

Client Update

The SEC's *Robare* Decision: Potential Financial Conflicts of Interest are *Per Se* Material and Must Be Disclosed

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OVERVIEW

On November 7, 2016, the U.S. Securities and Exchange Commission (the “Commission”) overturned an Administrative Law Judge’s (the “ALJ”) initial decision¹ and issued an opinion *In re The Robare Group, Ltd., Advisers Act Rel. No. 4566* (Nov. 7, 2016), finding that investment adviser The Robare Group, Ltd. (“TRG”) and its principals, Mark Robare and Jack Jones (collectively, the “Respondents”), negligently failed to fully and fairly disclose potential conflicts of interest arising from an arrangement with a mutual fund manager (the “Fund Manager”) pursuant to which the Fund Manager paid Robare for maintaining client assets in certain mutual funds the Fund Manager offered on its online platform.

The Commission additionally found that TRG’s disclosure that it “may” receive compensation from the Fund Manager was inadequate to alert clients either: (i) that it had such an arrangement with, and received fees from, the Fund Manager; or (ii) that the arrangement presented at least a potential conflict of interest whereby TRG had a financial incentive to purchase certain mutual funds over others and to prefer investments offered on the Fund Manager’s platform over those that were not. In making these findings, the Commission rejected TRG’s claim that it had exercised reasonable care in relying on compliance consultants, finding that there is no case recognizing such a defense and, in any event, TRG did not establish that it specifically sought or received consultants’ advice concerning how to disclose the arrangement with the Fund Manager. The Commission ordered each of the three Respondents to pay a \$50,000 civil penalty.

¹ *In re The Robare Group, Ltd.*, Admin. Proc. File No. 3-16047 (Jun. 4, 2015), available at <https://www.sec.gov/alj/aljdec/2015/id806jeg.pdf>.

BACKGROUND

TRG is an investment adviser that offers its clients a variety of model portfolios largely comprised of non-transaction fee mutual funds offered on the Fund Manager's online platform. In early 2004, TRG entered into a "revenue sharing arrangement" with the Fund Manager in which the Fund Manager paid TRG a fee of between 2 and 12 basis points when TRG's clients invested, using the Fund Manager's online platform, in certain "eligible" non-transaction fee funds that were not managed by the Fund Manager. Robare did not disclose this arrangement until it updated its Form ADV in August 2005, over a year later, to state that:

Certain investment adviser representatives of the Robare Group, when acting as registered representatives of a broker-dealer, may receive selling compensation from such broker-dealer as a result of the facilitation of certain securities transactions...[and these arrangements] may create a conflict of interest.

According to the SEC, TRG's updated disclosure was inadequate because it did not disclose the existence of the arrangement with the Fund Manager or provide any details about the conflict it presented.

In December 2011, TRG again amended its Form ADV, this time at the Fund Manager's behest. The Fund Manager had threatened to discontinue payments to TRG because it "did not find" the disclosure of the payment arrangement in TRG's Form ADV. TRG complied by updating its Form ADV to disclose that it "may" receive a fee from the Fund Manager based on "specified assets, namely non-transaction fee mutual fund assets in custody with [the Fund Manager]."

THE ALJ'S INITIAL DECISION

The ALJ dismissed the Division of Enforcement's case, finding that while the Respondents conceded that the arrangement with the Fund Manager created a potential conflict of interest, they did not act negligently because they "relied in good faith on the advice of compliance firms." The ALJ was persuaded by evidence indicating that the Respondents sought advice by outside consultants and believed that the fees were 12b-1 fees. The ALJ also concluded that certain language in an updated December 2005 custodial agreement with the Fund Manager appeared to adequately disclose the potential conflict of interest to new clients.

THE COMMISSION'S DECISION

On appeal by the Division of Enforcement, the Commission disagreed with the ALJ and found that the Respondents negligently failed to adequately disclose material conflicts of interest to their clients and willfully omitted material facts from TRG's Form ADV.

The Commission held that the arrangement involved material conflicts of interest, noting that "economic conflicts of interest, such as undisclosed compensation, are material facts" and that "potential conflicts of interest" are "indisputabl[y] ... 'material' facts with respect to clients" and, therefore, must be disclosed. The Commission reiterated that although the amount of the payments in question was immaterial, "because of the fiduciary relationship between an adviser and its client, the percentage or absolute amount of commission involved is not" determinative of materiality. The Commission further noted that the Respondents (and their expert) conceded that the payments from the Fund Manager "presented, at a minimum, a potential conflict of interest because they could have 'a tendency to slant' TRG's advice to increase revenue."

The Commission also held that TRG's Form ADV was inadequate in disclosing only that TRG "*may receive selling compensation*" (emphasis added) because it failed to reveal that TRG actually had an arrangement with the Fund Manager, that it received fees pursuant to the arrangement, and that the arrangement presented at least a potential conflict of interest. Furthermore, the Commission found that TRG's Form ADV disclosure after December 2011 continued to be inadequate because it failed to inform clients that the Respondents had a financial incentive to put client assets into eligible non-transaction fee funds over other funds available on the Fund Manager's platform. The Commission noted that without this information, TRG's clients could not properly assess the relevant conflicts.

The Commission rejected the Respondents' argument that they disclosed the arrangement to clients through the Fund Manager's custodial agreement. The Commission concluded that TRG's pre-2005 clients would not have received the custodial agreement with the Fund Manager. It also found that, in any event, the custodial agreement—which stated that the Fund Manager "may pay your advisor for performing certain back-office, administrative, custodial support, and clerical services for [the Fund Manager] in connection with client accounts for which [the Fund Manager] act[s] as custodian," and that "[t]hese payments may create an incentive for your advisor to favor certain types of investments over others"—did not inform a TRG client that TRG had in fact entered into an agreement with the Fund Manager to receive these payments.

Contrary to the ALJ, the Commission found that the Respondents acted negligently because they were aware of their disclosure obligations and that the arrangement with the Fund Manager presented at least potential conflicts of interest, yet failed to adequately disclose the relevant information. The Commission also rejected the Respondents' defense that they relied on "experienced and competent compliance consultants." The Commission noted that neither the Respondents nor the ALJ cited any case recognizing such a defense and that, in any event, the record did not contain evidence that TRG specifically sought or received advice from its consultants about how to disclose the arrangement with the Fund Manager and relied on that advice in good faith.

KEY TAKEAWAYS

- An adviser should identify and disclose in its Form ADV all sources of compensation to ensure that any associated potential or actual conflicts of interest or incentives are fully disclosed to clients.
- Disclosure that an adviser "may" receive compensation that presents a potential conflict of interest could be insufficient when the adviser does in fact receive that compensation.
- While the decision is not designed to discourage the use of compliance consultants, it is not clear that the Commission would recognize a "reliance on compliance consultant" defense as such. The decision suggests that if there is such a defense, it would need to be based on convincing evidence that the Respondent sought or received specific advice and that the Respondent relied on that advice in good faith. Such a showing would, at a minimum, help to demonstrate that the Respondent exercised reasonable care and, therefore, did not act negligently.

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Please do not hesitate to contact us with any questions.