

UBS SUIT PUTS SPOTLIGHT ON FEE-BASED ADVICE

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Eliot Spitzer's lawsuit against UBS' fee-based InsightOne program may prompt the separately managed account (SMA) industry to review issues of client suitability.

The suit involves mass market products like mutual funds, not high-net-worth-focused SMAs, and no one is suggesting that Spitzer will look at SMAs. But the theme of fee-based advisors placing clients in unsuitable investment vehicles is one SMA providers should take note of.

In the past five years, increasing Securities and Exchange Commission (SEC) regulation and spikes in National Association of Securities Dealers (NASD) arbitration hearings have sounded a warning to the \$774 billion SMA industry not to take its clean reputation for granted.

While no one expects the industry to lose that reputation, there are signs providers are paying closer attention to compliance matters, including issues concerning "client suitability," legal experts contend.

The New York attorney general's allegations that UBS was improperly steering clients into fee-based accounts to help boost company sales will likely spark more industry-wide introspection.

Attorney Michael Caccese, a Boston-based partner with the law firm of Kirkpatrick & Lockhart Nicholson Graham, says a SEC review of the managed account industry last year provoked many sponsor firms to re-examine their practices. Numerous service providers are already focused on ensuring that SMAs are being recommended for clients with the appropriate asset holdings and risk profiles.

"Based upon the sweep, firms started talking about the issues that were found," Caccese says. "The SEC asked questions during the sweep about suitability and what is the advisor's role versus the sponsor's role in terms of determining suitability." In some cases, it does take a letter from the government to get firms to re-examine their marketing and compliance practices, Caccese acknowledges.

At September's *American Banker*/Money Management Institute SMA conference, securities industry legal experts Steve Stone and Miriam Bahcall of law firm Morgan Lewis & Bockius advised attendees on the need to shore up compliance efforts in response to what appears to be a tougher regulatory environment.

Government records show that of 105 SMA service providers reviewed by the SEC in 2005, 97 companies received deficiency letters. Such notices document compliance flaws so firms can resolve inefficient and unclear practices.

Of the SEC-examined firms, approximately 72% had disclosure-related problems, 58% needed to improve brokerage practices and 54% had advertising deficiencies.

In Spitzer's lawsuit, the UBS program at issue is a non-discretionary wrap program in which investors pay a single annual fee based on total assets. Many users had previously paid UBS commissions per each transaction.

InsightOne clients need to pay a minimum annual fee of \$1,250 and can harness UBS' research, estate planning strategies, mutual funds and exchange-traded funds (ETFs) as well as many other services, according to the firm's Web site. (A SMA investor typically can access an equity or fixed-income strategy at \$250,000 minimums).

The main appeal of InsightOne is for investors who trade frequently. But according to Spitzer's lawsuit, UBS was improperly pushing investors into the program who had traded sporadically. That undertaking allegedly generated revenue for UBS while creating financial losses for the firm's clients.

"UBS fully understood, but did not disclose to its clients, that it was giving financial advisors a clear monetary incentive to steer unsuitable clients into InsightOne. Indeed, it was this conflict of interest that drove UBS' fraudulent scheme - encouraging financial advisors to overlook suitability problems in order to grow the program.

"As one financial advisor noted, financial advisors were discouraged from doing commission business by financial disincentives that 'even apply in cases where a conversion to fee is not appropriate,'" the lawsuit states.

The Swiss bank is vigorously fighting the attorney general's suit and has already rejected a \$150 million settlement. The firm counters that UBS clients have saved hundreds of millions of dollars by using the fee-based InsightOne as opposed to staying in commission programs.

"UBS categorically denies that the program was part of a scheme to disadvantage clients, and intends to defend itself vigorously in this matter. We are disappointed that the NYAG did not review or consider relevant data that supports the firm's position prior to filing the complaint," a company representative notes in a statement.

Daniel Seivert, managing partner of **ECHELON Partners** in Manhattan Beach, Calif., believes Spitzer's accusations that UBS overpromised and then underdelivered in its fee-based account program will have to be proven. As for the SMA industry overall, he does not expect to see greater regulatory scrutiny of advisors and sponsors as a result of the case.

When it comes to the investor suitability of SMAs, **Seivert** says while there's no official cut-off for clients, many view the \$1 million mark as the best threshold.

"For investors below this threshold, SMAs usually did not make sense given that most managers have minimums of \$250,000 and an investor needs at least four SMAs to have the appropriate diversification.

"With the amazing diversification of MDAs (multi-discipline accounts) and SMAs made from fractional shares,

this fault line is arguably \$250,000. Funds are still likely the best solution for investors below \$250,000, but many traditionalists view \$1 million as the best cut off point," **Seivert** says.

On the broader issues the UBS suit raises, he says, there's nothing wrong with moving clients from commission-based accounts into fee-based programs, although issues can arise when such a move is in the advisor's, not the client's, best interest.

"Offering incentives to move clients from one investment type of account type to another has long been a point of regulatory scrutiny. And rightly so. The move should be in the investor's best interest. If it benefits the advisor and the brokerage firm after that, then great," he adds.

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