

SEC Issues Guidance on Form ADV Disclosures for CARES Act Paycheck Protection Program Loans

On April 27, 2020, the Securities and Exchange Commission issued guidance regarding investment advisory firms' duty to disclose loans obtained under the Paycheck Protection Program (PPP) created under Section 1102 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. The SEC has concluded that an advisory firm must disclose to clients that it has taken a PPP loan to counter the impact of the COVID-19 pandemic in response to Item 18 (Financial Information) of Part 2A of Form ADV (brochure), or as part of Part 2A, Appendix 1 of Form ADV (wrap fee program brochure).

<https://www.sec.gov/investment/covid-19-response-faq> ("SEC FAQ")

The SEC's position regarding disclosure of PPP loans might seem to be inconsistent with FINRA's determination that forgiveness of an approved PPP loan does not trigger a disclosure obligation in response to Form U4 Question 14K as a "compromise with creditors."^[1] However, the results are not inconsistent because, in essence, FINRA imposes an after-the-fact "actual debt default" standard on FINRA associated persons while the SEC imposes a higher fiduciary duty standard on advisory firms to disclose the "likelihood" of current or future financial difficulty. Specifically, Form U4 Question 14K only comes into play when an associated person is unable to satisfy a debt obligation in full and he or she enters a compromise with the creditor. The reasoning is an associated person having financial difficulty could put investor assets at risk. The Investment Advisers Act of 1940 imposes a fiduciary duty to disclose material facts regarding current events that "are likely" to impact the firm's current or future ability to "provide advisory services" or to fulfill the firm's "contractual obligations" to clients.

The SEC Staff's position is an advisory firm should make broad disclosures, including all material facts impacting the advisory relationship, including the reason for and the "nature, amounts and effects" of the of the PPP loan/financial assistance. See SEC FAQ: Question II.4. For example, if it is likely that an advisory firm cannot pay the individuals who provide advisory services without a PPP loan, that risk is a material fact and must be disclosed. Similarly, if the advisory firm determines that it is reasonably likely the firm will be unable to meet its contractual obligations to clients, such as repayment of advisory fees charged in advance, without a PPP loan, that is a material event and risk the advisory firm must disclose. The SEC guidance sheds much-needed light on the distinction between FINRA's determination that the disclosure of a PPP loan is required on Form U4 only after default and the SEC's determination that immediate disclosure in the advisory firm's Form ADV brochure is required for events which necessitate a PPP loan or other financial assistance.

Finally, and equally important, even if an advisory firm elects to forgo or is unable to obtain a PPP loan or other financial assistance, the firm must disclose to clients if the COVID-19 crisis is likely to have a material impact upon the firm's ability to provide advisory services to clients or to fulfill the firm's contractual obligations to them.

This Alert does not constitute legal advice. Required disclosures may vary. Advisors should consult with regulatory counsel to determine their specific disclosure obligations.

For more information contact Ed Barkel at ebarkel@lrrc.com or visit www.lrrc.com.

[1] <https://www.lrrc.com/FINRA-Issues-Guidance-on-PPP-Loan-Forgiveness>

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