Securities Regulation Daily Wrap Up, TOP STORY—Commission reverses ALJ, finds failure to disclose conflicts of interest, (Nov. 8, 2016)

Securities Regulation Daily

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By Rodney F. Tonkovic, J.D.

The SEC has reversed an administrative law judge's decision finding that the failure to disclose conflicts of interest was neither intentional nor negligent. The Commission agreed that the record did not support a finding of scienter, but found that an investment adviser and its co-owners were negligent in failing to fully and fairly disclose material conflicts of interest to their clients. Each of the respondents was ordered to pay a $50,000 civil penalty (*In the Matter of The Robare Group, Ltd. Mark L. Robare, and Jack L. Jones, Jr.*, Release No. IA-4566, November 7, 2016).

Fee arrangement. In September 2014, the Commission charged Houston-based investment advisory firm The Robare Group Ltd. (TRG) and its co-owners with fraud for failing to disclose to clients a compensation arrangement tied to particular mutual funds. In 2004, TRG and a broker-dealer entered into a servicing fee arrangement under which TRG referred clients to the broker, which then paid TRG a percentage of every dollar that its clients invested in certain mutual funds.

According to the Commission, the arrangement created an incentive for TRG and its co-owners, Mark L. Robare and Jack L. Jones, Jr., to recommend the mutual funds over other investment opportunities without investors being aware of the arrangement. The Commission also alleged that TRG did not adequately disclose the arrangement on its Form ADV until at least April 2014. The failure to disclose the arrangement violated (or aided and abetted violations of) Investment Advisers Act Sections 206(1), 206(2), and 207, the Commission asserted.

Initial decision. The ALJ found that from 2005 onwards, the disclosure in the broker's own brokerage agreement adequately disclosed the fee program to TRG's clients. Approximately 150 clients, however, had signed on before 2005 and thus received a version of the brokerage agreement that did not reference the program. The ALJ held that even if the disclosure was inadequate, the Commission failed to show scienter. Even assuming that the SEC had carried its threshold burden on the scienter element, the respondents relied in good faith on the advice of its compliance firms, the ALJ said.

Failure to disclose. On appeal, the Commission found that the arrangement involved a material conflict of interest and needed to be disclosed to TRG's clients. The Commission said that a reasonable investors would have considered the payments important in evaluating the investment decisions being made on their behalf. Further, TRG's Form ADV disclosure was inadequate because it did not disclose the arrangement at all until 2011, and still failed to adequately disclose TRG's economic incentive until at least April 2014. TRG's non-Form ADV disclosures, such as in the broker's custodial agreement, similarly failed to provide full and fair disclosure of the arrangement.

The Commission agreed with the ALJ that TRG and Robare did not act with scienter, giving significant weight to the judge's credibility determination and a lack of evidence that TRG's investment decisions were influenced by the fees received from the broker. TRG and Robare, however, did act negligently in failing to reasonably fulfill the disclosure obligations of investment advisers. At a minimum, TRG's disclosure failed to satisfy the requirements of Form ADV, the Commission said.

Also, the fact that the respondents allegedly relied in good faith on compliance consultants did not negate the finding of negligence, the Commission continued. Even if there were such a defense, there was no evidence that TRG sought or received advice on how to disclose the arrangement. In any case, TRG knew that, as an investment adviser, it was obligated to disclose potential conflicts of interest.

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Sanctions. The Commission ordered the respondents to cease and desist from violations of Advisers Act Sections 206(2) and 207. TRG, Robare, and Jones were also each ordered to pay second-tier civil penalties in the amount of $50,000. Commissioner Piwowar concurred in the opinion, but stated that he would not impose a civil penalty, noting that of the six factors the Commission considered in deciding to impose the penalties, only one weighed in favor: that the act or omission involved fraud.

The release is No. IA-4566.

Companies: The Robare Group, Ltd.

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