

**Investment Adviser
Conflicts of Interest Disclosures**

Investment Adviser Association
Annual Compliance Workshop
New York, New York
October 27, 2008

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I. Introduction

A. Investment advisers are fiduciaries that have an affirmative duty to act in utmost good faith and provide full and fair disclosure of all material facts.¹ This is particularly so where the adviser may have a material conflict of interest.

B. A “conflict of interest” generally refers to any activity or relationship in which an investment adviser’s interests compete with the interests of its clients. Common conflicts of interest include dealing with affiliates, the receipt of compensation or other benefits from third parties that may affect the independence of the advice provided, an adviser’s financial interest in a transaction (*e.g.*, acting as principal), client referral arrangements and personal and proprietary trading by the investment adviser and its employees.

II. Common Law Obligations to Disclose Conflicts of Interest

A. Duty of Loyalty. Agency law² provides that an investment adviser must act loyally for the benefit of its clients in all matters connected with the advisory relationship.³ Implicit in this duty of loyalty is the principle that, unless the client otherwise agrees, an investment adviser may not act for persons whose interests conflict with the adviser’s client or deal with the client as an adverse party in a transaction related to the advisory relationship.⁴ However, under common law, an investment adviser may modify its duty of loyalty through clear disclosure and informed consent.

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¹ *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963); *Transamerica Mortgage Advisers v. Lewis*, 444 U.S. 11, 17 (1979).

² As a general rule, the nature of an investment adviser’s fiduciary duties is determined by reference to principles of common law applicable to fiduciaries, especially agents. Frankel, *The Regulation of Advisers – Mutual Funds and Investment Advisers* at §14.01 (2002 Supp.). *See also* Investment Advisers Act Release No. 40 (Jan. 5, 1945) (noting that “investment advisers, in addition to complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship”).

³ *See* Section 8.01 of the Restatement (Third) of Agency (2005) [the “Restatement”].

⁴ *See* Restatement Section 8.03. “When an agent deals with the principal on the agent’s own account, the agent’s own interests are irreconcilably in tension with the principal’s interests because the interest of each is furthered by action . . . that is incompatible with the interests of the other. If an agent acts on behalf of the principal in a transaction with the agent, the agent’s duty to act loyally in the principal’s interest

1. Disclosure and Informed Consent. In obtaining this consent, an investment adviser would be required to “disclose all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal’s judgment.”⁵ Thus, where the interests of the investment adviser are adverse to that of its client, the investment adviser would have to disclose not only its interest in the transaction, but also other facts material to the client’s determination to enter into the transaction.⁶ Further, broad language purporting to release an investment adviser from potential conflicts of interest in the future is not likely to be enforceable.⁷ The consent necessary to waive a breach of duty of loyalty is intended to apply to a specific act or transaction (or type of act or transaction) that could reasonably be expected to occur in the ordinary course of the relationship between an investment adviser and its client.⁸ The investment adviser bears the burden of establishing that the client consented to the transaction.⁹ Accordingly, under common law, full disclosure is necessary to advise clients of conflicts of interest and obtain their informed consent to transactions that might otherwise result in a breach of the duty of loyalty.

III. Selected Regulatory Obligations to Disclose Conflicts of Interest

A. Investment Advisers Act of 1940 (“Advisers Act”). While the Advisers Act and the rules thereunder do not explicitly define the contours of an investment adviser’s fiduciary duty, they do incorporate various common law fiduciary concepts through specific prohibitions and disclosure obligations.¹⁰ Thus, as under common law, an investment adviser has a duty to avoid putting itself in conflict with the interests of clients or, if it cannot do so, to make full and fair disclosure to its clients and/or obtain client consent to the adviser’s proposed activity.¹¹ Such disclosures “constitute a safeguard which the law imposes to prevent the possibility of abuse which is inherent in a situation presenting conflicts between a fiduciary’s self-interest and his loyalty to his principal.”¹² In addition, the Advisers Act, like the other federal securities laws, is based on the fundamental principal of “full

conflicts with the agent’s self interest. Even if the agent’s divided loyalty does not result in demonstrable harm to the principal, the agent has breached the agent’s duty of undivided loyalty.” Comment b to Restatement Section 8.03.

⁵ Restatement Section 8.06(1)(a)(ii). Section 8.06(a) further requires that in obtaining the principal’s consent, the agent acts in good faith and otherwise deals fairly with the principal.

⁶ Comment d to Restatement Section 8.06.

⁷ Comment b to Restatement Section 8.06.

⁸ Restatement Section 8.06(b).

⁹ Comment a to Restatement Section 8.06.

¹⁰ In many cases, the Advisers Act transforms common law “default” rules into “mandatory” ones or otherwise changes common law requirements to fit the context. For example, the Advisers Act: (i) prohibits a client from waiving an adviser’s duty to provide disclosure to the client (which common law would allow); (ii) permits an adviser to engage in principal transactions with clients but only upon satisfaction of procedures set forth in the Advisers Act (common law does not require such procedures); and (iii) requires an adviser to make full and fair disclosure to *prospective* clients (common law would not do so).

¹¹ See *In re Arleen Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948).

¹² *Id.*

disclosure.”¹³ In this regard, the Advisers Act reflects the “congressional intent to eliminate, or *at least to expose*, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested.”¹⁴ Emphasis added.

1. General Disclosures - Advisers Act Section 206. This emphasis on disclosure is incorporated into Section 206, which is the general anti-fraud provision of the Advisers Act. In particular, Sections 206(1) and 206(2) make it unlawful for an investment adviser to “employ any device, scheme, or artifice to defraud any client or prospective client” or to “engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.” Section 206(1) and 206(2), in particular, impose an obligation on investment advisers to fully and fairly disclose all material information to the clients. A violation of Section 206 may be based on an affirmative misstatement or the failure to disclose material facts.

2. Specific Disclosures. In addition, to the general requirements of Sections 206(1) and (2), many of the more specific provisions of Section 206 and the rules thereunder impose specific disclosure obligations on investment advisers that engage in certain acts or transactions involving potential conflicts of interests. The relevant provisions include:

a. Principal Trades – Section 206(3) – requiring disclosure of capacity and trade-by-trade consent for principal trades;

b. Agency Cross Trades – Rule 206(3)-2 – requiring written disclosure of the receipt of compensation and potentially conflicting division of loyalties and responsibilities associated with agency cross trades, confirmations and annual statements;

c. Advertising – Rule 206(4)-1 – requiring appropriate disclosure relating to certain types of advertising practices and, generally, such disclosure as is necessary to make sure that advertising materials do not contain any untrue statement of a material fact or are otherwise false or misleading;

d. Cash Referral Fees – Rule 206(4)-3 – requiring the solicitor to deliver the investment adviser’s Form ADV, Part II (or equivalent brochure) and a disclosure document that describes the relationship between investment adviser and the solicitor and the associated compensation at the time of the solicitation;

e. Financial Condition – Rule 206(4)-4 – requiring disclosure of financial conditions or legal or disciplinary events that are material to an evaluation of the adviser’s integrity or ability to meet contractual commitments to clients;¹⁵ and

¹³ *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (citations omitted) (noting that the cornerstone of the federal securities laws, including the Advisers Act, was to “substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry”).

¹⁴ *Id.* at 191.

¹⁵ In its most recent amendments to Form ADV, the SEC proposed to rescind Rule 206(4)-4 and instead incorporate the necessary disclosures into Item 9 (disciplinary information) of Part 2A. *Amendments to Form ADV*, Advisers Act Rel. No. 2711 (Mar. 14, 2008) [the “2008 Proposal”].

f. Proxy Voting – Rule 206(4)-6 – requiring advisers to describe proxy voting policies and to make copies of such policies, along with reports as to how an adviser voted particular proxies, available to clients on request.

B. Form ADV, Part II. In addition to the anti-fraud provisions of the Advisers Act, Section 204 and Rule 204-3 thereunder requires investment advisers to “furnish clients with a written disclosure statement” that contains the information required by Part II of Form ADV. Part II of Form ADV is the principal disclosure document under the Advisers Act. Section 207 makes it unlawful for an investment adviser to “willfully to make any untrue statement of a material fact . . . or willfully to omit to state . . . a material fact which is required to be stated” in any application or report required to be filed with the SEC under Section 203 or 204.

In March of 2008 the SEC proposed amendments to Part II 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.”¹⁶ In form and substance, the 2008 Proposal largely follows amendments originally proposed in April 2000.

1. Explanation of How Advisers Address Conflicts. As it relates to conflicts of interest, however, the 2008 Proposal requires investment advisers not only to identify actual or potential conflicts of interest, but also to explain how they address or attempt to mitigate conflicts. This additional requirement – that investment advisers “explain succinctly how they address the conflicts of interest they identify” – was added in lieu of an earlier requirement, incorporated into the April 2000 proposal, that would have required investment advisers to provide detailed disclosure describing their policies and procedures. While the focus on how advisers address conflicts is intended to eliminate the need for lengthy disclosures about policies and procedures, it seems to go further than existing legal principals would require. Under common law, for example, an investment adviser would only be required to disclose the conflict and provide the facts material to a client’s determination to engage in the transaction. Although it may be argued that the manner in which an investment adviser manages or mitigates its conflicts of interest is material to a client, in practice, this additional layer of disclosure generally is not provided. In addition, in other contexts, the SEC has focused only on whether disclosure covers both the existence and dimensions of a conflict, without going into detail about how particular conflicts are managed.¹⁷

2. Specific Conflicts Disclosure. In addition to proposing that investment advisers disclose how to address conflicts of interest, proposed Part 2A identifies a number of explanatory (sometimes critical) conflict disclosures that investment advisers are expected to incorporate into their brochures. For example, proposed Item 12 (brokerage practices) requires investment advisers who receive soft dollar benefits to “disclose that you may have an incentive to select or recommend a broker-dealer based on your interest in receiving the research or other products or services, rather than on your client’s interest in receiving best execution.” Exhibit A sets forth common conflicts of interest for

¹⁶ *Id.* at Section II.A.1.

¹⁷ See Brief for the Securities and Exchange Commission as Amicus Curiae in Response to the Court’s Request, *Press v. Quick & Reilly, Inc.*, 96 Civ. 4278(RPP) (S.D.N.Y. Aug. 8, 1997) (No. 97-9153). In discussing whether certain prospectus disclosure satisfied a broker-dealer’s obligation to disclose third-party remuneration under Rule 10b-10, the SEC stated that such disclosure was adequate because it “gives some idea of the dimensions of the conflict.”

investment advisers and, where applicable, identifies specific conflict of interest disclosure items that were included in the 2008 Proposal. Ultimately, it is an investment adviser's responsibility to disclose conflicts that are material to a client's evaluation of the adviser's services, and investment advisers should ensure that the language incorporated into Form ADV accurately reflects its business practices and assessment of its actual and potential conflicts.

C. Disclosures to Plan Sponsors Under 408(b)(2) and Form 5500. Instead of relying on disclosure and consent to address potential conflicts of interest, the Employee Retirement Income Security Act of 1974 ("ERISA") takes the much more restrictive approach of simply prohibiting self-dealing transactions between a plan and a fiduciary or other party in interest, absent an available exemption. One such commonly used exemption is ERISA Section 408(b)(2), which permits certain service contracts or arrangements (including investment management agreements) between plans and parties in interest if the contract or arrangement is reasonable, the services are necessary for the establishment or operation of the plan and no more than reasonable compensation is paid for the services.

1. Proposed Regulations. On December 13, 2007, the Department of Labor ("DOL") proposed amendments to the regulations under Section 408(b)(2) to clarify that a contract or arrangement will only be deemed to be "reasonable" if it requires an investment adviser or other service provider to disclose, and the service provider in fact does disclose, extensive information about all compensation to be received by the service provider and any conflicts of interest that may adversely affect the service provider's performance under the contract or arrangement with the responsible plan fiduciary.¹⁸

2. Reliance on Form ADV. The relevant disclosures must be provided in writing prior to entering into the contract or arrangement and all of the required disclosures need not be contained in the same document. For this purpose, the DOL has stated that the contracting parties are free to rely on Form ADV or prospectus disclosure and to incorporate those documents by reference.¹⁹ While helpful, the proposed regulations may require more detailed information than is ordinarily found in a Form ADV or a prospectus. Accordingly, investment advisers may be forced to provide supplemental disclosures or to enhance the disclosure currently in their Form ADV in order to satisfy the requirements of the Proposed Regulations.

3. Fee Disclosures. The Proposed Regulations require disclosure of all services to be provided to the plan, the compensation or fees received in connection with each such service and the manner of receipt of such compensation or fees.

a. For this purpose, "compensation or fees" is defined broadly in proposed Rule 408b-2(c)(1)(iii)(A)(1) to include "money or any other thing of monetary value . . . received, or to be received, directly from the plan or plan sponsor or indirectly . . . by the service provider or its affiliate in connection with the services to be provided pursuant to the contract or arrangement or because of the service provider's or affiliate's position with the plan." This definition is intended to cover, for example, gifts, rewards, and trips for employees, research, finder's fees, placement fees, commissions or other fees

¹⁸ *Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure*, 72 Fed. Reg. 70988 (Dec. 13, 2007) [the "Proposed Regulations"].

¹⁹ *Id.* at 70990.

related to investment products, sub-transfer agency fees, Rule 12b-1 fees, soft dollar payments, float income, fees deducted from investment returns, performance-based fees and asset based fees.

b. Indirect compensation includes fees that service providers receive from parties other than the plan or the plan sponsor, including compensation or fees received by the service provider's affiliates from third parties.

c. Additionally, if a service provider offers bundled services, the service provider must disclose information about all services to be covered in the bundle, the aggregate direct compensation or fees paid for the bundle, as well as all indirect compensation that will be received by the service provider (or its affiliates or subcontractors) from third parties, subject to certain exceptions.

4. Form 5500. In addition to the Proposed Regulations, the DOL had previously issued a final rule concerning revisions to Form 5500 Schedule C, which requires annual reports of the amount of compensation that service providers receive, directly or indirectly, for services provided to the plan.²⁰ While the Proposed Regulations are intended to provide disclosure to plan fiduciaries at the inception of the service provider relationship, the Form 5500 fee disclosures are intended to reinforce the plan fiduciary's obligation to monitor compensation and fees on an ongoing basis by requiring that plans report the amount of compensation earned by their service providers (broadly defined). Although Form 5500 does not impose a specific obligation on investment advisers, advisers will be requested to provide detailed information about the amount of compensation earned to their plan clients. Service providers who fail or refuse to provide this information may be reported to the DOL.

5. Conflict Disclosures. In addition to the extensive fees disclosures, the Proposed Regulations also require service providers to disclose information relating to conflicts of interest "that may be relevant to a plan fiduciary's assessment of the objectivity of a service provider's decisions or recommendations."²¹ These conflicts include:

a. Disclosure of any financial or other interest in any transaction to be entered into by the plan in connection with the contract or arrangement;

b. Disclosure of any material financial, referral or other relationship or arrangement with other parties that creates or may create a conflict of interest for the service provider in performing its services pursuant to the contract or arrangement;

c. Whether the service provider (or an affiliate) will be able to affect its own compensation or fees without the prior approval of an independent plan fiduciary and, if so, a description of the nature of such compensation; and

d. Whether the service provider (or any affiliate) has adopted policies and procedures designed to address actual or potential conflicts of interest and, if so, an explanation of the policies and procedures and how they address such conflicts of interest or prevent an adverse effect on the provision of services.

²⁰ *Annual Reporting and Disclosure*, 72 Fed. Reg. 64710 (Nov. 16, 2007).

²¹ Proposed Regulations at 70991.

IV. Practical Tips for Disclosing Conflicts of Interest

A. Think outside the Part II of Form ADV “box”. Form ADV provides a useful inventory of common conflicts of interest associated with an investment adviser’s business; however, it is not intended to be all inclusive. The 2008 Proposal makes clear that the items covered in Part 2A will not cover every possible conflict.²² Accordingly, advisers should consider whether there are additional conflicts – beyond those expressly outlined in Form ADV – that should be addressed or whether they are required to make additional disclosures under federal or state law.

B. Think outside the Form ADV “box” entirely. While the Form ADV is the principal disclosure document under the Advisers Act, it is not the only vehicle – and, indeed, may not be the most effective vehicle – for delivering client facing disclosures. Many investment advisers appropriately rely on other documents (in addition to the Form ADV) to deliver disclosures, including disclosures relating to conflicts of interest. Such documents may include:

1. Investment advisory agreements – Agreements increasingly are used not only to obtain consent (*e.g.*, blanket consent to agency cross trades), but also to deliver more general disclosures regarding conflicts of interest. For example, investment advisory agreements may contain general information about the different capacities in which the firm may deal with clients (including as a result of different business lines, products and services), explain how employees are compensated, address the allocation of investment opportunities (including IPOs) and trade rotation policies.

2. Fund offering documents, including confidential offering memoranda, prospectuses and statements of additional information – Such documents have always contained disclosure of the various risks associated with investing in the particular types of investments or investment program offered by the pooled investment vehicle.

3. “Relationship” brochures – In 2005, the SEC adopted Rule 202(a)(11)-1, which was designed to clarify the scope of the broker exception to the definition of investment adviser under Advisers Act Section 202(a)(11)(C) and, more specifically, to permit broker-dealers to charge asset-based fees without being subject to registration as an investment adviser.²³ Although this rule was subsequently vacated, many firms had prepared and continue to offer “relationship brochures” designed to clarify the respective roles that they may play, including the differences between investment advisory and brokerage services, how the firm charges for the services it offers and a detailed explanation of the fees for particular investments, products and services.

4. Client inquiries and requests for proposal – Existing and prospective clients increasingly request general information about how investment advisers identify, evaluate, monitor and manage conflicts.

C. Convey the Information Clearly. The 2008 Proposal would include General Instruction 2 to Part 2A of Form ADV requesting that investment advisers write in plain English, taking into consideration the client’s level of financial sophistication. For this purpose, the SEC defines “plain English” to mean: (i) short sentences; (ii) definite, concrete, everyday words; (iii) active voice; (iv) tables or bullets for complex material; (v) avoiding legal jargon or highly technical business terms; (vi) avoiding

²² See 2008 Proposal at n.16.

²³ *Certain Broker-Dealers Deemed Not to Be Investment Advisers*, Advisers Act Release No. 2376 (April 12, 2005).

multiple negatives. More than just writing clearly, however, the more significant challenge often is presenting the information in a meaningful way that clients will read and absorb. This is particularly challenging in light of the recognition set forth in the RAND study that, regardless of how carefully documentation is crafted, “investor rarely read these disclosures.”

One possible option is to take a “layered” approach to disclosure in which key information is sent or given to the client and more detailed information is provided online and, upon request, is sent in paper or by e-mail. Such an approach, which is borrowed from the mutual fund “summary prospectus” proposal, has the advantage of streamlining disclosure and proving a more flexible and cost effective mechanism for investment advisers to deliver detailed information.²⁴ Although the SEC unfortunately did not embrace this approach for purposes of the Part 2A of Form ADV, it nevertheless may be worth considering for additional client disclosures or more detailed information that is outside the technical requirements of Form ADV.

D. Map disclosures to exiting conflict inventories. In connection with developing the policies and procedures required by Advisers Act Rule 206(4)-7 or as part of their annual testing under that rule, many investment advisers perform conflicts assessments or create matrices of the risks, including risks associated with conflicts of interest, that are relevant to their business. Investment advisers may wish to consider augmenting such conflict inventories to map the relevant disclosures to each conflict. Such a chart or matrix might: (i) identify the categories of conflicts (or risks) associated with an investment adviser’s business; (ii) reference the policies and procedures designed to address or mitigate the relevant conflict; and (iii) identify the relevant disclosures (and locations of those disclosures) that apply to the different conflicts.

E. Don’t just test policies and procedures, test disclosures. Like policies and procedures, disclosures will need to change over time to reflect evolving regulatory standards and business practices. One way to institutionalize a review of disclosures is to incorporate a “disclosure review” into the annual testing of policies and procedures under Advisers Act Rule 206(4)-7. Under this approach, as each policy is tested, the disclosures associated with the topic of each policy would also be reviewed to ensure that they accurately reflect the investment adviser’s business practices.

F. Update disclosures annually or more frequently, if necessary. The 2008 Proposal would require investment advisers to deliver their current brochure to existing clients annually, within 120 days after the end of the adviser’s fiscal year. In addition, advisers would be required to deliver interim updates to their Form ADV, Part 2A and Brochure Supplement (the proposed brochure relating to certain supervised persons) only in the case of an addition or material change to disciplinary information. Notwithstanding these updating requirements, however, investment advisers would still have an ongoing fiduciary obligation “to inform their clients of any material information that could affect the advisory relationship. As a result, advisers may be required to disclose material changes to clients between annual updating amendments even if those changes do not trigger delivery of an interim update.”²⁵ In addition, under the Proposed Regulations, investment advisers would have to disclose any material changes to the disclosures provided under ERISA Section 408(b)(2) “no later than 30 days from the date on which the service provider acquires knowledge of the material change.” Taken together, these provisions require

²⁴ *Enhanced Disclosure of New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, Investment Company Release No. 28064 (Nov. 21, 2007).

²⁵ 2008 Proposal at n.148.

that disclosures be updated and distributed as necessary to address evolving business practices or new conflicts of interest.

G. Engage the business. When the SEC staff examines an investment adviser, it will often start with the firm's Form ADV and evaluate whether the firm's procedures are consistent with its disclosures. Thus, it is critical to engage appropriate business personnel in reviewing any disclosures to get their perspective on whether the disclosures adequately address business practices and potential conflicts – an also whether there are particular conflicts that are not covered in the existing documentation.

H. Be aware that the use of disclosure has limits. Although disclosure is necessary for investment advisers to meet their fiduciary obligations and comply with the Advisers Act and other federal and state laws, the use of disclosure is subject to limitations. First, there are situations where disclosure is not sufficient to eliminate a conflict of interest. Certain provisions of the Adviser Act, for example, require affirmative client consent (*e.g.*, trade-by-trade consent for principal transaction under Section 206(3), blanket consent to agency cross trades under Rule 206(3)-2 and client acknowledgement of the separate disclosure document for solicitation arrangements under Rule 206(4)-3). In addition, disclosure is not sufficient to eliminate a prohibited transaction in the case of retirement accounts. Finally, disclosure generally cannot cure a breach of the duty of care or a conflict that is ultimately unfair.

I. Manage conflicts – don't rely on disclosure alone. The SEC staff has observed that there are really “only two ways in which advisers can handle their conflicts of interest and remain within an acceptable level of regulatory compliance: (1) Eliminate the arrangements or activities that create the conflict; or] (2) Disclose each conflict fully and fairly and then manage the adviser's affairs so impact of a conflict on clients and fund investors will be consistent with the disclosures made.”²⁶ Given the pervasive presence of conflicts of interest in the investment management industry, the first often is not practicable. However, disclosure of conflicts of interest should not be addressed in isolation. Ideally, disclosure would be one element of a comprehensive program designed to identify and *manage* conflicts of interest.²⁷ Such a program might include a conflicts policy, a standing committee or conflicts officer, a conflicts assessment designed to identify the conflicts of interest associated with the investment adviser's business, employee training and a conflicts monitoring process.

V. Recent SEC Staff Statements Relating to Disclosure

A. SEC examination priorities and enforcement actions often focus on disclosure of conflicts of interest. Following is a list of examples of disclosure-related issues highlighted in recent SEC staff public statements and speeches:²⁸

²⁶ Gene A. Gohlke, *Remarks Before the Fund of Funds Forum*, Nov. 14, 2005 available at <http://www.sec.gov/news/speech/spch111405gag.htm>.

²⁷ In adopting Advisers Act Rule 206(4)-7, the SEC noted that “each adviser in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.” *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204 (Dec. 17, 2003).

²⁸ *See, e.g. Compliance.Alert* (July 2008) available at <http://www.sec.gov/about/offices/ocie/complialert0708.htm>; Andrew J. Donohue, *Remarks before the*

1. Personal Securities Trading – Inaccurate Form ADV disclosures relating to controls over personal trading.
2. Brokerage Arrangements, Best Execution and Soft Dollars – General focus on inappropriate and/or undisclosed use of soft dollars for the benefit of the adviser and use of any affiliated or preferenced broker-dealers for excessive commission payments, kickbacks or other undisclosed arrangements. Specific examples of failure to disclose conflicts associated with soft dollars include: acquisition of research with soft dollar payments from a research company in which affiliates of the investment adviser have an ownership interest, use of soft dollars to obtain products and services outside the Section 28(e) safe harbor and use of accounts for which the investment adviser does not have brokerage or investment discretion to obtain soft dollar credits.
3. “Free Lunch” Seminars to Seniors – Failure to disclose the name of the firm sponsoring the seminar and the fact that product sponsors (*e.g.*, mutual fund and insurance companies) may provide funding for the seminars with the expectation that investment professionals will sell their products.
4. SMA/UMA Programs – Focus on whether there is clear disclosure explaining how investment advice is provided and where investment decision-making authority resides. This is a particular issue in the context of these programs where there often is an allocation of investment advisory services (*e.g.*, asset allocation advice, model portfolios, overlay management and trade implementation) among multiple parties. The SEC staff believes this disclosure is particularly important when the originator of the advice has no direct contact with the client. There has also been attention on whether disclosure addresses the fact that the majority of trades in wrap programs are placed with sponsors and how such an arrangement achieves best execution.
5. Derivatives and Illiquid Securities – Focus on whether the adviser has made appropriate disclosures to clients about the risks associated with investments in derivatives and other complex investment products and illiquid securities.
6. Portfolio Management – Focus on whether securities recommendations and investments are consistent with the investment adviser’s disclosures and the client’s investment objectives and restrictions.
7. Trade Allocation – Focus on whether the adviser has disclosed its trade allocation practices, the policies and procedures for allocating IPOs, block trades and investment opportunities among clients and proprietary accounts, and whether actual practices are consistent with both policies and disclosures.

VI. Recent SEC Enforcement Actions Relating to Disclosure

A. *In the Matter of Banc of America Investment Services, Inc. (“BAI”) and Columbia Management Advisors, LLC (“Columbia”)* (as successors in interest to Banc of America Capital Management, LLC),

LA Week and the Investment Adviser Association 10th Annual LA Compliance Best Practices Summit 2008, March 21, 2008 available at <http://www.sec.gov/news/speech/2008/spch032108ajd.htm>; Lori A. Richards, *Focus Areas in SEC Examinations of Investment Advisers: the Top 10*, March 20, 2008 available at <http://www.sec.gov/news/speech/2008/spch032008lar.htm>.

Admin. Proc. File No. 3-13030, 2008 SEC LEXIS 968 (May 1, 2008). The SEC brought an action in which it alleged that between July 2002 and December 2004, BAI and Columbia did not follow the objective research process outlined in its promotional materials and, instead, followed a different, more subjective research methodology designed to favor its proprietary funds and, therefore, increase advisory fees paid to Columbia. The SEC also alleged that BAI failed to adequately disclose its conflict of interest in the selection process. As a result, the SEC found that BAI violated, and Columbia aided and abetted a violation of, various provisions of the federal securities laws, including Advisers Act Sections 206(2) and 206(4). Among other things, BAI and Columbia were order to cease and desist from causing future violations, were censured and were ordered to pay approximately \$10,000,000 in disgorgement and civil monetary penalties.

B. *In the Matter of Fidelity Management Research Company and FMR Co., Inc.* (collectively, “Fidelity”), Admin. Proc. File No. 3-12976, 2008 SEC LEXIS 507 (Mar. 5, 2008). The SEC brought an action against Fidelity alleging that certain of its equity traders allowed their receipt of travel, entertainment, gifts and gratuities (“TE”) from, or their relationships with, brokerage firm employees to influence the mutual fund firm’s allocation of order flow to brokers. The SEC alleged that between January 2002 and October 2004, ten Fidelity traders and two senior executives received TE worth approximately \$1.6 million from brokerage firms that provided, or sought to provide, brokerage services to Fidelity. During the same period, certain Fidelity equity traders placed fund trades with brokers with whom they had personal or familial relationships. The SEC found that Fidelity violated Advisers Act Section 206(2) by allowing TE and personal relationships to factor into broker selection decisions, failing to disclose the material conflict of interest arising from the TE and personal relationships in its Form ADV and fund SAIs and making materially false and misleading statements and omissions in its Form ADV, fund SAIs and in discussions with trustees relating to its broker selection practices. Among other things, Fidelity was ordered to cease and desist from causing future violations, was censured and was ordered to pay \$8,000,000 in civil monetary penalties in addition to the \$42 million Fidelity had already agreed to pay back to its funds.

C. *In the Matter of Financial Design Associates, Inc.* (“FDA”) and *Albert L. Coles, Jr.* (“Coles”), Admin. Proc. File No. 3-12827, 2007 SEC LEXIS 2208 (Sept. 25, 2007). The SEC brought an action against FDA, alleging that between 2002 and 2006, Coles received approximately \$361,307 in undisclosed referral fees from the issuer of a company in which Coles and FDA recommended that clients invest. In addition, FDA and Coles falsely represented in client disclosures that FDA and Coles were compensated solely by FDA clients and received no payments from the issuers of the securities in which its clients were invested. Such payments created a conflict of interest compromising the objectivity of FDA’s investment recommendations and, as a result, FDA and Coles were found to have willfully violated Advisers Act Sections 206(1), 206(2) and 207. FDA and Coles were ordered to cease and desist from causing future violations. Coles was ordered to pay \$300,000 in disgorgement and civil monetary penalties, in addition to \$101,307 in disgorgement owed.

D. *In the Matter of Yanni Partners, Inc.* (“Yanni”) and *Theresa A. Scotti* (“Scotti”), Admin. Proc. File No. 3-12746, 2007 SEC LEXIS 1970 (Sept. 5, 2007). The SEC brought an action against Yanni, an investment adviser and pension consultant, alleging that Yanni misrepresented and failed to disclose relationships it had with investment advisers it was recommending to pension plan clients. The SEC alleged that from January 2002 through May 2005 Yanni provided consulting services, including advice in developing appropriate investment strategies and selecting money managers, while at the same time selling subscription services that generated approximately \$600,000 in annual revenue to some of the same money managers its was recommending to its clients. The SEC found that the sales of

subscription services to money managers created a potential conflict of interest that Yanni should have disclosed and that the failure to do so violated Advisers Act Section 206(2). Yanni and Scotti were ordered to cease and desist from causing future violations and were censured. Yanni was ordered to pay \$175,000 and Scotti was ordered to pay \$40,000 in civil monetary penalties.

E. *In the Matter of Callan Associates* (“Callan”), Admin. Proc. File No. 3-12808, 2007 SEC LEXIS 2133 (Sept. 19, 2007). The SEC brought an action against Callan, a pension consultant, alleging that between 1999 and 2005, Callan referred clients to BNY Brokerage Inc., while failing to disclose that it was receiving payments contingent upon Callan’s clients generating certain amounts of commissions on an annual basis. The SEC found that this nondisclosure of payments from its preferred broker-dealer made Callan’s disclosures in its Form ADV, Part II misleading in violation of Advisers Act Section 207. Callan was ordered to cease and desist from causing future violations.

F. *In the Matter of Folger Nolan Fleming Douglas Capital Management, Inc., Neil C. Folger and David M. Brown* (collectively, “Folger Nolan”), Admin. Proc. File No. 3-12737, 2007 SEC LEXIS 1892 (Aug. 23, 2007). The SEC brought an action against Folger Nolan alleging that from January 1, 2002 through April 1, 2004, registered representatives at Folger Nolan’s affiliated broker referred customers seeking investment advisory services to Folger Nolan (“referred clients”). Folger Nolan then entered into advisory agreements with referred clients that required trades to be directed through the affiliated broker. Such referred clients were charged commission rates that averaged more than twice that of advisory clients not referred from Folger Nolan’s affiliated broker, without appropriate disclosure. As a result, the SEC found that the firm violated its duty of best execution and failed to disclose the conflict in violation of Advisers Act Section 206(2). Folger Nolan was ordered to cease and desist from causing future violations, was censured and was ordered to pay approximately \$350,000 in disgorgement and civil monetary penalties.

G. *In the Matter of John Hancock Investment Management Services, LLC* (“John Hancock”), Admin. Proc. File No. 3-12664, 2007 SEC LEXIS 1358 (June 25, 2007). The SEC brought an action against John Hancock alleging that from 2001 until 2004 certain investment advisers and broker-dealers owned by Manulife Financial Corporation and John Hancock failed to disclose their use of directed brokerage commissions to pay for distribution expenses relating to the sale of proprietary mutual fund and variable annuity products. Specifically, the investment advisers failed to disclose to the variable trust and mutual fund boards that they were directing brokerage commissions to pay for their affiliated distributor’s revenue sharing obligations. As a result, the SEC found that the relevant investment advisers caused, and the broker-dealers aided and abetted, a violation of Advisers Act Section 206(2). Among other things, the relevant entities were ordered to cease and desist from causing future violations, were censured and were order to pay approximately \$20,000,000 in disgorgement and civil monetary penalties.

Common Investment Adviser Conflicts of Interest and Form ADV Disclosure

	Conflict	Form ADV, Part 2 – Proposed Instructions Relating to Disclosure of Conflicts of Interest
1.	Agency cross trades	
2.	Allocation of investment and trading opportunities	
3.	Batching client trades	<ul style="list-style-type: none"> Describe whether and under what circumstances you aggregate the purchase or sale of securities for various client accounts in quantities sufficient to obtain reduced transaction costs. If you do not bunch orders when you have the opportunity to do so, explain your practice and describe the costs to clients of not bunching. (Item 12)
4.	Trade rotation policies	
5.	Cross trades	
6.	Directed brokerage	<ul style="list-style-type: none"> If you routinely recommend, request or require that a client direct you to execute transactions through a specified broker-dealer, describe your practice or policy. If you and the broker-dealer are affiliates or have another economic relationship that creates a material conflict of interest, describe the relationship and <i>discuss the conflicts of interest it presents. Explain that by directing brokerage you may be unable to achieve best execution of client transactions, and that this practice may cost clients more money.</i> (Item 12) If you permit a client to direct brokerage, describe your practice. If applicable, explain that you <i>may be unable to achieve best execution of client transactions.</i> (Item 12)
7.	Directorships in companies	
8.	Double dipping of fees	
9.	Fee differentials and different treatment for proprietary/nonproprietary or affiliated/unaffiliated products	<ul style="list-style-type: none"> Disclose whether related person portfolio managers are subject to the same selection and review as the other portfolio managers that participate in the wrap program. If they are not, describe how you select and review related person portfolio managers. (Appendix 1)
10.	Gifts and entertainment	
11.	Interests in securities	<ul style="list-style-type: none"> Disclose whether you or a related person recommends to clients, or buys or sells for client accounts, securities in which you or a related person has a material financial interest, describe your practice and discuss the conflicts of interest it presents. <i>Describe generally how you address conflicts that arise, including your procedures for disclosing the conflicts to clients.</i> (Item 11)
	<ul style="list-style-type: none"> Affiliate stock 	
	<ul style="list-style-type: none"> Client stock 	
	<ul style="list-style-type: none"> General partner for a hedge fund 	
	<ul style="list-style-type: none"> Investment Adviser for mutual funds 	
	<ul style="list-style-type: none"> Underwritings by an affiliate 	
12.	Interests in and affiliations with other financial industry participants	<ul style="list-style-type: none"> Disclose any relationship or arrangements the firm or its management persons have with related persons that are material to the firm’s advisory business or to clients and if the relationship or arrangement creates a material conflict of interest with clients, describe the nature of the conflict <i>and how the firm addresses it.</i> (Item

	Conflict	Form ADV, Part 2 – Proposed Instructions Relating to Disclosure of Conflicts of Interest
		<p>10)</p> <ul style="list-style-type: none"> • Disclose whether you or any related persons act as portfolio manager in a wrap program. (Appendix 1) • Describe any material conflict of interest with clients caused by the supervised person’s other financial industry activities. (Part 2B, Item 4)
13.	Parallel trading and front running	
14.	Pension consultants	<ul style="list-style-type: none"> • If you recommend or select other investment advisers for your clients and you receive compensation directly or indirectly from those advisers, or you have other business relationships with those advisers, describe the practices, discuss the conflicts of interest these practices create and <i>how you address them</i>. (Item 10)
15.	Performance-based fees	<ul style="list-style-type: none"> • Disclose whether the firm or its supervised persons accepts performance fees. (Item 6)
16.	Portfolio pumping/marketing the close	
17.	Possession of material, nonpublic information	
	<ul style="list-style-type: none"> • Rumors 	
18.	Principal trading	
19.	Proprietary and personal securities trading	<ul style="list-style-type: none"> • Disclose whether you or a related person invests in the same securities (or related securities) that you or a related person recommends to clients, <i>describe your practice and discuss the conflicts of interest this presents and generally how you address the conflicts that arise in connection with personal trading</i>. (Item 11) • Disclose whether you or a related person recommends securities to clients, or buys or sells 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 (or the related person’s own) account, <i>describe your practice and discuss the conflicts of interest it presents. Describe generally how you address conflicts that arise</i>. (Item 11)
20.	Proxy Voting	<ul style="list-style-type: none"> • Describe how you address conflicts of interest between you and your clients with respect to voting their securities. (Item 17) • Describe whether you pay for proxy voting services with soft dollars or pass the cost to clients. (Item 17)
21.	Receipt of transaction-based compensation	<ul style="list-style-type: none"> • Disclose whether you or your supervised persons accepts compensation attributable to the sale of securities or other investment products, including mutual fund distribution and service fees and <i>explain that this practice creates an incentive to base investment recommendations on the amount of compensation received, rather than on client needs</i>. (Item 5) • 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. (Part 2B, Item 4)
22.	Scalping	
23.	Selective dissemination of holdings information	
24.	Side-by-side management of hedge funds and other accounts	<ul style="list-style-type: none"> • Describe the difference, if any, between how you manage wrap fee accounts and how you manage other accounts. (Item 4)

	Conflict	Form ADV, Part 2 – Proposed Instructions Relating to Disclosure of Conflicts of Interest
		<ul style="list-style-type: none"> • Disclose whether you or your supervised persons simultaneously manage both accounts that are charged a performance fee and accounts that are charged other types of fees and <i>explain the conflicts associated with side-by-side management, including the incentive to favor accounts that pay performance fees.</i> (Item 6)
25.	Soft Dollars, including mixed use products and commitment to pay residual in hard dollars	<ul style="list-style-type: none"> • Explain that when you use client brokerage commission to obtain research or other products or services, you receive a benefit because you do not have to produce or pay for the research, products or services. (Item 12) • Disclose that you may have an incentive to select or recommend a broker-dealer based on your interest in receiving the research or other products or services, rather than your client’s interest in best execution. (Item 12) • Disclose if you may cause clients to pay commissions (or markups or markdowns) higher than those charged by other broker-dealers in return for soft dollars (paying-up). (Item 12) • Disclose whether you use soft dollar benefits to service all of your client accounts or only those that paid for the benefits. (Item 12) • Describe the types of products and services you and your related persons acquired with client brokerage commissions within the last fiscal year. (Item 12) • Explain the procedures you used during the last year to direct client transactions to a particular broker-dealer in return for soft dollar benefits. (Item 12)
26.	Solicitation Arrangements	<ul style="list-style-type: none"> • Describe any arrangement where a non-client provides an economic benefit (including sales awards or other prizes) to you or your supervised persons for providing investment advice or other advisory services to your clients. (Item 14 & Part 2B, Item 5) • Describe any arrangement where you or a related person directly or indirectly compensates a third party for client referrals. (Item 14)
27.	Trade errors	
28.	Use of brokerage for client referrals and fund sales	<ul style="list-style-type: none"> • Disclose that you may have an incentive to select or recommend a broker-dealer based on your interest in receiving client referrals, rather than on your client’s interest in receiving best execution. (Item 12) • Explain the procedures you used during the last year to direct client transactions to a particular broker-dealer in return for client referrals. (Item 12)
29.	Valuation issues	