



RISK ALERT

DIVISION OF EXAMINATIONS

July 21, 2021

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

I. Introduction

As part of the Division of Examination’s (the “Division”) assessment of market-wide risks and matters of importance to retail investors saving for retirement, the Division has prioritized examinations of advisers associated with wrap fee programs.¹ Advisory clients who participate in wrap fee programs generally pay the programs’ sponsors a consolidated fee that includes investment advisory services and the execution of transactions. The wrap fee is generally based on a percentage of the value of the client’s account in the wrap fee program (the “wrap fee account”), rather than upon the transactions in the client’s account. Wrap fee programs may offer clients certainty concerning advisory and execution costs for implementing, maintaining, and changing their investment strategies. However, these programs may also create conflicts of interest for advisers and risks to investors – such as incentives for advisers trading less frequently than may be in the client’s best interest, engaging in transactions that reduce costs to the adviser but increase expenses borne by the client, or mis-billing by failing to incorporate certain covered transactions costs into the wrap fee – to the extent that advisers or their supervised persons have incentives to lower their internal costs.

The Division focused on wrap fee programs because of the continued growth of investor assets participating in such programs and the conflicts and disclosure practices observed during previous examinations.² As part of this focus, the Division conducted over 100 examinations of

* The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the “Division”). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the “SEC” or the “Commission”). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by Division staff and is not legal advice.

¹ See, e.g., Division Examination Priorities for [2017](#), [2018](#), and [2019](#). Wrap fee programs can be called by several different names, such as: asset allocation programs, asset management programs, investment management programs, mini-accounts, uniform managed accounts, and separately managed accounts. See also, Office of Investor Education and Advocacy, [Investor Bulletin: Investment Adviser Sponsored Wrap Fee Programs](#) (Dec. 7, 2017) (provides basic information about adviser-sponsored wrap fee programs).

² See, e.g., [In re Robert W. Baird & Co Inc.](#), Advisers Act Rel. No. 4526 (Sept. 8, 2016) (settled) and [In re Raymond James & Associates Inc.](#), Advisers Act Rel. No. 4525 (Sept. 8, 2016) (settled) (the SEC alleged that these two advisers failed to establish policies and procedures necessary to determine the amount of commissions their clients were being charged when sub-advisers “traded away” with a broker-dealer outside the wrap fee programs). See also, [In re RiverFront Investment Group LLC](#), Advisers Act Release No. 4453 (Jul. 14, 2016) (settled) (the SEC alleged that this advisory firm made materially misleading disclosures to its clients concerning the frequency that it traded in a manner that resulted in additional,

advisers associated with wrap fee programs from two perspectives, including advisers that: (1) served as portfolio managers in, or sponsors of, wrap fee programs (“wrap fee advisers”); and (2) advised their clients’ accounts through one or more unaffiliated third-party wrap fee programs (“Wrap Fee Initiative”) (collectively, “examined advisers”).³

The staff observed that many examined advisers’ compliance programs could be improved. The most frequently cited deficiencies were related to: (1) compliance and oversight, including policies and procedures regarding the tracking and monitoring of the wrap fee programs; and (2) disclosures, including disclosures regarding conflicts, fees, and expenses. In some instances the staff questioned the appropriateness of recommendations of wrap fee programs for clients, particularly when the clients had no or low trading volume in their accounts. This Risk Alert discusses these deficiencies and other staff observations.

II. Focus of Examinations

Wrap Fee Initiative exams generally focused on the following areas:

- *Consistency with fiduciary duty obligations.*⁴ The staff reviewed whether the examined advisers had fulfilled their fiduciary duty by having a reasonable basis to believe that the wrap fee programs were in the best interests of participating clients – both initially and on an on-going basis – and whether the advisers had documented such assessments.⁵ The staff also reviewed for the imposition of undisclosed transaction charges (*e.g.*, charges associated with undisclosed trade-away practices) and for the extent of account trading activity (*e.g.*, little-to-no trading activity in accounts for extended periods of time).
- *The adequacy of the examined advisers’ disclosures.*⁶ The staff assessed whether the examined advisers provided full and fair disclosures of all material facts to their clients

insufficiently disclosed transaction costs to advisory clients in wrap fee programs that were not covered by the annual wrap fee).

³ Approximately one-quarter of the firms were examined as part of the Wrap Fee Initiative. The staff notes that some of the advisers examined under this Initiative recommended mutual funds within the wrap fee programs.

⁴ Section 206 of the Investment Advisers Act of 1940 (“Advisers Act”) imposes a fiduciary duty on advisers (*see, e.g.*, [Commission Interpretation Regarding Standard of Conduct for Investment Advisers](#), Advisers Act Rel. No. 5248 (Jun. 5, 2019) (the “[Fiduciary Interp.](#)”). As fiduciaries, investment advisers owe their clients a duty of care, which includes a duty to provide investment advice to a client that is in the best interest of the client, including a duty to provide advice that is suitable for a client. In order 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 fee wrap account continues to be in the client’s best interest. In providing advice about account type, an adviser should consider all types of accounts offered by the adviser and acknowledge to a client when the account types the adviser offers are not in the client’s best interest.

⁵ *See, e.g.*, [Pruco Securities LLC](#) (“Pruco”), Advisers Act Rel. No. 5657 (Dec. 23, 2020) (settled) (the SEC alleged that Pruco breached its fiduciary duty to its advisory clients participating in a wrap fee program by, among other things, failing to conduct stated monitoring of client accounts to determine whether the wrap fee programs continued to be suitable for clients and violated its duty to seek best execution for certain transactions by selecting or recommending mutual fund share classes when share classes of the same funds were available to the clients that presented a more favorable value or better performance).

⁶ Advisers must eliminate or make full and fair disclosure of all conflicts of interest that might cause them – consciously or unconsciously – to render advice which is not disinterested such that a client can provide informed consent to the conflict (*see id.*). Each wrap fee sponsor generally must deliver a Form ADV Part 2A Appendix 1 wrap fee program brochure to its wrap fee clients (Advisers Act Rule 204-3(d)). Advisers that are not sponsors and that recommend wrap fee programs as investments are required to provide their own Part 2A brochure to clients. Portfolio managers providing management services for wrap fee programs that they do not sponsor are generally required to provide their Part 2A brochure to clients invested in

participating in the wrap fee programs, particularly regarding the fees, expenses, conflicts of interest, and entities involved in the programs.⁷ The staff also reviewed whether the agreements between the examined advisers and the wrap fee program sponsors, portfolio managers, any solicitors referring clients to the wrap fee program, and other service providers sufficiently disclosed which parties would be fulfilling certain core responsibilities for the participating wrap fee clients' accounts.

- *The effectiveness of the examined advisers' compliance programs.*⁸ The staff assessed the effectiveness of the examined advisers' compliance policies and procedures and other processes, particularly those for determining whether the wrap fee programs and accounts were in the best interests of their clients.

III. Staff Observations

Below are the common deficient practices observed by the staff, as well as certain industry practices observed that may help firms address some of the areas of non-compliance.

A. Observations Regarding Common Deficient Practices

The staff observed common deficient practices in the areas of advice to clients about participation in wrap fee programs and monitoring the clients' wrap fee accounts, disclosures, and compliance policies and procedures, which are highlighted below.

Fiduciary Duty and Recommendations Not Made in Clients' Best Interests

The staff often observed issues with the examined advisers' recommendations for clients to participate in wrap fee programs. These issues related to both the advisers' trading practices and their assessments that the wrap fee programs were initially, and on an on-going basis, in the best interests of their clients. For example:

- *Advisers did not monitor the trading activity in clients' accounts or their monitoring activities were ineffective.* The most common duty of care issue was the examined advisers' failure to monitor for "trading-away" from the broker-dealers providing bundled brokerage services to the wrap fee programs and the associated costs of such trading-away practices. In

their wrap fee program portfolio (see [Instructions for Part 2A of Form ADV: Preparing Your Firm Brochure](#) ("[Form ADV Instructions](#)," Instruction 11).

⁷ See supra [Pruco](#) at note 5 (the SEC alleging that Pruco breached its fiduciary duty to advisory clients participating in its wrap fee programs and paying an all-inclusive fee for asset management and trade execution by: (1) charging certain fees to clients contrary to its disclosures; (2) recommending that clients purchase and hold certain mutual funds and mutual fund share classes that paid Pruco fees pursuant to Rule 12b-1 under the Investment Company Act of 1940 ("12b-1") without disclosing the conflict of interest arising therefrom; (3) failing to disclose that it received revenue sharing payments on client investments pursuant to an agreement with its clearing firm, which also allowed the firm to avoid paying certain transaction fees for its clients' purchases of mutual funds; and (4) recommending bank sweep vehicles for which the clearing firm paid the adviser revenue sharing, which was not disclosed).

⁸ Advisers Act Rule 206(4)-7 (the "Compliance Rule") requires SEC-registered advisers to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and rules thereunder by advisers and their supervised persons. In addition, advisers are required to conduct annual reviews of their policies and procedures to assess their adequacy and effectiveness. See also, generally, [Final Rule: Compliance Programs of Investment Companies and Investment Advisers](#), Advisers Act Release No. 2204 (December 17, 2003) ("Adopting Release").

these instances, the advisers were purportedly providing on-going monitoring services and continued to recommend the wrap fee programs to clients, but did not consider that the clients may have incurred transaction costs in addition to paying the bundled wrap fees. Infrequent trading in wrap fee accounts was also identified at several examined advisers, raising concerns that clients whose wrap fee accounts are managed by portfolio managers with low trading activity are paying higher total fees and costs than they would in non-wrap fee accounts.

- *Advisers did not have a reasonable basis to believe that the wrap fee programs were in the clients' best interests.* The staff observed instances where the examined advisers routinely recommended that their clients participate in wrap fee programs without conducting any assessments as to whether programs were in the best interests of clients (initially, on-going, or both). In other instances, the examined advisers: (1) conducted initial reviews, but did not continue to consider whether the programs remained in the clients best interests, and did not obtain or maintain information from clients to assist in periodically reassessing whether the wrap fee programs remained in the clients' best interests; or (2) conducted on-going assessments, but such reviews were inadequate, including instances of reviews comprising a very small sample of accounts or systematically excluding certain accounts (*e.g.*, transferred accounts, legacy accounts, or both).

Potentially Misleading or Omitted Disclosures

The staff observed that many of the examined advisers had omitted or provided inadequate disclosures, particularly disclosures regarding conflicts of interest, fees, and expenses. Examples of these disclosure issues are described below.⁹

- *Advisers had inconsistent disclosures regarding the same topic in various documents.*¹⁰ The staff identified disclosure issues when reviewing for consistency across the examined advisers' Part 2A of Form ADV (the firm brochure), sponsors' Part 2A Appendix 1 of Form ADV (the wrap fee program brochure), advisory agreements, and other account documents and agreements for wrap fee clients, such as:
 - The firm brochure did not provide full disclosures regarding fees that were not included in the wrap fee (*e.g.*, fixed income mark ups and trade-away fees that were discussed in the wrap fee program agreements, and information related to clients paying both an advisory fee and fees to participate in the wrap fee program).
 - Advisory agreements indicated that clients will pay brokerage commissions, but the wrap fee program brochures expressly stated that clients will not pay such fees.

⁹ See *supra* [Fiduciary Interp.](#) at note 4 (“[i]n order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent”).

¹⁰ Form CRS was not reviewed because the examinations occurred before the compliance date for this new form (June 30, 2020) (see [Form CRS Relationship Summary: Amendments to Form ADV](#), Advisers Act Rel. No. 5247 (June 5, 2019)).

- Disclosed house-holding discounts and other rebates (e.g., rebating 12b-1 fees on clients' fee billing statements) were not applied, resulting in clients being overbilled.
- *Advisers omitted disclosures or inadequately described conflicts of interest.* The disclosures often omitted or inadequately described the financial incentives the examined advisers and their supervised persons had to make certain recommendations.¹¹ Examples of poor or omitted disclosures include conflicts regarding:
 - Supervised persons, who would incur transaction costs when executing certain investments they recommended to clients, made investment and account recommendations that resulted in clients paying higher fees while avoiding transaction costs the supervised persons would incur. This included supervised persons that were: (1) responsible for paying any ticket charges, but recommended clients purchase mutual fund share classes that charged 12b-1 fees (and were likely more expensive for clients) that did not incur ticket charges;¹² and (2) not recommending that clients move from wrap fee accounts to non-wrap accounts because the supervised persons would be required to pay certain expenses and transaction fees with such account transfers.
 - Certain investment recommendations that resulted in clients paying higher expenses because they were participating in the wrap fee programs. For example, the advisers recommending wrap fee programs to their clients did not disclose that accounts with low trading volumes, high cash balances, or significant fixed income weightings may be able to receive similar services at a lower cost outside of a wrap fee program. Similarly, such advisers did not disclose that wrap fee accounts that incurred transaction-based costs for transactions excluded from the bundled fee, such as trading away fees, may collectively be paying higher fees.

Compliance Programs

The staff frequently observed that the examined advisers had weak or ineffective compliance policies and procedures relating to their wrap fee programs. Also, in some instances, advisers did not comply with their own policies and procedures, and a few advisers did not comply with the annual review and other provisions of the Compliance Rule. The staff's observations are discussed in greater detail below.

- *Advisers omitted compliance policies and procedures.* In many cases, the examined advisers did not adopt and implement written compliance policies and procedures for key business functions and risk areas, including conducting initial and/or on-going best interest reviews when recommending wrap fee accounts to clients. In some instances, the wrap fee advisers

¹¹ See Investment Management, [Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation](#) (Modified Oct. 18, 2019) (“[Financial Conflicts FAQs](#)”) (“an adviser must disclose if it or its supervised persons accepts sales compensation, including asset-based sales charges or service fees. This item includes several specific disclosures, including information about the conflict, how the adviser addresses the conflict and whether the adviser offsets the compensation against its advisory fees”).

¹² A ticket charge is a flat fee charged by a broker-dealer in connection with executing a transaction.

had no compliance policies or procedures that addressed the risk applicable to recommending and managing client participation in wrap fee programs, despite providing advisory services to such programs.¹³ Lastly, some of the examined advisers followed internal guidelines or informal practices for key operational areas, but had not memorialized these practices in written compliance policies and procedures. Examples of areas where advisers had informal practices included: (1) conducting best interest reviews of client accounts; (2) conducting best execution analysis for wrap fee accounts (when appropriate); and (3) selecting separate portfolio managers to advise portions of clients' wrap fee accounts.

- *Advisers had inadequate policies and procedures.* The staff observed compliance programs that were deficient because the examined advisers had inadequate policies and procedures for key areas. In some cases, the advisers' policies and procedures included inaccurate information about the firm, or the policies were not tailored to the advisers' businesses. In other cases, the policies and procedures touched on certain key risk areas, but did not fully address the applicable risks, such as in the areas of: (1) reviewing the trading activity in wrap fee accounts for trading-away practices; (2) determining suitability of wrap fee accounts versus other types of advisory or, if applicable, brokerage accounts;¹⁴ (3) conducting best execution analysis; (4) identifying accounts over which the firms maintained custody; and (5) delivering disclosure documents.
- *Advisers inconsistently implemented or enforced, or failed to implement, their policies and procedures.* Several of the examined advisers had not fully implemented or enforced their compliance policies and procedures. Examples of such practices included instances where advisers were not: (1) conducting due diligence on third-party portfolio managers they recommended to clients, despite statements otherwise, (2) reviewing client accounts and fee billing as outlined in the policies; and (3) implementing policies, as stated, related to best interest reviews, advertising, code of ethics, and ensuring disclosure documents were current.
- *Advisers did not perform required annual reviews or performed the reviews inadequately.* A few of the examined advisers did not conduct annual compliance reviews. Several others conducted annual reviews, but the reviews were inadequate due to: (1) the limited testing or validation that took place; (2) their failures to review the effectiveness of the advisers' policies and procedures, particularly in the areas of client fees and best interest, thus failing to identify compliance issues that occurred in these areas; or (3) their inability to demonstrate that they performed an annual review (primarily due to maintaining minimal documentation regarding the reviews and tests performed).

B. Observation Regarding Industry Practices

During the examinations, the staff observed advisers implementing a range of policies and practices to address their legal and regulatory obligations related to the compliance issues

¹³ See *supra* [Adopting Release](#) at note 8 (“[e]ach adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm’s particular operations, and then design policies and procedures that address those risks”).

¹⁴ See *supra* [Fiduciary Interp.](#) at note 4, at footnote 44 (discussing when a financial professional should consider both advisory and brokerage accounts).

identified above. Recognizing that there is no such thing as a “one-size fits all” approach, the staff is providing these observed examples of policies and practices to assist advisers with compliance in these areas.

Fiduciary Duty and Recommendations Made in Clients’ Best Interest

- *Conduct reviews of wrap fee programs – both initially and periodically thereafter – to assess whether the programs recommended to clients are in the best interests of clients, using information obtained directly from clients (e.g., through interviews, discussions, and/or questionnaires).* When such information was obtained, the staff observed that examined advisers used it to: (1) evaluate clients’ financial situations, risk tolerances, and investment objectives; and (2) determine the appropriateness of the account types, portfolio manager selections, and asset allocation recommendations, both when onboarding client accounts and periodically thereafter.

Although the information collected by advisers to conduct these reviews varied, most advisers collected at least the following information to assess clients’ personal and financial situations: retirement goals, current employment status, investment time horizon, stated financial objectives (e.g., capital appreciation), risk tolerances (e.g., conservative or aggressive), amount to invest, age, income, investment income needs, net worth, savings, planned spending from the account, dependents, liabilities, and other investment assets not managed by the adviser.

- *Periodically remind clients, after conducting initial best interest reviews associated with the recommendation to participate in wrap fee programs, to report any changes to their personal situations, or financial standing or needs, and investment objectives that might impact the clients’ risk tolerances, investment allocations, and/or recommended investments.*¹⁵ The staff observed that when advisers sent their clients these reminders, they often did so both orally (e.g., phone, video chat, or in-person) and in writing (e.g., email, text, or reminders on client account statements). Also, in most cases, the advisers sent these reminders on a fixed schedule and the communication clearly indicated the individuals to contact at the advisers, provided information regarding how to contact them, and identified the pertinent updates requested.
- *Communicate with clients – in-person or telephonically, as appropriate – to prepare and educate clients when recommending to convert their accounts from non-wrap fee accounts to participating in wrap fee programs.* The staff observed that during these communications clients were provided with information regarding investing through wrap fee program accounts (e.g., the differences associated with such account strategies and account best interest), including assessments of the fees, expenses, and other costs involved.

¹⁵ See *supra* [Fiduciary Interp.](#) at note 4, Investment Company Act of 1940 (“Company Act”) Rule 3a-4, and [Status of Investment Advisory Programs under the Investment Company Act of 1940](#), Company Act Rel. No. 21260 (Jul. 27, 1995) (stating that advisers that recommend or sponsor discretionary investment advisory programs, and rely on the safe harbor afforded under Company Act Rule 3a-4, have a requirement to contact clients at least annually “to ensure that sponsors have current information about clients in the program, which, in the Commission’s view, is critical to the provision of individually tailored advice”).

Disclosures

- *Provide clients with disclosures regarding the advisers' conflicts of interest related to transactions executed within the wrap fee programs.* For example, when applicable, the staff observed the following disclosures during examinations of advisers recommending wrap fee programs:¹⁶
 - The advisers receive compensation or incentives from wrap fee program sponsors or portfolio managers for investing client assets through the wrap fee programs (e.g., soft dollars, forgivable loans, technology, or other services provided).
 - The advisers have financial incentives to not migrate infrequently traded wrap fee accounts to brokerage or non-wrap advised accounts.
 - The advisers or their supervised persons have incentives to not trade in clients' accounts because they may be responsible for paying ticket charges or other costs.
 - Clients may incur more costs by participating in the wrap fee program than if they received similar services provided in other types of accounts.
 - Clients would pay share class charges – such as 12b-1 fees – when lower cost alternative classes of the same fund may be available, and that such fees would be paid to the advisers' supervised persons.
- *Provide clear disclosures, when recommending wrap fee programs to clients, about whether certain services or expenses are not included in the wrap fee.* For example, when the following types of fees were excluded from the wrap program, the staff observed that some advisers that recommended wrap fee programs provided clear disclosure concerning the impact on clients: (1) charges directly imposed by mutual funds or ETFs held in clients' accounts, including fees and expenses embedded within the funds' NAV or offering price; (2) additional charges for particular types of trades, such as options trading; (3) wire and electronic fund transfer fees; and (4) overnight carrier fees. The firms also disclosed other types of additional expenses that may be incurred by clients, such as those for transfer taxes, margin account balances, odd-lot differentials, early settlement fees (i.e., fees that may be charged when clients exit investment positions or withdraw cash), and custodial expenses on certain types of investments and services (e.g., spreads, clearing costs, reporting fees, processing fees, or revenue sharing fees).

Compliance Programs

- *Written compliance policies and procedures include factors to be used when assessing whether investment recommendations made to clients participating in wrap fee programs, including asset allocations and selection of managers, are in the clients' best interests.* The

¹⁶ Certain compensation arrangements result in related disclosure obligations arising from both the investment adviser's fiduciary duty and Form ADV. See supra [Form ADV Instructions](#) at note 6. See also supra [Financial Conflicts FAQs](#) at note 11.

staff observed policies and procedures designed to validate that supervised persons were complying with these factors by: (1) conducting periodic reviews of supervised persons' documentation; and (2) using compliance staff, automated systems, and/or internal controls to promote compliance.

- *Compliance programs monitor and validate that the advisers sought best execution for clients' transactions.* The staff observed that advisers, in making these assessments: (1) adopted policies and procedures to address best execution reviews, and periodically conducted and documented such reviews; and (2) ensured they had knowledge or control over the trading executed by underlying portfolio managers in the wrap programs, including trading-away activity. The staff also observed that when advisers conducted such reviews of trading activity, some firms identified 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.
- *Compliance policies and procedures define what the advisers that recommend wrap fee programs to clients consider to be "infrequently" traded accounts and compliance programs review such accounts to determine whether the wrap fee programs remain in the clients' best interests.* Furthermore, the staff observed that when these advisers identified that the wrap fee arrangements were no longer in their clients' best interests, the wrap fee accounts were either moved to brokerage accounts (*i.e.*, ending the wrap fee-related advisory agreement) or another type of advisory arrangement.

IV. Conclusion

The examinations within the scope of this review resulted in a range of actions. In response to the staff's observations, advisers elected to amend disclosures, revise compliance policies and procedures, conduct suitability reviews of wrap fee clients, or change other practices. In sharing the information in this Risk Alert, the Division encourages advisers that recommend wrap fee programs to consider and adopt policies and procedures to address those risks, conflicts, and challenges.

This Risk Alert is intended to highlight for firms risks and issues that Division staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
