MorrisonCohen LLP
Law Firm to the Middle Market®

Client Alert

SEC Takes Strict Stance on Conflict of Interest Disclosure

December 20, 2016 – Expanding its developing trend towards applying strict statutory construction when helpful to find sanctionable activities against investment advisers, a divided SEC imposed substantial penalties recently against the heads of a small advisory firm for failing adequately to disclose that an economic arrangement with its custodian raised conflicts of interest.

Using somewhat circular reasoning, in *Matter of The Robare Group, Ltd.*, the SEC in a 2-1 decision overturning the decision of an administrative law judge absolving the advisor of liability, ruled that the existence of a fee arrangement with its custodian for holding certain account securities was an actual conflict of interest requiring explicit disclosure under Rule 206(2), even though the majority acknowledged that in the specific instance, no investment advice was actually affected since the advisers did not know which securities engendered the fees. The Commission ruled that the advisor's disclosure that it *might* earn fees was inadequate and *ipso facto* negligent since in fact it *did* earn fees, essentially rejecting the defense of the lack of an actual conflict or of any harm to any clients.

In imposing penalties totaling $150,000 on the key managers of an adviser managing approximately $150 million in assets, the SEC majority also rejected TRG's defense that it could not have been negligent because it relied on outside compliance consultants to review and approve its disclosure, the opinion noting the absence of particular evidence that the advisor specifically discussed the custodial fee arrangement. The ruling also rejected mitigating factors such as the lack of unjust enrichment and a lack of previous disciplinary behavior.

Given the rigor of the Commission's interpretation, investment advisers should assume that only clear and conspicuous disclosure to its clients specifying every arrangement with a third party under which an adviser could receive compensation, stating unambiguously that each such arrangement is an actual conflict of interest, and stating with specificity how that conflict will be managed, will be viewed by the Commission as adequate. It remains unclear whether the Commission would consider it adequate management of the conflict for the adviser to remain unaware of the details of the payment arrangement as a method of preventing influence on the rendering of investment advice.

Background

TRG entered into an arrangement with its custodian, Fidelity Investments ("Fidelity") in 2004 in which TRG was compensated on a sliding scale for maintaining its clients' assets in certain Fidelity-managed mutual funds. Although TRG provided certain clients with their custodial agreement, TRG did not disclose the existence of the arrangement on its Form ADV until 2005 and the disclosure merely referenced the possibility of receiving compensation from Fidelity rather than acknowledging that it was actually receiving such compensation. The principals of TRG testified that the existence of the arrangement had no bearing on their decisions regarding how to invest client assets as they were not aware of which Fidelity products were fee paying as opposed to non-fee paying. They further claimed that they had relied upon the advice given to them by their compliance consultants who had advised on TRG's disclosure.

In overturning the administrative law judge's decision on appeal, the SEC agreed that although TRG's client assets were not disproportionately invested in fee paying financial products, there was no pecuniary harm to TRG's clients nor did TRG benefit as a result of their failure to appropriately disclose the arrangement, TRG had acted negligently in failing to disclose that there was an actual rather than a potential conflict of interest and that TRG was incentivized to invest their clients' money in the fee paying Fidelity funds. Furthermore, the SEC stated that they were not aware of a prior case where a defense of reliance on a compliance consultant had been recognized nor had the principals of TRG proven that they had discussed this specific disclosure with their compliance consultants.

Conclusion

In considering the effects of *Robare,* the current and possible future composition of the Commission cannot be ignored. *Robare* was decided 2-1 (two seats have remained vacant), with Commissioner White, who is leaving the Commission shortly, voting in the majority. The long term viability of *Robare,* namely, that any potential conflict of interest must be treated as an actual conflict for purposes of disclosure and exposure to sanctions, even if it has no effect on an adviser's clients, is unknown. *Robare* nonetheless serves as yet a further warning to investment advisers who outsource their compliance functions, that reliance on compliance experts does not negate the adviser's own compliance responsibilities as a registered investment adviser and any consultation with such consultants should be well documented in the adviser's books and records.

For further information regarding this and/or any other compliance issue, please contact:

Jessica Colombo	David Lerner
(212) 735-8752	(212) 735-8609
jcolombo@morrisoncohen.com	dlerner@morrisoncohen.com