Zeno AN SOLUTIONS

# Is it a Wrap?

## Observations from the SEC's View on Investment Advisers Treatment of Wrap Fee Programs

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*Quis custodiet ipsos custodes? –*

*Who will watch the watchers?*

*Juvenal*

**Introduction**

The SEC's recently renamed Division of Examination's (the "Division") mandate is to conduct organizational examinations to identify areas of risk, and poorly implemented or ignored compliance programs and policies. It should be noted that its mandate does not include quantifying the cost of that risk[1]. The Division periodically publishes the results of its examinations in the form of "Risk-Alerts" to both inform the industry and to help improve the industry's established policies and procedures.

Compliance and risk go hand in hand. Investment firms with effective and well executed compliance policies and procedures mitigate their risk. In this context, risk for investment firms implies greater legal exposure through conflicted, unclear policies that are not in the client's best interest or procedures that do not follow or are not in-line with established rules. These errors result in potentially greater costs for individual or institutional investors[1].

In a lengthy examination, the Risk Alert identified wrap fees as a focus area due to the growth in such accounts[2], and due to the conflict and disclosure practices noted during previous examinations. Over one hundred advisers managing wrap accounts were examined.

In the language of the SEC, a wrap account is an investment account where a "wrapped" "fee or fees" cover all the management (adviser) execution costs and administrative expenses for implementing and maintaining their account. The fee or fees are generally based on the total market value of the investment account. If there is little or no trading activity in a client's adviser account, a wrap fee arrangement may cost more than separately paying for the costs of trade services. Indeed, in current markets, brokerage firms have adviser affiliates that provide such accounts[2].

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*[1] Quantifying these risks can include measuring the costs associated with trading and/or quantifying the fees paid to execute trades.*

*[2] In Regulation Best Interest (17 CFR Part 240), Commission staff observed the transition by broker-dealers from traditional brokerage services to also providing investment adviser services (often under an investment adviser registration, whether federal or state), and many firms have been more focused on offering fee-based accounts because they provide a steadier source of revenue than accounts that charge commissions and are dependent on transactions.*

In their findings, the Division suggested:

1. Previous exams indicated specific firms were observed to have conflicts in their disclosures and practices with regard to wrap fee accounts.
2. The examinations considered both the firms that manage funds themselves and/or those firms that utilize the services of third-party asset managers to advise client's investments and identified areas of risk from those inquiries.
3. They examined the adviser's consistency with their fiduciary obligations, the adequacy of their disclosures, and the effectiveness of their compliance policies and procedures.

It is important to note that we identified as practical outcomes of the examinations that the risks inherent in the issues can be mitigated by measuring and managing the associated costs and by adhering to advisers' well-designed oversight programs. These are applicable to best execution, the direct costs of trading, the associated and direct costs of trading away and the oversight of advisers or external asset managers.

**What Did the Examinations Find?**

The Division identified several common deficient practices at the examined firms. Two broad areas were identified: "Fiduciary Duty and Recommendations Not Made in Clients' Best Interests" and "Potentially misleading or omitted disclosures." The Division found that in many cases advisers either did not monitor accounts in accordance with the Advisers Act[3], or they did not act consistently in the best interest of their clients. The highlights of their findings that are germane to this summary are described below:

a) Two areas of risk were identified under the heading "Fiduciary Duty and Recommendations Not Made in Clients' Best Interests"[4], which potentially incur a higher level of transaction costs and/or brokerage fees for their clients.

    1. *Advisers did not monitor the trading activity in clients' accounts, or their monitoring activities were ineffective.* This violated the most basic duty of care[4]. Wrap accounts were sometimes traded away with other firms. Since advisers generally trade wrap accounts within their own firm, trading away with another firm would incur higher transaction costs over and above the bundled wrap fees charged to clients by that firm. Also, accounts that

[3] https://www.sec.gov/rules/interp/2019/ia-5248.pdf *Investment advisers are fiduciaries. They owe their clients a "duty of care", which includes a duty to provide investment advice to a client that is in their best interest, and a duty to provide advice that is suitable for a client. To provide such advice, an adviser must have a reasonable understanding of the client's objectives. Further, an adviser's duty to monitor extends to all personalized advice it provides to the client, including, for example, in an ongoing relationship, an evaluation of whether a client's wrap fee account continues to be in the client's best interest.*

[4] *Duty of Care from Regulation Best Interest contains three underlying components: a) the duty to provide advice that is in the best interest of the client, b) the duty to seek best execution, and c) the duty to provide ongoing advice and monitoring for the duration of an advisory relationship.*

were infrequently traded incurred a higher (wrap) fee than they may have in a non-wrap account. As fiduciaries[3], advisers could have recommended non-wrap accounts to clients.

2. *Advisers did not have a reasonable basis to believe that the wrap fee programs were in the client's best interest*[4]. Routine recommendations of wrap accounts were not accompanied with periodic assessing of suitability[4]. When on-going assessments were conducted, they may have been inadequate, and in other cases account reviews were not in-depth, or included too few of the firm's clients. Consequently, clients were placed in higher cost wrap accounts.

**In order to address both points 1 and 2 (above), Abel Noser's asset owner division Zeno AN Solutions advocates that not only does the obligation to monitor rest with the incumbent WRAP account adviser, but as fiduciaries, asset owners (or the firms that place assets with third party asset managers) should examine those advisers' or asset-managers' practices on an annual basis, at a minimum. By extension and similar to the Division's recommendation, such follow-up would examine advisers' trading activity to establish whether the volume of trading and turnover is consistent with expectations, whether the use of trading firms or broker dealers is consistent with expectations and whether the level of direct costs (commissions and fees) and indirect costs (implicit costs including spreads, and opportunity costs of trading) paid are consistent with industry averages.**

**Zeno AN Solutions also recommends that asset owners should periodically examine the documented trading policies of their internal and (any) third party asset managers. Furthermore, in cases where those policies may imply or cause higher trading costs to be incurred, those costs should be measured in comparison with industry or peer-based averages.**

b) Two issues were identified under the heading "Potentially misleading or Omitted disclosures." In both cases, those disclosures either did not explicitly state all of the costs and fees that would be charged to clients, or conflicting information was presented in different brochures and advisory agreements.

1. *Advisers had inconsistent disclosures regarding the same topic in various documents.* This resulted in clients paying excessive fees and costs:
    i. Sales brochures failed to disclose the additional fees *not* included in wrap fees. For example, the costs of fixed income trading mark-ups and any fees associated with trading away were not disclosed. In some cases, <u>both</u> a wrap fee and an advisory fee was charged to accounts. A fixed income mark-up reflects the cost paid to a dealer to trade on a principal basis in over-the-counter (OTC) markets. These costs generally reflect the risk taken by the dealer and the relevant compensation paid for trade execution.

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ii. Conflicts were noted between advisory agreements which indicated accounts would pay brokerage commissions and the wrap fee program brochures which stated that clients would not pay commissions.

**In this regard, the Division's observation is applicable to both WRAP accounts and to asset owners who use third-party asset managers. Zeno AN Solutions recommends the quantification of commission expenses for equity trades and mark-ups for fixed income trades and their comparison with industry and peer databases to ensure costs are managed well and are thereby not excessive.**

iii. In certain cases, firms double charged accounts by not passing on stated discounts associated with internally managed funds or when rebates associated with 12-b1 fees were not applied. Clients were double charged both a wrap fee and the 12-b1 fees.

2. *Advisers omitted disclosures or inadequately described conflicts of interest*: In some cases, examined advisers and their supervised persons (employees) were given financial incentives for making specific account recommendations but these were not adequately disclosed to clients. This resulted in fees that were over and above the wrap fees the accounts had already incurred. It should be noted the included fees would otherwise have been incurred by the (wrap adviser) firm themselves.

   Advisers also made investment recommendations that resulted in clients being placed in the wrap fee program resulting in clients paying higher expenses than necessary and without the necessary disclosures.

**It should be noted that these shortcomings are germane to any manager follow-up conducted on behalf of retail investors or by asset owners. Indeed, Zeno AN Solutions advocates examining all asset manager policies in place when asset owners conduct their annual due diligence meetings.**

**Compliance Program-related Observations and Recommendations**

The compliance failures of the advisers who were examined are in fact the reason many of the issues identified above persist. Providing advisers with recommendations about adhering to established compliance programs, or to redesign aspects of their compliance programs as they relate to wrap fee accounts was at least one outcome of the Risk Alert.

In examining the compliance programs of the advisers, the Division noted that examined advisers had weak compliance policies due to one of four reasons: i) Several had no or limited written policies, ii) In many cases, those policies and procedures were inadequate, iii) The advisers' internal compliance staff inconsistently implemented or enforced procedures, or iv) Many advisers failed to perform required annual reviews related to wrap fee accounts. In addition, the examinations identified compliance failures and enhanced risks as they relate to eleven specific items. Of these, there were five that increased the transaction costs incurred by wrap fee clients:

1. A lack of identification and review of trading-away practices where additional fees were incurred due to trading at other brokerage or manager/advisery firms.
2. Advisers did not conduct best execution analyses for any of their accounts.
3. Advisers failed to review client accounts and fee billing as outlined in policies (where they were documented).
4. Advisers did not conduct due diligence on third party managers they selected and recommended to clients, despite stating otherwise.
5. Advisers failed to review the effectiveness of their compliance policies and procedures in the areas of client fees and best interest.

**Effective Compliance Policies for Wrap Fee Programs**

Based on the inadequacies and failures identified by the exams, the Division concluded the Risk Alert by compiling several practical compliance and due diligence policies and practices that were effective. They presented those for review with a caveat *that there is no such thing as a "one-size-fits-all" approach to compliance.*

There were three broad points made with regard to compliance policies that the Division staff believed would be helpful to advisers to adopt. *First,* they needed to conduct reviews of wrap fee programs initially when accounts were established and periodically in the spirit of the best interest of clients. *Second,* clients needed to be interviewed and reminded that the factors affecting the suitability of wrap accounts depended on their *current* personal situations, including their investment objectives, financial standing and risk tolerance. *Third*, client communication should be done periodically and consistently to ensure the adviser knew when to recommend a wrap or non-wrap account.

Separately, the staff also provided their view of how advisers' compliance policies needed to be improved. These are described below:

- Written compliance policies and procedures should include the specific factors used to assess whether investment recommendations made to clients participating in wrap fee programs (including asset allocations and selection of managers) are in the clients' best interests. Further, the policies and procedures should be designed to validate that supervised persons are complying with these factors by: (1) conducting periodic reviews of each supervised person's documentation; and (2) using compliance staff, automated systems, and/or internal controls to promote compliance.

- Compliance programs should monitor and validate that the advisers sought best execution for their clients' transactions. These assessments should be conducted periodically and documented. Further, the advisers need to ensure they had knowledge or control over the trades executed by the underlying portfolio managers in the wrap programs, including trading-away activity. The SEC noted that when advisers conducted such reviews of trading activity, some firms did in fact identify potentially problematic activity such as excessive trading, infrequently traded accounts, wash sales, inappropriate recommendations of affiliated products, and inappropriate charges of commissions for wrap fee clients.

- Advisers' compliance policies and procedures should define when an account is deemed "infrequently" traded, and the advisers' compliance programs should review such accounts to determine whether the wrap fee programs remain in those clients' best interests (whether the expenses associated with being placed in another type of account would be less). Furthermore, the SEC stated that when advisers identified wrap fee arrangements that were no longer in their clients' best interests, those client accounts should be moved out of the advisers' wrap fee programs.

**Conclusions and Recommendations**

In general, the Division's Risk Alerts do not result in punitive action against the examined firms. Instead, the recommendations prescribed are intended to be acted upon by the examined firms and the industry as a whole to improve their supervisory, compliance and/or other risk management systems. It should be noted that the examined firms began taking steps to improve their compliance policies, procedures, and reviews to reduce their risk concurrent with the staff's examination.

Well-run compliance departments at advisors generally incorporate many of the Division's recommendations as part of their efforts at complying with best practices. In this regard, many advisery firms, on a tactical basis, look either to industry groups or third-party consulting firms to help with their efforts at employing best practice policies and procedures.

**Abel Noser's asset owner division, Zeno AN Solutions, has for the past two plus decades, not only quantified the costs associated with some of the inadequacies noted above but has helped advisors to install best practice policies and procedures in-line with the discussion noted above. It is in this context that we conclude this analysis.**

In their review, the Division staff articulated three recurring themes which resulted as consequences from poor oversight processes:

1. *The potential for increased client trading-away costs, including commissions and exchange fees.* Commissions are fees generally paid to broker-dealers to facilitate trades. Commonly integrated (as a bundled fee) with commission are research costs paid to broker-dealers either for proprietary or third-party research. These charges can inflate the client and advisors' overall exposure to commissions costs. Separately, additional fees are charged either by venue or exchange where trades are completed. In suggesting commissions and fees are a (client and firm) risk, the Division subtly acknowledges that these costs can be substantial, without defining the magnitude of these costs and fees. From the Zeno AN Solutions database of trading, the dimensions of these commission costs range from a few hundred dollars up to a million dollars annually, depending on the size of the account and the amount of trading turnover executed annually.

2. *Any additional fees in wrap fee programs were not clearly disclosed*. Examples of these costs are fixed income trading mark-ups and 12-b1 fees from selling clients certain mutual fund products. In the final rules for Regulation BI published in 2019, the SEC sized the volume of revenues generated from commissions and fees (such as wrap and fees from selling funds) for dually registered investment advisors who also had a broker-dealer arm. They found that the revenues from fees (roughly $17.56) represented double the revenues from commissions. For standalone registered broker-dealers, both commissions and fees represent roughly equal amounts of revenue.

3. *The lack of adviser best execution policies and oversight and any resulting potential non-compliance and risk.* A term of art that generally refers to the advisors' own measurement of trading and trading policies, best execution is frequently quoted and seldom defined. In the CFA Institute's vast knowledgebase[5] is a definition for best execution that seeks not just to inform individual investors but institutional investors as well who are seeking clarity. The CFA Institute definition is as follows:

   *The trading process firms apply that seeks to maximize the value of a client's portfolio within the client's stated investment objectives and constraints.*

   In fact, the CFA institute has more to say on the subject, elaborating on the definition, with recognition that best execution:

   - Is intrinsically tied to portfolio-decision value and cannot be evaluated independently,
   - Is a prospective, statistical, and qualitative concept that cannot be known with certainty ex ante (or before the trade has taken place),
   - Has aspects that may be measured and analyzed over time on an ex-post (or after the trading event) basis, even though such measurement on a trade-by-trade basis may not be meaningful in isolation, and,
   - Is interwoven into complicated, repetitive, and continuing practices and relationships.

This definition of Best Execution is not intended to conflict with existing regulatory definitions but, rather, to provide additional explanation and guidance. In measuring costs consistently with the CFA Institutes definition over a long period of time, Zeno AN is able to describe the dimensions of these costs, which are many times the magnitude of commissions costs. In fact, these costs are consistently measured in the Zeno AN Solutions database to detract anywhere from a few basis points to several percentage points from annual portfolio returns.

[5] https://www.cfainstitute.org/-/media/documents/code/other-codes-standards/trade-management-guidelines.ashx

**Many of Zeno AN Solutions' asset owner clients as fiduciaries are obligated to maintain their own oversight policies for their internal and external advisers/asset managers. The clients with effective and efficient best execution oversight programs seek to:**

- **Articulate an internal policy that is actionable and clear**
- **Understand the magnitude of their asset manager's trading costs through measurement**
- **Consistently, and in a repeatable format, follow-up with their asset managers to understand their trade management policies, their best execution policies, and the structure of the compliance at the adviser/asset manager**
- **Review the manager's transaction cost measures specific to their account and to determine the scope of any issues they encounter when trading**
- **Ensure that the advisor's policies are adopted firm wide**
- **Gauge the efficacy of the asset manager's best execution oversight processes, including their internal record keeping and disclosures**

**In our experience working with clients, we find those asset owners and managers who document and articulate effective "risk-mitigating" compliance programs as they relate to best-execution should consider and implement these policies on a proactive basis.**