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The Securities and Exchange Commission's Latest Message Case on Investment Adviser Conflict Disclosure

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For any investment adviser who has not lived in a cave the last few years, the SEC's focus on conflicts of interest in the investment management industry comes as no surprise. More than a half century ago, the Supreme Court stated that the Investment Advisers Act reflects a congressional intent "to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."[1] While the Department of Labor is in the process of implementing a fiduciary rule largely prohibiting conflicts involving retirement assets, the SEC has been focused on investment advisers' identification and fulsome disclosure of conflicts. Indeed, the former co-chief of the Division of Enforcement's Asset Management Unit titled her 2015 address to the Annual Investment Advisers Compliance Conference: "Conflicts, Conflicts Everywhere." Her theme—which applies to investment advisers of all types—was that the Commission is "intensely focused on conflicts of interest" and that firms that fail to identify and disclose them are at risk of enforcement actions.

Last week, in a little-noticed case involving a small, regional investment adviser, the SEC made clear that even in cases involving marginal conflicts, no harm to investors, and no improper intent, knowledge or recklessness on the part of the adviser, the Commission will bring enforcement actions and insist on civil money penalties. *In the Matter of The Robare Group, Ltd., et al.*, Investment Advisers Act Release No. 4566 (Nov. 7, 2016). Indeed, the Commission reversed a rare administrative law judge dismissal and voted, over Commissioner Piwowar's dissent, to impose civil money penalties against the firm and two individuals despite the fact that they had acted in good faith, and that the alleged violations involved neither harm to investors nor a benefit to the respondents. We discuss the case and its implications below.

Background

The Robare Group ("Robare") is a small, regional investment adviser with approximately 300 clients. It has an enviable 97% 10-year retention rate for clients and, until recently, no disciplinary history.   To keep investor costs at a minimum, it primarily recommends investments in mutual funds that have no transaction fees. Its custodian is well-respected and serves as custodian for approximately 2,700 investment advisers.

The custodian pays Robare between two and twelve basis points for certain eligible mutual funds over which it has custody. The investment professionals did not know which funds triggered payments and which did not, and there was no evidence that even a single investment decision had been influenced by the possibility of such payments. The firm relied on two outside consultants and a supervising broker-dealer to draft and/or review its Form ADV disclosures,[2] including its disclosure of the arrangement, and believed that its disclosures were adequate. Over time, it modified the disclosures and improved them.

The Commission took issue with the disclosures and in September 2014 brought an administrative enforcement action against the firm, its chief executive officer, and another principal. Administrative Law Judge Grimes, in a 44-page opinion, found that there was no basis for the charges against either the firm or the individuals and dismissed the case. He agreed with the staff that the disclosures should have been better, but he concluded that the firm had neither acted with scienter nor negligently and instead had made a good faith effort to disclose the arrangement as best it could. He found that it had relied largely on outside consultants with far greater expertise in this area, and that the quality of the disclosures improved. He also stated that even had he found violations, no civil money penalty would have been justified because "Respondents did not act with scienter and their conduct was not egregious. Indeed, they relied on compliance professionals in attempting to craft appropriate disclosures. Finally, the Division presented no evidence of any losses to Respondents' clients."

The Commission's Decision

On November 7, 2016, the Commission reversed and, over the dissent of Commissioner Piwowar, imposed a total of $150,000 in civil money penalties against the firm and the two individuals. The Commission credited the testimony that the individual respondents did not know which particular funds triggered fees under the arrangement and stated that the record did not indicate that clients were disproportionately invested in funds that triggered the fees. It also acknowledged that outside compliance consultants advised the firm about its disclosures throughout the relevant period, that the broker-dealer's chief compliance officer testified that the broker-dealer "reviewed and approved" Robare's ADV and even audited Robare, and that respondents believed that the fees that they received were 12b-1 fees and commissions and therefore had been adequately disclosed by the reference in the ADV to conflicts involving "sales commissions" and "selling compensation." It also agreed with Judge Grimes that respondents had not acted with scienter, i.e., knowing or reckless deception. And it found that the Division of Enforcement had not put forward any evidence that would support an award of disgorgement because there was no evidence that had the firm more fully or accurately disclosed the conflict of interest, it would have had any effect on the fees it received; there was no evidence that better disclosure would have led the clients to withdraw their money or insist upon investments that did not pay the fees.

Unlike Judge Grimes, however, the Commission stated that the conduct "demonstrated a clear failure to reasonably fulfill the disclosure obligations of investment advisers." It rejected the defense of reliance on compliance consultants because it thought the disclosures were unreasonable regardless of whether the compliance professionals thought they were adequate. It also said that even if a reliance-on-consultants defense were available in some cases, Robare could not establish it because witnesses could not recall exactly what information had been shared with the compliance consultants at the time they drafted or reviewed the ADV disclosures. In finding the disclosures inadequate, the Commission, among other things, highlighted the difference between saying an investment adviser "may" be receiving certain fees, and saying that it "is" receiving those fees.

Commissioner Piwowar dissented from the decision to impose a civil money penalty because, he said, five of the six factors relevant to determining whether a penalty should be assessed weighed against imposing any penalty. He stated: “there was no harm to others, none of the Respondents was unjustly enriched, none of the Respondents has committed previous violations, there are no other matters as justice may require that would lead one to conclude that civil penalties are appropriate in this matter, and there has been no showing that we need to deter such persons, based on the findings of the administrative law judge and the record before us.”

Observations

There are five key takeaways from the decision:

First, ADV disclosures are important to the Commission. Firms need to be extremely careful in drafting their ADV disclosures.

Second, this is especially true for anything that even remotely sounds like an actual or potential conflict of interest. Conflict of interest has been the watchword in the investment adviser area for quite some time. This case illustrates that the Commission is focused on even the most minor conflicts and even those that involve small firms acting in complete good faith without any harm to investors.

Third, be sensitive to the use of the word “may” when describing conflicts and other types of arrangements. “May” is not the same as “is,” and advisers who use the word “may” to describe arrangements that currently exist run the risk that the Commission will consider such disclosure misleading.

Fourth, do not assume that reliance on consultants or other experts to draft the relevant disclosures will protect the firm from an enforcement action based on those disclosures.

Finally, expect the Commission to glide easily from a finding that a disclosure was not adequate to a finding that it was negligent and thus actionable under the Investment Advisers Act. In many cases, the Commission will equate inadequacy with negligence.

All that said, one may fairly ask whether this case was overkill by the Commission. Even if, contrary to the conclusion reached by Judge Grimes, one agrees with the Commission that there was a violation, it’s fair to ask why it made any sense to use limited enforcement resources to bring a case against a small, reputable firm that sought in good faith to accurately disclose what was at worst a marginal conflict that had no effect on any investment decisions. One could also legitimately ask why the Commission chose to issue a press release, at the time it brought the case, that in the very first sentence accused the firm of “fraud,” a term that had the potential to do great harm to Robare’s business by unfairly conveying to Robare’s customers something far worse than anything the Commission or Judge Grimes later found. And, while recognizing that the Commission is focused on naming culpable individuals in enforcement actions, one may fairly question whether it made sense to sully the reputations of the two individuals here when they acted in complete good faith, did not benefit in any way from the disclosures, and caused no harm to investors. The Commission would undoubtedly say that it needs to use these types of cases to send a message. The more compelling response, however, is that the Commission has much better cases for conveying the same message, and that a sound exercise of enforcement discretion suggests that cases involving marginal conflicts, people acting in complete good faith, and no harm to investors are best resolved outside the enforcement process.

[1] *SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 191-92 (1963).

[2] Form ADV is the uniform form used by investment advisers to register with the SEC and state securities authorities. Part II of the form, which includes a discussion of conflicts of interest and other matters, is the primary disclosure document that investment advisers provide to their clients.

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