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Division of Examinations Risk Alert:

Observations from Examinations of Investment Advisers Managing Client Accounts That Participate in Wrap Fee Programs

August 2021

On July 21, 2021, the SEC's Division of Examinations (the Division) issued a Risk Alert detailing examinations of investment advisers participating in wrap fee programs. The Division conducted over 100 examinations of advisers associated with wrap fee programs generally from two perspectives: (i) advisers serving as portfolio managers in, or sponsors of, wrap fee programs; and (ii) advising client accounts through unaffiliated/third-party wrap fee programs. The Division provides wrap fee programs may create conflicts of interests related to such things as:

- **Incentives for trading less frequently than what may be in a client's best interest;**
- **Engaging in transactions that reduce costs to the adviser but increase expenses borne by the client; and**
- **Failing to include certain covered transactions into the wrap fee.**

The wrap fee program examination initiative focused on the following areas: (i) Consistency with Fiduciary Obligations; (ii) Adequacy of Disclosures; and (iii) Effectiveness of Compliance Programs.

Consistency with Fiduciary Obligations

In regards to wrap accounts and advisers' fiduciary obligations, the Division reviewed whether advisers had a reasonable basis to believe that wrap fee programs were in the best interest of clients, both initially and on an ongoing basis. In examining such determinations, the Division reviewed whether advisers obtained client suitability information on an ongoing basis to assist in periodically reassessing whether the wrap fee programs remained in a client's best interest. In addition to suitability reviews at the individual client level, the Division addressed more firm-wide reviews regarding the suitability of a wrap fee program for client accounts. Specifically, did advisers review client accounts in a scope necessary to determine that trading activity warranted a wrap fee program? The Division noted advisers who were unable to document these client- and program-level reviews on both an initial and ongoing basis.

In addition, the Division highlighted the imposition of undisclosed transaction charges to wrap fee program

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participants. Specifically, the Division noted advisers who failed to monitor for trading away and costs associated with trading away.

Adequacy of Disclosures

In examining the adequacy of disclosures, the Division focused upon the fees, expenses and conflicts of interest involved in wrap fee programs. The Division noted advisers who failed to provide full disclosures regarding fees not included in the wrap fee, such as fixed-income markups and trading-away fees. In addition, advisers were found to have not disclosed, or adequately disclosed, financial incentives related to recommendations, such as the following:

- Adviser personnel would incur transaction costs when executing certain investments for clients, therefore incenting adviser personnel to make investment and account recommendations that resulted in clients paying higher fees to avoid transaction costs for which the adviser personnel would be subject;
- Adviser personnel would incur certain expenses and transaction fees for moving a client account from a wrap fee account to a non-wrap fee account;
- Accounts with low trading volumes, high cash balances or significant fixed-income weightings may be able to receive services at lower costs outside of a wrap fee program; and
- Wrap fee accounts that incurred excluded transaction-based costs (trading-away fees) may collectively be paying higher fees.

Effectiveness of Compliance Programs

The Division noted advisers who failed to adopt and implement compliance policies and procedures addressing such issues as:

- Determining whether wrap fee programs and other accounts were in the best interest of clients, both initially and on an ongoing basis;
- Reviewing trading activity for trading-away practices; and
- Best execution analysis.

The Risk Alert includes best practices observed by the Division. The observed best practices are described below.

Consistency with Fiduciary Obligations

The Division points to advisers who utilize suitability information obtained from clients (goals, objectives, income) to determine the appropriateness of account types, portfolio-manager selections and asset-allocation recommendations. In addition, advisers reminded clients, pursuant to a fixed schedule, to report any changes to their personal situations, financial standings or needs and investment objectives. These communications clearly identified the individual(s) to contact at the adviser and how to contact such people.

Adequacy of Disclosures

The Division noted the following utilized disclosures relating to advisers' conflicts of interest:

- The adviser receives compensation or incentives from wrap fee program sponsors or portfolio managers for investing client assets through a wrap fee program;
- The adviser has financial incentives to not migrate infrequently traded wrap fee accounts to brokerage or non-wrap advised accounts;
- The adviser and its supervised persons have incentives to not trade in clients' accounts since responsible for paying ticket charges or other costs; and
- Clients may incur more costs participating in the wrap fee program than if they received similar services provided in other types of accounts.

In addition, the Division noted disclosures relating to certain services and expenses NOT included in the wrap fee, such as:

- Charges directly imposed by mutual funds and exchange-traded funds;

- Additional charges for certain types of trades, such as options trading;
- Wire and electronic fund transfer fees;
- Overnight carrier fees;
- Transfer taxes;
- Margin account balances;
- Odd-lot differentials;
- Early settlement fees; and
- Custodial expenses on certain types of investments and services (spreads, clearing costs, reporting fees, processing fees or revenue sharing fees).

Compliance Programs

Best practices relating to compliance programs, as noted by the Division, include delineated factors to be used when assessing whether investment recommendations made to clients regarding wrap fee programs, including asset allocation and selection of managers, are in clients' best interests. The Division provided many advisers include periodic reviews of adviser personnel documentation supporting these assessments. In addition, the Division noted policies and procedures to evidence knowledge and control over trading activity in wrap fee program accounts, and to identify problematic activity, such as:

- Trading away;
- Excessive trading;
- Infrequently traded accounts; and
- Wash sales.

In reviewing infrequently traded accounts, the Division noted adviser compliance programs that defined what is considered to be "infrequently" traded accounts and the review of such accounts to determine whether the wrap fee program remains in a client's best interest. Advisers' procedures also addressed the movement of wrap fee accounts identified as no longer in a client's best interest to brokerage accounts or another type of advisory arrangement.

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