[DC Circuit Reinforces Importance Of Conflicts Disclosure For RIAs]

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On April 30, 2019 the U.S. Court of Appeals – D.C. Circuit ("D.C. Circuit") issued a decision in The Robare Group, Ltd. v. Securities and Exchange Commission, which could embolden the SEC to take a harder line on conflicts of interest disclosure obligations on Form ADV for registered investment advisors. The Circuit Court's decision is the culmination of nearly 5 years of litigation between The Robare Group, Ltd. ("Robare Group") and the Securities and Exchange Commission ("SEC").

In its decision, the DC Circuit determined that regardless of Form ADV requirements and instructions (which Robare Group had argued were not self-evident and difficult to comply with), Robare Group and its principals breached their fiduciary duty by failing to fully and fairly disclose to clients known conflicts of interest related to a revenue sharing arrangement with Fidelity Investments, the custodian broker-dealer ("Fidelity"). While Robare Group argued that they had relied on outside compliance consultants for their compliance disclosures, the DC Circuit agreed with the Commission that the record showed no evidence that the firm had specifically sought or received advice from its consultants with regard to disclosure of the arrangement.

Revenue Sharing Arrangement. Robare Group is an investment advisor in Texas that offered model portfolios based on client investment objectives using a Fidelity platform. Fidelity provided execution, custody and clearing services for Robare Group. Under the arrangement, between 2005 and 2013 Robare Group received approximately $400,000 in shareholder servicing fees from Fidelity based on Robare Group's clients investing in certain "eligible" non-Fidelity, non-transaction fee mutual funds offered on Fidelity's online platform. The fees were initially paid to Robare Group through Triad Advisors, a broker-dealer, and later directly to Robare Group from Fidelity.

Form ADV Disclosures. Item 14 of Part 2A of Form ADV instructs investment advisors to generally describe any arrangement in which they receive an economic benefit from a non-client for providing investment advice or other advisory services to clients, and explain the conflicts of interest related to such arrangement and how those are addressed. Prior to December 2011, Robare Group did not provide any disclosure to clients regarding the Fidelity arrangement. In December 2011, Fidelity told Robare Group that it would cease making the revenue sharing payments unless Robare Group modified its Form ADV to specifically refer to the arrangement. In response Robare Group filed an update to its Form ADV disclosing the payment arrangement with Fidelity. The disclosure, however, failed to describe the conflict (i.e. that Robare Group had an economic incentive to put client assets into eligible non-Fidelity, non-transaction fee funds over other funds available on the platform). Thereafter in April 2014, Robare Group modified Item 14 of Form ADV to disclose to clients for the first time the Fidelity payment formula revealing the source and details of the conflicts of interest.

Case History Preceding the D.C. Circuit Decision. In September 2014, the SEC instituted administrative and cease-and-desist proceedings alleging that Robare Group and its principals failed to disclose the compensation received and the associated conflicts of interest. An SEC Administrative Law Judge dismissed the charges and the SEC appealed the matter to the full Commission. In the case before the Commission, while Robare Group and its principals conceded the arrangement presented a conflict and incentive to maximize compensation by advising clients to invest in eligible funds rather than non-eligible funds, they argued the arrangement was adequately disclosed, the disclosures about the arrangement were made after seeking advice from outside consultants, and the arrangement resulted in no harm to clients since it did not influence any investment decisions.

According to the Commission, no reasonable client reading Robare Group's ADV disclosure between 2005 and 2011 about possible "sales commissions" and "selling compensation" (referred to by the SEC as "boilerplate") could have discerned the existence – let alone the details- of the arrangement, and Robare Group's disclosure that it *may* receive selling compensation did not reveal that Robare Group in fact had an arrangement with Fidelity, that it received fees pursuant to the arrangement, and that the arrangement presented a potential conflict of interest. The Commission also found the firm's

December 2011 Form ADV filing inadequate. Although it mentioned the arrangement and identified Fidelity as the source of the compensation, the disclosure failed to explain that Robare Group had an economic incentive to put clients into eligible non-Fidelity, non-transaction fee funds over other funds available on the platform.   While no concrete economic harm to the firm's clients was shown, the Commission emphasized that the firm's clients had been unknowingly deprived of conflict-free advice from their advisor. The Commission determined that the cease-and-desist order was appropriate and imposed a $50,000 penalty on Robare Group and each of the firm's two principals.

D.C. Circuit Decision. The D.C. Circuit applied the legal standard established by the United States Supreme Court that Section 206 of the Advisor's Act imposes federal fiduciary standards on investment advisors, which means they have "an affirmative duty of utmost good faith, and full and fair disclosure of all material facts".[1] The D.C. Circuit considered the Commission's determination that Robare Group and its principals violated Section 206(2) by negligently failing to disclose the arrangement with Fidelity to its clients, and violated Section 207 of the Advisors Act by willfully omitting material information about the payment arrangement with Fidelity from Robare Group's Form ADV.

On the negligence question, the D.C. Circuit found that there was abundant evidence that Robare Group negligently failed to disclose the Fidelity arrangement to the firm's clients. According to the D.C. Circuit, Robare Group and its principals "persistently failed to disclose known conflicts of interest arising from the payment arrangement with Fidelity in a manner that would enable their clients to understand the source and nature of the conflicts". The D.C. Circuit emphasized that Robare Group only modified its Form ADV disclosure after Fidelity advised it would cease making payments, and even then, the revised disclosure failed to adequately describe the source and details of the conflict. Importantly, the D.C. Circuit found that regardless of any supposed difficulty in ascertaining or satisfying Form ADV disclosure requirements (which Robare Group claimed), an investment advisor has an overriding fiduciary duty to fully and fairly disclose conflicts to its clients. The D.C. Circuit also agreed with the Commission that there was no evidence that Robare Group specifically sought or received advice from its consultants regarding disclosure of the Fidelity arrangement.

The D.C. Circuit dismissed the Section 207 charges agreeing with Robare Group that there was no evidence that they violated Section 207 by *willfully* omitting material information from the Form ADV. In the D.C. Circuit's first opinion addressing the meaning of "willfully" under Section 207, the D.C. Circuit found that in the context of Form ADV disclosure the Commission would have had to find subjective intent to omit material information from the Form ADV, and that intent and negligence are mutually exclusive. Accordingly, the negligent actions of the firm and its principals resulting in the Section 206 violations could not also serve as the foundation for willful actions to support a Section 207 violation.

Five Lessons Learned.

1) ***Conflicts of interest related to compensation or revenue deserve special scrutiny***. As we've seen with the Robare case and the SEC's 12b-1 share class self-disclosure initiative, circumstances or arrangements presenting compensation opportunities or other benefits for the firm have the potential for creating clear conflicts of interest prompting important disclosure requirements for the advisor.

2) ***A critical part of any compliance program is identification of all material conflicts of interest.*** This is typically achieved and documented through the development of a risk assessment or matrix, conflicts log, or similar document or exercise conducted by the CCO and key executives within the advisor. The conflicts identified should then drive the firm's disclosures and controls embedded within the firm's written compliance policies and procedures.

3) ***Overdisclosure of conflicts is better than underdisclosure.*** Investment advisors should make full and fair disclosure to clients regarding all known conflicts of interest, which disclosure may even go beyond the specific requirements and instructions of Form ADV. In drafting Form ADV disclosures, be sure to fully describe and explain any arrangement in which a conflict exists, particularly those involving an economic benefit to the advisor or its affiliates. When evaluating the adequacy of your firm's disclosures, ask yourself whether the average client could understand the conflict or issue based on the disclosure, the important details regarding the arrangement, and how the firm has addressed the conflict.

4**) In order to rely on advice from a consultant, an advisor should specifically request advice regarding the disclosure issue and provide the consultant the information necessary to provide the advice.** In situations involving a compliance consultant, an advisor needs to be fully transparent about its arrangements so the consultant can help the advisor identify the corresponding conflicts of interest and help draft adequate disclosures. In future cases, the Commission or a Court might consider a "reliance on consultants" defense but only to the extent the firm could show it specifically asked for and received advice from the consultant regarding the disclosure and provided the consultant all necessary and appropriate information in order to render the advice. An investment advisor has a fiduciary responsibility to its clients and the obligation to provide full and accurate disclose regarding conflicts ultimately rests with the advisor.

5) ***Avoid the use of "may" in your conflict disclosures where possible.*** Using "may" when discussing receipt of payments, for example, is not adequate disclosure when an arrangement exists and payments actually have been, or will be made. The SEC's expectation, noted in the D.C. Circuit opinion, is that disclosures are specific enough that a reasonable client reading them can recognize the existence of a conflict, understand the nature of the conflict, and grasp the measures the advisor has taken to address the conflict.

[1] *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 186 (1963).

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