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RIA DISCLOSURES: FORM CRS/ADV PART 3, SHARE CLASS DISCLOSURES, AND MORE

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Disclosure of Conflicts of Interest

An adviser must eliminate or at least expose through **full and fair disclosure all conflicts of interest** which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.

In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the conflict of interest and make an informed decision whether to provide consent.

Disclosure of Conflicts of Interest

“Disclosure that an adviser “may” have a particular conflict, without more, is not adequate when the conflict actually exists.

For example, the use of “may” is 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.”

Disclosure of Conflicts of Interest

“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 prevent the presence of those 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.”

Duty of Loyalty: Disclosures

“An adviser’s fiduciary duty and these instructions require the adviser to disclose in Form ADV the conflict of interest that results when it receives compensation, directly or indirectly, in connection with the investments it recommends.

Where this conflict exists, an adviser must also disclose how it addresses the conflict.

An adviser’s fiduciary duty may also require it to make disclosures to clients that are in addition to those required in Form ADV.”

Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation, October 18, 2019.

SEC Expectations of Disclosures

Does an adviser have to disclose both conflicts—i.e., conflicts associated with (1) making investment decisions in light of the receipt of 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?

Both of these disclosures are necessary.

SEC Share Class Selection Disclosure Initiative - FAQs.

SEC Expectations of Disclosures

Will the Division take into account that the adviser reduced or offset its advisory fee by the amount of the 12b-1 fees?

It depends on the facts and circumstances. Two scenarios are illustrative for this issue. For both scenarios, assume a Self-Reporting Adviser had an agreement with its client to charge an annual management fee of 1% of assets under management.

continued . . .

SEC Expectations of Disclosures

Continued . . .

In the first scenario, the Self-Reporting Adviser contends that its management fee with the client would have been 1.25% absent the receipt of 12b-1 fees. The Division does not expect to recommend any offset to the disgorgement to the Commission in circumstances similar to this scenario.

continued . . .

SEC Expectations of Disclosures

Continued . . .

In the second scenario, the Self-Reporting Adviser applied a portion of the 12b-1 fees it received to reduce the annual management fee so that the client was ultimately charged a management fee less than 1%. The Division may recommend an offset to the disgorgement to the Commission in circumstances like this second scenario.

Material Conflicts of Interest

Material conflicts of interest for investment advisers can include rollover recommendations, transfers of accounts from other firms, the receipt of payments from custodians, receipt of solicitor's fees, and receipt of 12b-1 fees (if dually registered).

Form CRS/ADV Part 3

The Form CRS rule requires that **SEC-registered investment advisers** file and deliver of a 2-page disclosure document (Form ADV Part 3) to “retail investors” covering the following:

- Introduction
- Relationships and Services
- Summary of Fees, Costs, Conflicts, and Standard of Conduct
- Disciplinary History
- Additional Information

Form CRS – Filing with SEC and FINRA

The Form CRS, Relationship Summary, may be filed beginning May 1, 2020, and must be filed no later than June 30, 2020.

The Form CRS for investment advisers is filed as Form ADV, Part 3 electronically with the Investment Adviser Registration Depository (IARD).

Note regarding Form CRS for broker-dealers.

Form CRS-Delivery to Retail Investors

The Form CRS must be delivered to each “**retail investor**,” *i.e.*, a “natural person, or the legal representative of such natural person, who seeks to receive or receives services primary for personal, family or household purposes.”

- Delivery must be made before or at the time of entering into an investment advisory contract.
- Delivery to prospective retail investors: Beginning June 30.
- Delivery to existing retail investors: Within 30 days of June 30.

Form CRS – Format

The CRS must include the specified disclosures and conversation starters. It may not include anything other than the disclosures required or permitted in the instructions.

The CRS for an investment adviser may not exceed two pages in paper format.

If delivered electronically, it may not exceed the equivalent of the paper limits.

Form CRS -- Updating

The Form CRS must be updated and filed within 30 days of whenever any information in the CRS becomes “materially inaccurate.”

Changes in the updated CRS must be communicated to the retail investors within 60 days after the updates are required to be made and without charge. The changes must be highlighted.

Additional Delivery Requirements

The most recent relationship summary must be delivered to a retail investor who is an existing client or customer before or at the time of:

- opening a new account that is different from the retail investor's existing account(s);
- recommending that the retail investor roll over assets from a retirement account into a new or existing account or investment; or
- recommending a new brokerage or investment advisory service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account.

Form CRS – Posting and Manner of Delivery

The current version of the Form CRS must be posted prominently on the firm's public website in a location and format that is easily accessible to retail investors.

The CRS (and any updates) may be delivered electronically, consistent with SEC guidance regarding electronic delivery.

- If the CRS is delivered electronically, it must be presented prominently in the electronic medium.
- If the CRS is delivered in paper as a part of a package, it must be first among the documents in the package.

For CRS – Electronic and Graphical Formats

In a CRS posted on a firm's website or otherwise provided electronically, firms must provide a means of facilitating access to any referenced information that is also posted on-line, e.g., links to fee schedules, conflicts disclosures, and other regulatory disclosures.

Form CRS – Plain English; Fair Disclosure

The CRS must be written in plain English, considering retail investors' level of financial experience.

The CRS should be concise and direct, using:

- Short sentences and paragraphs;
- Definite, concrete, everyday words;
- Active voice.

. . . And avoiding:

- Legal jargon;
- Multiple negatives.

The CRS must be written as if speaking to the retail investor, using “you,” “us,” “our firm,” etc.

Form CRS/ADV Part 3A

The CRS must be given to **retail investors** and must have a series of highlighted “conversation starters,” including the following:

"Given my financial situation, should I choose an investment advisory service? Why or why not?"

"How will you choose investments to recommend to me?"

"What is your relevant experience, including your licenses, education and other qualifications? What do these qualifications mean?"

"Help me understand how these fees and costs might affect my investments. If I give you \$10,000 to invest, how much will go to fees and costs, and how much will be invested for me?"

"How might your conflicts of interest affect me, and how will you address them?"

"As a financial professional, do you have any disciplinary history? For what type of conduct?"

Form CRS: Recordkeeping

Investment advisers are required to make and preserve a record of the dates that each relationship summary was given to any client or prospective client who subsequently becomes a client.

Investment advisers will be required to maintain and preserve these records in an easily accessible place for a period of not less than 5 years from the end of the fiscal year during which the last entry was made on such record, the first 2 years in an appropriate office of the investment adviser.

Information Disclosed in Form CRS

Item 3: Fees, Costs, Conflicts and Standard of Conduct.

- Use the heading: ***“What fees will I pay?”***
- Description of Principal Fees and Costs: Summarize the principal fees and costs that retail investors will incur.
 - Broker-dealers must describe their transaction-based fees.
 - Investment advisers must describe their asset-based fees, fixed fees, wrap program fees, or other direct fee arrangement.
- Describe Other Fees and Costs that a retail investor will pay directly or indirectly.

Information Disclosed in Form CRS

Item 3: Fees, Costs, Conflicts and Standard of Conduct.

- Additional Information: ***State “You will pay fees and costs whether you make or lose money on your investments. Fees and costs will reduce any amount of money you make on your investments over time. Please make sure you understand what fees and costs you are paying.”***
- The CRS must include specific references to more detailed information about your fees and costs that, at a minimum, include the same or equivalent information.

Information Disclosed in Form CRS

Item 3: Fees, Costs, Conflicts and Standard of Conduct.

➤ Heading:

- If you are an investment adviser, include (emphasis required): ***“When we act as your investment adviser, we have to act in your best interest and not put our interest ahead of yours. At the same time, the way we make money creates some conflicts with your interests. You should understand and ask us about these conflicts because they can affect the investment advice we provide you. Here are some examples to help you understand what this means.”***

Information Disclosed in Form CRS

Item 3: Fees, Costs, Conflicts and Standard of Conduct.

- Examples of Ways Firms Make Money and Conflicts of Interest: If applicable, summarize the following other ways in which a firm and its affiliates make money from investment advisory services and investments you provide to *retail investors*. If none of these conflicts applies to you, summarize at least one other material conflict of interest that affects *retail investors*. Explain the incentives created by each of these examples. . . .

Information Disclosed in Form CRS

Item 3: Fees, Costs, Conflicts and Standard of Conduct.

- Proprietary Products.
- Third-Party Payments.
- Revenue Sharing.
- Principal Trading.

Information Disclosed in Form CRS

Item 3: Fees, Costs, Conflicts and Standard of Conduct.

- Conversation Starter: Include the following question for a *retail investor* to ask a financial professional and start a conversation about conflicts of interest: **“How might your conflicts of interest affect me, and how will you address them?”**
- Additional Information: You must include specific references to more detailed information about your conflicts of interest.

Information Disclosed in Form CRS

Item 3: Fees, Costs, Conflicts and Standard of Conduct.

- Description of How Financial Professionals Make Money: Use the heading:
“How do your financial professionals make money?”
- Summarize how the firm’s financial professionals are compensated, including cash and non-cash compensation, and the conflicts of interest those payments create.

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