Do's and Don'ts of Disclosures

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Fiduciary Disclosure

"Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients."

SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963).

To whom might you owe disclosures?

- The person with whom you have a fiduciary relationship. For example, this may generally include:
  - Trustee/beneficiary
  - Investment advisers/clients
  - Employee benefit plans
- This does not generally include:
  - Other bank customers, including as borrowers and depositors (broadly speaking)
  - Third parties

    For example, a court found that a bank did not owe a fiduciary duty to disclose to a debtor that a company that was a customer of both the bank and the debtor was in financial distress, notwithstanding the fact that the bank profited at the expense of the debtor by not disclosing that information. *In re Cara Corp.*, 148 Bankr. 760 (Bankr. E.D. Pa. 1992).
  - The public at large

What do you need to disclose? Broadly speaking...

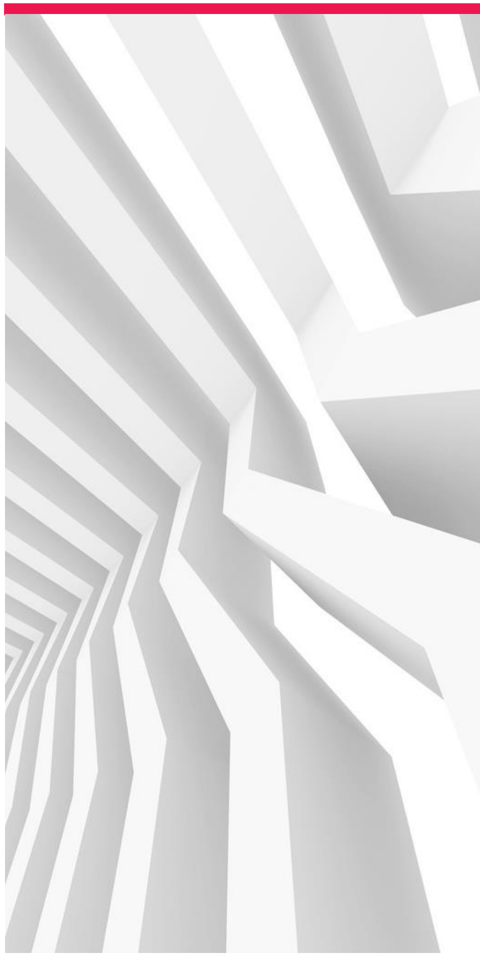
Material facts about the relationship

Real and potential conflicts of interest

Fees and expenses

Benefits of disclosure

- Fiduciaries can benefit from full disclosure, which, in connection with other appropriate procedures including consent, as required under applicable law, may allow fiduciaries to engage in otherwise prohibited activities.
- In short, disclosure may help eliminate a conflict that would otherwise be a breach of fiduciary duty.



Benefits of disclosure

As described by the OCC:

> "If permitted by applicable state law, <u>*a bank fiduciary may enter into a transaction presenting an otherwise impermissible conflict of interest based on the proper consent of all beneficiaries if the transaction is fair and executed in the beneficiaries' best interest*</u>. State law may further require that, to obtain proper consent, a bank must fully and completely disclose to the beneficiaries the facts about the conflict and that the beneficiaries must have the legal capacity to give consent. Even if not required by state law, full disclosure and informed affirmative consent are consistent with safe and sound banking practices."

Comptroller's Handbook: Conflicts of Interest, at p. 11. (Emphasis added.)

Disclosure facilitates certain activities for a fiduciary, such as:

- Charging fees (including sweep fees, tax preparation fees, termination fees and 12b-1 fees or administrative fees from registered investment companies (mutual funds) and fees paid to an affiliated broker)
- Investments in proprietary and affiliated investment products and services and associated fees
- Investments in a proprietary mutual fund
- Purchasing services from and engaging in business transactions with related parties and interests on behalf of fiduciary accounts

- Accepting financial benefits directly or indirectly conditioned on the investment of discretionary assets in a particular investment
- Relationships where there is a sale of fiduciary property
- Payments for order flow
- Fee concessions
- Brokerage placement practices
- Financial benefits, such as earnings credits or fee rebates
- Soft dollar arrangements

An important caveat

- Disclosure alone typically is not enough to engage in the activities listed on the preceding slide.
- These activities may only be permissible if they are:
  - Not prohibited by applicable law;
  - Consistent with other regulatory expectations;
  - Reasonable;
  - Subject to other appropriate safeguards and adequate oversight;
  - In accordance with the informed consent obtained, as is necessary.

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Examples of benefits of disclosure:

Finder's fees

The OCC allowed a national bank to enter into contracts with an investment adviser to provide services to bank customers and receive fees, including finder's fees, on the condition that proper disclosure was made to bank customers.

"The OCC has also long recognized that the payment of a reasonable finder's or referral fee in connection with the marketing of trust services, that is disclosed to bank customers, is appropriate."

OCC Interpretive Letter #850. (Emphasis added.)

Examples of benefits of disclosure:

Differentiated fund management fees

The OCC said "a national bank may … charge [collective investment fund] participants different fund management fees commensurate with the amount and types of services the bank provides to each participant" given proper disclosure and compliance with the other parameters outlined by the OCC.

OCC Interpretive Letter #829.

Examples of benefits of disclosure:

Shorter statute of limitations

Under the Uniform Trust Code statute of limitations provision, Sec. 1005, a shortened, one year statute of limitations applies (in lieu of the typical five year statute of limitations), where:

1. the trustee "adequately disclosed the existence of a potential claim for breach of trust";
2. and "informed the beneficiary of the time allowed for commencing a proceeding."

Under the Uniform Trust Code: "A report adequately discloses the existence of a potential claim for breach of trust if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence."

Examples of inadequate disclosure:

Actual vs. potential conflicts

The SEC found that an adviser's disclosure that it "may" receive compensation and that those arrangements "may" create a conflict of interest constituted inadequate disclosure because the adviser actually was engaged in the arrangement, creating a conflict of interest.

In the Matter of The Robare Group, Investment Advisers Act Release No. 4566 (Nov. 7, 2016) (Commission Opinion) *aff'd in relevant part by Robare Group v. SEC*, 922 F.3d 468 (D.C. Cir. 2019) (denying petition challenging the SEC finding that Petitioners violated Section 206(2) of the Advisers Act).

Examples of inadequate disclosure:

Failure to disclose fees

The SEC found that an adviser's failure to disclose service fees until years after the fees had been withdrawn was a breach of fiduciary duty. The SEC also found that the hiring of an affiliate "was a related-party transaction and created a conflict of interest" that should have been disclosed. The failure to disclose the conflict was a breach of fiduciary duty.

In the Matter of SLRA Inc., as successor to Liquid Realty Advisors III, LLC and Scott M. Landress (February 7, 2017).

Special case: ERISA

- Note that the implications of and requirements for disclosure, and its ability to “cure” conflicts, may differ based on applicable governing law. Notably, ERISA fiduciary duties cannot be waived or avoided with disclosure.

- For instance, in a transaction involving plan assets, a fiduciary may not represent the interests of a party whose interests are adverse to those of the plan for which it acts a fiduciary.

  - As an example, if an investment firm serves as the manager of several funds, one of which is treated as investing plan assets subject to ERISA, the ERISA fund could not engage in a transaction with one of the other sponsored funds, which could – absent ERISA – be permitted with disclosure and consent. ERISA Section 406(b)(2).

Special case: ERISA

Another example is that a fiduciary generally cannot select itself or an affiliate to provide services to an employee benefit plan subject to ERISA, if that would cause the plan to pay an additional fee for such services. ERISA Section 406(b)(1).

- Note that there is a class exemption promulgated by the DOL that allows a fiduciary to use an affiliate for brokerage services, so long as an independent fiduciary of the plan authorizes the fiduciary to do so and the fiduciary provides regular disclosure to the independent fiduciary about the services provided.

Finally, any arrangement that purports to exculpate a fiduciary from liability for breaching its duties – or an indemnity from a plan to the fiduciary against liabilities arising from any such breach – is simply void as against public policy.

- So while a trustee or other commercial party can be exculpated or indemnified under a disclosed and agreed contractual arrangement, an ERISA fiduciary cannot be excused from complying with its duties. ERISA Section 410. A current example of this would be that an ERISA fiduciary could not be told to target investments based on ESG factors, even if that meant a reduced return for the fund.

Some DO’s and DON’Ts of Disclosure

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DO lean on the side of disclosure

Banks in particular should "fully disclos[e] conflicts of interest and compensation received from proprietary products and third parties (for example, shareholder servicing fees) even when properly authorized by applicable law and disclosure is not expressly required by applicable law." Comptroller's Handbook, Conflicts of Interest, at p. 31.

DO accompany disclosures with other appropriate measures

Disclosure alone typically is not enough.

DON'T make disclosures too vague

For example, as the SEC has said: "In order for disclosure to be full and fair, it 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." Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) at 24.

DO strive to provide clear information for full and fair disclosure

For example, be careful that disclosures are not too voluminous.

(Excludes ERISA; see slides 14, 15)

Some DO's and DON'Ts of disclosure

DO establish effective procedures to ensure disclosure

It is a best practice for a fiduciary to establish comprehensive procedures that cover potential types of conflicts of interest relevant to the fiduciary relationships established.

DO integrate disclosure into core processes

For example, OCC guidance states: "The identification of actual and potential conflicts of interest and the determination of whether such conflicts are permissible, properly authorized, and appropriately disclosed should be integrated into a number of the bank's key processes." Comptroller's Handbook, Conflicts of Interest, at p. 21.

DON'T simply rely on Form ADV disclosures

For Form ADV filers, part II of SEC Form ADV only sets out a minimum level of required disclosures.

DON'T call a real conflict a potential conflict

For example, Form ADV instructions note that, if a conflict exists for certain types of clients, advice or transactions, then an adviser must "indicate as such rather than disclosing that [the adviser] 'may' have the conflict or engage in the practice."

Thank you