable in the aggregate, even if individually they are reasonable. Likewise, reasonable restrictions can become unreasonable if the client insists on changing them so frequently that it interferes with the orderly management of the account. That said, the SEC has made it clear that restrictions excluding specific securities, securities of an industry, or securities from a specific country generally would be considered reasonable.⁷ If the adviser's program involved investments in mutual funds, a restriction based on the specific securities held by the funds might be unreasonably burdensome.

As noted above, prior to reproposing Rule 3a-4, the SEC staff had issued a series of no-action letters based on the original rule proposal and its conditions, and these letters continue to be valid. The no-action letters generally required or assumed that the adviser would comply with restrictions on specific securities or groups of securities. The SEC staff granted no-action relief to an adviser that permitted clients to restrict purchases of specific securities, but reserved the right to deem the program to be unsuitable for investors who wanted to invest primarily in fixed income securities.⁸ The staff also granted no-action relief to an adviser that permitted clients to restrict investments in specific securities or entire industries, while conceding the adviser's right to terminate clients who wanted to have "continuous, frequent substantive . . . participation" in the management of their accounts.⁹

(b) Practical Procedures

Generally, a wrap sponsor should have procedures to ensure that its wrap program is operated to accommodate reasonable client restrictions. The existence and operation of these procedures will permit a more orderly consideration and administration of client requests in this area.

⁷ By contrast, a restriction on all foreign securities might be unreasonable if the adviser's strategy involves investments exclusively or primarily in foreign securities. Likewise, restricting an account to short-term debt instruments might be unreasonable if the manager's strategy is long-term capital appreciation through investment in equity securities.

⁸ See *Rauscher Pierce Refsnes, Inc.* (available April 10, 1992).

⁹ See *Morgan Keegan & Company* (available October 2, 1990).

Clients generally seek to impose restrictions for various reasons, including the client's investment or social preferences (for example, clients may wish to bar investments in tobacco, firearms or alcohol related companies). Other reasons include restrictions to which the client is subject by virtue of his or her employment (for example, the client may be employed within the securities industry or the accounting or legal profession and be subject to certain restrictions on what particular securities he or she may invest in; similarly, the client may be an officer of a public company and may, therefore, want to limit investments in that public company) or non-employment affiliation (for example, the client may serve as a director or be a significant stockholder in a public company and may, therefore, want to limit investments in that public company).

When considering client requested restrictions, a firm should consider whether the restrictions can be administered in a practical way, without the need to resort to manual processes. For example, a sponsor may reject as impractical such restrictions as bars on stocks subject to third-party social rating services that may be hard to both monitor and react to rating changes, and bars on stocks based on shifting economic or financial criteria (*e.g.*, a bar on any company deriving more than X% of its revenues or profits from tobacco, firearms or alcohol related businesses). Firms should consider placing the administration of client restrictions under the supervision of a client restriction committee, the mission of which is to articulate a list of client restrictions that it regards as reasonable and to work with operations personnel to ensure that acceptable restrictions are accommodated in the wrap program. Such a committee should meet periodically to review a report of client restriction requests (both those accepted and those rejected as unreasonable) and the firm's experience in administering client impose restrictions to determine whether the listing of acceptable restrictions should be modified.

(iv) Customer Reporting. The sponsor or person designated by the sponsor provides each client with a statement, at least quarterly, containing a description of all activity in the client's account during the preceding period, including all transactions made on behalf of the account, all contributions and withdrawals made by the client, all fees and expenses charged to the account, and the value of the account at the beginning and end of the period.

(v) Indicia of Ownership. Each client retains, with respect to all securities and funds in the account, to the same extent as if the client held the securities and funds outside the program, the right to:

- Withdrawal of securities or cash;
- Vote securities, or delegate the authority to vote securities to another person;
- Be provided in a timely manner with a written confirmation or other notification of each securities transaction, and all other documents required by law to be provided to the security holder; and
- Proceed directly as a security holder against the issuer of any security in the client's account and not be obligated to join any person involved in the operation of the program, or any other client of the program, as a condition precedent to initiating such proceeding.

b. Current Focus on Rule 3a-4 and Industry Practice

(i) ICI Petition

Rule 3a-4 and industry practice under it has come under increased scrutiny recently. This scrutiny has been triggered, in part, by the Investment Company Institute's submission, in March 2001, of a rulemak-

ing petition to the SEC urging the adoption of a definitional rule that would clarify that certain portfolio investment programs are “investment companies” within the meaning of the Investment Company Act. See <http://www.ici.org/portfolio_petition.html>. While this rulemaking petition was aimed primarily at so-called “folio” or “basket” products popularized by Folio^{fn} and E*TRADE, many viewed the petition as potentially undermining Rule 3a-4, even as applied in the traditional wrap fee context. In its June 14, 2001 letter to the SEC opposing the ICI’s rulemaking petition, the Securities Industry Association warned that the ICI’s proposed definitional rule could possibly “cause other types of investments to be deemed investment companies under the Investment Company Act of 1940 and thus subject them to the provisions of that statute.” <http://www.sia.com/2001_comment_letters/pdf/ICIRulepetition.pdf>.

(ii) SEC Sweep

While the SEC ultimately rejected the ICI’s rulemaking petition, in the summer of 2001, the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) conducted a sweep – ostensibly focused on Internet based investment advisory programs – that sought to scrutinize whether these programs are providing individualized investment advice and ascertaining whether they are operating outside Rule 3a-4. More recently, in late 2001 and early 2002, OCIE conducted a sweep of large wrap sponsors that, among other things, sought to gauge compliance with Rule 3a-4. While reportedly neither sweep uncovered significant problems, the SEC continues to be concerned that changes in technology may require modification to the Rule. In his December 6, 2001 address before the ICI’s Securities Law Developments Conference, Paul Roye, then Director of the SEC’s Division of Investment Management, stated “I think we should consider whether the conditions of rule 3a-4 continue to provide effective assurance that clients in those programs receive truly individualized treatment and whether the conditions of rule 3a-4 should be revisited.” <<http://www.sec.gov/news/speech/spch528.htm>>

(iii) Recent SEC Statements on Rule 3a-4

The SEC staff has continued to indicate that they intend to reconsider the substance of Rule 3a-4 in light of enhanced technologies and investor protection concerns. In an October 19, 2007 speech to the Money Management Institute Managed Account Solutions Conference, Andrew Donohue, director of the Division of Investment Management, stated that the SEC should “periodically review the conditions in Rule 3a-4 to consider whether they provide for an appropriate level of individualized treatment to support an exception from the definition of investment company for certain types of managed accounts or investment advisory programs.” <<http://www.sec.gov/news/speech/2007/spch101907ajd.htm>> In a March 21, 2008 speech before an IA Week and the Investment Adviser Association Summit, Donohue reiterated this statement and further stated that he has previously “expressed concerns with whether firms were complying with Rule 3a-4.” <<http://www.sec.gov/news/speech/2008/spch032108ajd.htm>>

C. Suitability Issues

Among the first cited concerns about wrap fee programs is the issue of whether wrap fee program sponsors and portfolio managers are honoring their duty to make sure that such arrangements are suitable for customers. Despite the decades’ worth of experience with wrap fee programs, there is surprisingly little regulatory guidance on the suitability obligations of wrap sponsors and portfolio managers, including the question of when suitability obligations arise in the context of wrap fee programs and who is responsible for satisfying these obligations.

1. Sources of Obligations

a. Broker-Dealers

The rules of the securities self-regulatory organizations “(SROs)” require a broker-dealer to ensure that its recommendations are suitable for the customer. *See, e.g.*, NASD Rule 2310 (suitability of recommendations); NYSE Rule 405 (same). For example, NASD Rule 2310 provides that a member, when making a recommendation to a customer, “shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.” Many states have codified a broker-dealer’s suitability obligations in their securities statutes and rules.

b. Investment Advisers

As fiduciaries, investment advisers similarly have a general obligation to ensure that, before making a recommendation to or taking action for a customer, the investment adviser has reasonable ground to believe that the recommendation or action is suitable for the customer based on information furnished by the customer after reasonable inquiry concerning the customer’s investment objectives, financial situation and needs, and any other information known or acquired by the investment adviser after reasonable examination of the customer’s financial records as may be provided to the investment adviser. As in the case of broker-dealers, many states have codified this suitability obligation in their securities’ statutes or rules. *See, e.g.*, Uniform Securities Act Rule 102(a)(4)-1(1) (adopted September 3, 1987).

The SEC proposed a rule under the Advisers Act in 1994 that sought to, in essence, codify an investment adviser’s suitability obligation. The proposed rule, which was patterned after the SRO suitability rules, would have specifically prohibited an investment adviser from giving investment advice (other than impersonal advice) to a customer, unless the adviser (1) has made reasonable inquiry into the customer’s financial situation, investment experience and investment objectives; and (2) reasonably believes the advice is suitable for the customer. *Suitability of Investment Advice Provided by Investment Advisers*, Investment Advisers Act Release No. 1406 (March 16, 1994). The SEC withdrew the rule from its regulatory agenda in 1996, but indicated that the rule would receive further consideration. If the SEC adopts the rule – which after fourteen years appears unlikely – investment advisers would be required to retain customer questionnaires or other documents obtained in making suitability inquiries as part of their required records. The SEC release proposing the rule did not discuss the application of the rule to wrap fee arrangements.

2. Suitability Issues in Wrap Programs

Suitability in the contexts of wrap fee accounts typically breaks down into at least five different questions.

a. Is the Portfolio Manager Suitable for the Program?

A wrap sponsor may, depending on the circumstances, be viewed as explicitly or implicitly recommending the portfolio managers participating in its program. A wrap sponsor may, therefore, be obligated under applicable SRO rules to ensure that it has a reasonable basis to believe the portfolio managers are suitable for participation in the programs before it admits the portfolio managers into the program or refers customers to them. There is no “bright line” as to what suffices as a “reasonable basis.” Firms vary on the type and degree of “due diligence” performed on portfolio managers. Rather than impose a minimum degree of due diligence in this area, the SEC has imposed a “say what you do” approach by requiring that wrap sponsors disclose in their Schedule H how they choose participating portfolio managers, as discussed below.

b. Is the Program Suitable for the Client?

Firms have an obligation to ensure that wrap fee programs are suitable for customers before recommending customer participation. In a letter from the SEC's Division of Investment Management to James Edmunds Wilson, President of the National Association of Personal Financial Advisers (September 20, 1989) (*"NAPFA Letter"*), the SEC staff said that an investment adviser must carefully consider whether a wrap fee arrangement is suitable for its customer before entering into such an arrangement, and that the investment adviser probably has a continuing obligation to ensure that the arrangement is suitable for the customer. The SEC staff also made clear that an investment adviser must consider each customer's investment goals and proposed investment in determining whether a wrap fee arrangement is suitable. Recently, Andrew Donohue, director of the SEC's Division of Investment Management, stated that the SEC would be "interested in how firms determine that a managed account is the appropriate account for a client and how firms determine that clients are receiving the full value of these accounts and particularly of the 'bundled' brokerage services." < <http://www.sec.gov/news/speech/2008/spch032108ajd.htm>>

There may be a disincentive to trade for wrap fee accounts because the profit from the wrap fee retained by the wrap sponsor is reduced each time a trade is done and the resulting execution costs are incurred. A participating portfolio manager may have an incentive to keep trading down to promote a continuing stream of referrals from the wrap sponsor. Similarly, a wrap sponsor may have an incentive to limit referrals to or outright exclude from its program any investment adviser that trades actively. The SEC staff has expressed concern that the portfolio manager's and wrap sponsor's fiduciary duties to customers may be compromised by these trading disincentives, although no hard evidence of abuse in this area has emerged.

c. Is the Chosen Strategy Suitable for the Client?

Where a wrap sponsor recommends an investment strategy to a customer as part of a wrap program (or otherwise), it has an obligation to make sure that strategy is suitable for that customer. Sometimes a customer may reject a recommended strategy and request, for example, a strategy that is more aggressive than the customer's circumstances might seem to warrant (possibly to seek the advisory services of a particular portfolio manager). Many firms will scrutinize these "out of category" requests and either reject them or at least seek written confirmation from the customer that the "out of category" request was not recommended by the firm (or its representative) and that the customer understands the added risk carried by the request.

d. Is the Portfolio Manager Suitable for the client?

As with recommended strategies, where a firm recommends a specific portfolio manager to a customer, it has an obligation to make sure the portfolio manager is suitable for the customer. This includes considering whether the portfolio manager is able to accommodate investment restrictions imposed by the client.

Some wrap sponsors seek to limit the scope of any express or implicit recommendation of a portfolio manager by (1) clearly stating the precise basis of any recommendation of a portfolio manager (including the methods used in screening portfolio managers); and (2) adopting the practice of recommending several different portfolio managers ("Rule of Three") for the customer's consideration, and leaving it to the customer to make the final selection. Whether these steps ultimately succeed in avoiding or narrowing a recommendation depends on the particular facts.

Special issues arise where a sponsor places a portfolio manager on a "watch list" or suspends referrals of new customers to the portfolio manager pending review but before a decision is reached on termination. This may happen because of such factors as lackluster performance, a series of seemingly imprudent investment decisions, the departure of key personnel, or regulatory and legal problems. In this context,

sponsors generally should consider whether to notify customers of these events to reduce the possibility that further problems will surface after customers have lost money.

Special issues also arise where clients elect to stay with portfolio managers that have been terminated from the wrap program. As with “out of category requests,” it is prudent for a wrap sponsor to document that the election was not recommended by the firm (or its representative) and that the customer understands the added risk. Some firms will also seek to lessen possible misunderstandings by transferring the customer’s account outside the wrap fee program and carrying the account as a fee-based brokerage account.

e. Are the Portfolio Manager’s Investments Suitable for the Client?

Wrap sponsors often take the position – which is often reflected in their client agreements and Schedule Hs – that they are not responsible for monitoring a portfolio manager’s day-to-day trading of a customer’s account. Although this position seems reasonable generally, special issues are posed where a sponsor assumes the role of tactically allocating or rebalancing among disciplines and portfolio managers, such as in the context of so-called “multi-discipline account” (or “MDA”) arrangements. For example, does the sponsor’s more frequent and in-depth involvement heighten a higher suitability obligation on its part? Further, does the sponsor take on greater responsibility for monitoring for conflicts among disciplines and portfolio managers – where one manager’s strategy negates another manager’s strategy or makes it more risky (e.g., where two managers load up on the same issuer resulting in a more concentrated portfolio)? Similarly, contemporaneous purchases and sales of the same stock by the portfolio managers could raise wash sale issues.

The extent of a portfolio manager’s suitability obligations beyond investments is less clear and should turn on the specific circumstances. In this regard, the SEC staff have questioned whether – if not hinted that portfolio managers still have a level of responsibility to perform a suitability analysis for each client. On a March 2007 panel at the IAA/IA Week Conference, Robert Plaze, associate director of the SEC’s Division of Investment Management, noted that a wrap fee client is a client of the portfolio manager “as if they were a direct client” of the manager. Accordingly, the manager may maintain overall responsibility for suitability determinations, although that responsibility may be delegated to the sponsor. *IM Insight, Wrap Fee Compliance: Beyond Rule 3a-4*, April 9, 2007.

3. “Due Diligence”

A wrap sponsor’s suitability obligations are viewed as imposing on the wrap sponsor the task of conducting some form of “due diligence” review of the portfolio managers to ensure they are appropriate participants in the wrap sponsor’s program. The thoroughness of any review should correspond to the nature of any recommendation (i.e., a mere referral may not warrant the same amount of “due diligence” as a full fledged recommendation). Also, the more a referral takes the form of a recommendation, the more necessary it may be to conduct routine follow-up due diligence. Wrap sponsors are required to disclose in their wrap fee brochures how portfolio managers are selected and reviewed, as discussed below. Topics that may be appropriate in portfolio manager screening include the following:

- Style. Does the portfolio manager actually manage customer accounts in line with its purported style?
- Personnel. Who are the key players, and does the portfolio manager have sufficient staffing to handle an increased volume of customer work?

- Performance Numbers. What is the portfolio manager's performance for each of its composites over the last five years, and how was the performance calculated (e.g., using GIPS, using performance of portfolio managers at other firms, etc.)? The validity of portfolio manager performance calculations have been a matter of some concern for regulators and wrap sponsors. See Susan Antilla, *This Money Manager Can't Count*, New York Times, June 20, 1993, at F15; *In the Matter of Seaboard Investment Advisers, Inc.*, Advisers Act Release No. 1431 (August 3, 1994) (enforcement action against a portfolio manager in various wrap programs that the SEC alleged to have used misleading performance). Wrap sponsors are required to disclose in their wrap fee brochures what they do to review portfolio manager performance information.
- Legal & Compliance. Is there adequate assurance that the portfolio manager has adequate internal controls to ensure compliance with applicable law? Wrap sponsors should screen portfolio managers to ensure they are not subject to disqualifications. Wrap sponsors can accomplish this in many ways, including through a combination of reviewing the portfolio managers' Form ADVs, running a search through the disciplinary databases made available through LEXIS-NEXIS, and contracting with third-party consultants.

D. Trading and Best Execution Issues

1. Issues for Portfolio Managers

Making trading and best execution decisions for wrap accounts can pose special issues for portfolio managers, including complications in the choice of brokers to execute wrap trades and the conflicts that can arise among clients where a portfolio manager needs to direct trades to multiple brokers.

a. Best Execution in the Choice of Brokers

Most wrap programs are structured so that the portfolio manager is, in theory and by contract, responsible for placing client trades with those broker-dealers that will provide best execution. In practice, most wrap program trades end up being executed through the sponsoring broker-dealer because generally commissions charged by the sponsor for executing transactions are included in the wrap fee and, conversely, the client will be separately charged for any commissions or charges on transactions a portfolio manager places with other broker-dealers. In addition to the actual cost of the execution, an investment adviser also must consider other factors that bear on best execution, including the quality, speed and reliability of the execution, to determine whether the customer is receiving best execution. The SEC staff emphasized this duty in the *NAPFA Letter*. Nevertheless, even factoring in the various factors relevant to best execution, most managers direct trades to the sponsoring broker-dealer based on the view that so doing is generally consistent with seeking best execution. The appropriateness of this practice has been acknowledged by members of the SEC staff. Recently, for example, Andrew Donahue, the director of the SEC's Division of Investment Management, acknowledged that there are "very legitimate reasons for an asset manager to place an SMA client's trades with the SMA's sponsor." As he acknowledged, because the client is paying a single fee for both asset management and trade execution services, execution of trades by a broker-dealer other than the sponsor may result in "possibly a charge the client was not expecting." Donahue cautioned that portfolio managers must still consider the "possibility that a non-SMA sponsor broker-dealer may be in a position to provide better execution in a particular circumstance." At a minimum, market participants should consider "the extent to which clients are informed of the way that trade placement decisions are made in the SMA context." Speech of Andrew J. Donohue to the 2007 Managed Account Solutions Conference <http://www.sec.gov/news/speech/2007/spch101907ajd.htm>.

In a minority of wrap programs, the customer instructs the portfolio manager to direct all trades to the wrap sponsor. This direction effectively absolves the portfolio manager of its best execution obligations

if the customer has been fully informed of all material facts concerning this type of trading arrangement (*i.e.*, the portfolio manager will not be able to select brokers based on best execution, and the arrangement may limit the portfolio manager's ability to bunch trades and may result in less favorable net prices). *See, e.g., In the Matter of Mark Bailey & Co.*, Advisers Act Release No. 1105 (February 24, 1988).

b. Trading Conflicts

Participation in wrap programs can raise challenging trading issues for a portfolio manager that also manages non-wrap accounts. The fact that wrap orders tend – by economics or client direction – to be directed to the sponsoring broker-dealer can force a portfolio manager to break up – across several brokers – orders it might otherwise send to a single broker. Rather than broadcast orders across multiple brokers, a portfolio manager may wisely seek to limit market impact by placing orders with one broker and, once those orders have been executed, then place orders with the next broker. This leads to situations in which some of the portfolio manager's clients are relegated to trade at the “back of the bus,” very possibly on less favorable terms.

Many portfolio managers seek to deal with these issues by implementing a rotational process in which wrap accounts, directed accounts and “unrestricted accounts” take turns going first. While rotation seems a sensible measure to ensure – as portfolio managers must – that clients are treated fairly and equitably over time, it can place institutional orders “at the mercy” of wrap orders especially where large wrap orders may take time to be executed by the sponsor. *See What Money Managers Need to Know About Wrap Trading*, TraderForum Executive Summary (May 2001). The use of “step outs” may ease this problem, but many sponsors are unwilling or unable to accommodate step outs.

Portfolio managers should ensure that they have appropriate Form ADV or other disclosure informing clients of these sorts of trading conflicts. The need for disclosure in this area is illustrated by a recent opinion of Florida's First District Court of Appeal that held that the City of Gainesville Consolidated Police Officers' and Firefighters' Retirement Plan may seek an accounting against the plan's former investment adviser for an alleged failure to obtain “best execution” on trades for the pension fund. In its complaint, Gainesville alleged that the adviser failed to disclose it would execute Gainesville's directed stock trades only after it had bought or sold hundreds of millions of dollars' worth of stocks for the adviser's other clients. *See Court Rules Gainesville Public Pension Fund May Hold Its Former Investment Adviser Accountable*, Business Wire (August 6, 2002).

Finally, given the SEC's emphasis in the release adopting Rule 206(4)-7 that advisers' policies and procedures should reflect conflicts unique to their business, portfolio managers' policies and procedures, and the process for their periodic review under the rule, should include consideration of these trading conflicts.¹⁰ These policies should address trading practices, including procedures by which the adviser satisfies its best execution obligation.

2. Issues for Broker-Dealer Sponsors

As broker-dealers, wrap sponsors too have obligations to seek best execution when executing client transactions, even those directed by unaffiliated portfolio managers responsible for the choice of brokers. In addition, when wrap sponsors or their affiliates themselves serve as portfolio managers or otherwise exercise investment discretion, this may result in the wrap sponsors becoming subject to restrictions on

¹⁰ Advisers Act Release No. 2204. 68 Fed. Reg. 74714 (December 24, 2003).

agency-cross and principal transactions under the Advisers Act and restrictions under the Exchange Act on exchange members executing discretionary transactions.

In 1996, the SEC instituted proceedings against a wrap sponsor and its president for, among other things, failure to obtain best execution of customer transactions. *See In the Matter of Portfolio Management Consultants, Inc. and Kenneth S. Phillips*, Exchange Act Release 37376 (June 27, 1996) <<http://www.sec.gov/litigation/admin/337308.txt>>. The SEC alleged that the wrap sponsor breached its duty of best execution by failing to pass on to its clients superior prices that the sponsor obtained in contemporaneous offsetting transactions. Specifically, the SEC alleged that PMC routinely executed client orders as principal at the prevailing national best bid or offer ("NBBO") and then, in contemporaneous offsetting principal trades, sought and obtained better prices for itself by routing limit orders to third market dealers at prices more favorable to PMC than NBBO prices. According to the SEC, the majority of the offsetting orders were in fact filled at more favorable prices. "Under the circumstances of its arrangement with its clients, PMC had a duty, absent meaningful disclosure and consent, to provide its clients with the superior prices that were reasonably available. In its failure to pass on the superior prices to its clients, PMC breached its obligation of best execution." PMC and its president, without admitting or denying the SEC's allegations, consented to the entry of an order imposing remedial sanctions.

Contemporaneously with the PMC settlement, the SEC instituted proceedings against PMC's chairman and CEO, Marc N. Geman. *See Exchange Act Release No. 37375* (June 27, 1996) <<http://www.sec.gov/litigation/admin/337307.txt>>. One year later, an administrative law judge ruled that PMC had "fulfilled its best execution obligation by executing its trades with clients at the NBBO." The administrative law judge pointed to the court's decision in *In re Merrill Lynch Securities Litigation*, 911 F. Supp. 754 (D.N.J. 1995), *aff'd sub nom., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 115 F.3d 1127 (3d Cir. 1997), which addressed the issue of whether failure to provide best execution occurred where trades were effected at the NBBO, without any effort to obtain better prices through other possible sources of liquidity. As recounted by the administrative law judge, "[a]fter an extensive review of the jurisprudence of best execution, which the court noted did not provide clear standards and was evolving, the court found that the duty of best execution, at the time that the defendants executed their trades, was ambiguous, so it could not hold the defendants liable for failing to provide best execution when they had effected trades at the NBBO." *See In the Matter of Marc N. Geman*, Initial Decision (August 5, 1997) <<http://www.sec.gov/litigation/aljdec/id112mcb.txt>>.

On appeal, the SEC sided with the administrative law judge in the SEC's Valentine's Day 2001 opinion. *See In the Matter of Marc N. Geman*, Opinion of the Commission, 43963 (February 14, 2001) <http://www.sec.gov/litigation/opinions/34-43963.htm#P254_60802>. While agreeing "that routine execution of customer orders at the NBBO when better prices are reasonably available can be a violation of the duty of best execution," the SEC went on to conclude that the record did not establish that prices better than the NBBO were reasonably available for the particular customer trades or that they would have been eligible for price improvement. Nonetheless, the SEC stated that it was "deeply troubled by the Firm's trading practices, particularly its failure to utilize a price improvement service on behalf of its customers." The SEC went on to caution that, "notwithstanding any ambiguity that may have once existed regarding the matter, it should now be clear that a firm must consider the potential for price improvement in carrying out its best execution obligations."

a. Agency-Cross and Principal Transactions

Where a wrap sponsor or one of its affiliates effects agency-cross transactions (that is, transactions in which the sponsor, or any person controlling, controlled by or under common control with the sponsor, acts as broker for the party or parties on both sides of the transactions), the wrap sponsor must disclose the capacity in which it is acting and obtain the customer's informed consent pursuant to the requirements

of Section 206(3) and Rule 206(3)-2 under the Advisers Act. Accordingly, wrap sponsors frequently incorporate into their customer agreements provisions whereby the client prospectively authorizes the sponsor and its affiliates to effect “agency cross” transactions and acknowledges that (i) the sponsor or its affiliates may receive compensation from the other party to such transactions; (ii) as such, the sponsor will have a potentially conflicting division of loyalties and responsibilities; and (iii) the client can revoke his or her consent anytime by written notice.

By contrast, where a wrap sponsor or one of its affiliates, acting as principal for its own account, effects a sale or purchase of a security for the account of a customer, the investment adviser must disclose the capacity in which it is acting and obtain the customer’s informed consent to the particular transaction under Section 206(3). See Advisers Act Release No. 1732 (July 17, 1998) <<http://www.sec.gov/rules/interp/ia-1732.htm>>; Advisers Act Release No. 881 (September 9, 1983); Advisers Act Release No. 40 (January 5, 1945). Section 206(3)’s restrictions on principal transactions apply to so-called “riskless” principal trades, see, e.g., *In the Matter of The Feldman Investment Group, Inc.*, Advisers Act Release No. 1538 (November 27, 1995), and to transactions effected in a principal capacity by an affiliate, see, e.g., *Hartzmark & Co., Inc.* (November 11, 1973). Unlike customer consent for agency-cross transactions (which, as noted, may be obtained prospectively), customer consent for principal transactions must be obtained, on a trade-by-trade basis, before the “completion of [each] transaction.” The SEC has brought enforcement actions against wrap sponsors for effecting principal transactions in violation of Section 206(3). See, e.g., *In the Matter of Gruntal & Co., Incorporated*, Advisers Act Release 1560 (April 9, 1996) <<http://www.sec.gov/litigation/admin/337278.txt>>.

Significantly, Section 206(3) does not apply to any transaction, whether principal or agency cross, with a customer of a broker-dealer if the broker-dealer is not acting as an investment adviser in relation to such transaction. Since in most wrap fee programs the wrap sponsor acts as investment adviser only by counseling customers on the selection of a portfolio manager and then monitoring the portfolio manager’s performance, the wrap sponsor is not acting as an “investment adviser” in relation to trades made at the portfolio manager’s direction. Therefore, Section 206(3)’s restrictions on agency cross and principal trades should not apply to the wrap sponsor in these circumstances.

This position was confirmed by the SEC staff in an April 16, 1997 letter to *Morgan, Lewis & Bockius LLP*. In this letter, the SEC staff determined that, when a transaction is directed to a broker-dealer sponsor by an unrelated portfolio manager that has investment discretion to manage the account, and the broker-dealer does not recommend, select or play any role, direct or indirect, in the portfolio manager’s selection of particular securities to be purchased for, or sold on behalf of program clients, then the broker-dealer would not be acting as an investment adviser in relation to the transaction for purposes of Section 206(3). As a result, many wrap sponsors incorporate into their client agreements provisions whereby the client prospectively authorizes the sponsor to effect principal transactions “to the extent permitted by law and subject to applicable restrictions.”

Despite the SEC staff’s *Morgan, Lewis* no-action letter, wrap sponsors generally have refrained from executing retirement account trades as principal because of open questions concerning the possible applicability of the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (“ERISA”) and corresponding provisions of the Internal Revenue Code. In May 1998, the Investment Adviser, Investment Company, Federal Regulation and Retirement Products and Estate Services Committee of the Securities Industry Association (“SIA”) together wrote the Department of Labor (“DOL”) urging the DOL “to clarify that it interprets Section 406(b)(2) of ERISA in a manner consistent” with the views of the SEC staff in the *Morgan, Lewis* no-action letter, stating that under the circumstances, “whether the trades by such a Dual Registrant are executed on a principal or agency cross basis, the concerns that underlie Section 406(b)(2) clearly are not present.”

http://www.sia.com/1998_comment_letters/html/dol98-1.html>. The DOL has not formally acted on this request.

b. Discretionary Trades by Exchange Members

Where a wrap sponsor is a member of a national securities exchange and effects a transaction on the exchange in which it or an associated person exercises investment discretion, the wrap sponsor must comply with Section 11(a) of the Exchange Act. Section 11(a) of the Exchange Act prohibits a member of a national securities exchange from effecting transactions on the exchange for its own account, the account of an associated person, or an account in which it or an associated person exercises investment discretion (collectively, “covered accounts”), unless an exception applies. Section 11(a) was substantially revised by the Securities Acts Amendments of 1975 to address trading advantages enjoyed by exchange members and conflicts of interest in money management.¹¹ In particular, as the SEC has stated, Congress was concerned about members benefiting in their principal transactions from special “time and place” advantages associated with floor trading – such as the ability to “execute decisions faster than public investors.”¹² Section 11(a) excepts from its prohibitions certain transactions, including (i) under paragraph (E), “any transaction for the account of a natural person, the estate of a natural person, or a trust created by a natural person for himself or another natural person”; and (ii) under paragraph (H), “any transaction for an account with respect to which [the] member or an associated person thereof exercises investment discretion if such member:

- “Has obtained, from the person or persons authorized to transact business for the account, express authorization for such member or associated person to effect such transactions prior to engaging in the practice of effecting such transactions”;
- “Furnishes the person or persons authorized to transact business for the account with a statement at least annually disclosing the aggregate compensation received by the exchange member in effecting such transactions”; and
- “Complies with any rules the Commission has prescribed with respect to the requirements of clauses (i) and (ii).”¹³

¹¹ See Securities Reform Act of 1975, Report of the House Comm. on Interstate and Foreign Commerce, H.R. Rep. No. 94-123, 94th Cong., 1st Sess. (1975) (“House Report”); Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs, S. Rep. No. 94-75, 94th Cong., 1st Sess. (1975).

¹² See Securities Exchange Act Release No. 14563 (March 14, 1978); Securities Exchange Act Release No. 14713 (April 27, 1978); Securities Exchange Act Release No. 15533 (Jan. 29, 1979); House Report at 54-57.

¹³ SEC Rule 11a2-2(T), the so-called “effect-versus-execute” rule, also permits an exchange member, subject to certain conditions, to effect transactions for discretionary and other covered accounts by arranging for an unaffiliated exchange member to execute the transactions directly on the exchange floor. To comply with the “effect-versus-execute” rule’s conditions, a member: (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution (the member may, however, participate in clearing and settling the transaction.); (iii) may not be affiliated with the executing member, and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction without express written consent from the person authorized to transact business for the account in accordance with the rule.

Although technically client authorization only needs to be obtained from non-natural person clients (*i.e.*, institutional clients), practically speaking, most sponsors subject to Section 11(a) incorporate the authorization into their client agreements (and indicate in the contractual language that it applies to “certain” accounts).

c. Limit Order Protection

Wrap sponsors must also comply with the NASD’s Limit Order Protection Rule, NASD Rule 2110 and Interpretation IM-2110-2, which generally prohibits NASD members from trading ahead of unexecuted customer limit orders. The rule’s prohibition also applies to orders for which the wrap sponsor acts as agent by sending the order to another NASD member for execution. Thus, if an order that the wrap sponsor sends to another market maker is triggered at the wrap sponsor because the wrap sponsor has traded as principal, the wrap sponsor must protect the order by ensuring that it is executed immediately. The broker-dealer holding the order, however, may not be obligated to execute the order at that time, and as a consequence, the wrap sponsor would be obligated under the Limit Order Protection Rule to retrieve the order and execute it as principal. This would result in a conflict between the Limit Order Protection Rule, which would require the wrap sponsor to trade with its customer as principal, and the Advisers Act, which prohibits the wrap sponsor from doing so in certain circumstances, as discussed above. FINRA staff has advised in a July 3, 1997 interpretive letter <http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P002531> that in the situation where the wrap sponsor is acting as an investment adviser in connection with a transaction, compliance with the Advisers Act supersedes the Limit Order Protection Rule. According to FINRA staff, “to the extent that the wrap sponsor is handling limit orders for wrap accounts for which it acts as a RIA, it would be permissible for the wrap sponsor to execute transactions in its market making capacity ahead of such limit orders when those orders are forwarded to another broker-dealer for execution.”

3. Confirmation of Transactions

The SEC staff has issued a series of exemptive letters granting relief from the confirmation requirements of Rule 10b-10(a) for transactions in securities in wrap fee programs. These letters have permitted broker-dealers to confirm transactions in their wrap fee programs through periodic statements, no less often than quarterly, in lieu of immediate or trade-by-trade confirmations subject to a variety of requirements. The first letter was issued on August 23, 1999 to Morgan, Lewis & Bockius LLP on behalf of the SIA and Money Management Institute as an exemption to all broker-dealers for discretionary wrap fee programs managed by fiduciaries other than the broker-dealer sponsor.

<http://www.sia.com/1999_exemption_letters/pdf/secexemp.pdf> In the wake of uncertainty that resulted from a footnote included in a letter from the SEC staff to Morgan Keegan stating that a broker-dealer that is also the adviser to a wrap fee account may not rely on the SIA/MMI letter, the SEC issued subsequent class-wide exemptive letters to Morgan Lewis & Bockius on behalf of Wachovia Securities, LLC on April 30, 2007 (for dually registered broker-dealers and investment advisers) and to Morgan Lewis & Bockius on behalf of UBS Financial Services, Inc. on May 24, 2007 (for broker-dealer sponsors acting as fiduciaries), permitting them to send periodic confirmations for wrap fee programs in lieu of trade-by-trade confirmations. The conditions of the latest exemption (provided to UBS) are:

- The broker will provide all program clients, at or prior to account opening, and at least annually thereafter offer to provide, a brochure describing the products, services, and fees of the program.
- The broker will develop a form of written or electronic consent that will be prominent, clear and easily understandable for program clients who request not to receive trade-by-trade confirmations and, in lieu thereof, receive a monthly statement that contains the information required by Rule 10b-10.

- Program clients electing not to receive trade-by-trade confirmations will be able to later change their minds and request, for no additional cost, trade-by-trade confirmations for any transaction since the date of the last monthly statement, as well as for all subsequent transactions. The broker will also inform program clients that they may request, for no additional fee, trade-by-trade confirmations for previous transactions effected for up to a one-year period preceding the last monthly statement.
- The broker will send all information required by Rule 10b-10 to electing program clients in the monthly statements, except for: (1) the trade date (provided that the broker discloses the settlement date instead); (2) certain disclosure with respect to mark-up, mark-downs, commissions and additional remuneration received from third-parties where no mark-up, mark-down or commission has been charged, and; (3) information about the redemption provisions of debt securities or information regarding the yield on asset backed securities.
- The broker will continue to generate and send trade-by-trade confirmations to those program clients who do not elect to receive monthly statements in lieu of trade-by-trade confirmations.
- The broker will not require or request that respective program clients elect not to receive trade-by-trade confirmations, but will make information available on how such clients will be able to make such an election. Client communications will inform program clients about their ability to receive confirmations on a trade-by-trade basis or in monthly statements, but will not suggest which choice is better. Such client communications will also inform program clients that, if interested, they should contact an adviser to obtain more information or to obtain a copy of a written or electronic consent to request a monthly statement in lieu of trade-by-trade confirmations. These client communications will not suggest that such an election is required for program accounts or that the clients will incur additional costs if they do not elect to receive monthly Statements in lieu of trade-by-trade confirmations.
- Communications sent to clients will inform them of the ability to elect not to receive trade-by-trade confirmations and the means by which they could make the choice without suggesting that they make that election. These communications may refer the client to a firm financial advisor to obtain more information or to request written or electronic consent to make the election.
- Clients will have access to the broker's website, and will be able to view, in no event later than the next business day after trade date (T+1), all information required by Rule 10b-10, including the information that this exemption permits to be omitted. Program clients will also be able to obtain all information required by Rule 10b-10 either by telephoning their adviser or by requesting the trade-by-trade confirmation for the particular transaction.

The *SIA Letter* explicitly noted that the exemption did not address compliance with SRO rules, such as NYSE Rule 409(b) and MSRB G-15. NYSE Rule 409(b) prohibits a member organization from addressing confirmations, statements or other communications to a non-member customer at the address of any member or member organization. MSRB Rule G-15 requires that at or before the completion of a transaction in municipal securities with or for the account of a customer, each broker, dealer or municipal securities dealer shall give or send to the customer a written confirmation that complies with the requirements of the rule.

E. Disclosure Obligations

1. Disclosure Obligations of Wrap Sponsors

The SEC adopted Rule 204-3(f) under the Advisers Act in April 1994. Rule 204-3(f) requires investment advisers that sponsor, organize or administer wrap fee programs to provide program customers with a

brochure containing at least the information required by new Schedule H to Form ADV, in lieu of Part II of the Form. The SEC has proposed amendments to Form ADV that would change the name of Schedule H to Part 2A Appendix 1 and would make limited changes to the information required in the brochure, including requirement that Part 2A Appendix 1 include a section describing material changes from the last annual update on the page immediately following the cover page.

a. Contents of Wrap Fee Brochure

Schedule H calls for the disclosure, in narrative form, of a wide range of information concerning the structure and operation of a sponsor's wrap fee program, including the services provided through the program, fees charged, and the sponsor's practices relating to the selection and retention of portfolio managers. Specifically, Schedule H wrap fee brochures are required to include the following:

(i) Cover Page and Table of Contents

On the cover page, the sponsor's name, address, telephone number, and a legend in bold type (or presented in some other prominent fashion) stating "This brochure provides clients with information about [name of sponsor] and the [name of program or programs] that should be considered before becoming a client of the [name of program or programs]. This information has not been approved or verified by any governmental authority."

(ii) A Table of Contents

(iii) Fee Information

- The amount of the wrap fee charged for each program or, if fees vary according to a schedule established by the sponsor, a table setting forth the fee schedule, whether such fees are negotiable, the portion of the total fee (or the range of such amounts) paid to portfolio managers, and the services provided under each program (including the types of portfolio management services);
- A statement that the program may cost the client more or less than purchasing such services separately, and a statement of the factors that bear on the relative cost of the program (*e.g.*, the cost of the services if provided separately and the trading activity in the client's account);
- If applicable, a statement that the person recommending the program to the client receives compensation as a result of the client's participation in the program, that the amount of this compensation may be more than what the person would receive if the client participated in other programs of the sponsor or paid separately for investment advice, brokerage, and other services, and that the person may therefore have a financial incentive to recommend the wrap fee program over other programs or services; and
- A description of the nature of any fees that the client may pay in addition to the wrap fee and the circumstances under which these fees may be paid, including, for example, commissions or charges on transactions a client's portfolio manager places with broker-dealers other than the sponsor and dealer mark-ups, mark-downs, or commission equivalents on principal transactions effected through dealers other than the sponsor; the dealer spread (normally the difference between the bid and the offer price) on principal transactions regardless of the broker-dealer executing the transaction; auction fees; debit balances and margin interest; certain odd-lot differentials; transfer taxes; electronic fund and wire transfer fees; charges imposed by custodians other than the sponsor, fees in connection with custodial, trustee and other services rendered by a sponsor affiliate; SEC fees on Nasdaq transactions; certain costs associated with trading in foreign securities; any other charges mandated by law; and certain

fees in connection with trust accounting, or the establishment, administration, or termination of retirement or profit sharing plans. The proposed amendments to Form ADV include the following additional disclosure relating to fees:

- A description of the nature of any fees that the client may pay in addition to the wrap fee and the circumstances under which these fees may be paid, including, for example, commissions or charges on transactions a client's portfolio manager places with broker-dealers other than the sponsor and dealer mark-ups, mark-downs, or commission equivalents on principal transactions effected through dealers other than the sponsor; the dealer spread (normally the difference between the bid and the offer price) on principal transactions regardless of the broker-dealer executing the transaction.

(v) Information on Portfolio Managers

- How the program's portfolio managers are selected and reviewed, the basis on which portfolio managers are recommended or chosen for particular clients, and the circumstances under which the sponsor will replace or recommend the replacement of the portfolio manager;
- If applicable, a statement to the effect that portfolio manager performance information is not reviewed by the sponsor or a third party and/or that performance information is not calculated on a uniform and consistent basis;
- If performance information is reviewed to determine its accuracy, the name of the party who reviews the information and a brief description of the nature of the review; and
- A reference to any standards (*i.e.*, industry standards or standards used solely by the sponsor) under which performance information may be calculated.

The proposed amendment to Form ADV includes the following additional disclosure relating to each portfolio manager and potential conflicts that it may face:

- Disclosure regarding any account minimums to open or maintain an account or has a minimum amount for assets placed with each portfolio manager. This part of the brochure should also describe the types of clients to whom the adviser provides services.
- Whether any related persons act as portfolio manager and any resulting conflicts of interests as well as the manner in which the adviser expects to address these conflicts;
- Whether the related persons are subject to the same selection and review process as other participating portfolio managers and if not, the selection and review process to which they are subject.
- If the adviser or any of its registered employees acts as portfolio manager, the adviser must respond to several additional items contained in Part 2A of Form ADV, including items 4B, 4.C, 4.D, 6, 8.A and 17 of the revised Form ADV;

(vi) Client Information

A description of the information about the client that is communicated by the sponsor to the client's portfolio manager, and how often or under what circumstances the sponsor provides updated information about the client to the portfolio managers;

(vii) Permitted Client Communication with Portfolio Managers

- Any restrictions on the ability of clients to contact and consult with portfolio managers;

(viii) Investment Strategies of Wrap Sponsor's Portfolio Managers

- If the sponsor or its divisions or employees covered under the same investment adviser registration as the sponsor act as portfolio managers for a wrap fee program described in the brochure, a brief, general description of the investments and investment strategies utilized by those portfolio managers;

(ix) Other Form ADV Information

In narrative text, the information required by Items 7 and 8 of Part II of Form ADV and, as applicable to clients of the wrap fee program, the information required by Items 2, 5, 6, 9A and C, 10, 11, 13 and 14 of Part II; and

- If any practice or relationship disclosed in response to Items 7, 8, 9A, 9C and 13 of Part II presents a conflict between the interests of the sponsor and those of its clients, the nature of any such conflict of interest must be explained.

(x) Index

The proposed amendments to Form ADV would require a sponsor to include an index with the brochure that is filed with the SEC, but not with the brochure that is delivered to the customer.

b. Brochure Delivery

As with Part II of Form ADV, the wrap fee brochure must be delivered to prospective wrap fee customers and annually offered to existing wrap fee customers. Currently, the brochure must be delivered not less than 48 hours before entering into a contract or when entering into a contract if the client may terminate the contract without penalty within five business days. The SEC has proposed amendments to the Form ADV under which the adviser would also have to deliver the brochure initially and thereafter annually to clients within 120 days of the end of the adviser's fiscal year.

c. Updating

The brochure must be updated promptly to reflect material changes to the information that it contains, or within 90 days after the end of the sponsor's fiscal year to reflect other changes. The brochure may be updated by the use of a sticker (*i.e.*, a supplement affixed to the brochure that indicates what information is being added or changed and states the new or revised information) as long as the document remains readable. The SEC has proposed requiring delivery of an interim update to clients only when the brochure is amended to reflect a disciplinary event or to materially change information already disclosed. Additionally, the SEC has proposed to require the adviser to deliver to each client a brochure supplement with information on each supervised person who provides advisory services to that client, a proposal that has generated substantial critical comment from the industry.

d. Sponsors of Multiple Programs

If an adviser sponsors more than one wrap fee program, the adviser has the option of preparing either a single brochure describing all of its wrap fee programs or separate brochures for each program, provided each brochure notes the existence of the other programs, and states how brochures for them may be obtained.

e. Applicability to Mutual Fund Asset Allocation Programs

While Rule 204-3(f) does not apply to mutual fund asset allocation programs, the SEC staff stated that it would not object if an investment adviser includes in its wrap fee brochure information about a mutual fund asset allocation program sponsored by the same adviser, and provides the brochure to both wrap fee customers and mutual fund asset allocation program customers. See *Pershing Division of Donaldson, Lufkin & Jenrette Securities Corp.* (September 15, 1994).

2. Portfolio Managers

Under Rule 204-3(a), before entering into an investment advisory contract with a customer (or at the time of contracting, if the customer can terminate the contract within 5 business days without penalty), an investment adviser must deliver to the customer a copy of Part II of its Form ADV or a substitute document that contains at least the information required by Part II. The SEC staff – with the concurrence of NAASA’s Investment Advisers Committee – issued the *NRS Letter* in 1992, discussing the disclosure obligations of investment advisers that participate in wrap fee arrangements by providing portfolio management services to customers. In this interpretive letter, the SEC staff addressed the following points:

a. Identity of Wrap Programs in which the Adviser Participates

A portfolio manager should disclose in its brochure that it provides advisory services through wrap fee programs, and identify the names and sponsors of the programs.

b. Differences Between Services Provided to Wrap Fee Versus Non-Wrap Fee Customers

If management services provided by a portfolio manager to wrap fee program customers differ from the services provided to non-wrap fee customers (or customers of other wrap fee programs in which the portfolio manager participates), the portfolio manager must describe the differences, including, for example, the degree to which the portfolio manager affords individualized attention to customer accounts.

c. Amount of the Portfolio Manager’s Share of Wrap Fees – No Longer Required

In the *NRS Letter*, the SEC staff said that a portfolio manager that receives its share of the wrap fee from the wrap sponsor (as opposed to the customer) must disclose the fee schedule under which it is compensated by the sponsor, but need not disclose the entire wrap fee charged by the sponsor. The SEC staff later reversed the position that the portfolio manager must disclose the portion of the wrap fee it receives,

however, in its release adopting Schedule H,¹⁴ because the rule amendments adopted in the *Release* require a wrap sponsor to include the information in its wrap fee brochure.

d. Brochure Delivery

If the customer's wrap fee agreement with the sponsor specifies the portfolio manager to be used, the portfolio manager's brochure must be delivered no later than the time the customer enters into the agreement. If the identity of the portfolio manager serving the account is not specified in the wrap fee agreement, the brochure must be delivered to the customer no later than the time that the portfolio manager begins to service the customer's account. In any case in which the brochure is provided at the time the contract arises, Rule 204-3 requires that the customer have the right to terminate the relationship without penalty within five business days. (The SEC staff also stated its belief that, for purposes of Rule 204-3, a contractual relationship and the corresponding brochure delivery obligations exist between the customer and the portfolio manager, even in the absence of a written contract.)

e. Delegation of Responsibility for Brochure Delivery and Recordkeeping

Although an investment adviser has the responsibility under Rule 204-2(a)(14) to ensure that its brochure is given or offered to customers as required, and to keep proper records of such delivery and/or offer, an investment adviser may delegate those tasks to other persons, including the wrap sponsor. Any such delegation does not, however, relieve the investment adviser of any legal obligations or immunize the investment adviser from penalties under the Advisers Act if the brochure is not delivered.¹⁵ Portfolio managers should take steps necessary to assure that the sponsor is actually performing the tasks assigned to it. While a portfolio manager may delegate the task of creating required records concerning brochure delivery to the wrap sponsor, the portfolio manager also must maintain those records in its *own offices* to comply with Rule 204-2(e)(1). As a result, a portfolio manager should consider seeking contractual or other assurances from a wrap sponsor that the sponsor will make available to the portfolio manager a report that lists the dates on which clients whose accounts are managed by the portfolio manager received or were offered the portfolio manager's brochure.¹⁶

F. Performance Presentation Issues

Wrap fee arrangements raise a number of issues relating to the presentation of portfolio manager performance. These issues include basic questions surrounding who "owns" wrap account performance (es-

¹⁴ *Disclosure by Investment Advisers Regarding Wrap Fee Programs*, Advisers Act Release No. 1411 (April 19, 1994) ("*Schedule H Adopting Release*").

¹⁵ *National Regulatory Services, Inc.* (December 2, 1992).

¹⁶ *cf American Bar Ass'n* (Dec. 8, 2005). The SEC staff took the position in the context of private funds that a registered investment adviser may outsource recordkeeping to a third-party administrator that acts as a service provider to the adviser provided that: (1) the administrator acts as a service provider in maintaining, preparing, organizing and/or updating the adviser's records for the adviser's ongoing use in its business, and does not merely provide long-term storage of the records; and (2) upon request of the SEC staff, the records are produced promptly for the staff at the appropriate office of the adviser or an office of the administrator. The SEC staff noted the position that it took in *National Regulatory Services, Inc.*, that maintenance of the records in the offices of the sponsor would not comply with the Appropriate Office Requirement and stated that its position "is superseded in so far as it is inconsistent with this response." It is unclear, however, whether the subsequent ABA letter supplants the NRS letter with respect to recordkeeping compliance of wrap fee programs.

pecially in multi-disciplinary accounts), responsibility for calculating performance and keeping records, and a range of specific methodological issues, including under the CFA Institute's Global Investment Performance Standards ("GIPS").

1. Use of Gross Numbers by Wrap Sponsors

Many wrap sponsors disseminate to customers and prospective customers performance information on participating portfolio managers that shows performance on a gross basis (that is, before the deduction of wrap fees and other account expenses). The use of gross numbers in advertising has been a matter of considerable concern to the SEC staff, and is permitted only in limited circumstances. In *Clover Capital Management, Inc.* (October 28, 1986), the SEC's Division of Investment Management stated that Advisers Act Rule 206(4)-1(a)(5) prohibits an advertisement of model or actual performance results that does not reflect the deduction of advisory fees, brokerage and other commissions, and any other expenses that a customer would have paid or actually paid. In *Investment Company Institute* (September 23, 1988), however, the SEC staff relaxed its position and said that it would not recommend enforcement action if an investment adviser used gross performance in one-on-one presentations to wealthy prospective clients and consultants,¹⁷ provided that the investment adviser furnishes at the same time to each prospective client or consultant in writing:

- Disclosure that the performance figures do not reflect the deduction of investment advisory fees;
- Disclosure that the client's return will be reduced by the investment advisory fees and any other expenses the client may incur in the management of its investment advisory account;
- Disclosure that the investment advisory fees are described in Part II of the investment adviser's Form ADV; and
- A representative example (in the form of a table, chart, graph, or narrative) which shows the effect that an investment advisory fee, compounded over a period of years, could have on the total value of a client's portfolio.

While previously many sponsors distributed gross performance information in reliance on the *Investment Company Institute* no-action letter, increasingly firms have moved to showing net-of-fee returns after deduction of the highest marginal wrap fees, as is permitted by the GIPS.

2. Inclusion of Non-Wrap Accounts in Composites with Wrap Accounts & Model Fee Issues

Non-wrap accounts managed by a portfolio manager are commonly included in a composite with wrap accounts managed by the portfolio manager. This is especially the case where the portfolio manager in question manages only a few wrap fee accounts or has a limited history of participating in wrap fee programs. Although performance of these blended composites is required to be shown on a "net" basis

¹⁷ For purposes of *Investment Company Institute*, wealthy prospective clients include wealthy individuals, pension funds, universities and other institutions that have sufficient assets to justify the investment adviser incurring the costs of a one-on-one presentation. As to what constitutes a one-on-one presentation, *Investment Company Institute* seems to permit a presentation to be made to more than one individual. To be "one-on-one," a presentation must be of a "private and confidential nature" and made in a setting that affords each prospective client with "the opportunity to discuss with the adviser the types of fees that the client might pay."

(unless it is to be presented only in one-on-one presentations), it raises the issue of what fees should be “netted” from the non-wrap accounts. Since fees for traditional advisory accounts tend to be lower than wrap fees, the deduction of actual investment advisory fees from the non-wrap accounts could distort the performance. In *Association for Investment Management and Research* (December 18, 1996), the SEC staff concluded that an adviser may advertise the composite performance of both wrap and non-wrap fee client accounts after deducting a model wrap fee equal to the highest fee charged to any wrap or non-wrap fee client.

3. CFA Guidance Statement on Wrap Fee Performance

In 2005, the CFA Institute adopted a *Guidance Statement on Wrap Fee Performance* <<http://www.cfainstitute.org/centre/codes/gips/pdf/WrapFeeSMAGSBoardApprovedFINAL.pdf>>. The Guidance Statement provided guidance and clarification – through commentary and illustrations – to investment management firms on the manner in which to apply the provisions of GIPS to wrap fee portfolios. This Guidance Statement does not apply to managers that provide model portfolios to sponsors or to overlays managers that do not have investment discretion. Several of the proposals were controversial and received significant comment.

This Guidance Statement frames several different issues surrounding the calculation and presentation of wrap fee performance returns in compliance with GIPS. Some of the more significant issues addressed in the proposed Guidance Statement include:

4. Assets Under Management

One area of particular uncertainty in the model SMA program is regarding the issue of which entity is able to claim the assets of a model SMA program as assets “under management.” Section 203A(a)(2) of the Advisers Act defines assets under management as “the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services.” Instruction 5.b(3) to Part 1A of Form ADV states that this definition is met if the registrant has: (1) discretionary authority; or (2) no discretionary authority, but ongoing responsibility to make recommendations for the program. See *Credit Agricole Asset Management Alternative Investments, Inc.* (August 7, 2006). In a model SMA program, the model manager is providing models to a broker-dealer sponsor and either the sponsor or an overlay manager are making the investment decisions. Accordingly, the model manager may not have an ongoing involvement in the implementation of the model. In this instance, no entity may be exercising investment discretion in the traditional sense and no one entity may have the sole ongoing responsibility to make recommendations for the account. Since no entity’s role may exactly match the definition of exercising investment discretion, it may be unclear which of the entities may claim the assets under management for purposes of reporting this figure on Part 2 of the Form ADV. In its recent proposal to amend Form ADV, the SEC proposed allowing advisers to calculate assets under management using methods that differ from the method used to make the calculation required in Part 1 of the Form ADV, provided that the adviser maintains records describing the methods used and uses an “as of” date no more than three months before the brochure was last updated in response to the relevant Item.

a. Portfolio Managers are Ultimately Responsible for Performance Calculations

The CFA Institute seeks to make clear that the investment management firm is ultimately responsible for its claims of compliance and is responsible for reporting compliant information to prospective clients. “The firm must be sure that the performance provided by the wrap fee sponsor meets the requirements of the Standards or the firm must maintain separate/duplicate records at the firm level (which meet the requirements of the Standards).” According to the *Guidance Statement*, “a firm claiming compliance with

the Standards is responsible for its claim of compliance and is responsible, as well, for reporting information in compliance with the Standards to prospective clients. The firm must be sure that the performance provided by the wrap fee/SMA sponsor can be used by the firm to satisfy the requirements of GIPS standards or the firm must maintain separate/duplicate records at the firm level (which meet the requirements of the standards). Further, if the firm undertakes the verification process, the wrap fee/SMA portfolios are subject to the same level of testing as all other portfolios within the firm.”

b. “Firm” Concept

The CFA Institute focuses considerable attention on the “firm” concept in the wrap program context, and acknowledges that the decision regarding whether to include or exclude the wrap fee division in the “firm” definition will have a significant impact on the performance that the firm is permitted to present to prospective wrap fee sponsors and clients. In this context, the CFA Institute admonishes that “the firm must maintain or have access to supporting records for all portfolios included in a composite. The lack of records is not a reason to classify these portfolios as non-discretionary.”

c. Responsibility for Underlying Records

The CFA Institute also focuses on the need of portfolio managers to either have access to underlying performance computations by the sponsor – an issue of some concern on the part of portfolio managers to date – or to undertake what may be costly and burdensome “shadow accounting” on their own. Since some firms may not maintain or have access to the necessary data to substantiate portfolio performance, the Guidance Statement gives firms three options to satisfy the requirements of the GIPS standards: (1) place reliance on the performance calculated and reported by the wrap fee/SMA sponsor either on the aggregate level or the underlying wrap fee/SMA portfolio level; (2) utilize “shadow accounting” to track the wrap fee/SMA portfolios on their in-house performance measurement systems, or; (3) exclude the wrap fee/SMA division from the definition of the firm.

d. Net-of-Fee Presentations

The new guidelines require that, when firms present wrap fee performance, they present that performance net of the entire wrap fee. “It is up to the firm to determine the appropriate highest wrap fee to deduct. This highest wrap fee should be obtained from the prospective wrap fee/SMA sponsor and should be comparable for the investment style or strategy of the wrap fee/SMA composite. ‘Pure’ gross-of-fees performance (i.e., gross of all expenses, including trading expenses) is only permitted as supplemental information to a compliant presentation. It is recognized that when starting with the gross-of-fees, non-wrap fee/SMA composite history, the gross-of-fees performance already reflects the deduction of actual trading expenses incurred. By then reducing the composite performance by the highest total wrap fee, which includes a portion attributable to trading expenses, performance will reflect the deduction of trading expenses two times (actual and portion of highest wrap fee). If the firm can identify the portion of the highest total wrap fee attributable to trading expenses, the firm may first calculate performance reflecting the deduction of both actual trading expenses and the highest wrap fee; the firm may then increase this result by the identifiable portion of the wrap fee attributable to trading expenses in order to compute a net-of-fees return.”

G. Cash Solicitation Fees

The SEC clarified in the *Schedule H Adopting Release* that the allocation of a wrap fee between a sponsor and a portfolio manager does not involve the payment of a cash solicitation fee subject to Rule 206(4)-3 under the Advisers Act. Rule 206(4)-3 continues to apply, however, in those instances where a referral

fee is paid outside of the wrap fee arrangement, *e.g.*, where a wrap program sponsor pays third-party solicitors a separate fee for referring customers.

If referral fees are involved, adequate written disclosure in Form ADV and the Schedule H brochure is required. In addition, under Rule 206(4)-3, a registered investment adviser may pay a cash fee for solicitation services only where the fee is paid pursuant to a written agreement between the adviser and the solicitor. Where the solicitor is not affiliated with the adviser, the solicitor must also furnish a separate disclosure document to the customer which specifies (i) the nature of the relationship between the solicitor and the investment adviser and (ii) the terms of the compensation arrangement.

In *Dechert Price & Rhodes* (December 4, 1990), the SEC's Division of Investment Management emphasized that Rule 206(4)-3 treats equally an investment adviser acting as a solicitor and "any other person acting as a solicitor." In addition, the Division made it clear that, where the (unaffiliated) solicitor is an investment adviser, the information required by the Rule to be disclosed by the solicitor in a separate disclosure document may not be provided in the adviser's brochure, but, rather, must be provided in a separate document. The Division stated that the purpose of the separate disclosure is "to ensure that the customer's attention will be directed to the fact that a cash referral fee is being paid."

H. SEC Examination Focus

The following are issues commonly focused on in SEC examinations of wrap programs:

- Rule 3a-4 compliance;
- Manager replacement or suspension;
- Whether the sponsor requires managers to make payments, provide services or throw business to the sponsor to participate;
- Sponsor's due diligence of manager performance data and background;
- Execution quality;
- Manager executions through other brokers;
- Timeliness of manager allocations;
- Trade errors and resolution;
- Complaints;
- Confirmation of trades;
- Prompt investment of available cash;
- Approach to investment restrictions;
- Use of other brokers; and
- Specific 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 inception then repurchasing them shortly afterwards;
 - Dispersion in account performance

In March 2007, Robert Plaze, associate director of the SEC Division of Investment Management announced a forthcoming sweep focusing on wrap fee programs, which would concentrate on the following areas:

- Best execution;
- Suitability;
- Fee calculations;
- Representations and disclosure, and;
- Rule 3a-4 compliance.

IM Insight, *SEC Plans New Wrap Fee Sweep*, April 2, 2007. Although no national sweep was actually launched, these areas are indicative of the SEC staff's intended areas of examination focus.

III. Mutual Fund Asset Allocation Programs

A. Mutual fund asset allocation programs are among the first SMA programs to be introduced and were the focus of many SEC staff no-action letters preliminary to the adoption of Rule 3a-4, discussed above. Although the SEC has stated that mutual fund asset allocation programs are not wrap fee programs for purposes of Schedule H and Advisers Act Rule 204-3, the SEC has permitted advisers to include information about a mutual fund asset allocation program in their wrap fee brochure and send the same brochure to wrap fee customers as well as mutual fund asset allocation customers. See *Pershing Division of Donaldson, Lufkin & Jenrette Securities Corp.* (September 15, 1994).

B. Of the few enforcement cases involving SMA programs, the largest share has come in the area of mutual fund asset allocation programs. The SEC has taken the following enforcement actions in this area in the past several years:

1. New England Securities Corp. In 2006, New England Securities Corp. (“NES”) settled an enforcement action for with the SEC for its alleged failure to rebalance client portfolios when its marketing materials stated that it would provide clients with notice if their asset allocation varied by a specified amount from client-chosen allocation and then would rebalance the portfolio on request. Advisers Act Release No. 2489 (February 21, 2006). According to the enforcement order, NES experienced difficulties in providing these services due to a lack of internal controls and appropriate software to execute these services. This difficulty persisted for several years, despite the fact that NES had notice of the problem and had made several attempts at rectification until NES ultimately closed the program to new investment, self-reported the issue to the SEC and took steps to remediate the problem. The enforcement order stated that NES’ conduct constituted a willful violation of the antifraud provision, although it noted NES’ remediation steps, which included payment of losses and reduced returns resulting from the failure to rebalance as well as rebating 12b-1 fees and sales commissions as factors in mitigating the penalties.

2. Bank of America Investment Services and Columbia Management Advisors. In May 2008, Banc of America Investment Services (“BAIS”) and its affiliate Columbia Management Advisors, as successor to Bank of America Capital Management (“BACM”), settled an enforcement action with the SEC relating to conflicts arising from recommendations of shares of affiliated investment companies for its mutual fund discretionary wrap fee program. Advisers Act Release No. 2733, May 1, 2008. According to the enforcement order, BACM, as the investment adviser to the wrap fee program, was to select funds for investment according to the criteria that it disclosed to customers in its program disclosure documents. These documents stated: (1) that BACM would use a “continuous, disciplined screening” process to identify and review funds; (2) that it would only consider funds and fund managers with established track records; (3) that it would use the same criteria for selection of affiliated and unaffiliated funds, and; (4) the fact that a fund pays a fee to BAIS or any affiliate is not considered a factor in the selection of the fund. According to the enforcement order, BACM, recommended two affiliated funds without subjecting them to the level of review described in its disclosure documents. As a result, the SEC found that the respondents selected funds that were inconsistent with the disclosed criteria and failed to disclose a material conflict of interest arising from the selection of affiliated funds, thereby violating several provisions of the Advisers Act.

IV. Model Portfolio Arrangements

A. The following outlines significant regulatory issues associated with “model portfolio” programs that have emerged over the past few years. Model account programs are the fastest growing segment of the SMA industry in recent years as many SMAs have been converted into a model-based structure. This outline describes these issues both from the perspective of firms that sponsor and implement trading decisions in these programs (“Sponsors”) and the investment advisers that may provide the model portfolios used in these programs (“Model Managers”).

B. Overview of Model Portfolio Arrangements

1. Model portfolio arrangements represent a bifurcation of the traditional investment advisory relationship into two components: research and portfolio construction (provided by the Model Managers) and individualized client advice (provided by the Sponsors). Consistent with this division of labor, the Model Managers of model portfolios usually are “big name” firms with significant marketing presence or smaller, niche players that specialize in a particular investment strategy (and have a compelling performance record). The Sponsors, in contrast, operate as the distribution platform for the Model Manager by using the model portfolios to provide investment advice (often through wrap fee and separate account programs) to their clients.

2. The Sponsor’s role may be an ostensibly passive one when it comes to asset management. Often the Sponsor will do little more than implement automatically the buys and sells called for by a Model Manager’s portfolio changes. At the very least, a Sponsor should ensure that trades are consistent with client-imposed restrictions and, where clients’ assets are invested using multiple model portfolios, monitor trades for wash sale and concentration issues. Some Sponsors provide additional layers of investment advice, including asset allocation advice and tax overlay services.

3. From the Model Managers’ perspective, model portfolio arrangements generate revenue opportunities without the need to develop the trading or other infrastructure or assume the responsibilities (and liabilities) associated with managing individual client accounts. The Sponsors benefit from enhanced visibility due to the Model Manager’s expertise and the ability to offer investment strategies for which they may not themselves have sufficient expertise (or a performance track record).

C. Presence of Advisory Relationship between the Model Manager and the Sponsor’s Clients

1. Given the division of responsibilities between Model Managers and Sponsors, one of the primary questions in structuring model portfolio arrangements is whether the Model Manager has – or should be viewed as having – an advisory relationship with the Sponsor’s clients. The SEC staff has not specifically addressed the question of whether the Model Manager should be viewed as having an advisory relationship with the Sponsor’s clients for purposes of model portfolio arrangements.

2. Generally, however, the Model Manager is viewed as providing advice to the Sponsor – not to the clients of the Sponsor.

a. This conclusion flows, in the first instance, from the structure of model portfolio arrangements and the fact that it is the Sponsor, not the Model Manager, that enters into an advisory contract with the client and that ultimately is responsible for determining the securities to be bought or sold for each particular client account. The Model Managers merely create and disseminate model portfolios to the Sponsor. The model portfolios and the recommendation implicit in those model portfolios are not tailored to the specific needs or circumstances of any particular client. The Model Manager typically does not know the identity or any other specific information about the Sponsor’s clients and typically is not involved in the implementation of the model portfolios for particular client accounts. Moreover, while it is understood that the Sponsors will invest their client assets in accordance with the recommendations implicit in the model portfolios, Sponsors are not required to do so. The Sponsor may deviate from the recommendations of the Model Manager for any reason, including to accommodate individual client investment guidelines or restrictions, cash flow, tax or other needs specific to particular clients.

b. Given the fact that the Model Manager does not know the end client or otherwise make investment decisions based on the specific needs or circumstances of that client, it may be difficult to argue that there is an actual advisory relationship between the Model Manager and the end client. Indeed, this is not the typical type of relationship of “trust and confidence” characteristic of a fidu-

ciary relationship between an investment adviser and its client. However, depending on the circumstances, a client could be deemed a third party beneficiary of the agreement between the Sponsor and the Model Manager and thereby obtain rights and remedies vis-à-vis the Model Manager.¹⁸

c. Several no-action letters under Rule 205-3 of the Advisers Act (relating to performance-based fees) stand for the proposition that an adviser that provides impersonal advice to an intermediary, which in turn passes the advice to its clients, does not have an advisory relationship with the intermediary's clients.¹⁹ For example, a no-action letter issued to *Kempner Capital Management, Inc.* involved the provision of investment advice to the trust department of a bank, which held various client accounts in a fiduciary capacity. The SEC staff agreed that because Kempner's advice was provided to the bank and was "not tailored to individual accounts or based on the individual circumstances of those accounts," Kempner could count the bank, and not the bank's underlying clients, as its client for purposes of Rule 205-3 of the Advisers Act. Similarly, in the *Copeland Financial Services, Inc.* no-action letter, the SEC staff concluded that sub-advisers providing Copeland Financial Services with signals as to when to transfer assets among investment options in a variable annuity product were not providing advice to the individual participants because "the sub-advisers' transfer recommendations are applicable generally to all the individual participants and are not specifically tailored to each individual client."

d. For purposes of the brochure delivery requirements of Rule 204-3 under the Advisers Act, the SEC takes the position that a contractual relationship exists between a client participating in a wrap fee program and the portfolio Sponsor, even in the absence of a written contract.²⁰ As a result, both the Model Manager and the portfolio Sponsors are viewed as having an advisory relationship with the wrap fee clients. However, that no-action letter was based on the wrap fee programs existing at that time and implicitly assumed that the portfolio Sponsors (not the Model Managers) were exercising discretionary authority and managing accounts based on each client's individual financial circumstances and investment objectives – functions that are performed by the Sponsor in a model portfolio arrangement.²¹

e. As noted above, the facts of any particular model portfolio arrangement will be determinative of whether there is an advisory relationship between the Model Manager and the client. For example, if the involvement of the Model Managers were prominently highlighted, such that a client could be said to participate in a model portfolio program for the sole purpose of gaining access to the management expertise of a particular Model Manager, there arguably may be a basis for implying the

¹⁸ See 4 *Corbin on Contracts* §§ 774-77, 779J (1951).

¹⁹ See *Lazard Freres Asset Management (February 12, 1996)*; *Kempner Capital Management, Inc.* (available Dec. 7, 1987); see also, *Copeland Financial Services, Inc.* (available Sept. 21, 1992). This issue arises in the context of Rule 205-3 under the Advisers Act because a performance-based fee may only be charged to "qualified clients" – that is, clients that have at least \$750,000 under management with the investment adviser or who have a net worth in excess of \$1,500,000. If the advisers who sought relief in these no-action letters were viewed as having an advisory relationship with the clients of the intermediaries (instead of the intermediaries themselves), they would be unable to charge a performance-based fee.

²⁰ *National Regulatory Services, Inc.* (available Dec. 2, 1992).

²¹ In two recent enforcement actions, the SEC has advanced the view that an entity is exercising investment discretion for purposes of the Advisers Act when it sends trading instructions, pursuant to a customer's authorization, to a broker-dealer to execute trades based on these instructions and has "personalized communications...regarding investment advice." *SEC v. Terry's Tips, Inc., et al*, Civil Action Number 2:05-CV-188 (USDC D.Vt.); *In the Matter of Weiss Research, Inc.*, Advisers Act Release No. 2525 (June 22, 2006).

existence of an advisory relationship. For this reason, among others, it is important that the Model Manager-Sponsor agreement and the Sponsor-client agreement and collateral documents be clear on the respective roles played by the Model Manager and the Sponsor and the relationship each has (or does not have) to the client.

3. The Sponsor-client agreements – and other collateral documents – should similarly be clear on the respective roles played by the Model Manager and the Sponsor and the relationship each has (or does not have) to the client.

D. Form ADV Delivery and Disclosure Obligations

1. There technically is no obligation on the part of a Model Manager to deliver its Form ADV to the Sponsor's clients. However, both the Sponsor and the Model Manager should disclose the services they provide in connection with model portfolios in Part II of their Form ADV (or substitute brochure) or, if clients access model portfolios through a wrap fee program, the wrap fee Model Manager's Schedule H (the Form ADV and the Schedule H collectively are referred to as the "Brochure").

2. Brochure Delivery

a. As discussed above, the Sponsor has an advisory relationship with the client and is, therefore, required to deliver its Brochure in the manner required under Rule 204-3 of the Advisers Act. The Model Manager, in contrast, is not required to deliver its Brochure to the Sponsor's clients because, as discussed above, there is no advisory relationship between the Model Manager and the Sponsor's clients. Even if there were an advisory relationship, any advice provided by the Model Manager would be impersonal advice for which Brochure delivery is not required. Rule 204-3(b)(2) of the Advisers Act exempts an investment adviser from Brochure delivery requirements in any circumstance in which the investment adviser is providing "impersonal advisory services." Impersonal advisory services are defined to mean "the provision of investment advisory services (i) by means of written material or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts; (ii) through the issuance of statistical information containing no expression or opinion as to the investment merits of a particular security; or (iii) any combination of the foregoing."

b. Although it is not required, in practice Sponsors often provide their clients with the Model Managers' brochures for informational purposes.

(i) From the Sponsor's perspective, delivery of these Brochures is useful to highlight the involvement of the Model Manager, particularly where the Model Manager has name recognition.

(ii) Moreover, delivery of Model Managers' Brochures may inform the Sponsor's clients of various conflicts raised by the Model Manager's business practices and relationships, including in the area of trading (discussed below).

c. However, Model Managers carefully should consider whether to permit their Brochures to be provided to Sponsor's clients. Delivery of a Model Manager's Brochure may create the mistaken impression that the Model Manager is providing advice to clients and, more cynically, may be used by the Sponsor to distance itself from ultimate responsibility for the investment advice provided to its clients.

d. From the Model Manager's perspective, delivery of its Brochure does provide an opportunity to communicate directly with the client, instead of operating through the Sponsor, and shape the client's understanding and expectation with regard to the services provided by the Model Manager (and related conflicts). Thus, some Model Managers do permit their Brochure to be delivered; however, they may choose to include a prominent statement that the Brochure is provided only for infor-

mational purposes. Following is sample language used for this purpose: “This brochure is made available to clients of Sponsor for informational purposes only. Model Manager does not act as investment adviser to clients of Sponsor, but provides Sponsor will certain information and model portfolios that Sponsor may consider when managing client accounts.”

3. Disclosure Issues. Even though only the Sponsors are required to deliver their Brochure, both Sponsors and Model Managers should update their Form ADV disclosure to describe the services and certain conflicts of interest associated with model portfolio arrangements.

E. Trading Sequencing Issues

1. One of the most controversial aspects of model portfolio arrangements is the timing of recommendations provided by the Model Managers and the corresponding impact on the trading of client accounts – both accounts managed by the Sponsor and the Model Manager’s discretionary accounts.

a. Trade sequencing issues arise because Model Managers are often chosen to provide model portfolios for strategies they already manage on behalf of their discretionary client accounts.

b. In this context, if a Model Manager disseminates a model portfolio (or any updates thereto) at the same time it implements the recommendations for its own discretionary client accounts, it might jeopardize trading opportunities for its discretionary clients. This might occur because of the market impact of the Sponsor’s trading.

c. Conversely, if a Model Manager disseminates model portfolios only after completing trades for its discretionary clients, the Sponsor’s clients may receive prices that are less favorable than those obtained by the Model Manager’s clients.

d. Although this sequencing issue is more pronounced in the case of large orders or thinly traded securities, it is nevertheless a matter of great importance in structuring model portfolio arrangements.

2. Model Managers and Sponsors attempt to deal with sequencing issues in different ways

a. Contemporaneous Updating

(i) From sales and other perspectives, it is important to Sponsors that their clients receive the same benefits as clients who receive investment advice directly from the Model Manager. As a result, Sponsors typically insist that they are notified of changes or updates to the model portfolios contemporaneously with the Model Manager’s other clients.

(ii) Some Sponsors attempt to further ameliorate sequencing issues by delegating the trading function back to the Model Manager. Under this structure, the Sponsors remain responsible for determining whether to accept or reject the Model Manager’s recommendations for each client account. The Sponsor then forwards trading instructions to the Model Manager, which is responsible for placing the trades with brokers for execution.

(a) By centralizing the trading function at the Model Manager, the Sponsor’s clients may be able to be “bunched” or aggregated or otherwise trade along side the Model Manager’s discretionary clients.

(b) Opportunities for bunching may be limited, however, if trading instructions are not communicated by the Sponsor to the Model Manager in a timely manner such that the Model Manager could include the Sponsor's trades in the bunched trade. As a result, even where taking this approach, some Sponsors have modified bunching disclosure to put clients on notice that if the Sponsor is not able to transmit the order to the Model Manager in a timely manner, trades for the Sponsor's clients will be executed after those of the Model Manager.

(c) This type of arrangement suffers from an additional drawback – namely, that the Model Manager's participation in trading brings it closer to having a relationship with the Sponsor's clients and increases the costs and possible liability to the Model Manager of these arrangements.

b. Delayed Updating

(i) Model Managers typically prefer to address the sequencing issue by delaying the dissemination of changes or updates to the model portfolios (generally or for particular holdings) for a reasonable amount of time necessary to complete any pending transactions for discretionary clients. This reflects the view that Model Managers owe a higher duty to their discretionary clients than to clients receiving only impersonal advice, including Sponsors of model portfolio programs).²²

(ii) Sponsors may, however, require that a Model Manager at least agree generally to treat them on a fair and equitable basis relative to other similarly situated clients for which the Model Manager provides recommendations but is not given investment or trading discretion.

3. Other Approaches

a. Other possibilities include a Model Manager adopting a rotational approach, as is sometimes done where an investment adviser manages accounts for which it is free to choose brokers, wrap accounts where the choice of brokers is constrained, and client-directed accounts where the client has directed the use of particular brokers.

F. Performance Presentation Issues

1. Appropriateness of Sponsor's Use of Model Manager's Performance Record

a. Sponsors typically choose a Model Manager because of the Model Manager's track record in managing accounts. Being able to use that track record is often critical to being able to sell the Sponsor's program and the model portfolio provided by the Model Manager. At the same time, a Sponsor's use of the Model Manager's track record raises several issues. Specifically:

(i) A Sponsor's use of a Model Manager's track record may suggest to the Sponsor's clients that the Model Manager is directly advising their accounts.

(ii) The Model Manager's track record often will not be representative of model portfolio program accounts because, among other things:

²² We have not extensively researched the legal foundation for this view, although we note that the Advisers Act loosens various regulatory requirements for clients receiving only impersonal advisory services. *See, e.g.*, Advisers Act Rules 204-3(b)(2) & 206(4)-3.

(a) Model portfolio program accounts are managed by the Sponsor (which interposes its own judgment, criteria and practices on the management of client accounts) not the Model Manager; and

(b) Often there are significant differences in the “translation” of the Model Manager’s approach to the context of a model portfolio program.

(iii) Nonetheless, given the practical importance of showing the Model Manager’s track record, it is appropriate for a Sponsor to use the Model Manager’s historical performance data or performance information to show the basis on which the Sponsor engaged the Model Manager.

(iv) The Model Manager’s historical performance data should not, however, be combined or linked with the Sponsor’s performance in managing program accounts.

(v) Information given to the Sponsor’s clients concerning the Model Manager’s track record should also make clear that (i) such information is provided to show the basis on which Sponsor has engaged the Model Manager; (ii) the Sponsor, not the Model Manager, exercises discretion over program accounts; and (iii) as a result, the performance of the Sponsor in managing program accounts will likely deviate from the past performance of the Model Manager.

2. Use of Model Performance

a. In addition to whether a Sponsor may use the Model Manager’s track record is the issue of whether that track record may take the form of model account performance. Any use of model performance must, of course, comply with the SEC staff’s guidance, including in the *Clover Capital* no-action letter and its progeny.²³

b. In this regard, any model account performance should be accompanied by clear disclosure to the effect, if true, that actual performance of accounts managed by the Sponsor or Model Manager (as the case may be) was materially different than the model account performance.

G. Applicability of Research Analyst Rules

1. Depending on the specific contents of a model portfolio presentation, the presentation may raise issues under SRO rules governing research analysts conflicts and accompanying SEC Regulation AC, to the extent applicable to the Model Manager and its affiliates.

2. The threshold question, of course, is whether these sorts of presentations are “research reports” under the NASD Rule 2711 and NYSE Rule 472 and SEC Regulation AC. Although the

²³ Under *Clover Capital*, the following could be viewed as false or misleading in connection with model account performance: (i) Failing to disclose the effect of material market or economic conditions; (ii) failing, except under certain circumstances, to reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid; (iii) failing to disclose whether (and to what extent) the results reflect reinvestment of dividends and other earnings; (iv) suggesting or making claims about the potential for profit without also disclosing the possibility of loss; (v) comparing results to an index without disclosing material factors relevant to the comparison; (vi) failing to disclose material conditions, objectives or investment strategies used to obtain the performance; (vii) failing to disclose prominently the inherent limitations in model results; (viii) failing to disclose material changes in the conditions, objectives or strategies of the model portfolio during the period and the effect of the changes; (ix) failing to disclose that some of the securities or strategies in the model do not relate (or relate only partly) to services offered by the adviser; and (x) failing to disclose, if true, that the adviser’s clients actually had results materially different from the model results.

exact contents may vary, typically a model portfolio presentation will simply list information needed to communicate the initial model portfolio and subsequent changes – namely, the securities in the model portfolio and, as to each security, the quantity (shares/units or dollar amounts) of the security and the percentage of the portfolio it represents. The presentation may also show position changes from the last report (*i.e.*, purchases and sales). The Sponsor uses the model portfolio presentation to manage its client accounts and usually is not free to disseminate the model portfolio presentation except on a limited basis to current or prospective clients. As discussed below, very good arguments support the position that model portfolio presentations are not “research reports” or that they otherwise fall within (or may be likened to) the types of communications that regulators have stated they would not treat as research reports.

3. With some immaterial differences, the research rules define “research report” to mean a written or electronic communication that both “includes an analysis” of a security and “provides information reasonably sufficient upon which to base an investment decision.”²⁴ A model portfolio presentation that only identifies the constituent securities and changes from the prior period should not be viewed as including any “analysis,” even though the presentation should be viewed as recommending those securities. Whether a model portfolio presentation “provides information reasonably sufficient upon which to base an investment decision” is less clear if one views the Model Manager’s recommendations implicit in the model as constituting the sufficient basis for the Sponsor’s investment decisions. However, a communication needs to include both analysis and information on which to base an investment decision to be a research report.

4. Even if model portfolio presentations were viewed as fitting within the definition of research report, such presentations may still fall within the types of communications that regulators have stated they would not treat as research reports. While none of these excluded communications specifically address (or were intended to address) model portfolio presentations, two of them may be loosely applicable or at least analogous.

a. First, the SEC and the SROs have each stated that listings of prior ratings or recommendations would not be treated as research reports even if they include a recommendation, so long as they do not include any analysis or narrative discussion on individual companies.²⁵ Correspondingly, a listing of securities constituting a model portfolio might not be viewed as a research report so long as the listing is not accompanied by any analysis or narrative discussion concerning the constituent securities.

b. Second, a model portfolio presentation to a Sponsor may be akin to “[a]n analysis prepared for a specific person or a limited group of fewer than fifteen persons,” which the SEC has deemed not to be a research report at least for purposes of Regulation AC.²⁶ The presentation is pre-

²⁴ See SEC Regulation AC; NASD Rule 2711(a)(9); NYSE Rule 472.10(2); *see also* the recent [Wall Street Settlement Undertakings, Addendum A](#) (“Settlement Undertakings”) (similarly defining “research report”) (“Settlement Undertakings”). The NYSE and the NASD rules currently provide that a communication must include a recommendation to be a research report. The NYSE and the NASD have proposed to amend the definition of “research report” to delete this element – so as to bring the definition in line with the Sarbanes-Oxley Act of 2002 and SEC Regulation AC. *See* [NASD and NYSE Rulemaking: Proposed Rule Changes Relating to Exchange Rules 344, 345A, 351 and 472 and the National Association of Securities Dealers, Inc., Exchange Act Release No. 47110 \(December 22, 2002\)](#).

²⁵ *See* [Securities Act Release 8193 \(February 20, 2003\)](#) (Regulation AC adopting release); *See* [NYSE Information Memorandum 02-26 \(June 26, 2002\)](#) (attaching the NYSE and NASD’s Joint Memorandum interpreting their respective research rules (“Joint Memorandum”)); [NASD Notice to Members 02-30 \(June 26, 2002\)](#); *see also* Settlement Undertakings.

²⁶ *See* [Securities Act Release 8193 \(February 20, 2003\)](#). The NYSE and NASD’s Joint Memorandum also excludes from research report any “analysis prepared by a registered representative for a specific customer’s account.” The

pared for the Sponsor within the framework of the model portfolio program – in which the model portfolio and the presentation are based on specifications set by the Sponsor (the Model Manager’s client) and where the Sponsor generally will not re-disseminate the presentation.

5. The positions that model portfolio presentations should not be treated as research reports is supported by the fact that these kinds of presentations were not – and are not – the focus of regulatory concerns over research analyst conflicts. Rather, these presentations are essentially recommendations by a non-discretionary investment adviser to its client, which (except as noted above) are themselves not carved out from being research reports.²⁷

Settlement Undertakings expands the scope of this exclusion to “an analysis prepared for a current or prospective investing customer or group of current or prospective investing customers,” but requires that the preparing representative not be “principally engaged in the preparation or publication of research reports.”

²⁷ The SEC did, however, exclude certain communications by discretionary investment advisers to clients. Specifically, the SEC has stated that “[p]eriodic reports or other communications prepared for ... discretionary investment account clients discussing past performance or the basis for previously made discretionary investment decisions” would not be deemed research reports under Regulation AC. See [Securities Act Release 8193 \(February 20, 2003\)](#); see also Settlement Undertakings.