Morgan Lewis

2008 NSCP Midwest Regional Meeting
April 28, 2008

Investment Adviser Conflicts of Interest Disclosures

Brian E. Franc, Mesirow Financial
Jennifer L. Klass, Morgan, Lewis & Bockius LLP

www.morganlewis.com

Conflicts of Interest - Disclosure

- “I know of only two ways in which advisers can handle their conflicts of interest and remain within an acceptable level of regulatory compliance:
  - Eliminate the arrangements or activities that create the conflict.
  - Disclose each conflict fully and fairly and then manage the adviser’s affairs so the impact of a conflict on clients and fund investors will be consistent with the disclosures made.”

What is a Conflict?

"Actually, I wear two hats."

What is a Conflict?

- Any activity or relationship in which an adviser's interests compete with the interests of its clients
  - Competing interests that may incline an investment advisers – consciously or unconsciously – to render advice that is not disinterested
  - Conflicts may involve divided loyalty as well as self-dealing
  - Suggestion: "Follow the Money"
    - Fee differentials, performance fees, compensation to affiliates, compensation from third parties

What is a Conflict?

- Conflicts Among Clients
  - Allocation of investment opportunities
  - Batching of client trades
  - Trade sequencing
- Conflicts Between Clients and the Adviser
  - Gifts and entertainment
  - Valuation
  - Recommendation of securities in which adviser has a financial interest
- Conflicts Between Clients and Advisory Personnel
  - Personal securities trading
  - Bonus and other outcome-based compensation

Conflicts of Interest – Regulatory Focus

» Cutler Challenge

- “[T]here's another reason why you should be thinking hard about conflicts of interest these days: the SEC and the entire regulatory community are doing so.”

» Compliance Program Rules (Rules 206(4)-7 and 38a-1)

- “[E]ach adviser, in designing its policies and procedures, should first identify ***conflicts*** and other compliance factors creating risk exposure for the firm and its clients . . . and then design policies and procedures that address those risks.”

» 2004 Conflicts Inquiry (sweep)

Conflicts of Interest – Disclosure Obligation

- Fiduciary Duty
  - Affirmative duty to act in utmost good faith and provide full and fair disclosure of all material facts
- Regulatory Requirements
  - Affiliated transactions
  - Cash referral fee arrangements
  - Proxy voting procedures
- Form ADV, Part 2
  - 2000 Proposal – Focus on disclosure of policies and procedures
  - 2008 Proposal – Focus on identifying conflicts of interest and then explaining how the investment adviser addresses or attempts to mitigate those conflicts
    - "describe generally how you address these conflicts"

Conflicts of Interest - Disclosure

» How to Approach Disclosure
- Start with Form ADV
- Consider whether there are additional issues not covered in Form ADV
- Augment conflicts assessment/inventory to create map of relevant disclosures
- Consider any updates to disclosure as part of annual testing under Rules 206(4)-7 and 38a-1

» How to Disclose
- In writing
- In plain English
- Taking into consideration client's level of financial sophistication
- Narrative brochure designed to provide advisers with sufficient flexibility to present and explain their business practices in a *clear and meaningful way*

Conflicts of Interest – Form ADV Disclosure

- Item 5 – Fees and Compensation
  - Disclose receipt of compensation attributable to the sale of securities or other investment products, including mutual fund distribution and service fees
  - Explain that this practice creates an incentive to base investment recommendations on the amount of compensation received
  - Part 2B, Item 4 – Other investment-related business or occupation
    - Disclose the receipt of commissions, bonuses or other compensation (including mutual fund distribution or service fees) based on the sale of securities or other investment products, including as a broker-dealer or registered representative
- Item 6 – Performance Fees and Side-By-Side Management
  - Disclose receipt of performance fees
  - Explain conflicts associated with side-by-side management, including incentive to favor accounts that pay performance fees

Conflicts of Interest – Form ADV Disclosure

» Item 10 – Other Financial Industry Activities and Affiliations
  - Disclose relationship or arrangements with related persons that are material to your advisory business or to clients
  - Disclose the receipt of direct or indirect compensation or business relationships with other investment advisers you may recommend or select for your clients
  - Part 2B, Item 4 – Other investment-related business or occupation
    - Describe any material conflicts of interest with clients caused by the supervised person’s other financial industry activities

Conflicts of Interest – Form ADV Disclosure

- Item 11 – Code of Ethics, Participation or Interest in Client Transactions and Personal Trading
  - Disclose whether you recommend to clients, or buy or sell for client accounts, securities in which you or a related person has a material financial interest
  - Disclose whether you invest in the same securities (or related securities) that you or a related person recommends to clients
  - Disclose whether you recommend securities to clients, or buy or sell securities for client accounts, at or about the same time that you or a related person buys or sells the same securities for your own account

Conflicts of Interest – Form ADV Disclosure

- Item 12 – Brokerage Practices
  - Research and other soft dollar benefits
  - Brokerage for client referrals
  - Directed brokerage
  - Trade aggregation and bunching practices
- Item 14 – Payment for Client Referrals
  - Describe any arrangement where a non-client provides an economic benefit (including sales awards or other prizes) to you for providing investment advice or other advisory services to your clients
  - Describe any arrangement where you or a related person directly or indirectly compensates a third party for client referrals
  - Part 2B, Item 5 – Additional Compensation
    - Describe any arrangement under which a non-client provides an economic benefit (including sales awards or other prizes) for providing advisory services

Conflicts of Interest – Form ADV Disclosure

» Item 17 – Voting Client Securities
  - Describe how you address conflicts of interest between you and your clients with respect to voting their securities
  - Describe whether you pay for proxy voting services with soft dollars or pass the cost to clients

» Appendix 1 – Wrap Fee Brochure
  - Disclose whether any your related persons act as portfolio managers
  - Disclose whether related person portfolio managers are subject to the same selection and review as the other portfolio managers that participate in the program
    - If they are not, describe how you select and review related person portfolio managers

Conflicts of Interest - Disclosure

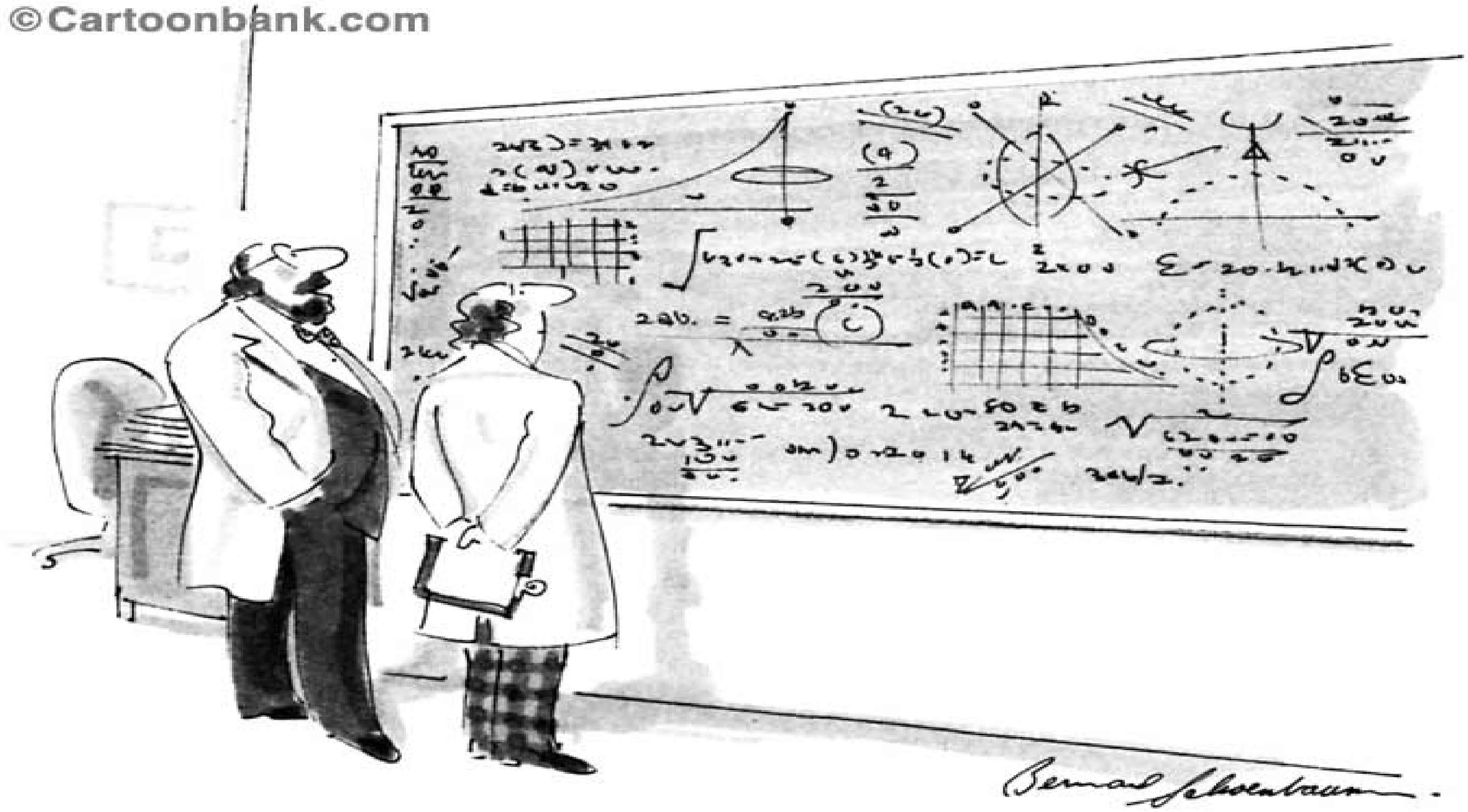
- Where to disclose
  - Form ADV
  - Advisory agreements
  - Fund offering documents
  - Prospectuses and statements of additional information
  - “Relationship” brochures
  - Website disclosure
  - Client inquiries
    - Describe your firm’s overall philosophy regarding conflicts and how they are managed (e.g., oversight committee, new product committee, governance committee)
    - Describe your firm’s process for identifying and evaluating conflicts
    - Describe how your compliance program is designed to identify, monitor and address those conflicts

Conflicts of Interest - Disclosure

» Limits of Disclosure

- Client consent
- Retirement accounts – prohibited transactions
- Disclosure generally cannot cure breach of duty of care
- Will disclosure cure a conflict that is ultimately unfair?

Conflicts of Interest – The End



"Oh, if only it were so simple."