

Insights

THE SEC'S DIVISION OF EXAMINATIONS HIGHLIGHTS INCREASED CONCERNS WITH WRAP FEE PROGRAMS

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Key Takeaways:

- Given the continued popularity of recommending wrap fee programs to clients, the Securities and Exchange Commission's ("SEC") Division of Examinations ("DOE") recently released a [Risk Alert](#) dated July 21, 2021, wherein it expresses concerns as to the appropriateness of such products for certain clients. According to the DOE, wrap fee programs (which typically bundle fees for investment advice, brokerage services, administrative expenses, and other fees and expenses) are not appropriate for and in the best interest of every client, particularly those advisory clients that engage in little to no trading activity for extended periods of time.
- The DOE specifically raises concerns over potential conflicts of interest presented by wrap fee programs in the form of: (1) incentives for investment advisers ("advisers") to trade less frequently than may be in a client's best interest; (2) engaging in transactions that cost less for the adviser but present additional costs to the client; and (3) failing to include assets in a wrap fee program that minimize a client's fees and expenses.
- The DOE also maintains the additional concern regarding clients receiving full and fair disclosure on the topics of fees and expenses, conflicts of interest, and the roles and duties of the respective entities in the participation and execution of wrap fee programs.
- Finally, the DOE provides insights into perceived compliance deficiencies observed in the examinations of more than 100 advisers.

Increased Regulatory Concerns With Wrap Fee Programs

The DOE is prioritizing its focus on the recommendation and use of wrap fee programs for retail clients when conducting examinations of advisers that offer these advisory programs. Having recently completed its examination of over 100 advisers that regularly recommended wrap fee programs to clients (the "examined advisers"), the DOE published a [Risk Alert](#) highlighting perceived deficiencies with some of these advisers' respective compliance programs and disclosure practices.

The Risk Alert highlights two key themes for advisers. First, advisers should conduct initial and on-going reviews of client accounts in wrap programs to ensure this investment strategy is appropriate and in the client's best interest. Second, advisers should provide full and fair disclosure on the topics of fees and expenses, conflicts of interest, and the roles and duties of the respective entities in the execution of wrap fee programs.

Notable Compliance Deficiencies

The following summarizes the DOE's observations and its commentary regarding these issues.

- ***Best Interest Reviews.*** Before recommending a wrap fee program, the DOE cautions advisers that they are required to have a reasonable basis to believe that an advisory program is in a client's best interests, both initially and on an on-going basis. The DOE observed that some of the examined advisers did not satisfy their fiduciary duties because they did not conduct an initial review to determine whether a wrap fee program was an appropriate investment vehicle for clients, and some did not conduct or document on-going reviews to ensure that a wrap fee program continued to be suitable based on a client's trading activity and incurred fees and expenses.
- ***Failure to Conduct and/or Document Annual Reviews.*** The DOE observed that some of the examined advisers failed to conduct annual account reviews despite the obligation to do so and/or failed to adequately document that the reviews occurred. The DOE also notes that some of the examined advisers that actually performed these reviews failed to design and implement policies and procedures to document these processes.
- ***Misleading or Omitted Disclosures.*** When recommending a wrap fee program, the client must receive full and fair disclosure about the fees and expenses s/he is being charged, the applicable conflicts of interest, and the roles and duties of the respective entities in the execution of wrap fee programs. The DOE observed that some of the examined advisers' disclosures were deficient in that they did not adequately explain the fees and expenses a client would incur as well as conflicts of interest associated with the wrap fee program. For example, the DOE expects that advisers would disclose that accounts with low trading volumes, high cash balances, or significant fixed-income holdings may qualify for decreased costs in other types of accounts.
- ***Failure to Deliver Disclosures.*** The DOE observed instances in which examined advisers failed to deliver the required disclosures to clients.
- ***Inadequate Policies and Procedures.*** The DOE notes that while many firms had policies and procedures to address certain risks that accompany the recommendation of wrap fee programs, such policies and procedures were not comprehensive enough to fully address the applicable risks.

- ***Inconsistent Implementation or Enforcement.*** The DOE identifies that some of the examined advisers had policies and procedures where they failed to implement or ascertain proper enforcement of their own policies. Examples include failing to conduct due diligence on portfolio managers even though the disclosures indicated that the advisers were conducting such reviews; reviewing client accounts to ensure proper billing, and implementing or enforcing policies that required best interest reviews.

Conclusion

Wrap fee programs are undoubtedly popular options for clients who want predictability with investment costs. Advisers offering these programs ought to ensure they have documented policies and procedures to address the best interests analysis for clients in these programs and that they are performing their duties consistent with their policies. Additionally, advisers should ensure their disclosures fully and fairly inform clients of the fees and expenses, conflicts of interest, and the roles and duties of the respective entities in the execution of wrap fee programs.

Please contact one of the listed authors of this Client Alert or your usual Bryan Cave Leighton Paisner contact if you have any questions with respect to the DOE's Risk Alert or if you need assistance with securities compliance, regulatory or litigation matters.

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