Choose Your Words Carefully When Drafting Disclosures and Policies and Procedures

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By: Les Abromovitz

When investment advisors and Chief Compliance Officers ("CCOs") draft policies and procedures, as well as Form ADV disclosures, there may be someone who chimes in, "I don't disagree." That particular comment can be frustrating, because it is not a ringing endorsement of the quality of the firm's policies and procedures and disclosures. The statement stops short of saying, "I agree." And if those policies and procedures and disclosures are later determined to be deficient, examiners may agree that the Registered Investment Advisor ("RIA") has violated the Investment Advisers Act of 1940 and its rules.

SEC brings civil enforcement action based on false and misleading statements and omissions

When an RIA contests deficiencies identified by examiners, the matter is often turned over to the SEC's Enforcement Division. On September 30, 2021, the SEC brought a civil enforcement action that alleged fraudulent misconduct and breach of fiduciary duty by an RIA based in California, as well as its affiliated broker-dealer and their president. According to the complaint, the president used his brokerage firm, as well as his RIA, to aid and abet this misconduct.

The complaint alleged that, for a number of years, the president and the RIA made materially false and misleading statements to advisory clients and defrauded them by falsely disclosing that the RIA "may" receive portions of the fees charged to advisory accounts by its third party clearing and custody firm. In fact, the president had directed the clearing broker to charge advisory clients an additional fee markup that was paid to the RIA.

According to the complaint, the RIA, the president, and the broker-dealer knew, or were reckless and negligent for not knowing, that significant fee markups were charged to clients approximately 60 percent of the time. The SEC further alleged that the president and the RIA made other materially false and misleading statements to clients regarding fee markups and did not adequately disclose the related conflicts of interest. Although the RIA and the president later disclosed the existence of markup fees, they allegedly continued to mislead advisory clients by claiming that the fees were only imposed "in some limited instances." It is unknown if anyone at the firm

expressed concern over the disclosures or simply said, “I don’t disagree.”

In addition, the complaint alleged that the RIA and its CCO failed to implement written policies and procedures that were reasonably designed to prevent these specific kinds of disclosure and conflict of interest violations. At times, the president served as CCO of the RIA. He also used his positions as chief operating officer, president, and managing member to substantially assist and further this fraudulent conduct. He and the RIA also violated their fiduciary obligations to clients.

By engaging in this conduct, the RIA and the president violated Sections 206(1) and 206(2) of the Investment Advisers Act. The RIA also violated Section 206(4) of the Investment Advisers Act and Rule 206(4)-7 thereunder. The president aided and abetted these violations.

The SEC’s complaint is seeking permanent injunctions, disgorgement with prejudgment interest, and civil penalties.

Conclusion

Whether the SEC wins the case or not, the enforcement action makes it clear that RIAs should fully and accurately disclose all conflicts of interest. Investment advisors are often inclined to minimize the impact of a conflict of interest, which creates a compliance risk for the firm.

It is imperative that RIAs and CCOs be precise in their disclosures. Saying that a conflict of interest “may” exist is problematic if that conflict is already present. Conflicts of interest must be sufficiently specific so that advisory clients can understand the conflicts of interest arising from the advisor’s advice. Only then will clients have an informed basis on which to consent or reject the conflicts of interest.

Regardless of the outcome, accusations that an RIA has made false or misleading statements and omissions are likely to follow the firm for years to come. With the stakes so high, all parties involved in drafting disclosures and policies and procedures should wholeheartedly agree with the final version of these documents. Consensus among the parties should be much more enthusiastic than, “I don’t disagree.”

The SEC’s civil enforcement action can be found here.