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The rewards and risks of managed account programs in the wealth management industry

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Introduction

Ten Disruptive Trends in Wealth Management

The wealth management industry is facing a period of unprecedented change in areas including technology, regulation and client expectations. Deloitte first addressed this disruption in a 2014 whitepaper entitled, "Ten Disruptive Trends in Wealth Management" and many of the elements of this disruption remain relevant today. The evolving nature of the industry makes the future of the business exceedingly difficult to predict and complicates the decision-making process for wealth management executives faced with myriad choices on how to invest limited resources in order to achieve the greatest return over the next three to five years. For the reasons detailed below, we believe that managed account solutions present some unique opportunities for wealth management firms to grow assets and revenues, but also present certain risks that should be effectively managed for the full potential of these programs to be realized.

Assets in managed account programs have grown by 117% since 2012[1] and now compose a substantial portion of assets under management and a majority of new asset flows for the wealth management industry. This growth reflects a long-term industry trend away from commission-based brokerage offerings towards fee-based advisory offerings.

1. Money Management Institute, Investment Advisory Solutions Data Q2 2012–Q2 2017. Managed account asset growth for the period of 2Q 2012–2Q 2017 is inclusive of new asset flows and investment returns. During the same time period the S&P 500 index increased 77.91%, the Barclays US Aggregate Bond Index increased 11.57% and the BofA Merrill Lynch 3-Month U.S. Treasury Bill index rose 0.8695%

Managed account programs are poised for continued growth as several financial institutions have announced plans to make these programs a strategic priority going forward, partially in reaction to the Department of Labor's (DOL) Fiduciary rule.[3] As shown in figure 2 below, a 2017 Deloitte/Securities Industry and Financial Markets Association (SIFMA) survey[4] shows that prior to the DOL rule, most survey participants supported an open choice platform, allowing their advisors significant flexibility in offering brokerage or advisory programs to their retirement clients. However, since June 9, 2017, when the DOL rule became applicable, many firms have become more restrictive in offering brokerage services to retirement clients while making fee-based accounts their primary or preferred option. While survey responses were specific to retirement clients, some survey participants indicated anecdotally that they anticipated applying the same business models to their non-retirement clients as well.

Figure 1: Overall growth in AUM from Q2 2012 to Q2 2017 by program[2]

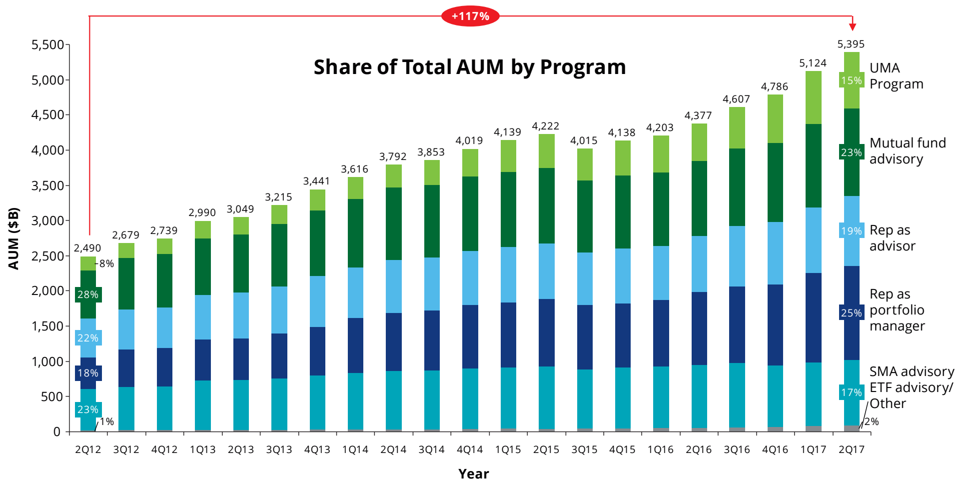
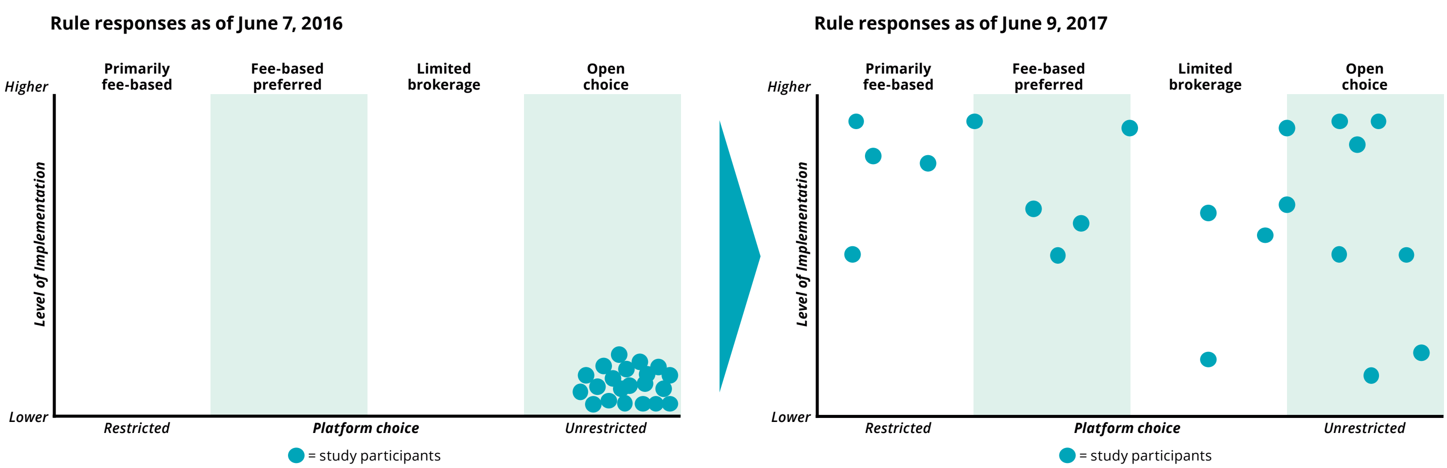


Figure 2: Responses to DOL rule as of June 7, 2016 and June 9, 2017



2. See footnote 1

3. 82 FR 56545, https://www.federalregister.gov/documents/2017/11/29/2017-25760/18-month-extension-of-transition-period-and-delay-of-applicability-dates-best-interest-contract

4. *The DOL Fiduciary Rule: A study on how financial institutions have responded and the resulting impacts on retirement investors,* August 9, 2017, https://www.sifma.org/wp-content/uploads/2017/08/Deloitte-White-Paper-on-the-DOL-Fiduciary-Rule-August-2017.pdf

Background

Managed account programs, often referred to as advisory programs or fee-based accounts, are primarily regulated by the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940 (Advisers Act)[5]. There are many variations of these programs as detailed in figure 3 below.

Figure 3: Common types of managed account programs[6]

Program type	Money Management Institute (MMI) definition
Traditional SMA Program (SMA)	A single account that corresponds to a single investment strategy. To hold multiple strategies, a client must open multiple accounts. These programs include all the attributes of investment advisory solutions (IAS) such as client profiling, fee-based pricing, and research. Includes SMA dual contract programs.
Multi-Discipline Portfolio Program (MDP)	A separate account only program that houses multiple investment strategies in a single account. The program allows clients to more easily diversify their portfolio via a single account.
Unified Managed Account (UMA)	A single account that houses multiple investment products such as SMAs, mutual funds, and ETFs. The account leverages a platform that provides the ability to manage an investor's portfolio in a comprehensive fashion.
Unified Managed Household Program (UMH)	A UMH is a placeholder that aggregates multiple accounts, supports the delivery of multiple products and provides the ability to manage an investor's portfolio in a comprehensive fashion.
Mutual Fund Advisory Program (MFA)	A mutual fund program that allows investors to allocate their assets across multiple mutual funds. The program includes capabilities such as client profiling, fee-based pricing, and rebalancing.
Exchanged-Traded Fund Advisory (ETF)	A managed account program that utilizes ETFs. The program and its components are similar to those defined above.
Rep as Portfolio Manager Program (RPM)	A fee-based, managed program that allows the financial services rep to act as the portfolio manager. Many of the attributes that define IAS apply to these programs.
Rep as Advisor Program (RAA)	A non-discretionary, fee-based, advisory program that enables an investor to hold different types of securities.

Typically, managed accounts offer a higher level of service than brokerage accounts and may include such features as:

- Detailed client profiling
- Investment policy statement
- Automatic rebalancing
- Tax management of portfolio
- Robust client reporting
- Annual portfolio review

In many ways, managed account programs offer an institutional investment process approach to retail wealth management clients.

5. Other regulations, such as Rule 3a-4 of the Investment Company Act of 1940, may also apply to certain managed account programs. Rule 3a-4 provides a safe harbor from the definition of Investment Company for programs that provide discretionary investment advisory services to clients and meet certain other requirements, including reasonable restrictions imposed by the client on the management of the account.

6. Money Management Institute, MMI Central Third Quarter 2017

The possible rewards of managed account programs

Managed accounts have the potential to thrive as a core engine of growth for the wealth management industry in the face of widespread disruption to the traditional brokerage service model offering. A few examples of areas that managed accounts may provide growth are detailed below.

A foundation for a fiduciary future

The issuance of the DOL Fiduciary rule generated an industry-wide conversation about the standard of care that financial advisors and brokers will be held to when offering investment advice. However, managed account programs, as fee-based investment advisory programs, have long operated under an SEC fiduciary standard as established by the Capital Gains decision in 1963,[7] while brokerage and directly held mutual fund accounts that are not part of a managed account program are primarily regulated by the Financial Industry Regulatory Authority (FINRA) suitability standard.[8] Industry observers question whether a SEC fiduciary standard will become the prevailing standard of care for wealth management firms for all accounts, including non-retirement commission based accounts. If this shift happens, wealth managers will likely need to enhance the services they offer to their non-fiduciary accounts. For example, existing reporting and disclosure will likely need to be enhanced to document that the fiduciary standard has been met. Because managed account programs often have the technology, operational, client service and supervisory infrastructure designed to support this higher standard of care, they are commonly viewed as providing a solid foundation from which to expand fiduciary offerings.

A response to robo-advisors

As noted in our 2014 whitepaper, robo-advisors have the potential to disrupt traditional wealth managers. There is an ongoing debate as to how real the robo threat is, but robo-advisors have caused an acceleration in investment in digital advice offerings across the industry. Many leading wealth managers are offering their own versions of robos that tend to be targeted at clients with fewer investable assets and are offered at lower cost than traditional advised programs.

While this is one approach to combatting the robo threat, we are not sure that it is the most powerful response. In fact, this segregated approach may cause conflicts when there is one service that is much less expensive than another but could still potentially serve the needs of the same client. This is because at their core, many robo-advisors are often simplified managed account programs that happen to be offered via digital client interfaces.

We believe that the real opportunity for wealth managers is building an integrated advisory offering where clients can seamlessly interact with their wealth managers over a variety of channels including digital, phone or face to face with a level advisory fee and a separate service fee that is adjusted based on the level and manner of interaction the client desires. In this way, rather than offering a robo service and a separate "traditional" managed account service, the real growth opportunity may be an advisory service that lets the client be the driver of their own experience. Deloitte further explored these opportunities in its 2017 whitepaper, "The Digital Wealth Manager of the Future."

7. See SEC v. Capital Gains Research Bureau, Inc., et al. 375 U.S.180 (1963)

8. It is possible for brokers to be held to a fiduciary standard under certain facts and circumstances but that discussion is beyond the scope of this paper

The Digital Wealth Manager of the Future

A scalable solution

Skilled financial advisors are amongst the scarcest and most valuable assets at wealth management firms and due to the aging advisor force, scarcity is likely to get worse before it gets better. As a result, for wealth managers to continue to grow assets and revenues, they will need to find a way to service more clients and more assets per advisor. One way this scale can be accomplished is through well designed managed accounts programs supported by a robust technology platform.

For example, many wealth management firms are seeing assets grow in centralized home office discretionary programs. In these programs, advisors focus more time on client relationships and much of the investment research is handled by a centralized function. By relieving the advisor of the day-to-day management of the portfolio, advisors have more time to spend on client relationships and business development. Combined with improving technology platforms that can integrate and streamline client onboarding, client reporting, and other administrative tasks with back office accounting and custody functions, the potential exists for managed account programs to greatly enhance advisor productivity and enable them to focus on delivering core services to investors.

A margin maintainer

In an era of cost compression, managed account programs continue to be a driver of steady, predictable and repeatable revenue for wealth managers that can be reinvested in the business. The last few years have seen unprecedented flows of assets into low cost investment products, including index funds, ETFs, and lower cost active management products. Lower cost products provide lower revenue to investment managers and therefore less revenue for them to share with wealth managers.

"As fast as managed account programs have grown in recent years, their growth prospects are even greater in coming years, particularly given innovation occurring around goals-based wealth management. Managed accounts truly hold the key to the future of the wealth management industry."

John G. Taft, Vice Chairman of Robert W. Baird & Co Incorporated and former Independent Senior Advisor to Deloitte & Touche LLP

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Managed account programs change the calculus by shifting the revenue stream: rather than relying on revenue share from product manufacturers, wealth managers receive more revenue directly from asset based fees assessed on client accounts. This enables wealth managers to offer lower-cost investment products, yet still generate profits and maintain margins. Clients in advisory accounts may pay similar total fees as they would in a brokerage account with a higher cost fund.[9] However, a smaller portion is going to the product manufacturer and more is going to the wealth manager. So, while clients have shown a desire to pay less for investment products they seem willing to pay, via a wrap fee, for personal fiduciary investment advice.

9. Fees in Advisory programs vary widely by financial institution, program type, underlying investment products, and other factors. These programs can be expensive than a brokerage account depending on the individual client situation.

The potential risks of managed account programs

As discussed above, managed account programs have many attributes that have proven attractive to clients and therefore give these programs the potential to be a leading source of growth and revenue for wealth managers. However, to fully maximize this opportunity, wealth managers must carefully manage both the operational and regulatory risk that is inherent in offering these programs.

"We expect the regulatory focus on managed accounts programs to continue to grow as these programs become an increasingly important part of the wealth management marketplace. Wealth managers will need to allocate resources to manage the residual operational and regulatory risks created in this evolving environment."

Karl Ehrsam, Deloitte Risk and Financial Advisory Wealth Management Leader

Increasing regulatory focus

The shift to managed accounts has not escaped the notice of regulators. During their fiscal years 2016 (FY16) and 2017 (FY17), the SEC imposed over $400 million in penalties at least partially attributable to managed account program activities. In addition to SEC fines and penalties, at least one of the notable enforcement actions during SEC FY16-17 resulted in simultaneous action from the CFTC and an additional $40 million in settlements.[10]

The SEC reaffirmed the focus on managed account programs in their 2017 Exam Priorities, stating:

"We will expand our focus on…registered investment advisers and broker-dealers associated with wrap fee programs… review(ing) whether investment advisers are acting in a manner consistent with their fiduciary duty and…meeting their contractual obligations to clients. Areas of interest may include…account suitability, effectiveness of disclosures, conflicts of interest, and brokerage practices…"[11]

The regulatory focus shows no sign of abating, as recently as September 26, 2017, SEC Chairman Jay Clayton indicated to Congress that the Commission was on-track to deliver a 30% year over year increase in the number of investment adviser examinations, and expects the number to continue expanding, stating:[12]

"I expect that for at least the next several years we will need to do more to increase the agency's examination coverage of investment advisers in light of continuing changes in the markets."

The following examples highlight some areas of risk that wealth managers should focus on in order to ensure their managed account programs are positioned to grow in an effective way.

10. U.S. Securities and Exchange Commission Press Release 2015-283, https://www.sec.gov/news/press-release/2015-283

11 U.S. Securities and Exchange Commission National Exam Program, Office of Compliance Inspections and Examinations, Examination Priorities for 2017, https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf

12. Chairman Jay Clayton Testimony on "Oversight of the U.S. Securities and Exchange Commission", Before the Committee on Banking, Housing and Urban Affairs, United States Senate, September 26,2017 https://www.sec.gov/news/testimony/testimony-clayton-2017-09-26

Say what you do and do what you say

In May 2017, a global financial services firm paid $97 million in part to settle charges that over 2,000 clients across two managed account programs were charged for due diligence and monitoring of certain third-party investment managers and investment strategies which they could not prove were actually performed.[13] As put in the SEC's press release relating to the settlement, the firm: "…failed to ensure that clients were receiving the services they were paying for."

Wealth management firms should also carefully review and monitor marketing materials distributed to advisors and clients. In December 2017, a leading independent wealth manager agreed to pay a civil penalty of $1.75 million plus $700,000 in prejudgment interest and $6.3 million disgorgement to settle charges that it violated securities laws by spreading false claims due to their reliance on representations made by an investment management firm about its flagship products.[14] This followed actions announced by the SEC in August 2016 totaling $2.2 million against 13 investment advisers to settle similar allegations resulting from misrepresentations of the same products.

While these may seem like straightforward errors, our experience shows that it is very challenging for wealth managers to maintain consistency between marketing material, regulatory disclosures, operational procedures, systems and service delivery. This can be the case for a variety of reasons, including turnover of staff, system upgrades and program changes that occur in complex operating environments. Whatever the reason, it has been shown to be unacceptable to regulators.

Action items

- Review marketing materials, disclosure forms, and client contracts to ensure managed account program details are accurately reflected
- Review policies and procedures to ensure they accurately reflect the materials cited above
- Review systems to ensure they accurately reflect both the policies and procedures and the source materials
- Establish a periodic review process to ensure that these areas stay in alignment

Measure twice and bill once

In FY17, a number of SEC actions related to fee billing were announced, including:

- A $13 million settlement with a global financial institution for overbilling managed account program clients due to improper coding and other billing system errors[15]
- An $18 million settlement with a global financial institution for overbilling managed account program clients due to a failure to confirm the accuracy of billing rates entered into its computer systems in comparison to fee rates outlined in client contracts, billing histories, and other documents[16]

13. U.S. Securities and Exchange Commission Press Release 2017-98, https://www.sec.gov/news/press-release/2017-98
14. U.S. Securities and Exchange Commission, Administrative Proceeding, Release Nos. 34-82244 and IA-4822, https://www.sec.gov/litigation/admin/2017/34-82244.pdf
15. U.S. Securities and Exchange Commission Press Release 2017-12, https://www.sec.gov/news/press-release/2017-12
16. U.S. Securities and Exchange Commission Press Release 2017-35, https://www.sec.gov/news/press-release/2017-35

In both cases, technology failures were to blame. The SEC is not the only regulator paying particular attention to technology related issues. While not specific to the managed account space or billing issues, as recently as December 2017, FINRA announced penalties totaling more than $14 million against two global banks[17,18] for failures related to systems not performing as understood and expected. Additionally, FINRA has listed technology governance as one of its regulatory and examination priorities for 2018, stating:

"Some firms have experienced significant customer service and regulatory problems as a result of operational breakdowns caused by the implementation of new systems as well as enhancements and modifications to existing proprietary or vendor systems…It is critical that firms maintain strong controls over changes to their information technology to prevent inaccurate, incomplete, untested or unauthorized changes to their production environments."[19]

These recent regulatory actions demonstrate the need for regular and rigorous testing of all systems to ensure they are functioning properly. This is particularly relevant for managed account programs which often rely heavily on interconnected technology platforms for end to end operations. These complex technology environments present numerous potential failure points and regulators are clearly paying attention.

Action items

- Conduct a comprehensive review of client contracts to ensure that the fees outlined in the contract align with what is set up in systems. (This is of potential concern for accounts such as ERISA Accounts, that may have special billing treatment such as fee rebating)
- Regularly test billing systems to ensure fees are coded correctly and are billed as intended. These tests should be conducted periodically as part of a supervision program and should receive attention anytime a program or fee structure is changed or updated
- Adopt and execute initial and ongoing regular and rigorous testing protocols for all technology systems to ensure appropriate functionality

17. https://www.finra.org/newsroom/2017/finra-fines-jp-morgan-securities-llc-28-million-customer-protection-rule-violations

18. https://www.finra.org/newsroom/2017/finra-sanctions-citigroup-global-markets-115-million-inaccurate-research-ratings

19. FINRA 2018 Regulatory and Examination Priorities Letter, http://www.finra.org/industry/2018-regulatory-and-examination-priorities-letter

Concentrate on conflicts

During FY16 and FY17, the SEC took numerous enforcement actions against firms for providing inaccurate or incomplete conflict disclosures to clients. The largest relevant settlement in FY16-17 totaled $267 million[20] and was due in part to the firm's failure to disclose the following conflicts in their ADV:

- The preference for use of proprietary mutual funds in an advisory program sold through an affiliate
- The availability and pricing of services provided by an affiliate being tied to the amount of UMA assets invested in the firm's proprietary products
- That certain affiliate funds within the advisory program offered a less expensive share class which would generate less revenue for a firm affiliate

Of note is the following quote from the SEC:

*"The Commission has stated that an investment adviser **has failed to uphold its fiduciary duty** when it causes a client to purchase a more expensive share class of a fund when a less expensive class of that fund is available."*[21] (Emphasis added)

While particular facts and circumstances come into play when selecting the most advantageous share class for use in managed accounts, the quote does indicate that fees and expenses in advisory programs are a focus of the Commission. The SEC also makes their expectations relating to conflicts of interest disclosure exceedingly clear in their press release announcing a settlement and admission of wrongdoing by a global financial services firm for failing to disclose conflicts of interests to clients within their investment advisory business: "Firms have an obligation to communicate all conflicts so a client can fairly judge the investment advice they are receiving…"[22]

Additionally, the focus on conflicts specifically related to managed account wrap fee programs shows no signs of abating, with the SEC issuing a December 2017 Investor Bulletin highlighting these programs and detailing recent relevant enforcement actions.[23]

In certain instances, the recommendation for a customer to switch to a managed account may itself pose a conflict for wealth managers. FINRA has specifically identified this conflict as a focus for 2018 exams, stating in the suitability section of their regulatory and examination priorities for 2018:

"FINRA will review situations in which registered representatives recommend a switch from a brokerage account to an investment adviser account where that switch clearly disadvantages the customer, such as where…the customer purchased a securities product subject to a front-end sales charge…and then shortly thereafter…transferred to a fee-based account."[24]

Action items

- Evaluate program, product and service offerings to identify potential conflicts of interest and leverage review of marketing materials, disclosure forms, and client contracts to ensure conflicts are accurately reflected
- Review policies and procedures to ensure they accurately and adequately reflect the firm's conflict management program
- Consider adopting or enhancing a conflict management program as necessary to help mitigate potential risks

20. See footnote 9 above

21. U.S. Securities and Exchange Commission, National Exam Program Risk Alert, July 13, 2016, https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf

22. See footnote 9 above

23. SEC Investor Bulletin: Investment Adviser Sponsored Wrap Fee Programs, https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_wrapfeeprograms

24. See footnote 18 above

What else lurks around the corner?

The preceding sections are largely related to recent SEC enforcement actions. We view these as indicators of how the SEC is allocating its examination and enforcement resources and therefore a reflection of the issues the Commission finds most relevant. However, as wealth managers are well aware, past results do not necessarily predict future results, and therefore firms should also proactively identify other emerging risks. With this in mind we highlight some ongoing and emerging risks below which wealth managers should carefully consider.

Ensure Rule 3a-4 compliance

Rule 3a-4[25] allows wrap programs an exemption from registering as an investment company. To utilize the safe-harbor, wrap programs must be individualized to each client's financial situation and the client must be able to impose reasonable restrictions on the management of the account at the time of opening and on an ongoing basis. At least annually, the wealth manager must contact the client to determine if there have been any changes in the client's financial situation or investment objectives, or whether the client wishes to impose or modify any reasonable restrictions on the management of their account. The wealth manager must also provide the client access to a person knowledgeable about the management of the account. On paper, these requirements appear quite reasonable. However, in practice we find that they are challenging to apply on a consistent and efficient basis given the scale of growth in these programs. These issues have recently been raised in a research paper with respect to robo-advisors[26] but are relevant to all types of advisory programs.

For these reasons, a baseline assessment of 3a-4 compliance across all relevant programs and accounts may serve as a good starting point for mitigating portions of managed account program risk.

25. 17 CFR Parts 270 and 274, Release No. IC-22579; IA-1623; S7-24-95, RIN 3235-AG07, https://www.sec.gov/rules/final/ic-22579.txt

26. *Robo-Advisors: A Closer Look,* Fein, Melanie L., https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2658701

Action items

- Conduct a comprehensive review of managed account program offerings to identify those relying on the 3a-4 safe harbor
- Test each identified program against the required components of 3a-4 to ensure provisions are being met. These tests should be conducted on a regular basis as part of an overall managed account supervision program and should be revisited anytime a program is changed or updated

Leverage data analytics

Regulators are increasingly utilizing "big data" and investing in advanced data analytics to detect problematic behavior.

> "Wealth managers that do not effectively utilize data analytics may increase the risk of regulators identifying potential compliance issues ahead of firm supervisory systems."

Maria Gattuso, Deloitte Risk and Financial Advisory Regulatory Leader

Wealth managers can leverage existing data sources and invest in their own data analytics capabilities to help detect potential issues ahead of regulators. Existing activity, position, performance and regulatory reports can often be used as a starting point for building out advanced supervisory focused data analytics designed to detect potential prohibited activities and identify patterns and trends.

Action items

- Inventory existing activity, position and regulatory reporting capabilities to identify potential sources of data
- Consider investing in enhanced data analytics capabilities to better enable supervisory functions and keep pace with regulators

Conclusion

We believe that managed account programs have the potential to serve as the core engine of growth for wealth management firms and provide a powerful antidote to the disruption facing the industry. However, wealth management firms will only be able to fully realize the managed account opportunity if they rigorously manage the many risks that managed account programs present. By doing so, wealth managers can harness an engine that can meet the needs of their clients, advisors, and shareholders, allowing them to take the lead in the wealth management industry.

Contacts

Deloitte has been a leading advisor with respect to regulatory risk and operating model transformation across the broker-dealer and investment adviser industries. As the wealth management industry continues its shift away from commissioned-based brokerage offerings towards fee-based advisory offerings, we stand ready to support our clients through our experience, insights, and perspectives.

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