COMMENTARY

Bum rap? Wrap fee programs under scrutiny

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Assets and fee-based advisory accounts at broker-dealers are growing exponentially, drawing increased scrutiny from the Securities and Exchange Commission, which is concerned that "wrap accounts" could be misused by some financial advisers. In a wrap account, clients pay an annual or quarterly fee for wrap products that manage a portfolio of investments, rather than paying individual commissions for trades.

In January 2014, the SEC's Office of Compliance Inspections and Examinations announced that wrap account programs would be an examination priority for the year. A primary concern of the SEC is so-called "reverse churning," where investors are in wrap accounts that pay a fixed fee but generate little or no activity to justify that fee. In their examinations, the SEC has been requesting information on how advisers determine the suitability of wrap fee programs and how advisers ensure best execution for their clients.

The SEC is particularly concerned with dual registrants, firms which are both broker-dealers and investment advisers, which may influence whether a customer establishes a brokerage or investment advisory account. The SEC is concerned where a customer is placed in an inappropriate account type that increases revenue to the firm and may not provide a corresponding benefit to the customer.

The "information request list" on wrap accounts, which the SEC sends to advisers who are being examined, seeks details on disclosure, account activity and transaction fees. For example, during an SEC examination, advisers will be asked by the examiner to provide their firm's compliance policies and procedures, and any additional procedures not included in their compliance manual that specifically address the wrap fee program.

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Examiners will request the following information:

- The name of the wrap program.
- The account's investment manager.
- Total value of the account's assets.
- Total fee percentage received by the adviser.
- Investment strategy and the performance composite in which the account is included.
- Whether the adviser has discretionary authority over the accounts.

The SEC will also request the program brochure, wrap advisory agreements, contract, agreements, client complaints involving the wrap fee program, information regarding any litigation concerning wrap accounts and any marketing material used to promote the firm's wrap fee program.

The SEC's focus on the issue comes as the lines between investment advisory activity and that of broker-dealers have been blurred. In 2007 a rule exempting fee-based brokerage accounts from the fiduciary standard investment advisers must adhere to — dubbed the "Merrill Lynch Rule" — was vacated. The SEC fears the inability to charge advisory fees in brokerage accounts may have created an incentive to transfer assets from brokerage accounts to advisory accounts.

In addition, under the Dodd-Frank law, the SEC is now studying the differences between regulations that apply to investment advisers' activities and those that apply to broker-dealers' activities. The examination the SEC is now conducting related to churning and reverse churning will be designed to help meet that mandate under Dodd-Frank.

The SEC's scrutiny of wrap accounts was demonstrated in August, with a ruling in its favor in a court case involving an adviser who improperly placed his clients in wrap fee programs. *SEC v. Sage Advisory Group LLC et al.*, No. 10-11665, *verdict returned* (D. Mass. Aug. 13, 2014). In Boston federal court, a jury decided in the SEC's favor against Benjamin L. Grant, an investment adviser who, the agency said, improperly induced clients to follow him when he left Wedbush Morgan Securities to set up his own firm.

The SEC's complaint, filed in September 2010, alleged Grant encouraged his clients to move with him, saying they would save money on fees. Grant said the clients would pay a 2 percent wrap fee to his firm, which included advisory and management fees, as well as transaction costs, instead of the 1 percent fee plus trading commissions the clients were charged at Wedbush.

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The SEC alleged Grant failed to disclose to his clients that brokerage costs would be significantly lower at the discount broker he used, Charles Schwab & Co., compared with the money manager Wedbush employed, First Wilshire Securities Management Inc. The SEC alleged the savings lined Grant's pockets, as his compensation rose from less than $500,000 in 2004-2005 to more than $1 million in 2006-2007.

The Financial Industry Regulatory Authority will also be paying attention when large numbers of clients switch to fee-based accounts with insignificant activity to justify the fee. While such actions are not a violation of FINRA rules per se, they could warrant additional review or referral to the SEC.

In addition, there has been an increase in FINRA arbitration claims related to fee-based accounts. In these claims, customers typically allege that the activity in their account did not justify the fee charged. In such claims, aggrieved customers seek a return of the advisory fee paid.

In defending against these claims, however, deciding whether such an account was right for a client is not always about the frequency of activity. An account that charges a fee based on a client's assets may, for example, provide access to additional account managers or also offer more frequent and comprehensive advice.

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Wrap programs will continue to present a challenge to broker-dealers from a supervisory and compliance perspective. In order to protect themselves from regulatory issues and claims, broker-dealers should consider the following:

- Offering detailed training to representatives on how to approach transfers from commission-based to fee-based accounts.
- Documenting discussions with customers that include clear disclosure of the available options, as well as their benefits and detriments.
- Surveillance reports that monitor for low volume of activity in fee-based accounts and a high volume of activity in commission-based accounts.

Broker-dealers should also train representatives to document every interaction with their customers. Documentation of interactions with the customer may be critical in situations where there is infrequent activity in the account itself, but the adviser provided frequent and comprehensive advice to the customer. WJ

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