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Going on the Offensive to Improve Advisers Act Disclosures

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This article is a playbook for disclosing conflicts of interest as effectively as possible under the Investment Advisers Act of 1940. With disclosure, going on the offensive means "playing big." Offensive disclosure leans towards obvious exhibition and expression in public. It invites engagement, for the purpose of obtaining from clients (and demonstrating to regulators) informed consent. In contrast, playing defense means "playing small." Defensive disclosure is subtle or generic, avoiding the attention of regulators or clients.

Adopting an offensive disclosure strategy is a logical response to the current regulatory environment. The standards for disclosing conflicts of interest have become increasingly formulaic and rigidly applied. The volume and complexity of economic interests that create the conflicts have never been greater. And scrutiny continues to grow for advisers that lean on disclosure to obtain informed consent, rather than eliminate or mitigate their conflicts of interest.

"Playing offense" is a unified strategy for meeting the obligation to "eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested."[1] This article focuses on strategies for disclosing conflicts of interest as an investment adviser or investment adviser representative (IAR). But the strategies may be effective for disclosing conduct as a broker-dealer or broker-dealer representative under Regulation Best Interest (Reg BI).

Playing Offense = Being Proactive, Not Reactive

The hallmark of "playing offense" with disclosure is being proactive. Extrapolate principles from past enforcement actions, judgments and guidance. Then apply the standards systematically to each interest that could, consciously or unconsciously, incline a financial professional to make a recommendation or decision. This section explains why and how to draft that disclosure *now*, without waiting for the US Securities and Exchange Commission (SEC or Commission) to address a particular fact pattern.

Why Go Proactive?

The 2018 Mutual Fund Share Class Selection Disclosure Initiative (Disclosure Initiative) demonstrated that bright line rules for conflicts disclosure can be applied to the industry at large, with seemingly retroactive effect and staggering consequences. It resulted in 95 Commission enforcement actions that ordered the return of more than $135 million to investors.[2]

In the Disclosure Initiative, advisers received strict formulaic rules for disclosing their incentive to select (and retain) one share class over another to earn 12b-1 fees.[3] Advisers were urged to evaluate the prior four years of disclosure against those standards. Then, the SEC presented a one-time opportunity to self-report violations and settle to more favorable terms.[4] Settlement was conditioned on the adviser

consenting to findings of deficient disclosures and disgorging to clients the 12b-1 fees accepted during the deficiency.[5]

In the SEC's view, the Disclosure Initiative did not introduce any new standards for disclosure.[6] It merely held advisers accountable to standards articulated in prior SEC enforcement actions.

The industry viewed it differently. Extrapolating disclosure standards from enforcement actions is difficult. Only a handful of fact patterns are addressed, relative to the infinite permutations of economic arrangements and resulting incentives. Even when facts align perfectly, aggravating factors or egregious behavior mask the disclosure standard being set. There is a temptation to discount SEC risk alerts, guidance and settlements as instructive but not conclusive.[7] Final judgments from a court have more precedential value but speak narrowly to the holding.[8]

Given the difficulty extrapolating disclosure standards, few advisers undertook the process systematically before the Disclosure Initiative. The Disclosure Initiative showed how severe the consequences would be—with sweeping effect. Failing to successfully interpret and implement any part of the bright line rules meant disgorgement. Advisers that could, but opted *not* to, "self-report" in the Disclosure Initiative took a risk. If subsequently discovered, the SEC would pursue enforcement more aggressively.[9] The risk materialized for many advisers.[10]

A couple of advisers have declined to settle. They are defending the adequacy of their disclosures in litigation against the SEC.[11] But most advisers are unable or unwilling to challenge their primary regulator in court. These advisers have little option but to plan to participate in the next self-reporting disclosure initiative and disgorge the benefit. An offensive disclosure strategy presents an alternative: anticipate and satisfy the SEC expectations for disclosure before the next self-reporting initiative, SEC inquiry or exam.

Extrapolating From the Past

So, what are the standards? How broadly are they applied? SEC enforcement actions and guidance suggest that advisers can be held liable for falling short of the following bright line rules.

No Materiality Threshold. No amount of economic incentive was *de minimis* enough to avoid disclosure (and disgorgement) in the Disclosure Initiative.[12] The obligation to disclose attaches to every economic benefit from someone other than a client in connection with the advisory services.[13] Unlike "facts material to the advisory relationship" (which are subject to a materiality threshold), conflicts are always disclosable.[14] It does not matter that the economic benefit is insignificant to the adviser[15] or affects only a fraction of clients.[16]

Negative Compensation. The same disclosure standards apply to discounts, offsets, credits, rebates, free or discounted services, etc.[17] An incentive to reduce amounts owed, or to avoid costs that would otherwise be incurred, is no different from an incentive to increase revenue (collectively, Compensation).[18] If the adviser is responsible for delivering the service, then reducing the cost of delivering the service is Compensation.[19]

Affiliates and Representatives. Compensation (including discounts, offsets or rebates) accepted by the adviser's IARs, affiliates or their representatives is disclosed no differently from Compensation to the adviser.[20] Conversely, the incentives of the adviser are shared by the IAR, in the SEC's view, because Compensation to the adviser (or its affiliates) is fungible and can be used to pay the IAR's Compensation and other benefits.[21]

Attributable to Advisory Activities. The obligation is to disclose *all* Compensation received in connection with advisory services.[22] That includes Compensation attributable to a *combination of brokerage and advisory activities*.[23]

Service Providers, Not Just Investments. The incentive to recommend or select *a service provider*

(for example, custodian) or directed brokerage arrangement is disclosed just as the incentive to recommend *a particular investment or share class*.[24]

Retain, Not Just Select. The incentive *to retain* a service provider or investment is disclosed no differently from the incentive *to initially select* or recommend that option.[25]

Contingent Incentives. The disclosure must specify if the Compensation *is contingent* on generating a certain level of demand for the service provider or the investment (be it a share class, platform, mutual fund family, etc.).[26]

Compounding Incentives. The disclosure must explain how *the formula* of the Compensation will compound or heighten the incentive.[27] For example, the disclosure must disclose if the rate, not just the amount, of Compensation increases with assets or sales.

Two Conflicts. Separate disclosure is needed to obtain the client's consent to two distinct conflicts.[28]

1. *Loss of Disinterested Advice*. One conflict results from the decision to accept, rather than decline or pass through to the client, Compensation (be it 12b-1 fees, revenue share, discounts, offsets, etc.) from someone other than the client in connection with advisory services. The fact that the adviser, its affiliates or its IARs has a financial interest in its recommendation or decision is, by itself, in conflict with the client's interest in receiving disinterested advice.[29]
2. *Compromised Returns.* Additional disclosure is needed if the recommendation or decision results in higher costs or lower returns to the client, as this conflicts with the client's interest in maximizing performance.[30]

Other Options. Disclosure must specify that other options *are* (not "may be") available to a client that result in less Compensation to the adviser, or in higher returns/lower costs to the client.[31] Disclosing the adviser may receive Compensation, and may have a conflict, is insufficient to obtain a client's consent.[32]

Availability. An option becomes "available" when offered on the market unless the adviser has taken steps to confirm it is unavailable to the client.[33] An adviser can limit the scope of the advice through informed consent, as described in the next section, but that is not easily done.[34]

Dynamic Comparison. New options and Compensation arrangements become available on an ongoing basis.[35] For an adviser with a duty to monitor, the disclosure must address the benefit to the adviser, and the harm to the client, of ***not refreshing*** the prior recommendation or decision immediately.[36]

1. *New Options***.** The fact that the Compensation to the adviser remained constant (on an absolute basis, or relative to other options) does not alter the obligation to disclose if other options have become available to the client with lower costs or higher returns.[37]
2. *New Compensation***.** The fact that options available to the client remained constant does not affect the obligation to disclose when the Compensation or incentives to the adviser has changed among those options.[38]

Applying To the Future

Distilled to a core, the foregoing "rules" would require all conflicts disclosure to contain three concepts. For each recommendation or decision in which the adviser has a financial interest, the disclosure would specify:

1. Other identical or "substantially similar" options were available to the client that generate less (or no) Compensation for the adviser, its affiliates or their representatives;
2. Accepting the Compensation is a conflict because it creates an incentive to favor one option over others, thereby denying the client disinterested advice; and
3. If true, the client is adversely affected because identical or similar options with higher yields/returns or lower costs were available.

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Additional disclosures would be necessary if, for example, the Compensation *is contingent* on generating a certain level of demand, creates *compounding or cumulative* incentives, varies for selection versus *retention*, etc.[39]

A critical challenge will be to identify what options are "substantially similar" enough to require comparison of the benefit to the adviser, and/or returns to the client.[40] A secondary challenge will be to determine the relative emphasis disclosures should give to the adviser's Compensation (and associated conflicts of interest), relative to other material differences, among those options.[41]

Playing Offense = Being Blunt, Not Promotional

The functional purpose of "playing offense" with conflicts disclosure is to obtain informed consent. Advisers can, and routinely do, shape their obligations to clients via informed consent. The better the disclosure is at obtaining informed consent, the more flexibility an adviser has to shape that relationship to allow for (rather than eliminate or mitigate) conflicts of interest. This section addresses how to draft disclosure with the greatest odds of obtaining the understanding and consent of a retail client.

Why Use Informed Consent?

Most advisers would prefer to obtain informed consent to a conflict of interest, rather than be forced to eliminate or mitigate it. These are an adviser's only options for handling a conflict of interest. If a particular conflict cannot be disclosed in a manner such that the client can provide informed consent, the burden is on the adviser to eliminate or mitigate (that is, modify practices to reasonably reduce) that conflict to the extent necessary to make informed consent possible.[42]

Increasing the effectiveness of disclosure at obtaining informed consent increases an adviser's ability to supplement its the advisory fee from the client by accepting additional forms of Compensation. Complimentary sources of Compensation to the adviser, its affiliates and its IARs are pervasive. Accepting this Compensation is a long-standing practice and even an assumption for many firms when pricing an advisory service.[43] Eliminating the practice raises operational challenges[44] and may require some advisers to raise their advisory fees.[45]

Accepting alternative sources of Compensation, with informed consent, is not at odds with the SEC's regulatory objectives or stated position. An offensive disclosure strategy builds on an historic understanding that the SEC is not in the business of regulating advisory fee rates.[46] It takes at face value statements that the SEC has no interest in dictating the amounts (or form in which) clients can agree to pay for advisory services; the SEC's interest is in ensuring the client's consent is fully informed.[47]

Be Blunt

Being blunt is critical to creating disclosure that is sufficiently specific but still understandable enough to obtain informed consent. The standard for shaping the fiduciary relationship via agreement with a client is "*full and fair* disclosure and *informed consent*."[48] The first section of this article extrapolates bright line rules to meet these standards. The specificity called for in those rules is tremendous. The more complex and extensive the conflicts, the more difficult it becomes to meet the standards.[49] The result is substantial risk that disclosure, which is sufficiently specific, will not be understandable, especially with retail investors.[50]

Being blunt allows an adviser to accept more complex and extensive conflicts without sacrificing the specificity or understandability necessary to obtain informed consent. Uglier words can be more effective in communicating why a client should care. Plain language is easier to understand.[51] An offensive disclosure strategy focuses on where the clients' interests diverge from, or oppose, the interests of the adviser, its IARs or its affiliates (not the many places where their interests align). Softening or genericizing disclosure undermines the adviser's case for informed consent.

Do Not Promote

Taken to the logical extreme, offensive disclosure will appear to dissuade rather than persuade advisory clients to select and retain the adviser. Sure, an adviser *could* emphasize laudatory statements about the standard of conduct required by law for advisers. If that disclosure is limited to a restatement of the law, it would not add to the adviser's obligations to clients. But the more prominent the promotion, the more prominent and blunt the balancing disclosure.

For that reason, an offensive disclosure strategy errs on the side of "under promise and over deliver." Advisers can, and routinely do, hold themselves to a standard *beyond what is required by law* for the conduct of an advisory business.[52] But articulating the standard or intent in disclosure raises enforcement and litigation risk.[53] Remaining silent can mitigate the risk of being held to an ill-defined (or undefined) standard based on how the SEC or clients might perceive the disclosure.[54]

Be Brief

Brevity and clarity weigh against use of the word "may" when disclosing conflicts, even when permitted to do so. In many cases, an adviser could use the word "may" to disclose a conflict that exists with respect to some, but not all clients, types or classes of clients, advice, or transactions.[55] But there is a price. The adviser must include "additional disclosure specifying the types or classes of clients, advice, or transactions with respect to which the conflict exists."[56] Before going to the trouble of fully and fairly explaining the circumstances in which the incentive is limited, consider the trade-offs in page length and complexity. It takes fewer words to paint the adviser's interests as opposed and then state that, although circumstances may vary, the client should assume the worst (to the extent consistent with applicable law).

Playing Offense = Embracing Scrutiny

If the benefit of playing offense is informed consent, then a foreseeable by-product is regulatory scrutiny. Disclosure needs to get noticed in order to obtain informed consent. Disclosure rarely gets noticed by a client without also drawing the attention of a regulator primed to the conflict. This section explains how "playing offense" allows an adviser to capitalize on the ability of conflicts disclosure to focus attention where merited and to use that insight to enhance training, supervision, and monitoring.

Why Expect Scrutiny?

By definition, conflicts disclosure shines a light on a financial incentive to act a certain way *for reasons other than a client's best interests*. Obtaining informed consent to operate with more of these financial incentives ratchets up regulatory scrutiny by increasing the risk of the adviser or its IARs acting on these incentives contrary to a client's best interests.

Even when the fiduciary obtains the consent of the client to engage in conduct that involves a conflict of interest, the fiduciary must be able to show that the dealings were fair and impartial, done in good faith, and in the best interests of the client.[57] An adviser satisfies its *duty of loyalty* to a client by making "full and fair disclosure" of a conflict and obtaining informed consent.[58] But that is only half of the equation. Advisers are also subject to a *duty of care*, which is a duty to provide investment advice in the client's best interest. The duty of care is what limits the ability of an adviser to shape the scope of its relationship via disclosure and informed consent. No amount of "full and fair disclosure and informed consent" would enable an adviser to provide advice that is not in the client's best interests.[59]

As a result, we expect more scrutiny for violations of the *duty of care* when an adviser relies on disclosure, rather than eliminating or mitigating the conflicts.

Prepare for Questions

An offensive disclosure strategy equips an adviser to anticipate and tend to regulatory concerns before articulated. Because an adviser cannot disclose away the duty of care, good conflicts disclosure gives the

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adviser a peek at the test in advance of the next SEC inquiry or exam. For each conflict, the question will be whether (and, if so, when) the adviser, despite providing disclosure and obtaining consent, is unable to provide investment advice in the client's best interest.

While there is no single right answer, there is a wrong one—namely, a blank stare. The SEC is likely to have understandable concerns if the response suggests the adviser or IAR had not realized the limitations of informed consent. This is especially true for advisers with extensive or complex conflicts.

The closer the adviser comes to the limits of informed consent, the more critical it is to have a concrete and applied understanding of how the adviser will draw that line in actual circumstances. Use every conflicts disclosure as a prompt to ask how the adviser respects the limits of what can be achieved via informed consent. Articulate the adviser's practical guidelines to assess when a recommendation or decision would no longer be in the best interests of the client, notwithstanding the client's consent.

Train and Supervise

An offensive disclosure strategy also can increase the effectiveness of an adviser's training and supervision. The more complex and extensive the disclosed conflicts, the greater the regulatory scrutiny of whether the adviser and its IARs are acting in a client's best interest. At some point, the better course would be to eliminate or mitigate (that is, reduce to reasonable levels) the conflict. But if the adviser seeks to rely on informed consent, "offensive" disclosure highlights where training and supervision is most critical.

Conflicts disclosure is a heatmap. It identifies where the incentives to act for reasons other than the client's best interest are greatest AND result in something that is not objectively the best option.[60] A logical expectation would be that training and supervision should address each scenario where acting consistent with the incentive results in a recommendation or decision with higher costs or lower returns/yields for the client.

The heatmap, coupled with the answers prepared in the preceding section, is the blueprint to train and supervise that recommendations and decisions remain in a client's best interests. The adviser should provide IARs and their supervisors with concrete parameters to judge when such a recommendation or decision is presumptively not in the client's best interests.[61] Extract those parameters from the answers prepared in the preceding section. They represent the adviser's practical and applied understanding of the limits of what can be achieved via informed consent.

Tailor the Monitoring

An offensive disclosure strategy also supports an adviser in establishing monitoring and, if necessary, mitigation measures. The bright line rules extrapolated in the first section require specificity as to *how* the advice or decision might be influenced by the incentive. The result is a testable 'hypothesis' as to what self-interested behavior might look like. The regulator and client should be able to discern which decision or recommendation has the greater benefit to the IAR, the adviser or its affiliates *relative to an alternative decision or recommendation* (aka, the self-interested recommendation).

Having a structured "hypothesis" makes it easier to determine whether and, if so, what to monitor. For many hypotheses, the monitoring is looking for patterns of self-interested recommendations. Outlier testing is one example. It builds on the premise that IARs should draw similar conclusions as to what recommendation is in the best interests of similarly situated clients. A significantly higher percentage of self-interested recommendations by a given individual, team of individuals, office, or region suggests some portions of the recommendations may not be in the clients' best interests. There is an expectation the adviser will conduct heightened review of whether the self-interested recommendation is nonetheless in the clients' best interests.[62]

For other hypotheses, the monitoring is looking for changes in the "substantially similar" options "available" to the client, or in the Compensation to the adviser (or its affiliates or IARs) among the options.[63] A change tends to trigger updates to the disclosure of the absolute or relative benefit to the adviser, or opportunity costs to the client. Timely updates are critical to informing clients' consent to program design decisions and product menu limitations approved by the home office.

Finally, an offensive disclosure strategy makes it easier to articulate and document why monitoring or mitigation is not necessary or possible, in some cases. There are likely to be questions if an identified incentive is not addressed in the compliance program. The better the disclosure, the easier it is to document the rationale for that (if not obvious from the disclosure). Create an annotated version of the ADV brochure, or plot out your conflicts disclosure in a chart. For each identified incentive, cross-reference or note the processes or controls (or why none are necessary) to care for that conflict. This documentation exercise reduces the risk of oversight and ensures a ready answer to the probable questions if a conflict is not monitored or mitigated.

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NOTES

1 *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248 (June 5, 2019), at part II [hereinafter *2019 Interpretation*].

2 Press Release, Sec. & Exch. Comm'n, *SEC Orders Three Self-Reporting Advisory Firms to Reimburse Investors* (Apr. 17, 2020), *https://www.sec.gov/news/press-release/2020-90*.

3 Share Class Selection Disclosure Initiative, Sec. & Exch. Comm'n, *https://www.sec.gov/enforce/announcement/scsd-initiative* (last updated May 1, 2018) [hereinafter *Disclosure Initiative Announcement*]; Share Class Selection Disclosure Initiative – FAQ, Sec. & Exch. Comm'n, *https://www.sec.gov/enforce/educationhelpguidesfaqs/share-class-selection-disclosure-initiative-faqs* (last updated May 1, 2018) [hereinafter *Disclosure Initiative FAQs*].

4 Most notably, the SEC agreed not to impose a civil monetary penalty for advisers who self-reported and promptly returned money to harmed clients with interest. Press Release, Sec. & Exch. Comm'n, SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors (Feb. 12, 2018), *https://www.sec.gov/news/press-release/2018-15*. The SEC also agreed not to pursue allegations the adviser violated its fiduciary duty to seek best execution for client trades by selecting a more expensive share class (with 12b-1 fees) for a client when a less expensive class is available, without adequate disclosure. Disclosure Initiative Announcement, *supra* n.3, at n. 3.

5 Disclosure Initiative Announcement, *supra* n.3, at part III.C.

6 *See, e.g.,* Stephanie Avakian, Co-Dir., Div. of Enf't, Sec. & Exch. Comm'n, Keynote Remarks at the 2019 SEC Regulation Outside the United States Conference: What You Don't Know Can Hurt You (Nov. 5, 2019) [hereinafter *August 2019 Remarks*] (stating "When the Division announced the Share Class Initiative in February 2018, the Commission had already brought more than 15 enforcement actions against advisers for failing to disclose this conflict of interest (dating back to 2013)"). In announcing the Disclosure Initiative, the SEC explained "the Commission has filed numerous actions against investment advisers relating to the disclosure failures." Disclosure Initiative Announcement, *supra* n.3.

7 The decision to settle with the SEC rather than pursue litigation is influenced by practical considerations, such as the cost of legal representation. It is not based purely on the strength of the adviser's legal arguments and probability of success in a court of law.

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8 Also, the judgment of the court can undergo years of potential appeals and further litigation before establishing binding precedent for or against the SEC's position on disclosure of a particular subject. *See, e.g.,* Carl Ayers, "Four Years on and $700,000 in, The Robare Group fights on," *Reg. Compliance Watch* (Nov. 15, 2018), *https://www.regcompliancewatch.com/four-years-on-and-700-000-in-the-robare-group-fights-on/*.

9 Disclosure Initiative Announcement, *supra* n.3, at part III.E (stating "For advisers that would have been eligible for the terms of the SCSD Initiative but did not participate, the Division expects in any proposed enforcement action to recommend additional charges, if appropriate, and the imposition of penalties. Eligible advisers are cautioned that staff… plan to proactively seek to identify investment advisers that may have failed to make the necessary disclosures related to mutual fund share class selection").

10 *See, e.g.,* "SEC Share Class Selection Disclosure Initiative Ends with Three Settlements," Fried, Frank, Harris, Shriver & Jacobsen LLP (Apr. 20, 2020), *https://www.findknowdo.com/news/04/20/2020/sec-share-class-selection-disclosure-initiative-ends-three-settlements?utm_source=mondaq&utm_medium=syndication&utm_term=CorporateCommercial-Law&utm_content=articleoriginal&utm_campaign=article* (stating "in the two settlements into which the SEC entered with investment advisers who were eligible to self-report under the initiative, but failed to do so, the SEC ordered the advisers to pay civil penalties of $300,000 (along with over $1 million in disgorgement and prejudgment interest) and $235,000 (along with almost $700,00 in disgorgement and prejudgment interest), respectively.")

11 *See, e.g.,* Sec. & Exch. Comm'n v. Cetera Advisors LLC, Civil Action No. 19-cv-02461-MEH, 2020 WL 1905046 (D. Colo. Apr. 17, 2020) (alleging adviser breached its fiduciary duty to clients when it, without any disclosure regarding the associated conflicts of interest: (1) selected and held for advisory clients mutual fund share classes with 12b-1 fees when lower-cost, share classes of the same fund were available; (2) funneled clients towards certain funds with respect to which it would receive revenue sharing from a broker-dealer, despite the availability of other funds; (3) collected service fees shared by the broker-dealer, which incentivized the adviser to funnel clients towards funds that paid these fees to the broker-dealer; and (4) directed the broker-dealer to mark-up certain non-transaction-fees charged to the adviser's clients by up to 300%, which were then paid from the broker-dealer back to the adviser). *See also* Complaint & Demand for Jury Trial, Sec. & Exch. Comm'n v. Commonwealth Equity Services, LLC, 1:19-cv-11655 (D. Mass. Aug. 1, 2019)

12 *See Disclosure Initiative FAQs*, at FAQ #3 (stating — "Q: Should an eligible adviser only self-report conduct if its proposed disgorgement amount pursuant to the SCSD Initiative exceeds a certain minimum threshold? A: There is no minimum threshold").

13 This is not a new position. Since 2010, the instructions to Form ADV have required disclosure of any economic incentive the adviser receives from someone other than a client for providing investment advice or other advisory services to its clients. *See* Form ADV, Part 2A of Form ADV: Firm Brochure, Sec. & Exch. Comm'n, at Item 14, available at *https://www.sec.gov/about/forms/formadv-part2.pdf* (last visited Mar. 15, 2023) [hereinafter *Form ADV Part 2A*] ("If someone who is not a *client* provides an economic benefit to you for providing investment advice or other advisory services to your *clients*, generally describe the arrangement, explain the conflicts of interest, and describe how you address the conflicts of interest.").

14 Historically, the instructions to Form ADV supported an argument that only material conflicts need to be disclosed. *See* Form ADV, General Instructions for Part 2 of Form ADV, Sec. & Exch. Comm'n, at #3, available at *https://www.sec.gov/about/forms/formadv-part2.pdf* (last visited Mar. 15, 2023) [hereinafter *Form ADV Part 2 General Instructions*], stating "As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest

between you and your clients that could affect the advisory relationship." The 2019 Interpretation clarified the SEC's position. After citing that quotation, the SEC explains its actual position, upheld by the First Circuit in *Robare*, is that "regardless of what Form ADV requires, [investment advisers have] a fiduciary duty to fully and fairly reveal conflicts of interest to their clients." *See* 2019 Interpretation, *supra* n.1, at n. 71, *citing* to *Robare*, *infra* n.27, at 478.

15 In more than one case, the total alleged benefit to the adviser has been a tiny fraction of its revenue and has been dwarfed by the adviser's legal fees. *See, e.g., In the Matter of the Robare Grp., Ltd.,* Investment Advisers Act Release No. 4566 at 2, 115 SEC Docket 2796, 2016 WL 6596009 (Nov. 7, 2016) ("[b]etween September 2005 and September 2013, [The Robare Group] received from Fidelity approximately four hundred thousand dollars, which was approximately 2.5 percent of [The Robare Group's] gross revenue"); *see also* Carl Ayers, "Four Years on and $700,000 in, The Robare Group fights on," *Reg. Compliance Watch* (Nov. 15, 2018), *https://www.regcompliancewatch.com/four-years-on-and-700-000-in-the-robare-group-fights-on/* (illustrating that legal fees of $700,000 far exceeded the amount received in revenue share).

16 *See, e.g.,* Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation*,* Sec. & Exch. Comm'n, *https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation* (last modified Oct. 18, 2019) [hereinafter *October 2019 FAQs*] (stating "the adviser must fully disclose the practice with respect to that program even if it represents a minority of the adviser's assets under management.").

17 October 2019 FAQs, *supra* n.16 ("[f]ollowing are some examples of material facts that, in the staff's view, an adviser should disclose about its practices and conflicts … whether the conflict arises: (a) as a result of differences in the compensation the adviser and its affiliates receive; or (b) *from the existence of any incentives shared between the adviser and the clearing broker or custodian (such as offsets, credits, or waivers of fees and expenses)*") (emphasis added).

18 Negative Compensation also includes avoidance of financial consequences. Examples in which the Division of Examination Staff have expressed interest include early termination fees or contractual obligations to repay business development and net flow credits.

19 Avoiding payment of transaction fees on client trades of mutual funds in wrap accounts is the classic example. In the 2022 and 2023 Exam Priorities, the SEC announced plans to target adviser's selection and retention of higher-cost mutual fund share classes (*e.g.*, with 12b-1 fees) in wrap accounts while failing to disclose the conflicts of interest associated with those investment recommendations. *See* Sec. & Exch. Comm'n, Div. of Examinations, 2022 Examination Priorities (Mar. 30, 2022), *https://www.sec.gov/files/2022-exam-priorities.pdf*; Sec. & Exch. Comm'n, Div. of Examinations, 2023 Examination Priorities (Feb. 7, 2023), *https://www.sec.gov/files/2023-exam-priorities.pdf*; *See also In the Matter of Highpoint Advisor Group, LLC,* Investment Company Act Release 6003 (April 27, 2022) (SEC Cease and Desist Settlement Order) (settling to charges of investing certain wrap clients' assets in higher-cost mutual fund share classes, while failing to disclose that, by investing clients in no-transaction-fee share classes, the adviser and its IARs avoided paying transaction fees on client trades of these mutual funds.).

20 The Disclosure Initiative made clear that 12b-1 fees payable to an IAR, or to an affiliated broker-dealer or its representatives, were no different than 12b-1 fees paid directly to the adviser. *See* Disclosure Initiative Announcement, *supra* n.3, at part III (stating "The investment adviser 'received' 12b-1 fees if (1) it directly received the fees, (2) its supervised persons received the fees, or (3) its affiliated broker-dealer (or its registered representatives) received the fees.").

21 The SEC Staff takes issue with disclosure that suggests IARs are not conflicted in the absence of differential Compensation to the IAR. In the Staff's view,

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eliminating differential Compensation to the IAR can mitigate but not eliminate the IAR's incentive to increase Compensation to the adviser or its affiliates.

[22] This is how the Staff interprets the requirement in Form ADV to disclose "any economic benefit to you for providing investment advice or advisory services" from "someone other than a client." *See* Form ADV Part 2A, *supra* n.13, at Item 14.

[23] In the Disclosure Initiative and the enforcement actions that followed, the SEC rejected arguments that no disclosure was required of the adviser if the affiliated broker-dealer (rather than the adviser) was the one that chose the clearing broker, or the platforms within the clearing broker, that the adviser could recommend to the advisory clients. Compensation attributable to decisions made by an affiliate (or by a dually registered adviser) in another capacity was still Compensation attributable to advisory activities, in the SEC's view. For Compensation solely attributable to brokerage activities (with no advisory client), it remains to be seen whether the SEC will extend these disclosure standards to activity governed by Reg BI.

[24] For example, the October 2019 FAQs presented the same standards as applicable whenever an adviser receives revenue share or other forms of Compensation as a result of its recommendation or selection of an investment, a service *or a service provider.* Incidentally, obtaining a client's consent to a directed brokerage arrangement does not reduce or alter the disclosure of an adviser's incentives to recommend or require that arrangement. The same disclosure standards have been applied to directed brokerage arrangements, as described in note 26 *infra*.

[25] *See* Second Amended Complaint, Sec. & Exch. Comm'n v. Cetera Advisors, LLC, Civil Action No. 19-cv-02461-MEH, 2020 WL 1905046 (D. Colo. Apr. 17, 2020) (alleging the adviser breached its fiduciary duty by failing to disclose "a financial incentive for Defendants to maintain their relationship with the Clearing Broker so they could continue to receive these undisclosed non-transaction mark-ups"); *See also* October 2019 FAQs, *supra* n.16 (stating that an adviser should disclose "[w]hether an adviser's practices with regard to recommending share classes differs when it makes an initial recommendation to invest in a fund as compared to: (a) when it makes recommendations regarding whether to convert to another share class; or (b) when it makes recommendations to buy additional shares of the fund").

[26] Examples would be preferred pricing that depends on maintaining or increasing the use of a service provider, platform, investment, etc. This standard appears in cases alleging flawed disclosure of directed brokerage arrangements. *See Sheer Asset Management, Inc. and Arthur Sheer,* Advisers Act Rel. No. 1459, 1995 SEC LEXIS 10 (Jan. 3, 1995) (stating that advisers have a responsibility to identify and disclose "all material terms of the directed brokerage relationship" which includes not only the existence of the payment, but the fact that a portion of the annual payments are contingent on advisory clients generating a certain level of commissions for that broker-dealer.). This is true even if the adviser routinely satisfies the threshold or if the threshold is based on historic levels of demand (not increasing demand). *See In the Matter of Callan Associates,* Investment Advisers Act Release No. 2650 (Sept. 19, 2007) (settled order).

[27] *See* Robare Group Ltd. v. Sec. & Exch. Comm'n, 922 F.3d 468 (D.C. Cir. 2019), in which the only allegation with respect to the period between 2011 and 2013 was the adviser's failure to disclose (1) that the rate, not just the amount, of the compensation increased with AUM, and (2) that only some, not all, funds on the sub-platform generated compensation for the IARs and adviser. There was no allegation that the adviser or its IARs considered the incentive when rendering advice, or made recommendations contrary to a client's best interest.

[28] Until the Disclosure Initiative, many advisers did not appreciate—and, therefore, did not disclose separately—two distinct conflicts. The Disclosure Initiative drew a line in the sand, requiring disgorgement if either prong was deficient (*i.e.*, no partial

credit). *See* Disclosure Initiative Announcement, *supra* n.3 (stating "To have been sufficient, the disclosures must have clearly described the conflicts of interest associated with (1) making investment decisions in light of the receipt of the 12b-1 fees, and (2) selecting the more expensive 12b-1 fee paying share class when a lower-cost share class was available for the same fund.… An adviser is eligible for the SCSD Initiative if it failed to disclose either or both of those conflicts.").

29 As a result, disclosure of the first conflict is required, even if the recommendation did not result in higher costs or lower returns to the client.

30 As early as 2006, the SEC provided guidance, in the context of comparing interests in an identical portfolio of securities (*i.e.*, share class), that an investment's return is a material fact that needs to be disclosed. *See In the Matter of IFG Network Securities*, Exchange Act Release No. 54127, Investment Advisers Act Release No. 2533, 88 SEC Docket 1195, 2006 WL 1976001 (July 11, 2006) (Commission opinion) (stating "The rate of return of an investment is important to a reasonable investor. In the context of multiple-share-class mutual funds, in which the only bases for the differences in rate of return between classes are the cost structures of investments in the two classes, information about this cost structure would accordingly be important to a reasonable investor. . . ."). The obligation to compare returns is similarly straightforward when the Compensation to the adviser (or its affiliates or IARs) comes directly from the client—dollar-for-dollar—in the form of higher costs (*e.g.*, when adding a markup on rebillable fees, margin loans or collateralized lending interest charged to the client) or lower returns (*e.g.*, when taking a larger split of the interest on a bank sweep account paid to the client). More recently, the focus has shifted to differences in the return of similar (not identical) investments. The August 2019 Remarks articulated how the obligation to disclose the effect on returns to the client applies in comparisons of cash sweep options, UITs and other investments for which there is a "substantially similar product available for lower or no cost." In the *July 2019 OCIE Risk Alert*, the SEC Staff asserted that disclosure was deficient if failing to specify that production-based incentives "resulted in higher fees and expenses for the affected clients." The Staff was referring specifically to disclosure of a forgivable loan but said the same standard applied to all Compensation to the adviser or its IARs that could affect the impartiality of the IARs' advice.

31 This inadequacy of the word "may" is not a new position. The Staff and Commission have repeatedly emphasized that using "may" in disclosure is inappropriate unless specifying the clients, advice or transactions with respect to which the conflict exists. General Instruction 2 for Part 2 mandates that, if a conflict or practice exists with respect to only certain classes of clients, advice or transactions, an adviser must "indicate as such rather than disclosing that [the adviser] 'may' have the conflict or engage in the practice."

32 Prior to the Disclosure Initiative, many advisers used "may" (rather than "are") to disclose the availability of other options, rather than monitor when other options were available. Some reasoned the client had consented to limit the scope of the advice or advisory service, to exclude monitoring for lower-cost share classes. The argument was that, by disclosing the adviser "may" receive 12b-1 fees and "may" be conflicted, a client could infer the adviser was disclaiming responsibility to monitor whether lower-cost share classes were available and avoid the conflict. Others reasoned that disclosing the adviser "may" receive 12b-1 fees effectively communicated that other share classes were, in fact, available. The argument was that, because the word "may" indicates variability, a client should infer: (1) other share classes of the same fund existed without 12b-1 fees in some cases; and (2) when the adviser received 12b-1 fees, the adviser was electing the option that offered less benefit to the client and more benefit to the adviser. The Disclosure Initiative clarified that was not sufficient. A client could incorrectly conclude a fiduciary only accepts the 12b-1 fees if no other share class was available. To be adequate, the disclosure needed to specify that

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the funds from which the adviser accepted 12b-1 fees "offered a variety of share classes, including some that paid 12b-1 fees and others that did not for eligible clients." *See* Disclosure Initiative Announcement, *supra* n.3, at part II.

[33] In the Disclosure Initiative, the SEC Staff indicated a lower-cost share class became "available" to an advisory client at the time the mutual fund's prospectus: (1) set forth criteria which the client satisfied to purchase the lower-cost share class; (2) disclosed the fund would give waivers from the investment minimum for advisory clients; or (3) disclosed the fund may give waivers for advisory clients AND the adviser failed to take reasonable steps to confirm the waiver was not available to the advisory client. *See* Disclosure Initiative FAQs, *supra* n.3, at #11. In recent enforcement actions, a lower-cost sweep option became "available" when offered by the clearing broker or platform or permitted by the clearing agreement. *See In the Matter of Centaurus Financial, Inc.,* Investment Advisers Act Release No. 5744 (June 2, 2021), available at *https://www.sec.gov/litigation/admin/2021/34-92095.pdf*; and *In the Matter of Cowen Prime Advisors, LLC*, Investment Advisers Act Release No. 5874 (Sept. 27, 2021), available at *https://www.sec.gov/litigation/admin/2021/ia-5874.pdf*; *In the Matter of O.N. Investment Management Company*, Investment Advisers Act Release No. 5944 (Jan. 11, 2022), available at *https://www.sec.gov/litigation/admin/2022/ia-5944.pdf*; *In the Matter of Rothschild Investment Corp.*, Investment Advisers Act Release No. 5860 (Sept. 13, 2021), available at *https://www.sec.gov/litigation/admin/2021/34-92951.pdf*.

[34] There are broad limits on an adviser's ability to disclose or contract away obligations which the Staff views as a fiduciary duty. In the 2019 Interpretation, the Staff summarized the law as follows: "an adviser's federal fiduciary duty may not be waived, though it will apply in a manner that reflects the agreed-upon scope of the relationship." 2019 Interpretation, at 10. In the context of retail clients in particular, the SEC has suggested that "hedge clauses" in client agreements that attempt to limit an adviser's liability for failure to fulfill fiduciary obligations would violate the anti-fraud provisions of the Advisers Act. 2019 Interpretation at note 31. One such fiduciary duty is the duty to monitor. As discussed in n.36 *infra*, the duty to monitor is relatively extensive for an adviser charging to a retail client an ongoing asset-based advisory fee. It is possible to limit the frequency or interim triggers (*e.g.*, market events) with which the adviser refreshes its advice (and, therefore, monitoring) by informed consent from the client. But obtaining informed consent to limit monitoring requires alerting the client to what he or she gives up, and the adviser gains, by not monitoring what else has become "available." That, in turn, requires some level of monitoring to determine when other options become "available" with greater benefit to the client or less Compensation to the adviser. As a result, it is unclear an adviser can forego monitoring entirely, at least in the retail context, given the breadth of the definition of "available."

[35] For a discussion of how Compensation arrangements have evolved with the advent of new options in recent decades, *see* "SEC Scrutiny of Advisers' Share Class Selection, Revenue Sharing and Disclosure Practices Continues Apace," Perkins Coie llp (Oct. 23, 2019), *https://www.perkinscoie.com/en/news-insights/sec-scrutiny-of-advisers-share-class-selection-revenue-sharing-and-disclosure-practices-continues-apace.html*; and "Trends in the Expenses and Fees of Funds," *ICI Research Perspective* Vol. 28, No. 2 (Inv. Co. Inst., Washington, D.C.) Mar. 2022, available at *https://www.ici.org/system/files/2022-03/per28-02_2.pdf*.

[36] The 2019 Interpretation sets forth the SEC's view that "when the adviser has an ongoing relationship with a client and is compensated with a periodic asset-based fee, the adviser's duty to provide advice and monitoring will be relatively extensive as is consistent with the nature of the relationship." *See* 2019 Interpretation, *supra* n.1, at part II.B.3.

[37] *See In the Matter of Jamison, Eaton & Wood, Inc.*, Investment Advisers Act Release No. 2129 (May 15, 2003) (settled order) (alleging that an adviser

violated its duty to seek best execution by, among other things, failing periodically and systematically to evaluate and disclose to long-standing directed brokerage clients the availability of other, low-cost brokerage arrangements that had become available as new business practices evolved over time. The fact that the benefit of the directed brokerage arrangement to the adviser remained constant did not relieve the obligation to refresh the informed consent as better options became available.).

38 A change in Compensation to the adviser (or its affiliates or IARs) among the options, triggers disclosure of a change in the incentives to recommend one option over another, even if the options available to the client remain constant. Subsequent guidance suggests disclosure also should allow clients to know how much they are paying. That would require disclosure of an increase in the absolute Compensation to the adviser or cost to the client, even if the options available to the client and the relative Compensation to the adviser (among those options) remain constant. August 2019 Remarks, *supra* n.6 (stating the Staff's focus on the question "Can investors figure out how much they are paying?"). The argument would be that an advisory client is entitled to quantify the benefit to the adviser, and the opportunity cost to the client, in order to judge whether the advisory fee is reasonable (and not too high) in light of the supplemental Compensation. This aligns with questions from the Division of Examination in recent routine inquiries suggesting advisers should disclose the amount or rate of the interest split they accept on bank deposit sweep vehicles. Given the variability of these rates (over time, between clients, at breakpoints, etc.), disclosure of projected or historical amounts is challenging. One strategy is to disclose the formula for the maximum Compensation to the adviser, its affiliates and/or its IARs under the applicable contract and then state the client should assume the adviser or its affiliates retain the maximum amount.

39 The universe of required disclosures grows further if advisory clients are entitled to know the absolute (not just relative) Compensation to the adviser, and the opportunity cost to the client. This would be the case if such information is deemed necessary in order for a client to provide informed consent to the advisory fee (on grounds that the information is needed to judge whether the advisory fee is reasonable (and not too high) in light of the supplemental Compensation).

40 As discussed, *supra* n.31, *two share classes* represent an interest in the same portfolio of investments. There, the relevance of a comparison (of the Compensation to the adviser and costs/returns to the client) is obvious. The relevance becomes less intuitive for a comparison to a "substantially similar product available for lower or no cost." August 2019 Remarks, *supra* n.6. *Mutual funds offering the same asset class exposure* have been identified as the option against which to compare proprietary mutual funds. *See In the Matter of City National of Rochdale, LLC*, Exchange Act Release No. 94352, Investment Advisers Act Release No. 5973, 2022 WL 656532 (Mar. 3, 2022); and *In the Matter of JPMorgan Chase Bank, N.A.*, Securities Act Release No. 9992, Exchange Act Release No. 76694, Investment Advisers Act Release No. 4295, 113 SEC Docket 26, 2015 WL 9256635 (Dec. 18, 2015). *Any cash sweep option* offered by the clearing broker has been identified as the options against which to compare a money market fund or bank deposit sweep account that generates additional Compensation to the adviser or its affiliates. Most recently, *other asset classes with historically higher yields* (*e.g.*, equities) were identified as the option against which to compare an allocation to the affiliated bank deposit sweep account. *See In the Matter of Charles Schwab & Co., Inc.*, Exchange Act Release No. 95087, Investment Advisers Act Release No. 6047, 2022 WL 2128612 (Jun. 13, 2022). When *revenue sharing payments and service fees vary between fund families and funds* (not just share classes), other peer funds or fund families available to the client have been identified as the appropriate point of comparison. When *the ability to markup ancillary (aka rebillable) fees or transaction fees or other Compensation vary*

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between clearing broker/platforms (or between client account types), the point of comparison is the clearing broker/platforms (or account type) that would generate less or no Compensation to the adviser, its affiliates or its IARs. When obtaining consent from long-standing clients to a *directed brokerage arrangement*, the point of comparison has been other lower-cost brokerage arrangements that evolved over time. *See*, *e.g.*, *In the Matter of Jamison, Eaton & Wood, Inc*., Investment Advisers Act Release No. 2129 (May 15, 2003) (settled order).

41 For example, in the comparison of a *bank deposit account to a money market mutual fund*, disclosure of the differences in Compensation to the adviser needs to be balanced with disclosure of how the investments have different legal rights and protections (*e.g.*, FDIC versus SIPC insurance), represent different investment portfolios (unlike share classes) and seek to maximize returns for different constituencies (*e.g.*, the bank versus shareholders). In the comparison *of one clearing broker/platform to another*, the disclosure needs to avoid oversimplifying the multidimensional comparison of Compensation to the adviser and cost to the client. Each clearing broker agreement has different fee schedules with varying charges for services and transactions. The actual incentives to the adviser or IARs, and costs to the client, will vary depending on the combination of client attributes, features, services, etc. An incentive to favor one clearing broker/platform over another may not be supported by the totality of the arrangement, even if accurate with respect to a particular transaction or client.

42 2019 Interpretation, *supra* n.1, at 28 ("… where an investment adviser cannot fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent, the adviser should either eliminate the conflict or adequately mitigate (*i.e.*, modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible").

43 *See* JPMorgan, *supra* n.40 (noting the adviser structured its managed account program with an expectation that a majority of the assets would be invested in proprietary mutual funds, money market funds and separately managed accounts); and Schwab, *supra* n.40 (noting "in significant part because of the revenue received from the spread on the [affiliated bank deposit] cash allocations, [the adviser] did not charge investors an advisory fee").

44 In some cases, there are easy options to operationalize rebates and pass through the benefit to clients. In other cases, it would be difficult or impracticable to calculate the complimentary sources of Compensation and attribute an accurate amount to a particular client.

45 Conversely, allowing these practices enables some advisers to remain competitive on fees while maintaining or increasing their quality of service and achieving their financial goals.

46 Even when adopting a fiduciary duty with respect to the receipt of advisory fees from a mutual fund, Congress went to lengths to assuage industry concerns that the government would begin regulating how much advisers could charge. There was concern the SEC or the courts might view adoption of this fiduciary duty (with respect to the receipt of advisory fees) in the 1970s as a mandate to regulate the maximum Compensation mutual funds could pay for advisory services (*e.g.*, to a fair return on a fair value of the service as with public utilities). To assuage industry concerns, the House of Representatives and Senate Reports accompanying the 1970 amendments of the Investment Company Act of 1940 explain the "committee recognized the fact that the investment adviser is entitled to make a profit. Nothing in the bill is intended to imply otherwise or to suggest that a "cost-plus" type of contact would be required. It is not intended to introduce general concepts of rate regulation as applied to public utilities." S. Rep. No. 91-184 at 5 (1969), as reprinted in 1970 U.S.C.C.A.N 4897, 4901 and 4910.

47 August 2019 Remarks, *supra* n.6 (prefacing the concerns about financial incentives by stating "At the outset, let me be clear about what we are not doing. We are not making value judgments on financial

incentives, the scope of services provided, or the fees that are charged to investors. The scope of a client relationship and the extent to which an adviser charges fees to a client are subject to agreement between the adviser and the client—the terms of the client relationship, including these financial incentives and the amount of fees, or in what form fees are paid, is not what I am talking about.").

48 2019 Interpretation, *supra* n.1, at 9 (explaining that, to be *full and fair*, the disclosure should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent. To *inform consent,* the disclosure should "adequately convey[] the material facts or the nature, magnitude, and potential effect of the conflict sufficient for a client to consent to or reject it.").

49 2019 Interpretation, *supra* n.1, at 28 (stating "[i]n some cases, conflicts may be of a nature and extent that it would be difficult to provide disclosure to clients that adequately conveys the material facts or the nature, magnitude, and potential effect of the conflict sufficient for a client to consent to or reject it").

50 2019 Interpretation, *supra* n.1, at 28 (stating "[f]or retail clients in particular, it may be difficult to provide disclosure regarding complex or extensive conflicts that is sufficiently specific, but also understandable.").

51 "A Plain English Handbook: How to create clear SEC disclosure documents," Sec. & Exch. Comm'n, Office of Inv. Educ. And Assistance (Aug. 1998) (stating "[b]ecause many investors are neither lawyers, accountants, nor investment bankers, we need to start writing disclosure documents in a language investors can understand: plain English.").

52 For example, disclosure can commit IARs to delivering objective or unbiased advice, but the federal securities laws permit an IAR to have a financial interest that could, consciously or unconsciously, cause the advice to not be disinterested.

53 *See, e.g.,* Complaint, Sec. & Exch. Comm'n v. Cambridge Inv. Rsch. Advisors, Inc., 4:22-cv-00071 (S.D. Iowa Mar. 1, 2022) (alleging that disclosure was misleading because the adviser stated it "endeavor[s] at all times to put the interest of [its] clients ahead of [its] own" when the adviser was, in fact, selecting and retaining a higher-cost share class when lower costs were available. It was insufficient to qualify the undertaking with a statement that "these arrangements could affect the judgment of [CIRI] or its affiliated persons when recommending investment products").

54 *See, e.g.*, *In the Matter of TIAA-CREF Individual & Institutional Services, LLC*, Securities Act Release No. 10954, Exchange Act Release No. 92376, Investment Advisers Act Release No. 5772, 2021 WL 2953457 (July 13, 2021) (alleging that disclosure was misleading because the adviser stated the advice of its IARs was unbiased and objective despite the existence of financial incentives or pressure to prioritize advisory products over brokerage products.).

55 Similarly, use of the word "may" is permitted to describe "a potential conflict which does not currently exist but might reasonably present itself in the future." *See* Form ADV Instructions, *supra* n.14, at #2.

56 *See* 2019 Interpretation, *supra* n.1, at 25 (stating that "we would consider the use of 'may' inappropriate when the conflict exists with respect to some (but not all) types or classes of clients, advice, or transactions without additional disclosure specifying the types or classes of clients, advice, or transactions with respect to which the conflict exists.").

57 *See* Restatement (Third) of Trusts § 78 cmt. a (2007), at cmt. c(1)-c(3), g.

58 *See* 2019 Interpretation, *supra* n.1, at n. 57 (stating that "while an adviser may satisfy its duty of loyalty by making full and fair disclosure of conflicts of interest and obtaining the client's informed consent, an adviser is prohibited from overreaching or taking unfair advantage of a client's trust.").

59 The 2019 Interpretation, while discussing the duty of loyalty, notes that "[w]e believe that while full and fair disclosure of all material facts relating to the advisory relationship or of conflicts of interest and a client's informed consent prevents the presence of those

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material facts or conflicts themselves from violating the adviser's fiduciary duty, such disclosure and consent do not themselves satisfy the adviser's duty to act in the client's best interest." *See* 2019 Interpretation, *supra* n.1.

60 The bright line rules extrapolated in the first section of this article require specificity as to: (1) which decisions or recommendations generate the most Compensation to the adviser, its affiliates or its IARs; and (2) where acting consistent with the incentive results in higher costs or lower returns/yields than another "substantially similar" option available to the client.

61 Advisers have been found liable for breaching the duty of care by neglecting to provide their supervised persons with sufficient detail in guidelines concerning how to assess the continued appropriateness of each fiduciary recommendation. *See Pruco Securities, LLC*, Advisers Act Release No. 5657 (December 23, 2020) (alleging an adviser breached its fiduciary duty to advisory clients by adopting policies and procedures that "required IAR supervisors to monitor the level of trading activity and…determine whether advisory accounts were… "suitable" for clients…on an ongoing basis" but "provided no details or parameters to IARs or their supervisors concerning how to assess whether a wrap account was and remained appropriate for clients").

62 Questionable results would trigger further inquiry and escalation as necessary. Qualitative inquiry is especially important if the monitoring reveals a trend or pattern of self-interested recommendations.

63 *See* above, at nn.34–38 and surrounding text.

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