

# An Inconvenient Truth: Disclosure of Conflicts of Interest in Proposed Form ADV Part 2

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The Securities and Exchange Commission (the "SEC") recently re-proposed amendments to Part 2 of Form ADV that are intended to "greatly improve the ability of clients and prospective clients to evaluate firms offering advisory services and the firms' personnel, and to understand relevant conflicts of interest that the firms and their personnel face and their potential effect on the firms' services."<sup>1</sup> This most recent effort comes eight long years after the last comprehensive attempt by the SEC to address the disclosures in Form ADV<sup>2</sup> and reflects the continuing evolution of the SEC's approach to regulating the way investment advisers handle potential conflicts of interest. This evolution has seen the SEC shift from requiring investment advisers to simply disclose the presence of a conflict to encouraging firms to be proactive in identifying and managing potential conflicts of interest. By requiring specific disclosures reflecting the actions that investment advisers are taking to address conflicts of interest, the current proposal reinforces the SEC's message that investment advisers are expected to actively manage their conflicts of interest.<sup>3</sup>

Although conflicts of interest are inherent in every corner of the securities industry, they are particularly relevant in the context of the fiduciary relationship between an investment adviser and its client, and they have increasingly been an area of SEC focus. The responsibility of an investment adviser to disclose conflicts of interest is derived from the concept of fiduciary duty that is established in common law agency principles and trust law.<sup>4</sup> The Investment Advisers Act of 1940, as amended (the "Advisers Act") itself "reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested."<sup>5</sup>

In the wake of the highly publicized research analyst and mutual fund cases, the securities industry came under pressure to address conflicts

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of interest more proactively. In a September 2003 speech, then SEC Director of Enforcement Stephen Cutler challenged securities firms “to undertake a top-to-bottom review of [their] business operations with the goal of addressing conflicts of interest of every kind.”<sup>6</sup> The concept of a conflicts review was subsequently incorporated into the development and testing of compliance policies and procedures when the SEC adopted Advisers Act Rule 206(4)-7 in December 2003.<sup>7</sup>

## Part 2 of Form ADV

Consistent with this regulatory emphasis on conflicts of interest, the proposed amendments to Part 2 of Form ADV reflect the view that advisers should not simply identify conflicts or describe policies and procedures, but should explain how they propose to address conflicts of interest. As a result, “several items to require advisers to explain succinctly how they address the conflicts of interest they identify, rather than disclosing their ‘policies and procedures’ as [was required in the 2000 Proposal.]”<sup>8</sup> The following discussion highlights the disclosure requirements set forth in the proposed amendments Part 2 of Form ADV, with particular emphasis on conflicts of interest.

### Part 2A – The Firm Brochure

**Item 1 – Cover Page.** The cover page would include basic information such as the firm’s name, business address, telephone number, web site address and the date that the brochure was created.<sup>9</sup> In addition, the SEC is proposing to add a requirement for advisers to list the name and telephone number of an individual or service center that can respond to questions about the brochure.<sup>10</sup>

**Item 2 – Material Changes.** The proposed amendments would require advisers to deliver their brochure to existing clients annually, rather than simply “offer” to deliver it as currently required.<sup>11</sup> In order to inform clients of changes since the last annual update, the SEC is proposing that advisers provide a summary update of any material changes to Part 2A either on the cover page of the brochure or immediately thereafter, or in a separate communication (such as a cover letter) that would be distributed to existing clients along with the annual update to the brochure. This summary, which is not

required to be filed with the SEC, is intended to highlight significant changes to an adviser’s business or the risk of new conflicts of interest.<sup>12</sup>

**Item 3 – Table of Contents.** Item 3 would require a table of contents designed to assist clients in quickly locating the information contained in the brochure. The SEC requested comments as to whether it should require a standardized format to the table of contents in order to facilitate the comparison of information from one brochure to another.<sup>13</sup>

**Item 4 – Advisory Business.** The fourth item would require advisers to describe the types of advisory services they offer and the amount of assets managed on a discretionary and non-discretionary basis.<sup>14</sup> Under the current version of Form ADV, advisers choose from among nine categories and estimate the percentage of their compensation that is derived from billing for that service. The proposed approach gives advisers more flexibility to describe the types of services they offer, and requires enhanced disclosure if the adviser specializes in particular services. Advisers are not required to list the wrap fee programs in which they participate as the 2000 Proposal would have required; however, they are required to describe any differences between how they manage wrap fee accounts and how they manage other types of accounts and to disclose that they receive a portion of the wrap fee.<sup>15</sup> Advisers also have the flexibility to calculate assets under management in a manner that differs from Part 1A of Form ADV, as long as they document the method that is used.

**Item 5 – Fees and Compensation.** Item 5 would require advisers to describe how they are compensated for their advisory services and describe other fees, including custody fees, brokerage commissions and mutual fund expenses<sup>16</sup> that clients may pay in connection with the advisory services they receive. The adviser would be required to include its fee schedule, whether it will negotiate its fees, how it bills client accounts and the method by which the adviser assesses the fees and calculates any prepaid fees.<sup>17</sup>

The current proposal notably focuses on the conflicts associated with the receipt of compensation by the investment adviser or its supervised persons. Advisers that receive commissions, including distribution or sale or service fees from the sale of securities or other investment products, are required to disclose that this practice creates an incentive

for the adviser or its supervised persons to make investment decisions based on the compensation they receive, rather than the best interest of their clients. Advisers are further directed to explain how they address the conflict, including the procedures they have in place to disclose the conflicts to clients, and to notify clients that they can also purchase securities from unaffiliated broker-dealers.<sup>18</sup> Further, if an adviser collects over half of its revenue from brokerage commissions or transaction-based compensation, the adviser would need to disclose that its primary form of compensation is sales-based.<sup>19</sup>

**Item 6 – Performance Fees and Side-By-Side Management.** Item 6 would require advisers to disclose the receipt of performance fees. This disclosure item, which is a new addition that was not included in the 2000 proposal, reflects an area of significant potential conflicts of interest and particular SEC staff scrutiny. This is because the side-by-side management of accounts that charge a performance fee and those that do not creates an incentive for the adviser to preference the performance fee accounts over other accounts in order to generate higher fees. This may lead to preferential allocations of investment opportunities and unfair trade sequencing practices. Accordingly, advisers that simultaneously manage accounts that charge a performance fee and those that do not would be required to disclose that fact and the associated conflict of interest and explain how the adviser responds to the conflict.<sup>20</sup>

**Item 7 – Types of Clients.** Item 7 requires a description of the adviser's clients. This would include a general summary of the type of clients and any limitations the firm places on opening or maintaining an account such as a minimum amount of assets.<sup>21</sup>

**Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss.** The eighth proposed item would require advisers to disclose their methods of analyzing investments, their investment strategies and the risks inherent in the adviser's management of client assets. If an adviser offers a large number of services, the adviser can meet the requirement of describing the risk of loss for these services by generally explaining that investing in securities involves a risk of loss. Advisers that rely on a certain type of analysis or investment strategy or primarily invest in a certain type of security would be required to explain the risks associated with the

manner in which they manage client assets if they are significant or unusual, including whether the adviser employs strategies that involve frequent trading and the impact that frequent trading may have on performance.

One interesting addition is that advisers would be required to disclose their practices for managing uninvested cash in client portfolios in the

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absence of any client instruction.<sup>22</sup> Advisers who invest excess cash balances in affiliated securities or other investment products should consider the need for additional disclosure about the receipt of compensation or other potential conflicts of interest associated with such practices.

**Item 9 – Disciplinary Information.** Item 9 incorporates and effectively would replace<sup>23</sup> the disclosure provisions of Advisers Act Rule 206(4)-4 by requiring advisers to report the facts surrounding any material legal or disciplinary event that is deemed material to a client's evaluation of the adviser's business or the integrity of its management. Item 9 would include a list of disciplinary events that are presumed to be material if they occurred within the past 10 years. As with Rule 206(4)-4, the presumption of materiality can be rebutted; however, the adviser must document the reasons for its decision in a memorandum and keep records of any supporting documentation.<sup>24</sup> The list of material events is not exclusive – meaning that advisers may be required to disclose other types of legal or disciplinary events that are not specifically referenced in Item 9 if they are deemed to be material. Advisers are also not bound to the ten year time period. If a particular event is so serious that it remains currently material to a client's evaluation of the adviser's business or the integrity of its management, it should be disclosed – even if the event occurred more than ten years ago.

**Item 10 – Other Financial Industry Activities and Affiliations.** The tenth item requires advisers to describe material affiliations and relationships between the advisers (or their management persons) and related persons in the securities industry or any financial or business arrangements between such persons. Although the current version of Part 2 of Form ADV requires this type of disclosure, the new proposal goes further by requiring the adviser to disclose any conflicts of interest involved in these affiliations and how the adviser addresses those

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conflicts.<sup>25</sup> Interestingly, this item also specifically requires disclosure of any direct or indirect compensation or other business relationship an adviser may have with other investment advisers it recommends or selects for clients.

**Item 11 – Code of Ethics, Participation or Interest in Client Transactions and Personal Trading.** This item contains three parts. The first part of this provision, Item 11.A, would require advisers to describe the code of ethics they have adopted pursuant to Advisers Act Rule 204A-1.<sup>26</sup> Similar to Item 9 on the current Form ADV, Item 11.B would require advisers to disclose their level of participation in client transactions including any interest the adviser may have in the transaction. As part of the response, advisers will have to describe any conflicts of interest created by their participation in client transactions and the way in which the adviser addresses those conflicts.<sup>27</sup> Items 11.C and 11.D would require advisers to disclose proprietary or personal trading by the advisory firm and its related persons if they are trading in securities that are recommended to or bought or sold for clients. This includes securities, such as warrants, options or futures, that are related to the security being recommended to or bought or sold for the client. If an adviser or its related persons may trade at or about the same time

a client trades, the firm must explain the conflicts involved in this practice and the method by which the adviser addresses the conflict.

**Item 12 – Brokerage Practices.** Item 12 would require advisers to describe their broker selection practices and, specifically, the impact of the use of soft dollars (products and services provided by brokers to advisers in return for advisers directing transactions to the brokers), the receipt of client referrals and directed brokerage arrangements on their broker selection practices.

The 2008 Proposal is designed to enhance existing disclosure about soft dollar practices to give clients better information about not only whether their advisers obtain research and brokerage services through the use of soft dollars, but to describe the types of products and services that were acquired with enough specificity to permit clients “to evaluate possible conflicts of interest.”<sup>28</sup> Products and services that do not qualify as research or brokerage under Section 28(e) of the Securities Exchange Act of 1934, as amended, require a more detailed description. Advisers are required to identify the specific conflicts associated with the use of soft dollars, including that they benefit from using client brokerage commissions to obtain soft dollar services because they are not required to produce or pay for the research or brokerage services and that they may have an incentive to select or recommend broker-dealers based on the soft dollar services they provide rather than the best interests of their clients. Finally, advisers would be required to describe the procedures or internal controls that they use to direct brokerage in return for soft dollar benefits.

Advisers that direct brokerage in return for client referrals would have to disclose that they have an incentive to select broker-dealers based on the business they refer to the adviser, rather than based on the best interests of their clients. As in the case of soft dollar practices, advisers would have to describe their procedures or internal controls related to the direction of client transactions in return for client referrals.<sup>29</sup>

Item 12.A.3 would require advisers that “routinely recommend, request or require” that clients instruct them to use particular broker-dealers to explain whether they have any affiliation or other economic relationship that creates a material conflict of interest with such broker-dealers. Regardless of whether such directed brokerage arrangements

are encouraged or permitted by the adviser, it would have to describe the associated conflicts of interest, including that the directed brokerage arrangement may prevent the adviser from obtaining best execution and may result in higher prices and transaction costs. Notably, the SEC states that “soft” directions to execute transactions through specific broker-dealers subject to best execution are not considered directed brokerage arrangements and are subject to best execution.

Finally, Item 12 would require advisers to explain when they aggregate trades and, if they do not aggregate trades, to disclose to clients that their failure to do so may increase their brokerage costs.

**Item 13 – Review of Accounts.** Item 13 requires advisers to describe their process for reviewing client accounts and financial plans, and describe what client reporting they make available. Similar to current Item 11, if this review is based on circumstances other than timing, the adviser must identify those factors that might trigger a review.<sup>30</sup>

**Item 14 – Payments for Client Referrals.** Item 14 would require advisers to describe any cash or other payments such as sales awards or other prizes they receive from non-clients. Advisers would also have to describe any arrangements under which they or their related persons make referral fee payments to other persons and the compensation associated with such arrangements. Advisers already make these types of disclosures for item 13 under Part 2 of Form ADV.<sup>31</sup>

**Item 15 – Custody.** This item relates to the Advisers Act Rule 206(4)-2, the custody rule. If client assets are held with a qualified custodian that is responsible for sending account statements, the disclosure need only state that clients will receive account statements from their custodian and remind clients to review their statements. Advisers with clients who do not custody their assets with a qualified custodian must disclose this practice and explain the risks involved with the adviser holding custody of client assets.<sup>32</sup>

**Item 16 – Investment Discretion.** Similar to the disclosures under Item 12 of the current version of Part 2 of Form ADV, Item 16 would require advisers to explain whether they exercise discretion over client accounts and any limitations clients may place on that discretionary authority. This requirement is intended to ensure that clients understand that they may place reasonable restrictions (such

as limiting particular issuers or asset classes) on the management of their account.<sup>33</sup>

**Item 17 – Voting Client Securities.** Item 17 incorporates the requirement for advisers to describe the proxy voting policies and procedures they have adopted under Advisers Act Rule 206(4)-6 and explain how clients can obtain information about the adviser’s voting record and procedures for proxy voting. This item would also require advisers to explain how they address any conflicts of interest inherent in their proxy voting practices. If an adviser uses third-party proxy voting services, it would have to describe how it pays for those services.<sup>34</sup> If an adviser does not have discretion to vote clients’ proxies, the adviser must disclose that the client will receive proxies from the custodian or transfer agent.<sup>35</sup>

**Item 18 – Financial Information.** The 2008 Proposal would also require advisers to include a balance sheet with Form ADV under Item 18 if the advisers mandate prepayment of over \$1,200 in fees per client or six months or more in advance. Currently, advisers who have custody of client assets or require prepayment of over \$500 in fees per client, six months or more in advance, must provide audited account information as part of item 14 and Schedule G on the current Form ADV. In addition, if an adviser is registered with the SEC and has discretion over or custody of client accounts, it must disclose any financial situation reasonably likely to impair its ability to satisfy its contractual commitments. Finally, Item 18 would require an adviser to disclose if it was the subject of a bankruptcy petition over the last 10 years.<sup>36</sup>

**Item 19 – Index.** In Item 19, the SEC is proposing to require that the Form ADV include an index indicating where in the brochure the adviser addresses each of the items described above. The index, however, is for use by the SEC staff and would not need to be provided to clients.<sup>37</sup>

**Item 20 – Requirements for State-Registered Advisers.** The final proposed item for the firm brochure requires those firms that are state-registered advisers to disclose certain additional information.<sup>38</sup>

## Appendix 1 to Part 2A – The Wrap Fee Program Brochure

Proposed Appendix 1, which relates to wrap fee programs, is substantially the same as the current Schedule H, except that there is additional focus

on the conflicts of interest associated with the selection of affiliated portfolio managers.<sup>39</sup> Specifically, Item 6.B requires sponsors of wrap fee programs to disclose whether any of their related persons act as portfolio managers in the program. Similar to many of the items noted above, the sponsor would have to explain the inherent conflict of interest involved in hiring affiliated portfolio managers and the how the sponsor addresses that conflict of interest.<sup>40</sup> The sponsor would also have to explain whether affiliated portfolio managers are subject to the same selection and review process as unaffiliated managers.

## Part 2B – The Brochure Supplement

In addition to providing information about the adviser itself, the SEC is also re-proposing the requirement to deliver a “brochure supplement” that would provide information about the education, professional experience, qualifications and disciplinary history of supervised persons who service particular clients.<sup>41</sup> The use of the brochure supplement differs in two respects from the 2000 proposal. First, the SEC has limited the universe of personnel for whom an adviser is required to prepare a brochure supplement to supervised persons who: (i) formulate investment advice for clients and have direct client contact; and (ii) have discretionary authority over client assets, even if they have no direct client contact. Second, the brochure supplement would not need to be delivered to clients that are not required to receive a firm brochure, clients that do not receive personal investment advice, clients that meet the requirements of a “qualified purchaser” as defined under Section 2(a)(51)(A) of the Investment Company Act of 1940, as amended and individuals who would be considered “qualified clients” under Advisers Act Rule 205-3(d)(1)(iii), meaning that they are executive officers and directors of the adviser or employees who participate in the firm’s investment activities.

In terms of conflicts of interest, Item 4 of Part 2B requires an explanation of any investment-related business or occupation in which a supervised person is actively engaged, whether such financial industry activities create material conflicts of interest with clients and how the adviser addresses those conflicts. The receipt of cash or non-cash compensation,

including commissions, bonuses, mutual fund distribution or service fees and any other compensation based on the sale of securities or other investment products would also need to be disclosed, along with a statement that supervised persons may have an incentive to recommend securities and investment products based on the compensation they receive, rather than the needs of the client. If the supervised person receives a substantial portion of his or her income or spends a substantial portion of his or her time in a non-investment related business, the adviser must describe the type of business in which the supervised person engages.<sup>42</sup>

The proposed changes to Form ADV also focus on additional compensation received by supervised persons from non-clients. This additional compensation may include any economic benefit, including sales awards and other prizes, other than the regular salary of that employee, for providing advisory services.<sup>43</sup> In discussing the importance of this item, the SEC noted that “these types of arrangements can create significant and material conflicts of interest that may bias the advice being presented. We believe clients need to know about these arrangements in order to assess the advisory services of a firm’s supervised person.”<sup>44</sup>

## Conclusion

The new proposal for amending Form ADV sets forth a number of new disclosures that would be required, but also reflects the SEC’s ongoing focus on conflicts of interest and encouraging advisers to address these conflicts proactively. As stated in the proposal, “[m]uch of the information that would be required in the brochure concerns conflicts between an adviser’s own interests and those of its clients.”<sup>45</sup> In addition to requiring more thorough disclosures, however, the 2008 Proposal also reflects a more proactive approach to managing conflicts of interest. Given the SEC’s continuing focus on conflicts of interest, investment advisers would be well served to incorporate a review of their disclosures into any conflicts or risk assessment process that is currently in place and to consider whether their business practices create additional conflicts of interest that are not explicitly covered by the proposed changes to Part 2 of Form ADV.

## ENDNOTES

- <sup>1</sup> Amendments to Form ADV, SEC Rel. No. IA-2711, 34-54719, at 1 (Mar. 3, 2008) [the "2008 Proposal"].
- <sup>2</sup> The SEC proposed minor changes to Form ADV in 2005, but the last comprehensive proposal was published in 2000. See Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, SEC Rel. No. IA-1862, 34-42620 (Apr. 5, 2000) [the "2000 Proposal"].
- <sup>3</sup> Amendments to Form ADV, SEC Rel. No. IA-2711, at 10.
- <sup>4</sup> *In re Geman*, 65 SEC-Docket 360-46; 1997 WL 436272, at \*6 (Aug. 5, 1997), *aff'd* SEC Rel. No. 34-43963, 2001 WL 124847, at \*12 (Apr. 5, 2000); *Glaziers and Glassworkers Union v. Newbridge Secs. Inc.*, 93 F.3d 1171, 1180 (3d Cir. 1996).
- <sup>5</sup> SEC v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963) (citations omitted).
- <sup>6</sup> Stephen Cutler, Remarks Before the National Regulatory Services Investment Adviser and Broker-Dealer Compliance / Risk Management Conference (Sept. 9, 2003), available at <http://www.sec.gov/news/speech/spch090903smc.htm>.
- <sup>7</sup> SEC, Final Rule: Compliance Programs of Investment Companies and Investment Advisers, SEC Rel. No. IA-2204, IC-26299 (Dec. 17, 2003), available at [http://www.sec.gov/rules/final/ia-2204.htm#P65\\_13121](http://www.sec.gov/rules/final/ia-2204.htm#P65_13121) (noting that "each adviser, in designing 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").
- <sup>8</sup> 2008 Proposal, SEC Rel. No. IA-2711, at 10.
- <sup>9</sup> *Id.* at 11.
- <sup>10</sup> *Id.* at 12.
- <sup>11</sup> 17 C.F.R. § 275.204-3(c)(1).
- <sup>12</sup> 2008 Proposal, SEC Rel. No. IA-2711 at 12-13.
- <sup>13</sup> *Id.* at 13-14.
- <sup>14</sup> *Id.* at 14. It should be noted that an adviser would be allowed to use a method that differs from their calculation of assets under management for Part 1 of Form ADV.
- <sup>15</sup> *Id.* at 15.
- <sup>16</sup> The proposal would not require investment advisers to disclose the amount or range of mutual fund or other third-party fees that clients pay. *Id.* at 17.
- <sup>17</sup> *Id.* at 16-17.
- <sup>18</sup> *Id.*
- <sup>19</sup> *Id.* at 17, n.43.
- <sup>20</sup> *Id.* at 19.
- <sup>21</sup> *Id.* at 21.
- <sup>22</sup> *Id.* at 21-23.
- <sup>23</sup> As part of the 2008 Proposal, the SEC would rescind SEC Rule 206(4)-4. *Id.* at 27.
- <sup>24</sup> *Id.* at 23-24.
- <sup>25</sup> *Id.* at 28, n.74.
- <sup>26</sup> *Id.* at 26-27.
- <sup>27</sup> *Id.* at 30.
- <sup>28</sup> *Id.*, Appendix C at 6, Item 12.A.1.e.
- <sup>29</sup> *Id.* at 36.
- <sup>30</sup> *Id.* at 38.
- <sup>31</sup> *Id.* at 39.
- <sup>32</sup> *Id.* at 40.
- <sup>33</sup> *Id.*
- <sup>34</sup> The SEC also requested comment regarding whether clients should be informed about how the proxy voting services are used by the adviser, whether the client can direct the use of a particular proxy voting service and the amount of soft dollars used to pay proxy voting services. *Id.* at 42-43.
- <sup>35</sup> *Id.* at 40-42, Appendix C at 8-9.
- <sup>36</sup> *Id.* at 43-44, Appendix C at 9.
- <sup>37</sup> *Id.* at 45.
- <sup>38</sup> *Id.*, Appendix C at 10.
- <sup>39</sup> *Id.* at 45-46.
- <sup>40</sup> *Id.* at 46, Appendix 1, at 2.
- <sup>41</sup> *Id.* at 53-57.
- <sup>42</sup> *Id.*, Appendix 1, Part 2B, at 3.
- <sup>43</sup> *Id.* at 66-56, Appendix 1, Part 2B, at 3.
- <sup>44</sup> *Id.* at 67.
- <sup>45</sup> *Id.* at 8.

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