

Wrap Accounts/Separately Managed Accounts (SMAs)

PLI Introduction to Investment
Adviser Regulation

July 16, 2010

Topics

- Types of Wrap Accounts
- Terminology
- Roles of the Different Players
- Compliance Issues
 - Rule 3a-4
 - Suitability
 - Fees
 - Disclosure
 - Due Diligence
 - Best Execution

Types of Wrap Accounts

- “Discretionary” wrap programs give clients the option to authorize the sponsor to exercise discretion in selecting portfolio managers, rebalancing the client’s assets among existing investment options and making other changes.
- “Mutual Fund Wrap Programs” provide for a sponsoring adviser to select a basket of mutual funds rather than selecting portfolio managers. These programs are sometimes referred to as mutual fund asset allocation programs.
- “Rep as Portfolio Manager” or “Rep as Adviser” wrap programs offer financial representatives the ability to act as portfolio managers, granting each of them sole discretion to purchase and sell securities. In connection with these programs, review committees are often established to evaluate the candidate’s stated investment strategy(ies), investment process, diversification and risk management strategies, prior investment experience, performance returns and dispersion, strategies for allocating investment opportunities and execution fills, among other things.
- In “Dual Contract Programs” the client enters into a contract directly with the portfolio manager.

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Terminology

- Separately Managed Account (“SMA”)
- Unified Managed Account/Household (“UMA/UMH”)
- Turnkey Asset Management Provider/Program (“TAMP”)

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Roles of the Different Players

- Sponsor
- Investment Adviser Representative
- Portfolio Manager
- Platform Provider
- Model Provider

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Compliance Issues

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Rule 3a-4 under the Investment Company Act

Safe harbor from the definition of "Investment Company" under the Investment Company Act of 1940, as amended.

1. Managed based on client's financial situation and objectives.
2. At least once a year, sponsor contacts client about whether financial situation or objectives have changed.
3. At least quarterly, sponsor contacts client in writing about whether financial situation or objectives have changed.
4. Client is sent quarterly account statements.
5. Client owns portfolio securities directly.
6. Client has the ability to impose reasonable restrictions on the management of the client's account.

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Suitability

1. Suitability of the Program
2. Suitability of the Strategy for the Client
3. Suitability of the Portfolio Manager for the Client
4. Suitability of the Specific Investments Made on Behalf of the Client

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Fees

- The “wrap fee” generally covers: sponsor’s services, platform provider’s services, investment adviser representative’s services, custody, clearing, execution, portfolio management (portfolio manager and model provider (if applicable)).
- Stated fees do not include mutual fund and ETF expenses.
- Fees in wrap programs are a big focus of the SEC during exams.
 - SEC reply to No-Action Request, John G. Kinnard & Co. Inc. (October 30, 1973)
 - SEC reply to No-Action Request, Consultant Publications, Inc., (December 30, 1974)

“With respect to the size of investment advisory fees, it is our position that an annual investment advisory fee of more than 2% of assets under management is higher than that normally charged by persons in the investment advisory industry and that any investment adviser who charges more than 2% would be violating the antifraud provisions of Section 206 unless he discloses to existing and potential clients that his fee is higher than that normally charged in the industry and that other investment advisers provide the same or similar services at lower rates.”

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Disclosure

- Form ADV Part II, Schedule H Brochure for Wrap Sponsors,
 - Narrative format, rather than “check the box.”
 - A sponsor can have separate brochures for separate programs.
 - If there are multiple sponsors, only one sponsor needs to complete the Sch. H.
 - Some of the items required:
 - All fees and the services covered by the fees (whether negotiable, portion (or range) paid to portfolio manager).
 - Statement that the fee for the program may be higher than if obtained separately.
 - How portfolio managers are selected.
 - Information about performance reporting.
 - Restrictions on client’s ability to contact portfolio manager.

(Refer to pages 230 and 231 of the materials for the Instructions to Schedule H)

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Disclosure (continued)

Form ADV Part I – Item 5.I.

If you participate in a *wrap fee program*, do you (check all that apply):

(1) *sponsor the wrap fee program ?*

(2) *act as a portfolio manager for the wrap fee program? If you are a portfolio manager for a wrap fee program, list the names of the programs and their sponsors in Section 5.I(2) of Schedule D.*

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Due Diligence

- Sponsor due diligence of portfolio managers and investment vehicles
 - Make sure the process disclosed is the process followed.
 - *Banc of America Investment Services, Inc., and Columbia Management Advisors, LLC, IA Rel. No. 2733 (May 1, 2008)*
 - *Morgan Stanley & Co. Incorporated, IA Rel. No. 2904 (Jul. 20, 2009)*
- Should platform providers, portfolio managers, etc. perform due diligence on sponsors and other counterparties?

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Trading

Best Execution

- How are best execution practices different for wrap accounts?
- SEC Focus: Sponsor review of portfolio managers' best execution of "trade aways."

Trade Errors and Error Correction

General principles:

- The client must be made whole as soon as possible under ALL circumstances.
- Losses should be allocated to the causing party (sponsor, broker-dealer, portfolio manager, etc.) Which party coordinates the correction?
- How should gains be treated? What if the parties have different policies?

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Enforcement Actions

*Banc of America Investment Services, Inc., and
Columbia Management Advisors, LLC, IA Rel. No.
2733 (May 1, 2008)*

New England Securities, IA Rel. 2489 (Feb 21, 2006)

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