GREENWICH COMPLIANCE

SPOTLIGHT ON

Compliance Considerations for Wrap Fee Programs

The contents of this Spotlight have been prepared for informational purposes only and should not be construed as legal or compliance advice.

Overview of Wrap Programs

Investment advisors have the option to implement a Wrap Fee Program ("Wrap Program") as a fee structure for the investment advisory services they provide to clients. Due to the conflicts of interests inherent in Wrap Programs, the Securities and Exchange Commission ("SEC") highlighted Wrap Programs as a priority for examinations in its 2017-2019 Examination Priorities lists. Investment advisors that recommend a Wrap Program structure to their clients continue to come under extreme regulatory scrutiny to ensure they properly disclose any information regarding their Wrap Programs.

What is a Wrap Program?

A Wrap Program refers to a fee structure that is applied to an investment advisory program where an overall fee based on a percentage of the client's assets under management is charged, covering all expenses associated with the investment, including but not limited to, brokerage costs, administrative expenses, mutual fund fees and expenses, and third-party service costs. Separate brokerage commissions based on the execution of transactions are not charged but covered in the overall AUM fee.

What is a sponsor?

In a Wrap Program, the sponsor is the party that is responsible for organizing or administering the program or providing advice regarding the investment advisor selection. The sponsor collects and disperses the comprehensive fee to the appropriate parties. While the sponsor is typically an investment advisor or a broker-dealer, it could also be a hybrid combination of the two.

If the sponsor of the Wrap Program is a broker-dealer, the investment advisor is either affiliated with the broker-dealer, or unaffiliated but using the broker-dealer's Wrap Program. In other cases, the sponsor could be an investment advisor that has a Wrap Program with the broker-dealer, where the broker-dealer does not sponsor any Wrap Program at all. The sponsor could provide services, including but not limited to investment advice, brokerage, and administrative services.

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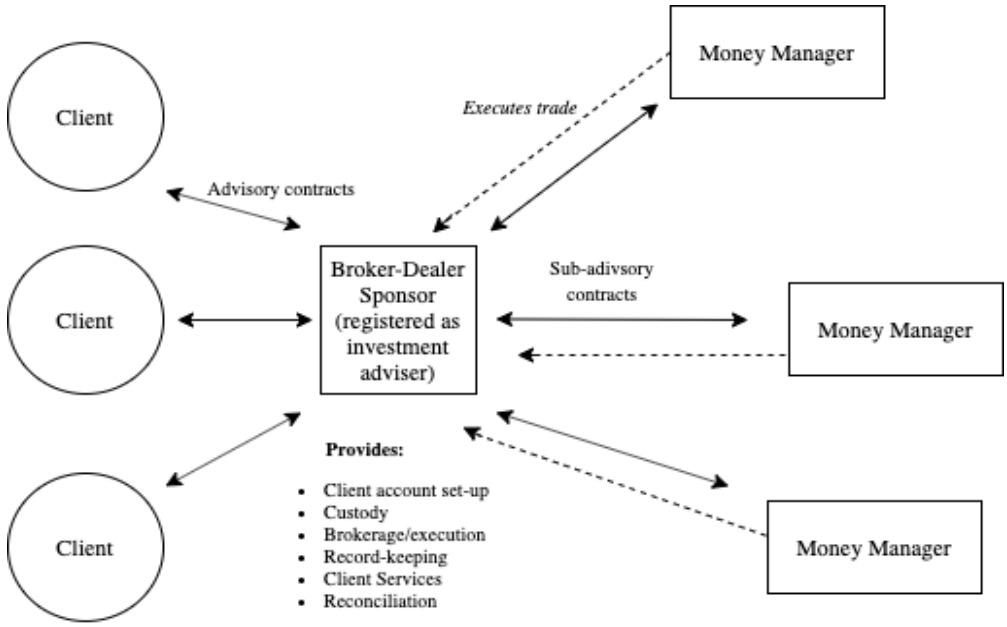
What is the general structure and application of a Wrap Program?

A Wrap Program involves the application of an all-inclusive fee structure to an investment management program. While not all types of investment management programs are offered by an investment advisor, they can take the general structure of a bundled or unbundled program, where the differences lie in the relationship between the client, sponsor, and the money manager.

Under bundled programs, the client does not have the option to choose the participants of the program. Rather, program participants are pre-selected by the sponsor. For an example of a broker-dealer sponsor offering a bundled program, refer to Figure 1 below. While Figure 1 is not representative of all Wrap Program structures, it illustrates the concept of clients entering into advisory contracts with the sponsor while the sponsor enters into sub-advisory contracts with the investment advisor. In this case, the client does not have a choice as to who the investment advisor will be.

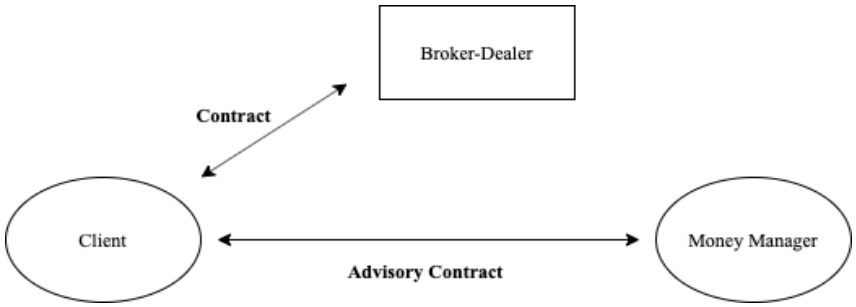
Figure 1. Broker-dealer Sponsor, Bundled Program[1]



[1] THOMAS P. LEMKE & GERALD T. LINS, SECURITIES LAW HANDBOOK SERIES: REGULATION OF INVESTMENT ADVISERS, 415 (2018).

Alternatively, under unbundled programs, the client is able to choose the participants in the program. The client enters into individual contracts with the sponsor and money manager, where the money manager does not need to be pre-approved by the sponsor. For an example of an unbundled program, refer to Figure 2 below. While Figure 2 is not representative of all unbundled programs, it illustrates the concept of clients having the ability to choose the participants in the program.

Figure 2. Unbundled Program[2]



What precludes a Wrap Program from being considered an investment company?

Rule 3a-4 of the Investment Company Act of 1940 (the "Investment Company Act") allows Wrap Programs to claim an exemption that exempts the Wrap Program from having to register as an investment company under the Securities Act of 1933 (the "Securities Act"). The Wrap Program must meet the following conditions to claim the exemption and avoid being classified as an unregistered investment company in violation of the Investment Company Act's registration requirement:

> *(1) The" financial situation" and "investment objective" of the client are used alongside any client-imposed restrictions as guidance to manage the client's account.* [3]
> *(2) Upon the establishment of the account, the sponsor or another sponsor-designated person need to obtain information regarding*

[2] THOMAS P. LEMKE & GERALD T. LINS, SECURITIES LAW HANDBOOK SERIES: REGULATION OF INVESTMENT ADVISERS, 420 (2018).
[3] The Investment Company Act of 1940, 17 CFR § 270.3a-4

the client's financial situation and investment objective and give the client the opportunity to place any restrictions on the management of the account.[3]

(3) At least annually, the sponsor or its designee contacts the client to determine whether there have been any changes in the client's financial situation or investment objectives, and whether the client wants to impose any reasonable restrictions on the management of the account and reasonably modify existing restrictions;

(4) At least quarterly, the sponsor or its designee notifies the client in writing to contact it if there have been any changes in the client's financial situation or investment objectives, or if the client wants to impose any reasonable restrictions on the management of his account or modify existing ones and provides the client with a means to make such contact;

(5) Sponsor and account manager personnel reasonably knowledgeable about the account and its management need to be "reasonably" available for "consultation" with the client.[3]

(6) "At least quarterly," the sponsor or another sponsor-designated person will provide the client with a quarterly statement of account activity.

(7) Clients must "retain" the right to "withdraw securities or cash," "vote" or "delegate the authority to vote," "be provided… with a written confirmation of transactions," and "proceed directly" as a security holder relative to the issuer.[3]

Brochure Requirement for Sponsors of a Wrap Program

Are you required to deliver a Wrap Program brochure?

Part 2A Appendix 1 is the disclosure brochure for Wrap Programs. Under Rule 204-3(d)(1), a registered investment adviser compensated under a Wrap Program for sponsoring, organizing, or administering a Wrap Program, or for providing advice to clients under the Wrap Program, must provide clients Appendix 1 of Form ADV Part 2A. Appendix 1 must be provided to clients in lieu of providing the registered investment adviser's Form ADV Part 2A. Therefore, Appendix 1 is a completely separate document from Part 2A of Form ADV.

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As long as you sponsor a Wrap Program, you must deliver a brochure to each client participating in the program. If, however, there are other sponsors that have created or delivered a Wrap Program brochure to those same clients, you are not obligated to create or deliver a separate brochure. For clients participating in a Wrap Program that you sponsor, the Wrap Program brochure takes the place of the firm's Part 2A brochure.

When must the Wrap Program brochure be delivered?

A Wrap Program brochure must be provided to the client before or at the time the client enters into a Wrap Program contract. Within 120 days of the end of the fiscal year, each participating client is to be provided with an updated Wrap Program brochure that contains or includes a summary of material changes and information as to how the client can obtain the updated brochure.

When are we required to update the Wrap Program Brochure?

The Wrap Program brochure must be updated annually and submitted along with the annual updating amendment or whenever there is a material change in the Wrap Program brochure.

What if we sponsor multiple Wrap Programs?

You have the option of preparing a single brochure including information about all the Wrap Programs that you sponsor or preparing separate brochures describing each specific Wrap Program.

What needs to be disclosed in the Wrap Program Brochure?

Part 2A Appendix 1 of Form ADV requires specific information and disclosures to be provided to prospective clients of a Wrap Program. Specifically, Items 4, 5, 6, 7, and 8 highlight some disclosures to be made in Part 2A Appendix 1 of Form ADV that clients need to know to make informed decisions regarding participation in the Wrap Program.

i. **Item 4 Services, Fees and Compensation.**
   Under Item 4, the investment advisor is to describe the types of services offered by the advisor, the fees associated with those services, and other types of compensation that the advisor might receive. Specifically, a disclosure is required in this item if the recommender of the Wrap Program receives some sort of compensation due to the client's participation in the Wrap Program.

ii. **Item 5 Account Requirements and Types of Clients.**
Under Item 5, the investment advisor is to include any prerequisites for opening or maintaining an account, i.e., minimum account size. Information regarding the types of clients that the advisor provides advice to will also be included in this section.

iii. **Item 6 Portfolio Manager Selection and Evaluation.**
In Item 6, the investment advisor must describe the process by which it selects and reviews portfolio managers. Specifically, disclosures of conflicts of interests must be made in this section if any related persons act as a portfolio manager for the Wrap Program, including but not limited to, selection and review criteria and conflicts of interests associated with related portfolio managers.

iv. **Item 7 Client Information Provided to Portfolio Managers.**
This section must discuss the client information that is communicated to portfolio managers, and how often or under what circumstances the advisor provides updated information to the portfolio manager. Specifically, a disclosure must be made in this section regarding client information shared with the client's portfolio manager and the frequency of providing updated client information to the portfolio manager.

v. **Item 8 Client Contact with Portfolio Managers.**
Restrictions on contact and consultation between the client and the portfolio manager must be disclosed in this section.

Regulatory Requirements and SEC Alerts

Aside from the Wrap Program brochure, investment advisors must also submit a Form ADV Part 1A along with any related schedules. Pursuant to amendments adopted by the SEC in 2016, investment advisors and portfolio managers that act as sponsors for a Wrap Program are required to disclose information regarding their regulatory assets under management. The SEC has also amended Schedule D to require advisors acting as portfolio managers to provide CRD numbers. These changes assist the SEC in better understanding the advisor's business, assessing risks, and examining processes by allowing "staff to identify the extent to which the firm acts as sponsor or portfolio manager of wrap fee programs and collect information across investment advisors involved in a particular wrap fee program."[4]

[4] Form ADV and Investment Advisers Act Rules, Investment Advisers Act Release No. IA-4509, (August 25, 2016)

SEC Examination Alert. As previously mentioned, the SEC highlighted Wrap Programs in its 2017-2019 Examination Priorities lists. Specifically, examinations of Wrap Programs will include a review of the advisor's commitment to its fiduciary duty and advisory obligations. In 2017, the SEC highlighted that areas of interest would include suitability, effectiveness of disclosures, conflicts of interest, and brokerage practices including best execution and trading away. In 2018, the SEC elaborated on these areas of interest to include whether or not the recommendation to participate in a Wrap Program is reasonable and to view conflicts of interests in compliance with regulatory requirements. In 2019, the SEC paid particular attention to the fees and expenses of the Wrap Program, highlighting the importance of adequate disclosures regarding brokerage practices and Wrap Program fees.

Paying particular attention to these alerts will assist investment advisors with complying with SEC regulations.

Compliance Risks Associated with Wrap Programs

The Investment Advisers Act of 1940 (the "Investment Advisers Act") establishes fiduciary duties for investment advisors. As such, investment advisors must provide impartial investment advice and have an obligation to prevent or mitigate any conflicts that are impossible to completely eliminate. While an investment advisor has a duty to provide information to the client so that the client can consent to or reject the practices of the investment advisor, there are still potential conflicts of interest that could adversely affect the client if the client decides to participate in a Wrap Program.

Trading Away & Best Execution. Under a Wrap Program, trades are executed by the broker-dealer, though not always. In some cases, the money manager can also execute trades. It is typically more cost-effective for the client if equity transactions go through the sponsor or the sponsor's affiliated broker-dealer instead of unaffiliated broker-dealers. This is because the sponsor or affiliate brokerage fees are included in the all-inclusive fee. A conflict of interest arises when the sponsor is unable to provide best execution and therefore may be obligated to trade away to another broker-dealer with appropriate expertise. In so doing, clients could potentially incur additional costs that are not included in and are in addition to the all-inclusive fee.

- **Example.** The all-inclusive fee charged in a Wrap Program encompasses services provided by an advisor and a broker. While the services that the broker provides are included in the fee charged in the program, the advisor has an option to trade away to another broker that has the appropriate expertise. This particular broker no longer falls under that all-inclusive fee and therefore will charge the client based on the transactions it executes. The client ends up paying brokerage commissions in addition to the overall Wrap Program fee that covered commissions through the program broker.

- **SEC Enforcement.** The SEC has taken action against investment advisors that fail to disclose information regarding trading away activities to Wrap Program clients. These actions have resulted in the investment advisor paying significant penalties as a result of violations. In some exams, SEC staff even noted that advisors mistakenly overcharged Wrap Program clients by charging them brokerage fees even though the transactions were covered under the overall program fee.

  Recently, the SEC took action against Morgan Stanley Smith Barney LLC (MSSB) as it failed to properly disclose the nature of its Wrap Program to its clients. The firm marketed its Wrap Program as having a "transparent" fee structure and clients were led to believe that they were not going to incur additional costs. In the examination of MSSB, the SEC found that the firm failed to disclose to its clients that its Wrap Managers, would trade away to third-party broker-dealers or direct trades through a Morgan Stanley affiliated broker-dealer. As a result, clients incurred costs beyond the Wrap Program Fee charged by Morgan Stanley. In light of this enforcement action, Investment advisors need to make sure that disclosures are sufficient to ensure that clients understand trading away activities as they pertains to the practices of the firm. Investment advisors must disclose trading-away practices and activities and any potential fees that clients can incur due to trading away in the firm's Wrap Program brochure.[5]

Reverse Churning. While a Wrap Program can remove incentives for churning associated with commission-based accounts where fees are based on transactions, it could possibly lead to reverse churning. Reverse churning is a broker-dealer-related risk. In cases where an investment advisor provides non-discretionary services, the broker-dealer would be responsible

[5] SEC Charges Morgan Stanley Smith Barney With Providing Misleading Information to Retail Clients, (2020), https://www.sec.gov/news/press-release/2020-109, (last visited May 14, 2020).

for executing trades and transactions. This could incentivize lesser trading than would have occurred had the broker-dealer been receiving commissions from those trades. Broker-dealers may be incentivized to delegate more time to accounts where commissions are not capped and perform less work for Wrap Program accounts where the set overall program fee charged to the client is earned regardless of the trades and transactions that occur.

Broker-dealers that offer Wrap Programs are expected to review accounts with minimal trading activity to see whether a different type of fee structure, aside from the Wrap Program, may be more appropriate.

- **SEC Enforcement.** The SEC has taken action against investment advisors that improperly place clients into Wrap Programs. Advisors must have underlying support when recommending one account type or program over the other, especially when that recommendation favors participation in a Wrap Program.

Takeaway

With significant scrutiny being placed on Wrap Programs by the SEC, it is essential for investment advisors to understand the nuances, requirements, and conflicts of interests associated with Wrap Programs. The SEC and its Office of Compliance Inspections and Examinations will continue to review Wrap Programs with increased attention on proper disclosures so that clients can make informed decisions with respect to participation in the program. As a result of increased attention on Wrap Programs, there will likely be an increase in actions and enforcement activity against those investment advisors that are unable to comply with these requirements.