NATIONAL REGULATORY SERVICES, INC.

Investment Advisers Act of 1940 -- Rule 204-3

December 2, 1992

TOTAL NUMBER OF LETTERS: 2

SEC-REPLY-1:
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 2, 1992

Ms. Jacqueline H. Hallihan
President
National Regulatory Services, Inc.
Main Street
Lakeville, CT 06039

Dear Ms. Hallihan:

In your letter of July 22, 1992, you request our views on the disclosure obligations of investment advisers that participate in wrap fee programs by providing portfolio management services to clients of the program ("portfolio managers"). Specifically, you inquire whether portfolio managers must disclose the programs in which they participate, the total fee paid to the sponsor of the program, and the portion of that fee eventually received by the portfolio manager. In addition, you request our views on several matters concerning the application of rule 204-3 under the Investment Advisers Act of 1940 (the "Act"), which requires advisers to deliver or offer to deliver a disclosure document (a "brochure") to clients and prospective clients, and rule 204-2 under the Act, which requires advisers to create and maintain records of such delivery or offer of delivery, to portfolio managers for wrap fee programs.

A wrap fee program provides an investor with a number of investment services for a single "wrap" fee. Typically, the party that administers and solicits clients for the program (the "sponsor") will execute client transactions, provide custody services, and recommend to the client potential portfolio managers, who may or may not be affiliated with the sponsor. The portfolio manager will manage the client's portfolio, relying primarily on the sponsor to provide direct service and assistance to the client.

1. Disclosure Obligations

Under rule 204-3, the brochure that must be delivered or offered to clients may be either a copy of Part II of the adviser's Form ADV, or a narrative document containing at least the information required by Part II.

(a) Services Provided. Item 1 of Part II requires that an adviser describe on Schedule F of the Form the services it provides. You inquire whether this Item requires the portfolio manager to disclose the names of the broker-dealer sponsors of wrap fee programs for which the portfolio manager provides advisory services. n1

To comply with Item 1 a portfolio manager should disclose in its brochure that it provides advisory services in connection with wrap fee programs, and provide the names and sponsors of the programs. In addition, Item 1 requires disclosure on Schedule F of the nature of the portfolio management services provided. If the same services are provided to both wrap fee clients and other clients, a single description of the services provided by the portfolio manager would be all that is necessary. However, if the management services provided to a wrap fee program client differ from the services provided to non-wrap fee clients or clients of other wrap fee programs for which the adviser is a portfolio manager, Schedule F should include a description of the differences. n2

(b) Fee Schedule. Item 1 of Part II of Form ADV requires that an adviser include a schedule of fees in Schedule F. In a wrap fee program, the portfolio manager does not typically receive a fee directly from the client, but receives a portion of the wrap fee paid to the sponsor. Your letter asks whether the Division interprets Item 1 to require the portfolio manager to disclose the wrap fee charged by the sponsoring broker-dealer and the portion of that fee received by the portfolio manager.

A portfolio manager would satisfy the fee schedule requirement of Item 1 if it discloses the schedule under which it is compensated by the sponsor for services provided to wrap fee program clients. Because the sponsor of a wrap fee program must register as an investment adviser under the Act (unless entitled to an exception from the Act) and will have an independent obligation to deliver a brochure disclosing the total wrap fee, n3 a portfolio manager need not also disclose the total wrap

2. Termination of Wrap Fee Contracts

Paragraph (b)(1) of rule 204-3 under the Act requires a registered investment adviser to deliver its brochure to a prospective client not less than 48 hours prior to entering into any investment advisory contract or at the time of entering into a contract if the advisory client has a right to terminate the contract without penalty within five business days. You ask whether (i) a wrap fee program client may terminate its contract with a portfolio manager without penalty within five business days of receiving the portfolio manager's brochure, and (ii) whether the client may also terminate its contract with the sponsor if the contract with the portfolio manager is terminated.

Because there is often no written contract between a wrap fee program client and its portfolio manager, the exact time at which a contractual relationship arises may be uncertain. n4 If the client's contract with the sponsor specifies the portfolio manager to be used, the client's contractual relationship with the portfolio manager arguably arises at the time the contract with the sponsor is entered into. In these circumstances, the client must receive the brochure of the portfolio manager no later than the time it enters into the contract with the sponsor. In other circumstances, the client's contractual relationship with the portfolio manager may arise at a later time, but in no event will it arise later than the time the portfolio manager begins to provide services to the client. In these latter circumstances, a client must receive the brochure of its portfolio manager no later than the time that the manager begins to provide services. In any case in which the brochure is provided at the time the contract arises, rule 204-3 requires that the client have the right to terminate the relationship without penalty within five business days.

Rule 204-3 does not address directly whether a client that terminates its relationship with a portfolio manager may without penalty also terminate its contract with the sponsor. Regardless of rule 204-3, however, advisers, including wrap fee sponsors, are required to refund prepaid advisory fees upon termination of a contract. n5 In light of the personal nature of the advisory contract, "a client should not be put in a position where it is impossible to end the relationship without suffering a financial loss." n6 Therefore, wrap fee clients must be able to terminate the wrap fee arrangement at any time without penalty (i.e., sponsors must refund prepaid wrap fees upon termination).

3. Creation and Maintenance of Records

In some wrap fee programs, portfolio managers delegate to the sponsor certain responsibilities, including the delivery of the portfolio manager's brochure as required by rule 204-3. Paragraph (a)(14) of rule 204-2 requires that advisers maintain a copy of each brochure (or amendment) given or sent to any client or prospective client and a record of the dates that each brochure (or amendment) was given, or offered to be given, to any client or prospective client who subsequently becomes a client. You request our views regarding whether the sponsor, the portfolio manager, or both must obtain acknowledgement of the client's receipt of the portfolio manager's brochure and must maintain records of such receipt. n7

An investment adviser has the responsibility to ensure that its brochure is given or offered to clients as required, and to keep proper records of such delivery and/or offer. However, an adviser may delegate to other persons, including the wrap fee program sponsor, the tasks of delivering the brochure on its behalf

and creating the appropriate records. n8 Of course, this delegation does not relieve an adviser of any legal obligations or immunize the adviser from penalties under the Act if the brochure is not delivered. Therefore, the portfolio manager should take steps necessary to assure that the sponsor is actually performing the tasks delegated to it.

While a portfolio manager may delegate the task of delivering and offering its brochure and creating the required records to the wrap fee program sponsor, maintenance of the records in the offices of the sponsor would not comply with the rule 204-2. Paragraph (e)(1) of rule 204-2 requires that most records, including records of brochure delivery and offer, be maintained in an "easily accessible place for a period of not less than five years . . . , the first two years in an appropriate office of the investment adviser." Therefore, a portfolio manager must maintain the records required by paragraph (a)(14) of rule 204-2 for at least two years in its offices, not someplace else. The sponsor may create these records, but they then should be transferred to the portfolio manager for maintenance. n9

If you have any questions concerning these matters, please contact me or Eric C. Freed of this office at (202) 272-2107.

Sincerely,

Robert E. Plaze
Assistant Director

Footnotes

n1 Form ADV is used by investment advisers to register with the Commission and with most states that require adviser registration. The Investment Advisers Committee of the North American Securities Administrators Association concurs in the positions taken in this letter.

n2 Among the differences that should be disclosed is the degree to which the portfolio manager affords individualized attention to client accounts.

n3 In almost all cases, the sponsor of a wrap fee program will be providing investment advisory services to the wrap fee client. See Section 202(a)(11) of the Act; Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987) [52 FR 38400 (Oct. 16, 1987)]. A sponsor that is a registered broker-dealer will generally not be able to rely on the exception from the definition of investment adviser in Section 202(a)(11)(C) of the Act because receipt of the wrap fee will constitute special compensation, and the program is not solely incidental to the sponsor's business as a broker-dealer. See Robert S. Strevell (pub. avail. Apr. 29, 1985) (discussing "special compensation" provision); FPC Securities Corp. (pub. avail. Dec. 1, 1974) (discussing "solely incidental" provision).

n4 We believe that, for purposes of rule 204-3, a contractual relationship and the corresponding brochure delivery obligations exist between the client and the portfolio manager, even in the absence of a written contract. See, e.g., A. Corbin, Corbin on Contracts §§ 776-77, 781 (one vol. ed. 1952) (discussing third-party beneficiaries); Restatement (Second) of Contracts § 4 (1979) (discussing implied contracts).

n5 See, e.g., J. Baker Tuttle Corp., Initial Decision Rel. No. 13 (Dec. 21, 1990); Wellington Financial Corp. (pub. avail. Jan. 17, 1983); Churchill Management Corp. (pub. avail. May 30, 1974).

n6 Tuttle, supra note 5.

n7 While the rule does not require that advisers obtain written acknowledgements of receipt of the brochure from clients, such acknowledgements may serve as the record of the dates the brochure was given or offered to be given.

n8 In another context, rule 206(4)-3(a)(2)(iii)(A)(3) under the Act requires delegation of brochure delivery obligations. Under that rule, contracts between advisers and paid solicitors (other than those specifically excepted) are required to provide that the solicitor will deliver the adviser's brochure.

n9 Cf. rule 204-2(a)(15) (requiring investment advisers to maintain copies of records created by a paid solicitor).

INQUIRY-1:
NATIONAL REGULATORY SERVICES, INC.
Main Street . Lakeville, CT 06039 . (203) 435-2541 . Fax (203) 435-0031

July 22, 1992

Mr. Thomas Harmon, Chief Counsel
Mr. Robert Plaze, Special Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street NW
Washington, DC 20549

Dear Messrs. Harmon and Plaze:

I am writing to ask your help in trying to determine what disclosures are required for investment advisers participating in "wrap-fee" programs. Specifically, I am inquiring about the amount of detail required in disclosing the relationship between the participating adviser and the wrap-fee sponsors.

One of our clients is an adviser which acts as a portfolio manager in several wrap-fee programs sponsored by various broker dealer/investment adviser firms. This "sub-adviser" has chosen to disclose (a) the names of the brokers who sponsor wrap-fee programs in which the firm participates, (b) the fees charged by the sponsoring brokers, and (c) the portion of the fees received by the adviser.

This firm recently asked NRS to help it review this disclosure policy. In particular, this adviser is reviewing the necessity of disclosing in its Form ADV:

> (a) the names of the sponsoring broker dealers, and;
> (b) the fees charged by the sponsoring broker dealers, because this information is disclosed in the sponsor's Form ADV.

We spoke to Eric Freed in the Division of Investment Management, who informally told us that while advisers are required to name the wrap-fee sponsors, they are not required to disclose either the fee charged by the sponsor or the portion paid to the adviser. We sent a written request to this attorney to verify that our understanding of his comments is correct; to date, we have not had a reply.

The attorney's comments were somewhat of a surprise to us, as they differed from comments made to advisers by SEC Regional offices in examination letters. The Denver office, for example, told an adviser in October, 1990 that "The discussion on Schedule F regarding Registrant's arrangement to manage the portfolios of [a wrap sponsor's] clients should include the amount or range of the wrap fee paid to [the wrap sponsor] by the clients." The Los Angeles office told another adviser in May, 1992 that "Registrant's Form ADV failed to disclose the following:

> 1) That Registrant has wrap fee arrangements with [two wrap sponsors];
> 2) That the wrap fee may be "higher or lower" than paying for the various brokerage and advisory services separately; and
> 3) The amount of the fee that Registrant receives under wrap fee arrangements."

We understand that neither staff attorneys nor SEC Regional offices are representing the definitive position of the Division. The discrepancies in the opinions we have received, however, leave us wondering how wrap program sponsors and participants can adequately disclose their involvement in these programs in the absence of clear guidelines. It is difficult for these advisers to avoid "deficiencies" when examined if the standards for wrap-fee disclosures change from district to district.

NRS and its clients want to make sure that disclosures of all parties involved in wrap-fee programs regarding their participation in these programs are complete in order to ensure that these advisers are meeting their fiduciary obligations to their clients. To this end, we request guidance regarding questions (a) and (b) on the previous page.

On a related topic, I am also trying to determine how the Brochure Rule (Rule 204-3 of the Advisers Act) applies in wrap-fee programs. Section 204-3(b)(1) states:

> *An investment adviser, except as provided in paragraph (2), shall deliver the statement required by this section to an advisory client or prospective advisory client (i) not less than 48 hours prior to entering into any written or oral investment advisory contract with such client or prospective client, or (ii) at the time of entering into any such contract, if the advisory client has a right to terminate the contract without penalty within five business days after entering into the contract.*

Section 204-2(a)(14) requires that an adviser maintain

> *A copy of each written statement and each amendment or revision thereof, given or sent to any client or prospective client of such investment adviser in accordance with the provisions of Rule 204-3 under the Act, and a record of the dates that each written statement, and each amendment or revision thereof, was given, or offered to be given, to any client or prospective client who subsequently becomes a client.*

As you know, the structures of various wrap programs vary. In some programs, the client enters into a written contract with the sponsor only; in others, the client enters into written contracts with both the sponsor and the sub-adviser.

While all of the wrap-fee sponsors of our acquaintance document, in the form of written acknowledgement of receipt, that the client has received the sponsors' disclosure brochures, not all sponsors obtain a written and dated acknowledgement that the client has received the brochure of the sub-adviser who has been selected to manage the client's account. Is it the obligation of the wrap sponsor or of the wrap sub-adviser (or of both) to obtain written acknowledgement of the client's receipt of the sub-adviser's brochure? Who is required to maintain this record? Similarly, in keeping with the provisions of Rule 204-3(c), is it the obligation of the sponsor or of the sub-adviser (or of both) to offer the sub-adviser's brochure on an annual basis? It stands to reason that for both advisers to disseminate these disclosures and to maintain written acknowledgement of receipt of the sub-adviser's brochure is both burdensome and costly.

In discussing this matter informally with Eric Freed in the Division of Investment Management, he indicated that under the provisions of the Brochure Rule, a client would be able to terminate his advisory contract without penalty within five days of receiving the sub-adviser's brochure. Is this correct? If so, does this mean that the client may cancel the sponsor's contract within five days of receiving the sub-adviser's brochure? Your comments on this issue are eagerly awaited.

Please do not hesitate to contact me to discuss these matters in greater detail.

Very Truly Yours,

Jacqueline H. Hallihan
President