FORM ADV PART 2A DISCLOSURES: DUE DILIGENCE ON INVESTMENT STRATEGIES AND RISKS

RON A. RHOADES, JD, CFP®

Asst. Professor, Alfred State College (Aug. 2011)

Columnist, RIABiz.com

CCO, Director of Research, Joseph Capital Management, LLC

E-mail: Ron@ScholarFi.com

For the Fi360 Conference, San Antonio, Texas, May 2011

Agenda

- **What Does Form ADV Part 2A Require:**

  Method of Analysis ▌ Investment Strategies ▌ Risks

- **What is the Fiduciary Duty of Due Diligence?**
- **Must All Your Investment Portfolios be "Prudent?"**
- **Can You Defend Your Investment Strategy?**
  - ***Daubert* and *Frye* – Admissibility of Expert Testimony**
- **Recommended Best Practices**
- **Questions and Answers**

The ATTORNEY and the ANGEL

SEC vs. Gendreau (Feb. 17, 2011)

After bank stocks and the market take a dive in 2008

THE STRATEGY

- Borrow against homes
- Withdraw funds from qualified retirement accounts
- Invest in a few bank stocks using up to 50% margin
- Invest in leveraged ETFs

SEC vs. Gendreau (Feb. 17, 2011)

- ## The Risk Disclosure:

"[I]nvestment methods involve a Beta 2 to 4 times higher than the [S&P 500]"

"[W]hen market conditions are not favorable, clients may lose more than the [S&P 500] declines."

SEC vs. Gendreau (Feb. 17, 2011)

SEC alleged:

Gendreau "failed to provide **adequate** **disclosures of the risks** associated with the **investment strategy**"

Investment **strategy** … **unsuitable** for many of his clients"

Misrepresentation of strategy as **"guaranteed"**

RESULT: Gendreau barred from being an RIA

Form ADV Disclosures

section 8

of your Form ADV Part 2A

- **Are your investment strategy and risk disclosures "mentally unfit"?**

In Section 8, you must describe …

1. Each **<u>significant investment strategy</u>** utilized

- And its **material risks**

"significant" = "used for most clients"

"material" = whether it would matter to a client

2. Each **<u>significant method of analysis</u>** utilized

- And its **material OR "significant or unusual risks"**

"unusual" = "not readily discernable from Form ADV"

In Section 8 …

- What if **multiple strategies** are utilized by your firm?
  - Disclose in Form ADV those **investment strategies** used for **most clients** in Form ADV Part 2A
    - If **many investment strategies,** you can provide summary in Form ADV Part 2A and more detailed disclosure later
  - Disclose others in **additional disclosures** **(not in Form ADV)** as to those investment strategies used for only **some clients**

DUE DILIGENCE: SUITABILITY

Three Aspects …

- “**Adequate and Reasonable Basis**”
  - for investment strategy
  - for security
- “**Customer-Specific**”
- “**Quantitative**” (no excessive trading, churning, switching)

Due Diligence - ERISA

- **“Independent investigation” is required of merits of an investment using *prudent methods***
  - Substantive prudence
  - Procedural prudence
- **Diversification required**
  - No specific percentage requirement – instead, “facts and circumstances” test applies
  - Special rules for employer stock

Due Diligence – Advisers Act

- **"Reasonable Basis" to ensure "not basing recommendations on materially inaccurate or incomplete information"**
- No "prescribed manner" by which to manage portfolios
- **But – "duty of due care" … "requires greater articulation" … SEC rule-making in 2012 ???**

DUE DILIGENCE – State Common Law

- **RIA has duty to make reasonable efforts to achieve the desired results**
- **Apply your special skills**
  - **Must Possess Competence**
  - **Undertake Diligence – FOLLOW AN "ACCEPTED" PROCESS; USE GOOD JUDGMENT AT EACH STEP OF THE PROCESS**
- **Greater due diligence required for riskier strategies or products (hedge funds, etc.)**
- RIA is not a "guarantor" of returns

Must investment portfolio strategies and securities recommended meet the "Prudent Investor Rule"?

- *Erlich*: Investment strategy must be "prudent"
  - Advice must be based upon objective, independent analysis
  - Actions judged against "degree of care, knowledge and skill expected of professional investment advisers"
  - Obligation to diversify exists
    - *Erlich v. First Nat. Bank of Princeton*, 505 A.2d 220 (N.J.Super.L., 1984)

  - BUT: Other courts have declined to follow *Erlich*

Suggestion … (Best Practice)

- **ASSUME** your clients **expect** their portfolio to conform to the “Prudent Investment Rule”
- If your portfolio investment strategy or products do **not** conform to the Prudent Investment Rule –
  - **DISCLOSE** in Form ADV (if strategy used for most clients)
  - Client signs a **WAIVER**

Due Diligence – *Do What You Say*

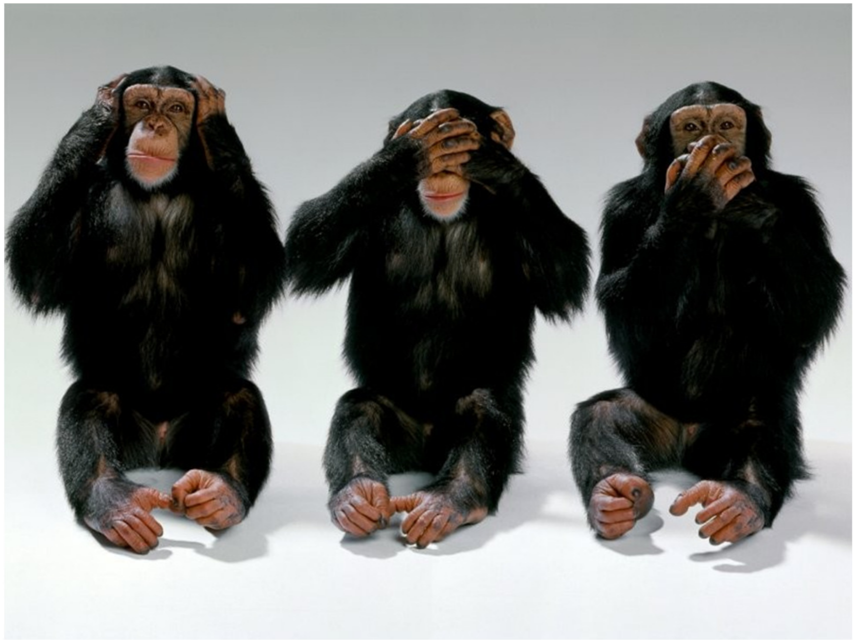
- **Morgan Stanley …**
  - Disclosed the detailed due diligence process it followed
  - To select and approve money managers (MAP)
  - Then … money managers selected by registered representative which had not been subjected to firm's due diligence process

In the Matter of Morgan Stanley & Co.,

SEC Release IA-2904 (July 20, 2009)

Don’t Ignore Your Duty of Due Diligence

Hear No Evil	**See No Evil**	**Speak No Evil**



… and you have breached your fiduciary duty of due care.

Defending Your Investment Strategy

SEC ?

State securities administrators?

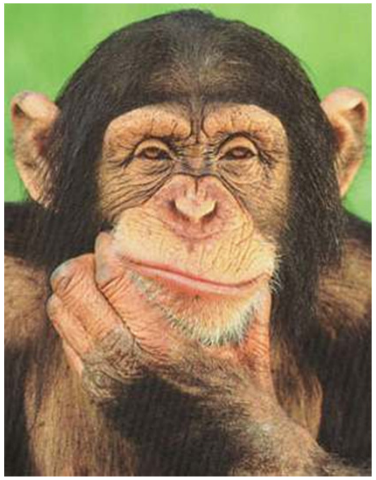
DOL (EBSA)?

Private litigant?

Breach of Fiduciary Duty of Diligence

- **Is <u>expert</u> testimony required by a Plaintiff to prove breach?**
- Once **<u>credible</u>** evidence submitted …

  Shift of "**<u>burden of persuasion</u>**" occurs to **<u>YOU</u>**



WHAT HAPPENS THEN?

THE BATTLE OF THE EXPERTS

Will **<u>Your</u>** Expert Be Allowed to Testify?

- *Daubert*
- *Frye*

Expert possesses ….

- all the facts needed

- a <u>reliable</u> SCIENTIFIC <u>method</u> to apply the analysis to the facts

Expert has *reliably* applied the method to the facts

Can you …

- **Explain your *investment strategy?***
- ***Explain why your investment strategy is "prudent"?***
- **Discuss what *benchmarks* the strategy should be evaluated against?**
- **Show *back-tested results* for your investment strategy?**
- **Point to *academic research* supporting your investment strategy?**

Which Investment Strategies Possess Academic Support?

Strong Support

Diversification

(not sufficient alone, however)

Strategic Asset Allocation

- with select asset classes

- IF clients rebalance

Momentum

Value Effect

Small Cap Effect (x-SCG)

Low Fee and Cost Strategies

- Understand ALL fees/costs

Weaker Support

Tactical Asset Allocation

- many different types

Active Manager Selection

- if qualified to do so

Morningstar Star Ratings

Individual Stock Selection

- but … net of fees charged?

Recommendations (Best Practices)

1. RESEARCH your investment strategy

- Academic support?
  - SSRN /Financial Economics Network
  - Journal of Finance, etc.
- Back-testing (objectively)
  - Sufficient period of time ?
  - Multiple data sets ?

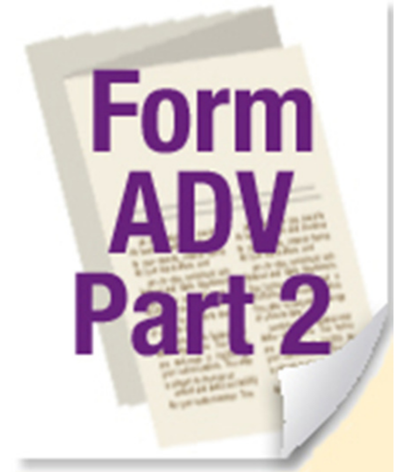
2. DOCUMENT your investment strategy

- Investment Committee minutes
- Update annually

Recommendations (Best Practices)

3. Disclose, Disclose, Disclose

- **Form ADV, Part 2A**
  - *Supplemental <u>Written</u> Disclosures for <u>Some</u> Clients*
- **Investment Policy Statement**
  - Historic returns of strategies
    - By year, and …
    - Best/worst returns by month, quarter, year, 3-year, 5-year, 10-year, 20-year rolling time periods
  - Standard deviation of returns
  - Fees and costs of particular recommended investments
  - Risks of strategy / particular products
  - Obtain client signature
- **DON'T OVER-RELY ON PROSPECTUS DISCLOSURES**
  - Not timely (unless at time of recommendation)
  - Not complete (fees and costs, tax drag, especially)



Recommendations (Best Practices)

4. If Your Investment Strategy is Not PROVEN … seek WAIVER of the Prudent Investor Rule

(don't seek waivers under ERISA, however)

5. Review Form ADV Part 2A Disclosures, Section 8, *in person* with clients

Document how much time you spent, and what you covered

Recommendations (Best Practices)

6. If Needed, Engage Expert

to Design and Document Your Investment Strategy

7. ***Product Selection*** –

- UNDERSTAND and CONTROL

"Total Fees and Costs"

- Follow a Prudent Process

Exercise GOOD JUDGMENT at each step

Recommendations (Best Practices)

8. Be careful on the use of hedge clauses

Example: only liable if "bad faith"

9. Adopt investment strategies which limit "tax drag" on investment portfolio returns

(Broad disclaimers of "no tax advice" *may* prove ineffective)

Recommendations (Best Practices)

10. <u>MANAGE</u> YOUR RISKS

CONDUCT Due Diligence

Then … <u>Say What You Do</u> …

and *<u>Do What You Say</u>*

Further Reading …

- **Materials**

THANK YOU !

… Questions and Answers