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Milne Legal Regulatory Bulletin

"Revenue Sharing Arrangements, Form ADV Disclosures & Conflicts of Interest"

Do you represent an investment advisory firm registered with the U.S. Securities and Exchange Commission ("SEC")? Does your advisory firm receive revenue in addition to the advisory fee charged to its clients? If "yes", have these additional streams of revenue been adequately disclosed upfront to the firm's advisory clients?

This Regulatory Bulletin analyzes the most recent enforcement action brought by the SEC against an investment advisory firm for willfully violating the Investment Advisers Act of 1940 (the "Advisers Act") when it failed to disclose to its clients the inherent conflict of interest that existed when the firm entered into certain Revenue Sharing Arrangements with a third-party broker-dealer, as described below.

The SEC advisory firm agreed to pay over $ 3'000'000 to the SEC in civil money penalties, disgorgement and interest.

I. Lesson to be Learned

If your advisory firm accepts any additional revenue, from any source, on top of what it charges its clients for providing investment advisory services, then you should carefully read this SEC order, located at the following link, to ensure that proper and timely disclosure of such revenue arrangements have been made: *www.sec.gov/litigation/admin/2017/34-80177.pdf*

II. SEC Enforcement Action

On March 8, 2017, the SEC brought and settled an enforcement action against an Iowa-based, registered investment adviser, Voya Financial Advisors, Inc., (Voya), for failure to adequately disclose to its advisory clients that it received revenue from a third-party broker-dealer in violation of its investment advisory obligation to disclose or eliminate all conflicts of interest the adviser may have with its clients.[1]

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

The enforcement action focused on an agreement between Voya and the third-party clearing-broker whereby the broker agreed to share with Voya a certain percentage of revenues the clearing broker received from mutual funds purchased by Voya's clients.

In addition, the SEC found that the Clearing Broker agreed to pay Voya a per account fee for each customer account of Voya held at the Clearing Broker. The SEC order also determined that Voya failed to disclose to its advisory clients administrative fees it earned from the same clearing broker under an administration service agreement in violation of the Voya's duty to disclose all conflicts of interest with its clients.

Finally, in its Form ADV filed with the Commission, Voya did not disclose that it received payments from the Clearing Broker based on Voya client assets invested in broker's mutual fund program or that these payments presented an additional conflict of interest. Nor did Voya's advisory agreements with its clients contain such disclosures.

III. Violations of the Investment Advisers Act of 1940

Because of the undisclosed revenue sharing arrangements above, the SEC concluded that Voya *willfully* violated Section 206(2), Section 206(4) and Section 207 of the Advisers Act.

Section 206(2) of the Advisers Act prohibits investment advisers from directly or indirectly engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." A violation of Section 206(2) of the Advisers Act may rest on a finding of simple negligence.[2] Proof of scienter (intent or knowledge of wrongdoing) is not required to establish a violation of Section 206(2) of the Advisers Act.[3] As a result of the conduct described in Part I. above, the SEC found that Voya willfully violated Section 206(2) of the Advisers Act.

Section 206(4) of the Advisers Act makes it "unlawful for any investment adviser . . . to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." Rule 206(4)-7 under the Advisers Act requires registered investment advisers to, among other things, "[a]dopt and implement written policies and procedures, reasonably designed to prevent violation" of the Advisers Act and its rules. A violation of Section 206(4) and the rules thereunder do not require scienter. Steadman, 967 F.2d at 647. As a result of the conduct described above, VFA willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

Section 207 of the Advisers Act makes it unlawful for any person to make any untrue statement of a material fact in any registration application or report filed with the Commission, or to omit to state in any such application or report any material fact which is required to be stated therein. As a result of the conduct described above, VFA willfully violated Section 207 of the Advisers Act.

Finally, on a related note, it is worth highlighting that on September 12, 2016, the Office of Compliance Inspections and Examinations, in coordination with the SEC, identified conflicts of interest as part of its examination priorities when reviewing an adviser's compliance program: *https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-supervision-registered-investment-advisers.pdf*

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[2] See SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963)).

[3] Id.

In the SEC's Risk Alert, the SEC staff stated, "As a fiduciary, an investment adviser has a duty to make full and fair disclosure of all material facts, including all material conflicts of interest that could affect the advisory relationship. Examiners will assess the conflicts of interest that a registered adviser or supervised person may have. Particular attention will be given to conflicts that may exist with respect to financial arrangements (*e.g. unique products, services, or discounts*) initiated by supervised persons with disciplinary events."

IV. Conclusion

If you are or represent an investment advisory firm that receives any additional streams of revenue above what has been agreed with the firm's clients *via* the investment advisory agreements, these additional revenue arrangements must be adequately and timely disclosed to the clients, including in the firm's Form ADV. This disclosure should take place prior to the firm taking any action under such revenue arrangements or receiving any compensation per such agreements.

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If you have any questions regarding this Bulletin, please do not hesitate to contact a Milne Legal representative at one of the email addresses below.

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