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Regulatory Scrutiny on Wrap Fee Programs – Not Such a Wrapper's Delight

By Michael Abbriano

Since the first wrap fee program was launched in 1975, their popularity has grown exponentially, with more than $3.5 trillion in assets under management as of 2013.[1] In its 2014 Examination Priorities, the SEC's Office of Compliance Inspections and Examinations ("OCIE") announced an initiative focused on wrap fee programs, and wrap fee programs have been referenced specifically in OCIE's Examination Priorities in each subsequent year.

Because wrap fee programs are primarily marketed to retail investors (including to individuals who are investing retirement assets) and have the potential to raise numerous potential conflicts of interest, these programs historically have been subject to significant regulatory scrutiny. After several years of focusing more on private funds following the enactment of the Dodd-Frank Act in 2010, regulatory scrutiny on wrap fee programs has re-intensified. This article will provide an overview of how wrap fee programs operate as well as practical guidance for advisers to address certain aspects of wrap fee programs that have been a focus of the SEC in recent years.

Overview of Wrap Fee Programs

Rule 204-3(g)(4) under the Investment Advisers Act of 1940 (the "Advisers Act") defines a wrap fee program as "an advisory program under which a 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." Typically, clients in a wrap fee program are charged a single fee based on a percentage of the client's assets under management, which covers the cost of all services provided within the program, including investment advice and trade execution. This is in contrast to traditional brokerage and advisory relationships in which the client pays for all transaction costs, such as brokerage commissions.

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1. www.gipsstandards.org

Wrap fee programs have one or more advisers who act as sponsors. Program sponsors are responsible for administering the program, which includes providing or selecting the service providers that execute trades and maintain custody of client assets. In addition, program sponsors provide advisory services, including recommending particular wrap fee programs to clients and selecting the investment options (e.g., mutual funds, sub-advisers, etc.) available to clients through each wrap fee program.

The day-to-day management of client accounts can be handled by the program sponsor or delegated to one or more third-party portfolio managers (also referred to as sub-advisers), who may be affiliated or unaffiliated with the program sponsor. Sub-advisers provide advisory services only and do not have any administrative responsibility with respect to the wrap fee programs in which they participate. The specific services provided by the adviser will differ depending on the nature of the program(s) in which they participate.

Common Types of Wrap Fee Programs

Asset Allocation

In an asset allocation program, the portfolio manager recommends an asset allocation model to the client, which indicates how the client should allocate their investments across various asset classes (e.g., equities, fixed income, real assets, etc.). The portfolio manager also recommends the investments (e.g., mutual funds, ETFs, etc.) that will be used to implement the allocation and monitors the portfolio on an ongoing basis for consistency with the target allocation. These programs may be discretionary or non-discretionary.

Asset allocation programs tend to be strategic in nature and generally are not designed to take advantage of short-term market conditions on a tactical basis. Trading in these programs most commonly occurs when there are contributions or withdrawals as well as to rebalance the portfolio when it deviates from the recommended allocation (e.g., due to market movement) or when there are adjustments to the recommended allocation.

Separately Managed Accounts ("SMAs")

In an SMA program, the program sponsor recommends or selects a third-party investment adviser (that may or may not be an affiliate of the program sponsor) to manage a client's account on a discretionary basis. SMA programs offer clients the ability to invest directly with an adviser that may otherwise only manage money for institutional clients, such as mutual funds. SMA programs also may offer more tactical investment strategies than asset allocation programs because the portfolio manager is actively managing the account.

Rep as Portfolio Manager ("RPM") / Advisor as Portfolio Manager ("APM")

RPM or APM programs are similar to SMA programs except that they are managed by a representative (or team of representatives) of the program sponsor rather than a third-party adviser and may be offered on a discretionary or non-discretionary basis.

Unified Managed Accounts ("UMAs")

UMAs are designed to allow clients to consolidate their managed account assets into a single account. UMAs typically have an "overlay" manager who coordinates all activity in the account, including the construction and implementation of the portfolio, rebalancing, and tax-management. A UMA's strategy is typically implemented by allocating assets across different sub-advisers within the same account. A portion of the UMA may also be allocated to mutual funds, ETFs, or other investment products rather than a sub-adviser.

Model Delivery Programs ("MDPs")

In an MDP, a third-party investment adviser (that may or may not be an affiliate of the program sponsor) provides model portfolios to the program sponsor. The model portfolios typically are reviewed and updated periodically at the discretion of the model provider and in accordance with any applicable provisions in the agreement between the program sponsor and model provider. The program sponsor has ultimate discretion to implement the model portfolio and for placing any trades necessary to do so. Unlike in an SMA program, individual wrap accounts are not deemed to be advisory clients of the model provider.

Robo-Advisers

Robo-advisers (also referred to as internet or digital advisers) are automated platforms that provide advisory services to clients using algorithms to formulate investment advice. Clients enter information about themselves into a website, mobile application, or similar digital platform that is used by the robo-adviser to generate a portfolio for the client and to manage the client's account. The nature of the information collected, the means of collecting such information, and the level of human interaction can vary widely from one robo-adviser to another.

Applicability of the Investment Company Act of 1940

Advisory programs, including wrap fee programs, that provide discretionary investment advice to clients could be deemed to be operating as investment companies, as defined in the Investment Company Act of 1940 (the "IC Act") to the extent that clients receive substantively the same advice that is not tailored to each client's specific needs. Because investment companies are subject to additional onerous regulation, this is a highly undesirable outcome in most cases.

Rule 3a-4 under the IC Act, adopted in 1997, provides a non-exclusive safe harbor from the definition of an investment company for advisory programs that meet certain criteria. Specifically, the rule requires that: (1) each client's account in the program is managed based on the client's financial situation and investment objectives; (2) the client has the ability to impose reasonable investment restrictions; (3) the sponsor obtains sufficient information about the client during the account opening process to provide individualized investment advice; (4) the sponsor contacts the client on at least an annual basis to determine whether there have been any material changes in the client's financial situation, investment objectives, or investment restrictions; (5) the sponsor and portfolio manager are reasonably available to the client for consultation; (6) the client receives statements at least quarterly showing all activity during the statement period; and (7) the client retains certain indicia of ownership of the securities in the account, including the receipt of trade confirmations and the ability to vote proxies (or to delegate such authority).

Program sponsors should ensure that they maintain sufficient documentation to evidence compliance with Rule 3a-4, including client new account paperwork, questionnaires or other materials used to establish the client's investment profile, and documentation of conversations or meetings with the client to review the account and to discuss any material changes in the client's investment objectives or financial situation.

Program sponsors should also ensure that any client-imposed investment restrictions are communicated to portfolio managers and that the program sponsor and portfolio manager both have controls in place to ensure compliance with such restrictions. There should not be any ambiguity as to what exactly is restricted. For example, many investors choose to restrict purchases of so-called "sin stocks" in industries such as gaming, alcohol, and tobacco. However, different investors may have significantly different views as to whether a company falls into one of these industries, so it would be better for a program sponsor to obtain a list of specific issuers that are restricted rather than accepting a broader restriction that is open to interpretation.

Form ADV

Advisers who participate in wrap fee programs, either as a sponsor or a portfolio manager, historically have had to disclose this fact in Item 5.I of Form ADV Part 1 and to indicate the names of all wrap fee programs in which the adviser participates in Section 5.I.(2) of Schedule D.

In August 2016, the SEC adopted amendments to Form ADV Part 1 that became effective on October 1, 2017. Among other things, advisers that participate in wrap fee programs now have to report additional information, including the amount of regulatory assets under management ("RAUM") attributable to acting as (a) sponsor to a wrap fee program; (b) portfolio manager for a wrap fee program; and (c) sponsor and portfolio manager to the same wrap fee program. In addition, advisers that are portfolio managers to a wrap fee program are now required to identify the sponsor of the program.

The amended Part 1 also asks for additional information regarding managed accounts generally, which will apply to advisers who participate in wrap fee programs. This includes information on the use of leverage and derivatives in managed accounts, as well as information about custodians who hold more than 10 percent of the adviser's RAUM attributable to managed accounts.

Rule 204-3(d) under the Advisers Act requires wrap fee program sponsors to prepare a wrap fee program brochure (the "wrap brochure") for the wrap fee programs that they sponsor containing all of the information required by Form ADV Part 2A, Appendix 1. In general, the wrap brochure must be prepared in addition to Form ADV Part 2A (the "firm brochure"). The wrap brochure is required to disclose certain information about:

- the adviser's services, fees, and compensation;
- any requirements to open or maintain an account;
- the types of clients to whom the adviser generally provides advisory services;
- the adviser's process for portfolio manager selection and evaluation;
- the nature of any client information provided to portfolio managers;
- any restrictions on a client's ability to contact their portfolio managers;
- disciplinary information; and
- information about the adviser's other financial industry activities and affiliations.

The wrap brochure is also required to include certain information that is disclosed in the firm brochure, as applicable to the adviser's wrap fee clients.

If an adviser sponsors multiple wrap fee programs, the adviser may prepare a single wrap brochure describing all of the programs or a separate wrap brochure for each program.

Program sponsors must deliver the wrap brochure to clients and prospective clients of the applicable wrap fee program, and the wrap brochure takes the place of the adviser's firm brochure with respect to such clients. If an adviser's entire business is sponsoring wrap fee programs, the adviser does not need to prepare a separate firm brochure.

If an adviser provides portfolio management services as part of a wrap fee program, Form ADV Part 2A, Item 4.D requires that the adviser disclose the differences, if any, between how the adviser manages wrap fee accounts versus other accounts and explain that the adviser receives a portion of the wrap fee for its services.

The requirements for preparation and delivery of Form ADV Part 2B brochure supplements are the same as for any other adviser.

Recent Regulatory Scrutiny on Wrap Fee Programs

OCIE has stated that its examinations of wrap fee programs will focus on whether advisers are fulfilling their fiduciary and contractual obligations to clients. As with other types of advisory programs, advisers who are providing investment advice to a client in connection with a wrap fee program, including the program sponsor and any sub-advisers, owe a fiduciary duty to that client. This means that the adviser must act in the best interest of the client at all times and take steps to eliminate or mitigate (e.g., through full and fair disclosure) any potential conflicts of interest that the adviser may have.

The following are areas that may present potential conflicts of interest for advisers who participate in wrap fee programs or that may otherwise create a risk of harm to wrap fee clients. All of these areas have been recently identified by OCIE as an examination priority and/or have been the subject of recent enforcement actions brought by the SEC.

Fee Selection

To the extent that an adviser offers different account types with various fee structures, OCIE is keenly interested in the adviser's process to recommend a particular account type and whether such recommendation is in the best interest of clients, both at the time of the initial recommendation and on an ongoing basis thereafter.

For example, asset allocation programs tend to have lower fees than actively managed SMA programs. If an adviser offers both types of programs, it is important for the adviser to have a reasonable basis for recommending one program rather than the other, particularly when the recommendation is for the client to participate in the higher-fee program.

Reverse Churning

The term "reverse churning" refers to the practice of placing clients who do very little trading into wrap fee accounts where the client is unlikely to benefit from the fact that the fee is inclusive of transaction costs.

Reverse churning is of particular concern when the program sponsor also offers traditional brokerage accounts and/or advisory fee-only accounts in which clients pay transaction costs on a trade-by-trade basis. In these instances, the program sponsor has a financial incentive to steer clients who do little trading away from commission-based accounts and into wrap fee accounts in order to generate additional revenue. As former OCIE Director Drew Bowden remarked:

The dual-registrants we examine can pretty quickly explain why the migration to fee-based accounts is good for them. Their commission-based business is under pressure from decreasing trade volumes and declining commission rates. They can transform choppy, transaction based-compensation into a steadier, more reliable, and predictable revenue stream. They no longer have to make a sale to collect a fee.[2]

While a low number of trades is not, per se, an indication that a wrap fee program is inappropriate for the client, it is certainly a red flag that will likely attract increased scrutiny from SEC examination staff. In connection with examinations of wrap fee programs, examiners commonly request a list of accounts that have executed few trades (commonly three or fewer trades) over an extended period of time (commonly 18 months), and an adviser should be prepared to explain its process for periodically assessing the appropriateness of wrap fee accounts that have low levels of trading activity.[3]

In 2016, the SEC settled charges with three advisers affiliated with a large insurance company alleging, among other things, that the advisers failed to monitor trading activity in their wrap fee accounts to ensure that the wrap fee program remained in the best interest of clients with little trading activity. The advisers agreed to pay more than $9.5 million dollars in disgorgements and civil penalties.

Trading Away

Typically in a wrap fee program, the program sponsor will designate a particular broker-dealer through which all trades must be executed. "Trading away" is the practice of placing trades on behalf of wrap fee clients through a broker-dealer

2. *People Handling Other People's Money*. Remarks by Andrew J. Bowden to the Investment Adviser Association Compliance Conference, Arlington, VA (March 6, 2014) available at https://www.sec.gov/news/speech/2014-spch030614ab

3. Investment Advisers Act Release No. 4351 (March 14, 2016) available at https://www.sec.gov/litigation/admin/2016/34-77362.pdf

other than the broker-dealer designated by the sponsor. Trades that are executed away from the sponsor-designated broker-dealer may cause the client to incur additional commissions and/or other transaction costs that are not covered by the wrap fee.

An adviser's fiduciary duty requires the adviser to seek to obtain best execution of client transactions and it may be the case that trading away represents best execution in light of considerations other than transaction costs (e.g., if another broker is offering to transact at a materially better price). However, trading away practices should be fully disclosed to clients who might otherwise think that all transaction costs are covered by the wrap fee. Clients should have sufficient information about trading away practices to assess the total cost of the wrap fee program (including the wrap fee and any incremental transaction costs) and to understand the relative costs of selecting different sub-advisers who may have different trading away practices.

Program sponsors should have policies and procedures to assess the trading away practices of sub-advisers in order to evaluate whether a particular sub-adviser is suitable for its wrap fee clients. In 2016, the SEC brought enforcement actions against two wrap fee program sponsors for allegedly failing to adopt and implement adequate policies and procedures to monitor and disclose the trading away practices of sub-advisers participating in their wrap fee programs.[4] The advisers agreed to pay civil monetary penalties of $250,000 and $600,000, respectively.

Sub-advisers should also ensure that their trading away practices are consistent with their contractual obligations pursuant to any sub-advisory agreements with program sponsors and with the disclosures made to wrap fee clients. In 2016, the SEC settled charges with a wrap fee sub-adviser that the adviser made materially misleading disclosures regarding its trading practices. Specifically, the SEC's order alleges that when the adviser first started sub-advising wrap fee accounts, it disclosed in Form ADV that it would "generally" execute trades through the sponsor-designated broker-dealer. However, according to the SEC's order, the adviser began to trade away more frequently until it was trading away the majority of its trades on behalf of wrap fee clients. The order indicates that the adviser did not undertake to update its disclosures in Form ADV to reflect this material change in its trading practices. The adviser agreed to pay a civil monetary penalty of $300,000.

Mutual Fund Share Class Selection

On July 12, 2016, OCIE issued a Risk Alert announcing an initiative focused on conflicts of interest that may arise in connection with the recommendation of certain mutual fund and 529 plan share classes.[5]

Mutual funds often offer different share classes to investors, which have different fee structures. Because each share of a mutual fund represents an interest in the same portfolio of securities regardless of the share class, if an investor can choose among different share classes of the same fund, it is generally in the investor's best interest to purchase the share class that results in the lowest fees.

The mutual fund share classes that are offered to retail investors typically require the investor to pay a sales charge (or "load") based on the amount of the investment and/or an ongoing fee (known as a "12b-1 fee") for certain costs related to shareholder servicing, distribution, and marketing. The broker-dealer through which the investor purchases the fund receives compensation for the sales of these share classes.

It has become increasingly common for funds to offer a share class designed for fee-based accounts (commonly known as an "institutional" or "advisory" share class) that charges neither a load nor a 12b-1 fee. To the extent that an investor in a fee-based account is eligible to purchase the institutional share class, it is generally in their best interest to do so because it results in the lowest fees. However, advisers that are dual-registrants or that are affiliated with a broker-dealer have a financial incentive to recommend a share class in which the client pays a load and/or 12b-1 fees because the adviser or its affiliates may receive additional fees as a result.

In the enforcement action described under Reverse Churning above, the SEC additionally charged the three advisers with failure to disclose a material conflict of interest due to a financial incentive to place investors in higher-fee mutual fund share classes. According to the SEC's order, the advisers invested clients in share classes with 12b-1 fees when lower-fee share classes of the same funds were available, resulting in the advisers receiving $2 million in 12b-1 fees that they would not otherwise have received.[6]

Fee Billing

While many wrap fee programs have a standardized fee schedule, these fees are often negotiable, which can result in clients being subject to myriad fee arrangements.

In its most basic form, a negotiated fee schedule may simply be a discount applied to the standard fee – 1.5% instead of 2%, for example. However, many programs offer much more complex arrangements, which may include fee breakpoints that reduce the fee as clients' assets under management increase and the aggregation (or "householding") of multiple related accounts for fee-billing purposes.

Some firms may also allow individual assets to be held unsupervised or "below-the-line," which means they are excluded from the client's billable assets when calculating fees. For example, if an affiliated mutual fund is included in a client's recommended asset allocation, some program sponsors may not include these funds in the client's billable assets because the adviser or an affiliate is already receiving compensation for managing the fund. In addition, if fees are paid in advance, the fees may also need to be adjusted if the client makes significant contributions and/or withdrawals or terminates the account in the middle of a billing period.

Program sponsors also need to be mindful of the "self-dealing" prohibitions under ERISA and the Internal Revenue Code, which are outside the scope of this article, but which impact the fees that can be charged in IRA and other types of retirement accounts.

Needless to say, managing all of these different types of fee arrangements can be incredibly complicated and there are numerous potential points of failure. In January 2017, the SEC and the New York State Office of the Attorney General announced settlements with two large, diversified

4. Investment Advisers Act Release No. 4525 (September 8, 2016) https://www.sec.gov/litigation/admin/2016/ia-4525.pdf and Investment Advisers Act Release No. 4526 (September 8, 2016) available at https://www.sec.gov/litigation/admin/2016/ia-4526.pdf

5. *OCIE's 2016 Share Class Initiative*. National Exam Program Risk Alert, Volume V, Issue 2 (July 13, 2016) available at https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf

6. See Footnote 3

financial services firms related to, among other things, the advisers allegedly overbilling their advisory clients.[7] In one of the orders, the SEC noted that they identified 36 different categories of errors that resulted in overcharges, including:

- A system error that caused accounts to default to the highest program fee when the accounts were transferred between branches;
- Failure to enter discounted fee rates into the firm's billing system immediately after they were negotiated; and
- A failure to reimburse terminated accounts for the unearned portion of fees that were paid in advance.

It is imperative that program sponsors implement strong controls around all aspects of the fee billing process to ensure that negotiated fees are accurately and timely entered into the firm's billing systems (both at account opening and upon any fee changes thereafter), that fees are calculated and billed in accordance with the account agreement and other disclosures made to clients, and that adequate books and records are maintained to substantiate the fees charged to clients.

These controls should include robust testing with an emphasis on clients that were subject to non-standard fee billing arrangements or where the fee schedule changed during the testing period to ensure that any errors are caught and resolved in a timely manner. In one of the enforcement actions referenced above, the SEC specifically noted in its order that the adviser "did not, as part of its periodic fee testing, conduct targeted testing of accounts with attributes, or that experienced changes, that created an increased risk of fee error, and its testing was limited to checking calculations against billing rates contained in the firm's billing system without validating such information against client contracts, fee billing histories, and other documentation."[8]

Conclusion

Wrap fee programs continue to be a popular solution for retail investors who are looking for professional asset management services, but they can be fraught with pitfalls for the advisers who participate in them. Advisers must be mindful of the myriad conflicts that can arise in connection with their participation in a wrap fee program and take steps to ensure that such conflicts are eliminated or mitigated. To do otherwise during this period of seemingly perpetual regulatory scrutiny is to court serious danger. Fulsome disclosure, reasonably designed policies and procedures, and proactive monitoring and testing are the keys to staying out of the SEC's enforcement crosshairs.

7. Attorney General of the State of New York Investor Protection Bureau, Assurance No. 16-178 (January 5, 2017) available at https://ag.ny.gov/sites/default/files/2017.01.12_cgmi_fully_executed_aod.pdf; Investment Advisers Act Release No. 4607 (January 13, 2017) available at https://www.sec.gov/litigation/admin/2017/34-79794.pdf; and Investment Advisers Act Release No. 4626 (January 26, 2017) available at https://www.sec.gov/litigation/admin/2017/34-79882.pdf

8. Investment Advisers Act Release No. 4607