



When Words Get in the Way

New SEC Trove of “Plain English” Disclosures by Money Managers Reveals Much, Leaves Much to Be Desired

Gadi Dechter October 2011



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doing what works

CAP's Doing What Works project promotes government reform to efficiently allocate scarce resources and achieve greater results for the American people. This project specifically has three key objectives:

- Eliminating or redesigning misguided spending programs and tax expenditures, focused on priority areas such as health care, energy, and education
- Boosting government productivity by streamlining management and strengthening operations in the areas of human resources, information technology, and procurement
- Building a foundation for smarter decision-making by enhancing transparency and performance measurement and evaluation

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Introduction and summary

People paid to manage others' money have a legal duty to put client interests above their own. And yet your trusted adviser at AXA Equitable Life Insurance Company won't get health benefits unless he convinces you to buy the insurance giant's wares over third-party products. Bank of America Corp.'s "wealth managers" at its Merrill Lynch subsidiary have a policy of firing clients who refuse to engage in a type of transaction identified by Congress as potentially abusive. And traders at Goldman Sachs Group Inc.'s proprietary trading desks sometimes bet against the very people whose money they manage.

These are among the many revealing disclosures released publicly with little fanfare earlier this year by the Securities and Exchange Commission, the Washington regulator that keeps tabs on more than 11,000 investment advisers. Now, under new rules more than a decade in the making, all money managers registered with the SEC must publicly release annual disclosures of their fees, conflicts of interest, and disciplinary history—and do so in "plain English."¹

For the first time since the SEC began registering money managers in 1940, these brochures are now available to the general public and in one searchable database. They represent "one of the most important investor protection initiatives in decades," according to SEC Commissioner Elisse B. Walter. Indeed, they are a major step forward by the federal government in helping investors make informed choices about perhaps the single-most important financial decision they make: Whom to entrust with their money.²

Unfortunately, the new "Form ADV Part 2" disclosures (the bureaucratic name for these documents) are also an object lesson in missed opportunity. They're still too hard to understand, cumbersome to navigate, and will likely continue to be ignored by the very people they're intended to help—unless the SEC releases the data in a more user-friendly way, or encourages the private sector to do it.

“They’re a vast improvement over what we had before, which sets a pretty low bar,” says Barbara Roper, director of investor protection with the Consumer Federation of America. “There’s better disclosure about conflicts of interests. There’s a clearer description of the services they’re offering.”³

William Lutz, a retired English professor who led a yearlong SEC disclosure initiative during the Bush administration, is less charitable. “The random sample that I looked at were pretty terrible,” he says.⁴

For the SEC to make good on its regulatory goal of ensuring that investors get “clearly written, meaningful, current disclosure of the business practices, conflicts of interests and background of the investment adviser,”⁵ the agency should take the following three steps:

- The commission should bulk-release all adviser registration information on data.gov, in a format that most readily allows the data to be sliced and diced in meaningful ways by private companies and consumer advocates.
- The SEC should use its newfound authority under the Dodd-Frank financial reform law to conduct “investor testing” to determine whether the new disclosures are comprehensible, useful—and improve them accordingly.
- The SEC should vigorously enforce its “plain English” requirement, penalizing money managers that fail to explain their business practices and conflicts of interests in a way that the average investor can understand.

In general, the commission and other government agencies should move toward an outcome-focused way of measuring whether regulated industries are fairly, effectively, and efficiently disclosing information.

What do we mean by that? Today, laws that require companies to share information with investors or consumers tend to measure compliance by whether mandatory disclosures are made. But any casual reader of a Federal Register notice or credit card agreement knows that ineffective disclosures can undermine the civic and protective aims of a responsible government. Too much information is overwhelming. Poorly presented information creates confusion. Gratuitous complexity sows distrust.

We need a better standard for determining whether the government and the industries it regulates are fulfilling their obligations to communicate openly and honestly with the public. That's why in addition to measuring whether companies are complying with disclosure requirements by outputs—whether a required disclosure form was filled out—the SEC should measure transparency by outcomes—whether the information was comprehensible to its intended audience. This paper details how this can and must happen.

Progress

From check-the-box to “plain English”

Until this year, financial advisers who managed more than \$25 million in client assets had to file a series of forms every year with the SEC, one of which was also given to prospective and current clients. That disclosure was a generic check-the-box sheet that often failed to meaningfully convey what powers advisers had, how they were paid, potential conflicts of interests, and disciplinary record, according to SEC Chairman Mary Schapiro.⁶

Under new rules first proposed in 2000 and finalized last year, advisers must now also give clients detailed “narrative” disclosures in plain English, including far more information about the conflicts of interest that bedevil the money manager business—for example, when advisers are also stockbrokers who peddle trades for commission, or when they get clients to buy securities off the firm’s own books. (See box)

So do the new disclosures give investors meaningful disclosure that investors can actually understand, as SEC officials intended? Well, they certainly give investors more information, judging by a cursory examination of several dozen new disclosures. And more disclosure is generally good.

To wit, some of the revelations contained in these thousands of filings should give pause to anyone hunting for a trusted adviser, such as the AXA Advisory acknowledgment that its financial planners “may qualify for certain [employee] benefits, such as health and retirement benefits, based solely on sales of ... proprietary products” issued by AXA “rather than products issued by third parties.”⁷

Or consider Goldman Sachs Asset Management, caretaker of \$523 billion in client assets, which tells wealthy clients about midway through its 74-page disclosure that their advisers may buy for customers a stock that the market-moving firm is simultaneously betting against. Such a so-called short position may “impair” the client’s holdings, Goldman admits in its disclosure.⁸

Another of the potential conflicts of interests the SEC requires advisers to highlight in their brochures is whether they engage in “principal transactions.” A

principal transaction is when the adviser causes the client to buy an investment product from the advisory firm's own account. These transactions are more heavily regulated because of congressional worries that trusted advisers would use client accounts as a dumping ground for undesirable or hard-to-sell firm holdings.

Careful readers of the Bank of America's Merrill Lynch Personal Advisor Program disclosure will learn it doesn't care for clients who are uncomfortable with these trades. "If you ... revoke your consent to principal transactions," Merrill says in its new disclosure, "we will terminate your participation in [Merrill Lynch Personal Advisor Program]."⁹ A cautious investor might be wise to ask why. (The company did not reply to a request for more information about this practice.)

Single, searchable website is major step forward

Another major development under the new disclosure rules is the SEC's laudable decision to make them all available to anyone for free through one website. Until now, advisers only had to offer the disclosures to prospective and existing clients, although other registration information has been available online since 2001. The new and improved policy should make it easier for people to go online and compare, evaluate, and rate the firms they entrust with their savings, retirement, and future family security.

That's good. Today, less than 10 percent of people searching for a financial services firm use the Internet to make their decision, according to a 2010 RAND survey, even though nearly 90 percent of Americans making over \$75,000 a year conduct consumer research on the web.¹⁰

Despite these advances, there remain two major obstacles standing in the way of the SEC's goal in the redesign, which was to ensure investors had "clear and concise" information presented in a way that makes it easy to "compare and contrast" advisers. We'll explore those obstacles in the next section.

Old Form ADV Part 2 “brochure”



FORM ADV
Part II - Page 6

Applicant:

SEC File Number:
801-

Date:

12. Investment or Brokerage Discretion.

A. Does applicant or any related person have authority to determine, without obtaining specific client consent, the:

- | | |
|--|---|
| (1) securities to be bought or sold? | Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> |
| (2) amount of securities to be bought or sold? | Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> |
| (3) broker or dealer to be used? | Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> |
| (4) commission rates paid? | Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> |

B. Does applicant or a related person suggest brokers to clients? Yes ☒ No ☐

For each yes answer to A describe on Schedule F any limitations on the authority. For each yes to A(3), A(4) or B, describe on Schedule F the factors considered in selecting brokers and determining the reasonableness of their commissions. If the value of products, research and services given to the applicant or a related person is a factor, describe:

- the products, research and services
- whether clients may pay commissions higher than those obtainable from other brokers in return for those products and services
- whether research is used to service all of applicant's accounts or just those accounts paying for it; and
- any procedures the applicant used during the last fiscal year to direct client transactions to a particular broker in return for product and research services received.

13. Additional Compensation.

Does the applicant or a related person have any arrangements, oral or in writing, where it:

- | | |
|---|---|
| A. is paid cash by or receives some economic benefit (including commissions, equipment or non-research services) from a non-client in connection with giving advice to clients? | Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> |
| B. directly or indirectly compensates any person for client referrals? | Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> |
- (For each yes, describe the arrangements on Schedule F.)

14. Balance Sheet. Applicant must provide a balance sheet for the most recent fiscal year on Schedule G if applicant:

- has custody of client funds or securities (unless applicant is registered or registering only with the Securities and Exchange Commission); or
 - requires prepayment of more than \$500 in fees per client and 6 or more months in advance
- Has applicant provided a Schedule G balance sheet?..... Yes ☐ No ☒

Answer all items. Complete amended pages in full, circle amended items and file with execution page (page 1)

The old “brochure” was meant to help investors, but it doesn’t even address itself to them. It looks more like a government form filled out by an “applicant” for a license or permit of some kind.

The check-the-box format doesn’t give context or explain what a “yes” or “no” means.

Relevant details are relegated to “schedules” that are appended to the form.

Conflict-of-interest information is presented in a generic way that doesn’t convey why an investor should care or what the risks are—or even use the phrase “conflict of interest.”

New “plain English” brochure

Material Relationships Maintained by this Advisory Business and Conflicts of Interest

Managing Member Todd Bauman's principal business is as an insurance agent and an estate planner. Greater than 50% of Mr. Bauman's time is spent in these business practices. From time to time, he will offer clients advice or products from those activities.

These practices represent potential conflicts of interest because it gives Mr. Bauman an incentive to recommend products based on the compensation amount received. This conflict is mitigated by the fact that clients are not required to purchase any products or services. Clients have the option to purchase these products or services through another insurance agent or estate planner of their choosing.

Recommendations or Selections of Other Investment Advisors and Conflicts of Interest

BAG may at times utilize the services of Third Party Money Managers to manage client accounts. In such circumstances, BAG will share in the Third Party asset management fee. This situation creates a conflict of interest. However, when referring clients to a third party money manager, the client's best interest will be the main determining factor of BAG. These fees do not include brokerage fees that may be assessed by the custodial broker dealer. Fees for these services will be based on a percentage of assets under management not to exceed any limit imposed by any regulatory agency. The final fee schedule will be attached to Exhibit D in BAG's Investment Advisory Agreement.

This relationship will be disclosed to the client in each contract between BAG and Third Party Money Manager. BAG does not charge additional management fees for Third Party managed account services. Client's signature is required to confirm consent for services within Third Party Investment Agreement. Client will initial BAG's Investment Advisory Agreement to acknowledge receipt of Third Party fee Schedule and required documents including ADV2 disclosures.

Item 11: Code of Ethics, Participation or Interest in Client Transactions and Personal Trading

Code of Ethics Description

The employees of BAG have committed to a Code of Ethics that is available for review by clients and prospective clients upon request. The firm will provide a copy of the Code of Ethics to any client or prospective client upon request.

Investment Recommendations Involving a Material Financial Interest and Conflict of Interest

BAG and its employees do not recommend to clients securities in which we have a material financial interest.

- 7 -

Bauman Advisory Group, LLC

The new “brochure” is written as a narrative, following a loose format set by the SEC to make sure certain topics are covered.

Conflicts of interests are clearly labeled and detailed.

The degree to which each new disclosure conforms to the “plain English” varies with advisers, but they are told to be “concise and direct,” using “definite, concrete, everyday words.”

The new format allows and encourages advisers to be explicit about how they avoid conflicts of interests.

Source: SEC.gov

Problems

Not-so-plain English and not so easy to use

The first problem is that these “plain English” disclosures are often written in turgid and convoluted prose that is anything but plain. This obscures the very information they’re meant to reveal. In some cases, these documents seem to violate in a single paragraph every rule of plain writing laid down in the SEC’s own “Plain English Handbook.”¹¹ Consider this 104-word sentence from Goldman Sachs:

Emerging Markets and Growth Markets Risk—In addition to the risks described in “—Non-U.S. Securities Risk” below, investing in the securities of governments in emerging markets involves certain considerations not usually associated with investing in securities of developed market companies or countries including, without limitation, political and economic considerations, the potential difficulty of repatriating funds, general social, political and economic instability and adverse diplomatic developments, the small size of the securities markets in such countries and the low volume of trading, resulting in potential lack of liquidity and in price volatility, and certain government policies that may restrict an Advisory Account’s investment opportunities.

(Translation into actual plain English: Lending money to poorer countries, even if they’re growing fast, is riskier than buying U.S. Treasury bonds. These countries are more likely to have politically unstable governments and volatile economies. That means you might not get paid back on time or ever, and you might not be able to sell the bonds when you want to.)

The second big problem is that the disclosures and the data they contain are not presented in a way that enables investors to easily compare, search, or rate different financial advisers. An investor in upstate New York, for example, who is looking to place \$500,000 in the care of a talented money manager should be able to use the wealth of information gathered by the SEC to find and then compare all registered advisers that meet the following criteria:

- Located within driving distance of his address
- Have been in business at least 10 years
- Have between \$100 million and \$500 million in assets under management (big

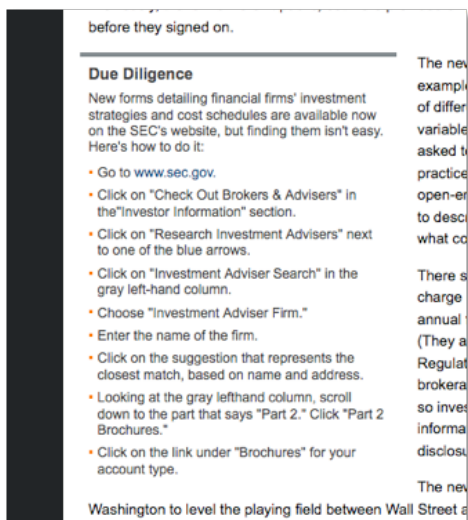
enough to be reputable, but not so big that his \$500,000 is insignificant to them)

- Charge between 0.5 percent and 1.5 percent of assets under management (to fall within the low end of national adviser fees)
- Receive no commissions on sales or trades (to avoid conflicts of interest or “churning” of client funds for transaction fees)
- Accept no performance-based compensation (to avoid incentives for excessive risk-taking by the adviser)
- Have no record of disciplinary action against the firm or its employees within the last 10 years

Alas, the primitive functionality of the government website only allows users to search advisers by name—not location, size, fee schedules, or any other useful search variable. “The term primitive is too generous,” says Lutz. “Neanderthal leaps to mind.”

The SEC is aware of these limitations. Agency staff in January recommended that the commissioners enhance the search features of the website and add “educational content to make the data ... more useful to investors.”¹² The report also recommended merging the adviser disclosures database with a separately maintained one called BrokerCheck that contains the disciplinary history of stockbrokers (who are often also registered advisers).

These are welcome suggestions. The commissioners should act on them, but it’s unlikely that a bureaucracy that produced such an unwieldy product will suddenly transform into an expert creator of user-friendly web services. Case in point: The new disclosures are so hard to find on the SEC’s website that The Wall Street Journal had to recently publish a guide for its readers on the nine-step process:¹³



Happily, we don't have to wait for the SEC to become a paragon of user-centered design before this valuable information can be put to effective use. Just as Yahoo! Finance and other websites mine the commission's EDGAR corporate filings database to give users a usable presentation of company financials, so should private companies be able to let retail investors slice and dice the unwieldy Investment Adviser Public Disclosure database.

One firm, San Diego-based BrightScope, has already begun to manually gather and republish SEC adviser data in a free, searchable website that already has far more robust search functionality than the government site. BrightScope co-founder and CEO Mike Alfred says his company has no plans to charge investors, who will eventually be able to conduct searches like the one described above. But he acknowledges it won't happen overnight. "Everybody writes a narrative differently, so you need to have MBA-level people figuring out what's behind the data," says Alfred, whose team of 40 employees has been working on the project for a year. "This is the area that's absolutely going to be the biggest challenge."¹⁴

Brightscope's first-iteration "Advisor Pages" are promising, and the company's pledge to keep its data free to consumers is important. But the SEC should make it easier for other companies and investor advocates to also distribute such data, and encourage healthy competition in this space.

In the next section we recommend three steps the SEC can take to enhance the impact of its new adviser disclosure rules.

A tour of “plain English” disclosures by asset managers

The good...

Here’s an example of a clearly written disclosure of a potential conflict of interest by Sunlake Investment Management of Ithaca, New York:

*Sunlake may refer clients to unaffiliated professionals for specific needs, such as accounting and estate planning. These professionals may refer clients to Sunlake for investment management. We do not have any agreements with individuals or companies that we refer clients to, and we do not receive any compensation for these referrals. However, it could be concluded that Sunlake is receiving an indirect economic benefit from the arrangement, as the relationships are mutually beneficial. For example, there could be an incentive for us to recommend services of firms who refer clients to Sunlake.*¹⁵

The bad...

And here’s Credit Suisse Asset Management’s attempt at explaining a related business practice in their “plain English” brochure:

*Written agreements may be entered into between the Registrant and solicitors pursuant to Rule 206(4)-3 under the Advisers Act. Pursuant to such agreements, the Registrant provides the solicitor with this Part 2 of its Form ADV, or the relevant Schedule H, Managed Accounts Brochure, as applicable (“Disclosure Documents”). The solicitor must provide to clients, at the time of solicitation, (i) the Registrant’s Disclosure Documents and (ii) a written disclosure statement on the solicitor’s letterhead which shall: (a) advise the client of the nature of the relationship between the solicitor and the Registrant; (b) include a statement that the solicitor will be compensated for its solicitation services by the Registrant; (c) indicate the terms of such compensation arrangement, including a description of the compensation paid or to be paid to the solicitor by the Registrant as a result of the solicitation agreement; and (d) indicate whether client will be charged amounts in addition to the investment advisory fee in connection with the solicitation agreement between solicitor and the Registrant.*¹⁶

...and the bizarre

Finally, here’s a paragraph from Annapolis, Maryland-based Adrian Day Asset Management’s disclosure that ends up disclosing Mr. Day’s worldview of, among other things, the SEC, the Internal Revenue Service, and the Transportation Security Administration, in addition to his business practices:

*“We do not accept as clients employees of the IRS, SEC or TSA, nor other known criminals (whose crimes involve serious violations of other individuals’ rights), nor illiberal dictators or their agents unless and until a public apology for their crimes is forthcoming.”*¹⁷

In an e-mail, Day clarified: “Yes, I do indeed mean that people who spend their ‘working day’ fondling people, and others who steal 40 percent of productive workers’ income are criminals. A liberal dictator might be more acceptable than an illiberal democracy. If you have to ask, you obviously don’t get it.”¹⁸

Recommendations:

Release, test, and enforce

As the Brightscope example shows, government officials do not need to design perfect information systems to improve the usefulness of disclosure regimes. In many cases, complementing government websites by also releasing information in machine-readable formats will allow the private sector to transform data into usable tools, websites, and services.

If the information is useful, and the data are easy to manipulate, then enterprising companies and public-interest advocates have an incentive to figure out how to best present it—at no additional cost to the taxpayer. As a first step, then, the SEC should release all adviser registration information on data.gov in a format that most readily allows the data to be manipulated. The data should be available for bulk download, as well.

It should then require FINRA, the independent regulator of stockbrokers, to likewise release all BrokerCheck data. FINRA’s “[terms and conditions](#)” requires BrokerCheck users to agree they “will not use the information retrieved from FINRA BrokerCheck to develop or create a database of information to be sold, licensed or made otherwise commercially available.” That’s an outrage. This is information collected for public benefit, and the public should be able to access it in whatever manner it sees fit.

Meanwhile, the SEC should take advantage of its clarified authority in the Dodd-Frank financial reform bill to “engage in investor testing,” something that might have helped them design more user-friendly disclosure brochures in the first place.¹⁹ “If you took most SEC disclosures out into the field and tested them you would find that most people don’t have a clue, and that the commission is not providing information in a form that investors are either willing to look at or capable of understanding,” says Roper of the Consumer Federation of America. “So obviously, the SEC should test these forms.”²⁰

A good model for the SEC in this regard is the new Consumer Financial Protection Bureau, which is subjecting revamped mortgage disclosures to consumer testing before beginning the formal rule-making process. “We think the

CFPB is on the right track in terms of building in that consumer testing on the front end to make sure they convey the desired information,” Roper says.

To be sure, the SEC is under great strains to implement hundreds of new rules and provisions under its purview in the Dodd-Frank Act. Once it gets a breather, the commission should also get serious about enforcing the “plain English” requirement in the new disclosures.

Just as it did when requiring mutual fund prospectuses be written in plain English, the SEC should offer model examples of what a well-written disclosure looks like, and it should penalize advisory firms that so brazenly flout the clarity and conciseness rules.²¹

“The name of the game, as we all know with regulation, is enforcement,” says Lutz, the English professor-turned SEC consultant. “If people never got pulled over for running red lights, how many people would stop for them? Go to Paris and you’ll find out.”

Conclusion

The SEC’s “plain English” revamp of investment adviser disclosures, and its wise decision to release them online, present an opportunity for the commission to lead a shift in government disclosure policy. By requiring money managers to explain their business in plain language brochures, the SEC is acknowledging—as it has in the past—that mere disclosure is insufficient to protect investors. For markets to function well, all participants must have access to useful and understandable information.

The only way to know for certain whether a document is comprehensible is to test it on its intended audience. The Consumer Financial Protection Bureau is conducting user testing to guide its revamp of mortgage disclosures. The SEC should likewise conduct investor testing to study how well the new investment adviser disclosures are working.

If it does, the commission will likely find that many of these new “plain English” brochures are still too confusing and dense to be useful—and that investors would more likely pay attention if the data were presented in online comparison and search tools that had more robust functionality and intuitive interface.

That’s why the SEC should vigorously enforce its new plain English standard, and also release all its adviser registration data, so that enterprising companies and advocates can explore ways to make this information relevant to investors when they need it, and in a form that’s easy to use.

About the author

Gadi Dechter is Associate Director of Government Reform at American Progress, where he focuses on information policy. He previously worked as a reporter at Bloomberg News, The Baltimore Sun, and Baltimore's City Paper. At Bloomberg, Gadi was an investigative reporter covering the intersection of finance and politics. At The Sun, he covered the Maryland General Assembly and higher education. He received the American Association of University Professors's 2009 Iris Molotsky Award for Excellence in the Coverage of Higher Education and was a finalist in the 2008 Livingston Award for Young Journalists competition. He holds a bachelor's degree in literature from Yale and a master's in writing from Johns Hopkins. He teaches public policy communications at George Washington University's School of Media and Public Affairs, and has also lectured at Georgetown University, Johns Hopkins University, and the Maryland Institute College of Art.

Acknowledgments

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