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SPOTLIGHT ON

The SEC's Risk Alert on Wrap Fee Programs

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The Latest Wrap Fee Risk Alert

The Securities and Exchange Commission's ('SEC") Division of Examination (the "Division") posted their latest Risk Alert relating to Investment Advisers participating in Wrap Fee Programs on July 21, 2021. Briefly, a Wrap Fee Program is a fee structure for Investment Advisers where the client pays a bundled fee that, in addition to the investment management fee, also covers the additional fees that Investment Adviser clients typically encounter, such as broker fees, ETF fees, administrative fees, and third-party service costs. This bundled fee is typically charged as a standard annualized assets under management (AUM) percentage. The intent underlying this fee structure is to reduce costs for the clients and provide them a simpler fee structure, rather than random itemized fees coming out of their account throughout the year.

This specific Risk Alert addressed three main issue areas in connection with Wrap Fee Programs the Division has observed in recent examinations:

1) Consistency with Fiduciary Duty Obligations;

2) Adequacy of Examined Advisers' Disclosures; and

3) Effectiveness of Examined Advisers' Compliance Programs.

Issues of Focus

Consistency with Fiduciary Duty Obligations

The most fundamental duty an Investment Adviser has while going through their day-to-day operations is their fiduciary duty to the client. A fiduciary duty is most simply described as the obligation to act in the best interests of the client. Thus, in the Division's first issue, they illuminate the question of whether Investment Advisers recommending client participation in Wrap Fee Programs are fulfilling their fiduciary duty to said clients. More specifically, whether the Investment Advisers implement an assessment of the client on both a client-by-client basis and an ongoing basis once the client has engaged in the Program.

The Division provided three specific suggestions to address the potential fiduciary duty question. The first includes the Adviser conducting a review of the wrap fee program and how compatible it is with the specific client. This can be achieved by obtaining certain information about the client that aids the assessment as to whether a wrap fee program would be in the best interest of the client. This list should include the following pieces of information: retirement goals, current employment status, investment time horizon, stated financial objectives, risk tolerances, 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.

The Division noted that the Adviser should instruct the client to immediately inform the Adviser if any of the abovementioned pieces of information change. The Adviser should also take the next step by reaching out to clients on a fixed schedule to check whether any financial information has changed. By utilizing this double-sided system, the Adviser can ensure the implemented wrap fee program is still justifiable with the client's finances and financial goals.

Similarly, the Division recommends the Adviser communicate with clients regarding wrap fee programs in an extensive manner. This includes that the Adviser properly prepares and educates the client about the process of converting their account from a non-wrap fee account to a wrap fee program. These communications may include an assessment of fees, expenses, and other costs involved.

Adequacy of Examined Advisers' Disclosures

The Investment Adviser must provide many required disclosures throughout multiple documents in an effort to provide clients full transparency of where and what their money is going to. Investment Adviser's Wrap Fee Programs are no different. The Division's second issue revolves around whether Advisers were 1) properly disclosing all material facts regarding the Wrap Fee Program, including the specific fees, expenses, conflicts of interest and entities involved in the programs, and 2) the agreements between the Advisers and the wrap fee program sponsors, portfolio managers, any solicitors referring clients to the wrap fee program, and other service providers properly defined the core responsibilities for the wrap fee accounts.

The Division provided two main suggestions to address improper disclosure issues. The Adviser should provide clients with the conflicts of interest that may arise from participating in a wrap fee program. These potential conflicts of interest disclosures include: 1) the Adviser may receive compensation or incentives from wrap fee program sponsors to invest client assets in their specific programs; 2) the Adviser have financial incentives to remove infrequently traded accounts out of wrap fee accounts; 3) the Adviser has an incentive to not trade in client accounts if they are responsible for paying ticket charges or other costs; 4) clients may incur higher costs by participating in a wrap fee program; and 5) clients would pay share class charges when lower cost alternative classes of the same fund may be available.

Finally, the Adviser should provide proper disclosures to the client regarding what specific services or expenses are *not* included in the wrap fee program. In other words, the fees that the client will still have to pay above and beyond the wrap fee.

Effectiveness of Examined Advisers' Compliance Programs

Similar to the requirement of disclosures, Investment Advisers are also expected to adopt many compliance policies and procedures in an effort to eliminate any abuse, as has been seen in the past of this industry. Likewise, the Division's third issue is whether proper compliance policies and procedures have been adopted in regard to the Wrap Fee Programs. In addition, the Division also brings to light whether the adopted policies and procedures are effective in assessing whether the adoption of a Wrap Fee program was in the best interest of the client.

The Division provided three suggestions to Advisers to properly fulfill the compliance program requirements. The first is to include written compliance policies that create an assessment of whether recommendations made to clients to participate in wrap fee programs are in the best interest of the client. Specifically, this can be exercised by conducting periodic reviews of supervised persons' documentation and using different outlets and measures to promote compliance with these duties owed to the client.

The second is that compliance programs ensure the advisers seek best execution for client transactions. The Division found that many underlying portfolio managers were engaging in problematic behaviors such as over-trading, wash sales, improper recommendation of products, and improper commission charges. Advisers can address these problematic behaviors by adopting policies and procedures that require documented periodic execution reviews. In addition, Advisers are encouraged to ensure that they have knowledge or specific controls over the trading executed by the portfolio managers.

The final recommendation is to adopt compliance policies and procedures that require an analysis and further review of client accounts that may be defined as infrequent traders. This analysis and review can ensure the Adviser is properly charging a client a wrap fee program in the best interests of a client. Typically, if an account is infrequently trading, they are not accumulating many additional fees on top of management fees. If they are not incurring additional fees, then clients participating in wrap fee programs are likely paying much more comparatively to paying those fees in the standard itemized fashion.

In sum, Advisers should consider implementing compliance policies and procedures that specifically address these three main problem areas regarding wrap fee programs.

An Example Enforcement Case: Buttonwood Financial, LLC

The SEC filed a complaint against Buttonwood Financial, LLC ("Buttonwood," "the firm") and its principal officer on September 23, 2021. The SEC found multiple violations of the Adviser Act regarding the structure and execution of the firm's Wrap Fee Programs, which included all three issues discussed in the Division's recent risk alert. The SEC highlighted the fact that nearly all of Buttonwood's clients participated in Wrap Fee Programs, some of which likely did not need to be in a Wrap Fee Program. This coincides with Buttonwood's fiduciary duty to their clients, as highlighted in the first issue of the risk alert. Simply put, if the client is overpaying for services, it the Wrap Fee Program is not in the best interests of the client. Furthermore, the SEC makes no mention of an assessment system implemented on a client-by-client basis, from the initial engagement or ongoing, analyzing what would be each individual client's best interests, as recommended in the risk alert.

Another finding by the SEC was that Buttonwood primarily invested their clients' assets in higher internal cost mutual funds in an effort to reduce transactional costs for the firm. If the mutual fund had higher internal costs, Buttonwood's broker typically did not charge the firm. Thus, the clients regularly ended up paying a higher amount of fees out of their own assets, which allowed Buttonwood to receive a higher "management fee" through the bundled wrap fee. On top of this generalized violation, Buttonwood also actively participated in a specific arrangement with their main broker that reduced costs assessed against the firm and instead charged the clients higher fees through a "60/40" agreement. The 60/40 arrangement provided that in exchange for Buttonwood maintaining at least 60% of all client assets in a specific share of mutual funds (generally the more expensive ones), the broker would waive all transaction fees for the other 40% of client assets. These scenarios create a blatant conflict of interest where Buttonwood investment adviser representatives are incentivized to place client assets in more expensive funds in order to avoid more expenses for the firm. Under their fiduciary duty or duty of loyalty, Investment Advisers must disclose all conflicts of interest. In this case, Buttonwood did not make any mention of the glaring conflicts of interest muddled within their business structure. This is specifically addressed in the second issue of the risk alert regarding proper disclosures of a wrap fee program.

Finally, the SEC found that Buttonwood did not have proper compliance policies and procedures in place, which could have helped avoid these violations. The third issue of the risk alert highlights all of the suggested procedures and policies an Adviser should have in place and after the SEC's investigation, it was clear that Buttonwood did not possess any of them. Specifically, the SEC highlighted a lack of policies and procedures relating to investments in mutual funds, selection of the different mutual fund share classes, the payment of transaction fees by advisory clients, or how the 60/40 arrangement and related conflicts of interests should be disclosed.

The fact that the SEC specifically targeted these issues showcases that the Commission aligns with the Division's observations regarding Wrap Fee Programs, and it will be an area of emphasis moving forward.

What does this mean and how does it affect Investment Advisers?

This Risk Alert should put Investment Advisers on notice that their Wrap Fee Programs will be further scrutinized to ensure the Adviser is adhering to the requirements and principles laid out above. In addition, Advisers who are in the registration process or preparing to start the process should consider these highlighted areas when preparing their registration documents.

Implications for the future?

As indicated in the risk alert, a growing number of Advisers are utilizing Wrap Fee Programs. While the Division did not indicate the specific percentage of deficiencies regarding Wrap Fee Programs, the tone is apparent that it is significant. Thus, the Commission itself is likely to issue a specific ruling sometime in the near future, adjusting their regulations on Wrap Fee Programs, even more so considering the Buttonwood suit. This is something your compliance department should be on the lookout for in an effort to avoid fines or other disciplinary actions regarding your Wrap Fee Program.