SPOTLIGHT ON

Compliance Considerations for Investment Advisor Conflicts of Interest

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Overview of Conflicts of Interest

Investment advisors have a fiduciary duty to prioritize the interests of their clients over their own. When an investment advisor has a vested interest in the outcome of a situation, a clash between the advisor's self-interest and his or her fiduciary duties to the client may intervene. This clash could result in the advisor knowingly or unknowingly giving advice that is not in the best of the client. While some decisions or advice result in the aforementioned clash, some activities come with inherent conflicts that may or may not be managed or mitigated, and the advisor needs to commit to ensuring the client understands the risks involved with those conflicts and attempt to eliminate or mitigate them.

What is the Standard of Conduct for Investment Advisers under the Investment Advisers Act of 1940 (the "Advisers Act")?

Section 206 [80b-6] of the Advisers Act establishes the fiduciary relationship between the investment adviser and the client. This fiduciary relationship necessitates that the investment adviser expresses a duty of care and loyalty to the client.

- **Duty of care.** In the Commission's view, the duty of care "requires an investment adviser to provide investment advice in the best interest of its client, based on the client's objectives."[1]

- **Duty of loyalty.** In the Commission's view, the duty of loyalty requires an investment adviser "to eliminate or make full and fair disclosure of all conflicts of interest" that could adversely affect the client as a result of the practices of the investment adviser.

An investment advisor must provide the client with information that pertains to the investment adviser's practices and any and all material conflicts of interest that the investment adviser may

[1] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963); *See also*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. IA-5248 2, 6 n.15 (June 5, 2019).

have so that the client is able to give informed consent to or reject the investment adviser's conflict of interest or business practices.[2]

- **Commission Interpretation.** The Securities and Exchange Commission ("SEC") noted in its July 2019 Interpretation of Standard of Conduct for Investment Advisers that the concept of fiduciary duty is broad and that both the Advisers Act and Commission rules do not specifically define the fiduciary duties of advisers. However, the Commission did acknowledge that the fiduciary duty of advisers reflects Congress' 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."[3] As such, this guidance pushes advisers to act with strict adherence to its fiduciary duty.

With this in mind, investment advisers need to have a commitment to mitigating and lessening the amount and magnitude of their conflicts of interest. The SEC finds this area to be of particular importance during examinations and looks at disclosures to understand how the investment adviser is analyzing conflicts of interest and also how it is addressing the conflicts and mitigating the impact for its clients.

What conflicts of interest can be present or could arise in your investment advisory practice?

In order to eliminate or lessen the impact of conflicts of interest, investment advisors need to understand what conflicts of interest are already present or are arising in business practices. Common areas where conflicts of interest are present or could arise include best execution, soft dollar practices, proxy voting, and investment type selection.

Best Execution. Best execution refers to the manner by which the investment adviser places trades with the broker-dealer. As a fiduciary to the client, the investment adviser is required to place trades in the best interest of the client. Best execution, however, is judged based on the quality of the execution, and this may sometimes result in the investment adviser placing trades with an unaffiliated broker-dealer, which could result in the client incurring higher costs.[4]

- **SEC Examination Alert.** The SEC has noted that it may look to see whether commission rates are consistent with industry norms by looking at the average commission rates

[2] FORM ADV (Paper Version) UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION, *available at* https://www.sec.gov/about/forms/formadv-part2.pdf

[3] *See SEC v. Capital Gains*, supra footnote 2; see also In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948) ("Arleen Hughes") (Commission Opinion) (discussing the relationship of trust and confidence between the client and a dual registrant and stating that the registrant was a fiduciary and subject to liability under the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934).

[4] Terrance J. O'Malley, John H. Walsh & William M. Watts, Investment Adviser's Legal and Compliance Guide § 4.03 (3rd Edition, 2020-1 Supp. 2019)

paid to broker-dealers. Similarly, the SEC could also request a list of broker-dealers used by the adviser and an explanation as to why the adviser is using those broker-dealers.

- **Compliance Alert.** The SEC's Office of Compliance Inspections and Examinations ("OCIE") noted that issue areas during adviser examinations include "not performing periodic and systematic best execution reviews," "not considering relevant factors," not seeking quality and cost comparisons from different broker-dealers, "not fully disclosing best execution practices," and not maintaining adequate best execution compliance policies and procedures.[5]

- **SEC Enforcement Action.** A conflict of interest arises when an investment adviser chooses to pursue a relationship with a clearing broker in exchange for certain benefits. In July 19, 2017, the SEC pursued action against KMS Financial Services, Inc. ("KMS"), a dually registered broker-dealer and investment adviser. KMS failed to disclose its compensation arrangements with a clearing broker where they would share revenues received from the clearing broker's no-transaction-fee mutual fund program ("NTF Program"). In light of this arrangement, KMS had a financial incentive to recommend mutual funds in the NTF Program over other investment options, creating a conflict of interest. In addition to this arrangement, KMS also received a reduction in execution and clearing costs but failed to "pass" on the reduction in costs to its advisory clients and in assessing whether it was achieving best execution. The firm was required to display its cease-and-desist order on its website for a period of six months, include the order in its September 30, 2017 quarterly statement, provide in writing its certification of compliance, cease and desist acts in current and future violation of the Advisers Act, and pay disgorgement, prejudgment interest, and a civil money penalty to the SEC. In light of this case, firms need to ensure proper disclosure of their trading away practices and best execution in order to avoid violating their fiduciary duty and facing action brought by the SEC.[6]

Investment advisers need to pay particular attention to these alerts and enforcement actions as they may need to trade away transactions in order to provide best execution services for their clients.

Soft Dollar Practices. Soft dollar arrangements refer to arrangements where the adviser receives products or services from a broker-dealer in return for placing trades through that particular broker-dealer. A conflict of interest arises when the adviser chooses to place trades through a specific broker-dealer and causes the client to pay more than the "lowest possible

[5] Terrance J. O'Malley, John H. Walsh & William M. Watts, Investment Adviser's Legal and Compliance Guide § 4.03 (3rd Edition, 2020-1 Supp. 2019)

[6] *See In re KMS Financial Services, Inc.* Investment Advisers Act Release No. 4730 (July 19, 2017) available at https://www.sec.gov/litigation/admin/2017/34-81169.pdf

commission rates for securities transactions."[7] Section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act") provides a safe harbor that investment advisers can take advantage of. Under Section 28(e), advisers who cause clients to pay more than the lowest possible commissions are not deemed to be acting unlawfully if they have determined in "good faith" that the commission amount is reasonable with respect to the brokerage or research services provided.[8]

- **SEC Interpretation.** If the adviser receives soft-dollar compensation as a result of its relationship with an affiliated broker-dealer or its use of a particular broker-dealer, it must disclose this relationship as it pertains to disclosure and books and records requirements set by the Advisers Act and the Investment Company Act of 1940 (the "Company Act").

Proxy Voting. A conflict of interest arises when the investment adviser accepts the authority to vote proxies for clients' securities. The investment adviser may be incentivized to vote in favor of its own interest. To ensure that an investment adviser votes in the best interest of its client, Rule 206(4)-6 of the Investment Advisers Act (the "Advisers Act") has required investment advisers to "adopt and implement written policies and procedures" that address proxy voting procedures.[9]

- **SEC Final Rule.** The SEC has stated that an investment adviser can demonstrate that its vote was not a product of a conflict of interest if they demonstrate that the vote required "little discretion on the part of the adviser" or was made in "accordance with pre-determined policies that are based on third-party recommendations." Rather than voting proxies, investment advisers also have the option of referring clients to engage with third-parties to determine proxy voting decisions.[10]

When investment advisers are given the power to vote proxies on clients' investments, this creates the possibility of the investment adviser inadvertently breaching its fiduciary duty when voting. Voting procedures are to be in accordance with the client's applicable voting guidelines, publicly available information, and reasonable judgment of the adviser in assessing the outcome of favorable financial results for the client. By adopting proxy voting policies and procedures, the investment adviser can mitigate some conflicts from occurring. However, there

[7] Terrance J. O'Malley, John H. Walsh & William M. Watts, Investment Adviser's Legal and Compliance Guide § 4.04 (3rd Edition, 2020-1 Supp. 2019).

[8] Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Release No. 34- 23170, (April 28, 1986).

[9] The Investment Advisers Act of 1940, 17 CFR § 275.206(4)-6.

[10] Proxy Voting by Investment Advisers, Release No. IA-2106, (January 31, 2003).

are still scenarios where conflicts of interest cannot be prevented. The following is not an exhaustive list of proxy-voting related conflicts of interest but these conflicts are important to consider and analyze if the investment adviser is given the power to vote proxies.

- **Role of Proxy Advisory Firms.** Investment advisers need to consider the implications of their use of proxy advisory firms. The SEC has interpreted the use of proxy advisory firms as constituting solicitation. A conflict of interest arises when an investment adviser solicits a proxy advisory firm that is compensated for and receives fees from the public companies that it provides governance advice on. Investment advisers have a fiduciary duty to ensure that the proxy advisory firm that it engages is not biased in voting in favor of results that benefit the companies that compensate them. This arrangement, along with pertinent information regarding the reasoning as to the recommendation, needs to be properly communicated to clients.

- **Proxy Voting on Matters that Result in Additional Costs or Minimal Benefits.** A conflict of interest arises when an investment adviser is given the power to vote proxies on a matter regarding circumstances that could impose additional costs on the client. For example, there could be a vote on the use of securities for lending. The investment adviser needs to consider the opportunity costs for the client resulting from restricting the use of securities for lending, where restricting securities lending results in higher costs. Similarly, there are circumstances where the cost of voting proxies is high while the benefits are low for the client. For example, when "casting a vote on a foreign security that involves additional costs of hiring a translator or traveling to the foreign country to vote the security in person, or casting a vote would not reasonably be expected to have a material effect on the value of the client's investment."[11] The investment adviser is to make voting determinations in accordance with its fiduciary duty.

- **Proxy Voting on Securities Where the Investment Advisor Has a Personal Interest.** A conflict of interest arises when an investment adviser is given the power to vote proxies on a security where it holds a financial stake or has financial interest on outcomes relating to the investment in the security. In cases where both the investment adviser and the client are invested in the same security, the investment adviser might have to vote proxy on a security where he and the client hold different philosophies. While the investment advisor may personally vote on a matter one way, the client's guidelines may require the adviser to vote opposingly on the client's holdings.

<u>**Investment Type Selection.**</u> A conflict of interest arises when the investment advisor recommends an investment where he or she may receive some sort of compensation as a result

[11] Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release No. IA-5325; IC-33605, (September 10, 2019).

of the client pursuing a certain investment. For example, if the investment adviser recommends the client to purchase an insurance product where he or she receives commissions, this presents a conflict of interest in that the investment advisor has a vested interest in the client pursuing the investment.

- **SEC Interpretation.** In its July 2019 Interpretation of Standard of Conduct for Investment Advisers, the SEC discussed the effect of disclosures and its contribution to a possible reduction in the amount of investment advisers willing to recommend certain types of investments and products. The SEC acknowledges that the decline in the supply of investment advice regarding these investments or products could result in reduced portfolio allocation efficiency for investors that would otherwise benefit from this advice but are no longer going to receive the necessary advice.

- **SEC Enforcement Actions.**

    - On December 11, 2017, the SEC charged Westport Capital Markets ("Westport"), LLC, a dually registered investment adviser and broker dealer, and Christopher E. McClure for violating fiduciary duties and defrauding clients by buying securities that resulted in additional compensation that was not disclosed to clients. Christopher E. McClure invested his clients' funds in securities that he bought at discount and then resold. The investment in these securities generated undisclosed mark-ups and resulted in more than $1 million in losses. Aside from these actions, Westport received 12b-1 fees from mutual funds that were not disclosed to clients. While there were cheaper share classes of the same mutual fund, Westport and Christopher E. McClure invested in those mutual fund shares with 12b-1 fees. Its actions in defrauding clients and its failure to disclose the 12b-1 fees resulted in Westport being charged with violating the Investment Advisers Act. The SEC sought injunctive relief, disgorgement of ill-gotten monetary gains plus interest, and penalties. When investment advisers are given a financial incentive to invest in a particular share class, they must disclose these conflicts of interest in order to avoid breaching their fiduciary duty and violating the requirements set by the Advisers Act.[12]

    - On February 12, 2020, the SEC brought an action against Criterion Wealth Management Insurance Services, Inc. ("Criterion") and its previous co-owners Robert Gravette and Mark MacArthur for their failure to uphold the firm's fiduciary duty and disclose its financial conflict of interest when they recommended their clients to invest in private real estate funds. Between 2014 and 2017, the pair recommended clients invest more than $16 million into

[12] *See In Re Securities and Exchange Commission v. Westport Capital Markets, LLC and Christopher E. McClure*, Litigation Release No. 24007 (December 11, 2017) available at https://www.sec.gov/litigation/litreleases/2017/lr24007.htm

private real estate investment funds without disclosing that the funds' managers had paid the pair more than $1 million. The pair received this compensation on top of the fees they were receiving from clients. This gave Criterion the financial incentive to continue recommending that clients invest in these funds. For two of the four private real estate funds, this undisclosed arrangement led to lower returns for advisory clients. In violation of the Advisers Act, the complaint sought permanent injunctions, disgorgement and prejudgment interest, and civil penalties from Criterion, Robert Gravette, and Mark MacArthur. In light of this case, investment advisers must disclose any financial conflicts of interest that may incentivize them to recommend certain investments over others and possibly breach their fiduciary duty to clients.[13]

Scenarios by Conflict Type. While this is not an exhaustive list of all possible conflicts of interest that are present or could arise, investment advisers need to pay particular attention to these areas.

- **Investment Advisory Firm versus Client Conflicts.** Conflicts of interest that arise between the advisory firm and its clients are the most common.

  Scenario 1. A conflict of interest arises when an investment adviser recommends an investment that may provide the adviser more compensation than other investments. This creates the incentive for the adviser to recommend the investment that offers more compensation to it than other investments. This investment may not necessarily fall in line with the investment philosophy of the client or may provide lower returns than other investments to the client.

  Scenario 2. A conflict of interest arises when the investment adviser is dually registered as a broker-dealer. Being a broker-dealer, the revenue sources related to account holdings may give rise to a conflict of interest. For example, a mutual fund revenue sharing arrangement may provide a financial incentive for the investment adviser to recommend the mutual funds that its broker-dealer side may have arrangements with.

  Scenario 3. A conflict of interest arises when the investment adviser participates in personal trading activities at or about the same time the client is active in the markets as well. This could create a financial incentive for the investment adviser to base client trades and transactions on personal stakes.

[13] *See In Re Securities and Exchange Commission v. Criterion Wealth Management Insurance Services, Inc., Robert Allen Gravette, and Market Andrew MacArthur*, Litigation Release No. 24738 (February 13, 2020) available at https://www.sec.gov/litigation/litreleases/2020/lr24738.htm

While these conflicts of interest need to be communicated through the Form ADV Part 2A, the investment adviser should also adopt policies and procedures regarding reviewing, analyzing, and mitigating present and potential conflicts of interest relating to advisory practices.

- **Client versus Client Conflicts.** Conflicts of interest can arise between clients when they are interested in participating in the same investments or when fees are different for clients when services are the same or similar.

  Scenario 1. The investment adviser may be presented with a conflict of interest when two clients of different sizes are interested in investing in the same securities or assets. In this case, the investment adviser may be incentivized to favor the larger client.

  Scenario 2. A conflict of interest arises when clients are charged differently for the same investment strategy. When investment advisers charge an asset-based fee, clients will have differing fees based on the assets under management, though accounts may be managed with the same investment strategy.

  These conflicts of interest can be managed by disclosing the conflicts to the client to ensure proper communication of investment propriety and transparency with fees.

- **Employee versus Client Conflicts.** Conflicts of interest can arise when an employee has vested interest in client transactions.

  Scenario 1. A compensation agreement that incentivizes the employee to recommend a particular investment over another creates a conflict of interest between the employee and the client. The employee could recommend the client to invest in a particular firm proprietary product that may not be in the best interest of the client.

  Scenario 2. Employees with outside business activities may also present a conflict of interest. For example, when an employee has an insurance license, the employee may be incentivized to recommend an insurance product where they would receive commissions on those particular products.

  In particular, these conflicts of interest can be addressed by disclosure in proper documents and proper communication to the client. However, the investment adviser can also adopt policies and procedures regarding the review of employee activities.

Disclosure

<u>Form ADV Part 2A Disclosure Requirements.</u> All material facts that relate to the advisory relationship are required to be disclosed to the client in the Form ADV Part 2A. The items below

require the following disclosures to be provided to the client as a result of conflict of interest in the business practices of the investment adviser.

- **Item 5 Fees and Compensation.** This section contains information regarding how the firm is compensated, how clients are billed, any fees or expenses that the client may pay, prepayment practices, and any additional compensation the firm or any supervised person receives.

  A disclosure in this section will be made regarding a conflict of interest that is present when any supervised persons of the investment adviser accept "compensation for the sale of securities or other investment products, including asset-based sales charges or service fees from the sale of mutual funds."[2] This creates an incentive for the supervised persons to recommend products due to compensation received instead of the needs of the client.

- **Item 6 Performance-Based Fees and Side-By-Side Management.** This section contains information regarding whether or not the firm charges performance-based fees and whether any supervised persons manage performance-based fee accounts alongside any account charged in a different manner.

  A disclosure in this section will be made regarding a conflict of interest that is present when the investment adviser or any supervised persons accept performance-based fees.

  Similarly, the disclosure will also discuss the conflict of interest present when the investment adviser or any supervised persons manage a performance-based account and an account that is charged a different type of fee. This creates the incentive to favor accounts that are performance-based as the investment adviser will benefit from the capital appreciation of the assets of the client.

- **Item 10 Other Financial Industry Activities and Affiliations.** This section contains information regarding any outside business activities and affiliations the firm may have.

  A disclosure in this section will be made regarding conflicts of interest present when the investment adviser or any of its management persons have a relationship with any of the following related persons:

    1. broker-dealer, municipal securities dealer, or government securities dealer or broker;
    2. investment company or other pooled investment vehicle (including a mutual fund, closed-end investment company, unit investment trust, private investment company or "hedge fund," and offshore fund);
    3. other investment adviser or financial planner;

4. futures commission merchant, commodity pool operator, or commodity trading advisor;
5. banking or thrift institution;
6. accountant or accounting firm;
7. lawyer or law firm;
8. insurance company or agency;
9. pension consultant;
10. real estate broker or dealer; and
11. sponsor or syndicator of limited partnerships.

- **Item 11 Code of Ethics, Participation or Interest in Client Transactions and Personal Trading.** This section will contain a general description of the firm's code of ethics and information regarding personal trading and personal interest in the client's investment.

  A disclosure in this section will be made regarding material financial interests that an investment adviser or a related person has as a result of client transactions and personal trading activity.
  For example, a conflict of interest arises when the investment adviser or a related person acts as principal and buys or sells securities from clients; or acts as a general partner in a partnership where client investments are solicited; or acts as an investment adviser to an investment company that is recommended to clients.

- **Item 12 Brokerage Practices.** This section contains information regarding research and other soft dollar benefits, brokerage for client referrals, and directed brokerage.

  A disclosure in this section will be made regarding brokerage practices. A conflict of interest arises if the investment adviser receives research, other products or services, or client referrals as a result of recommending a particular broker-dealer. The client could end up paying commissions higher than those charged by other broker-dealers.

  Similarly, the disclosure will discuss the conflicts of interest present with directed brokerage. Clients may direct the investment adviser to execute trades through a particular broker-dealer. However, directing brokerage may not be the most favorable execution and may end up costing clients more.

- **Item 14 Client Referrals and Other Compensation.** This section contains information regarding whether the firm provides or receives some sort of economic benefit from client referrals.

  A disclosure in this section will be made regarding the investment adviser and arrangements with non-client parties. A conflict of interest can arise when the investment adviser receives an economic benefit including a sales award or other prize

from the non-client party as a result of providing clients with advice or other advisory services.

- **Item 17 Voting Client Securities.** This section contains general information regarding how the firm handles proxy voting procedures**.**

  A disclosure in this section will be made regarding the conflict of interest that arises as a result of the investment adviser proxy voting on the client's securities.

Disclosure Content. The SEC has discussed how disclosures are to be made regarding the material facts of the conflict of interest. Particularly the SEC has highlighted the importance of disclosing the existence and effect of different incentives and resulting conflicts, the nature of the conflict, and how the adviser addresses the conflict.

- **Disclosing the existence and effect of different incentives and resulting conflicts.** The SEC looks at what conflicts of interest are currently present within the practices of the adviser. The Commission wants the adviser to address how certain incentives could cause conflicts of interest to arise as well.

  Investment advisers need to be able to discuss how they identify conflicts of interest present in its practices. It is not sufficient to state what those particular conflicts of interest are.

- **Disclosing the nature of the conflict.** In the conflicts of interest disclosures, the SEC also looks at the current and potential impact of a certain conflict of interest on the client and at what level the conflicts arise.

  Investment advisers need to be able to understand the entirety of the conflicts of interest that are present or will arise as result of their practices.

- **Disclosing how the adviser addresses the conflict.** It is not enough for the adviser to be able to identify and understand its conflicts of interest. Rather, the adviser needs to have a concrete way of addressing the conflicts of interest that can be avoided and mitigate the impact of any conflicts of interest that cannot be prevented.

Key Takeaways

Investment advisers have a fiduciary duty to act in the best interests of their clients. As such, the firm's analysis of conflicts of interest needs to be at the forefront of its compliance program so clients understand and acknowledge the risks associated with their participation in the advisory program.

Proper disclosures need to be made regarding conflicts of interest that are present or will arise as a result of the adviser's advisory practices. These disclosures do not need be long, but they need to be concise enough for the client to understand the conflict at hand and be able to make an informed decision as to the acceptance or rejection of the conflict.

Conflicts of interest are considered "living issues" for investment advisers as more may come up over time.[14] It is not enough to describe the conflict of interest. And advisers need to be able to identify conflicts of interest beyond that which was reported in its ADV Form Part 2A. In addition, advisers need to have a way to address conflicts of interest as they arise.

[14] Amy Greer, Valerie Mirko, *Managing through Financial Conflicts of Interest*, (April 16, 2020), https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/webinars/200416_ConflictsofInterest/200416_ConflictsofInterest_Slides.pdf?_cldee=bXN3aW5nQGludGVyYWN0aXZlYnJva2Vycy5jb20%3d&recipientid=contact-fd314771347fea11a812000d3a148177-07abe2a9e22645ccb4f8871268656eca&esid=b37e4342-fe7f-ea11-a812-000d3a148177