



Insights: Alert

SEC Continues Focus on Conflicts Disclosures in Enforcement Actions Totaling \$106 Million in Fines and Disgorgement

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The U.S. Securities and Exchange Commission (the “**Commission**”) recently entered into four consent orders (collectively, the “**Orders**” and each, an “**Order**”) with registered investment advisers (“**RIAs**” and each, an “**RIA**”) that sanctioned the RIAs for failures to provide full and fair disclosure regarding conflicts of interest. Notably, the Orders highlight the RIAs’ various efforts to correct disclosure issues, and the Commission’s ultimate position that each additional disclosure was still inadequate. These Orders again demonstrate the Commission’s continuing focus on ensuring firms provide full and fair disclosure of conflicts of interest, and the difficulty for practitioners in pegging what the Commission will deem a complete and accurate disclosure.

A summary of each Order and its key takeaways is set forth below.

a. Conflicts Arising from Incentive Compensation on Rollovers at Dual Registrant¹

Case Summary

On July 13, 2021, the Commission sanctioned a dually registered investment adviser and broker-dealer for its alleged: (1) failure to adequately disclose conflicts of interest; and (2) dissemination of inaccurate and misleading statements, in connection with recommendations regarding the rollover of retirement assets into a managed account program called “Portfolio Advisor”² between 2013 and 2018. While many of the issues followed from common complications of so-called “hat switching” by dually registered representatives (which have since been addressed through the firm’s compliance with the Department of Labor’s first fiduciary rule and Regulation Best Interest), the Order still provides helpful guidance for RIAs more broadly.³

Specifically at issue in the Order was: (1) an incentive compensation plan that paid the firm’s representatives more in variable compensation for signing up rollovers into Portfolio Advisor compared to other rollover options that did not generate as much revenue for the RIA; and (2) negative consequences—including the threat of termination—for representatives who failed to meet targets. Also at issue in the Order was eye-catching verbiage in training that purportedly taught representatives to “use the rollover process to discover areas of vulnerability for these clients, called ‘pain points’ to ‘create pain’ by helping clients ‘self-realize’ their financial vulnerability, and then to recommend Portfolio Advisor as the solution to their problem.”⁴

In the Order, the Commission found it misleading to describe the firm's representatives as objective, non-commissioned fiduciaries because those representatives were compensated more when their clients' rollovers went into Portfolio Advisor (even though that compensation differential was also disclosed).⁵ While the firm's policies and procedures required representatives to present clients with four rollover options, the Commission found that representatives commonly presented managed accounts as the only option for a rollover and that they were, in certain instances, trained to avoid discussing fees.⁶

Even though the firm's policies and procedures required representatives to discuss fees with clients in connection with rollover recommendations, the Commission found the procedures violative because they “did not take sufficient steps to ensure that [representatives] conducted and memorialized those fee discussions.”⁷ Similarly, before 2015, the group responsible for supervising all product recommendations did not have procedures that required confirming the representatives had the required fee and expense discussions with (prospective) clients.

As to disclosures, the Commission found that the firm's written and verbal disclosures:

- disclosed the compensation differential for selling Portfolio Advisor, but stated that the difference followed from the “degree of effort” and “complexity” involved in selling that product;⁸
- described incentive compensation relative to both core and complex products in a way that suggested the same compensation structure applied to both types when, in fact, compensation for complex products was greater than that for core products;
- implied that the fiduciary duty that applied in the financial planning relationship extended to rollover recommendations when, for much of the relevant time period, the firm's supervisory system treated and reviewed rollover recommendations under the suitability (not the fiduciary) standard;⁹
- did not explicitly disclose that the incentive compensation plan meant that representatives who recommended Portfolio Advisor had other reasons for doing so unrelated to the client's particular investment needs.

Sanctions

The firm was censured and ordered to pay a total of \$97 million, including disgorgement of almost \$74 million, prejudgment interest of roughly \$14 million, and a civil penalty of \$9 million.

Takeaways

- *Disclosures.* Registrants are often tempted to explain a conflict in a manner that operates to minimize its import, but they do so at their own potential peril. The Order explains that the Commission judges disclosures based on what a reasonable investor could have understood in the context of the disclosure and the investor's experience.¹⁰
- *Culture of Compliance.* It is critical to be thoughtful in verbiage used in all business communications, including training materials. When it comes to the Commission's exercise of its discretion in bringing enforcement cases, the “how” often matters as much as the “what.” Verbiage that suggests leveraging a client's “pain points” to generate business is almost certain to raise concerns with regulators (and prospective whistleblowers). We have seen similar verbiage issues arise in employee's self-evaluations,

performance reviews, and other internal records. A culture of compliance includes thoughtful use of language throughout a firm's business operation.

- *Recordkeeping.* Registrants have substantial regulatory recordkeeping requirements. It is prudent to make and keep records necessary to show compliance with applicable regulations and the firm's policies and procedures regardless of whether the record is enumerated in one of the SEC's (or FINRA's) recordkeeping requirements.
- *Testing.* For a supervisory system to be "reasonably designed", policies and procedures must be tested – and enhanced if testing shows that they are ineffective.
- *"Free" Means Really Free.* If free is not really free, the Commission expects that to be made clear up front. In the Order, the Commission explained that the firm's representatives were contacting employee-sponsored plan participants with eligible rollovers to offer "free, holistic financial planning" as an advisory service with the intention of directing those prospective clients into a program with a "lucrative management fee" for the firm and incentive compensation for the representative.¹¹

b. Cash Sweep Conflicts and the Perils of the Word "May"¹²

Case Summary

On July 8, 2021, the Commission sanctioned an RIA ("SG-IA") for failing to adequately disclose a revenue sharing arrangement or the related conflicts of interests to its advisory clients.¹³ According to the Order, SG-IA's affiliated broker-dealer ("SG-BD") received cash sweep revenue sharing from the unaffiliated clearing broker used by SG-IA. SG-IA disclosed in its Form ADV that it "may utilize ... funds for cash sweeps", but did not disclose that SG-BD actually received cash sweep revenue.¹⁴ Later, SG-IA amended its Form ADV to disclose that "St. Germain"¹⁵ received a monthly payment from its sweep program, and described how such payment was calculated. However, the Order stated that these disclosures were inadequate because they failed to identify or address the financial conflict arising from the receipt of the cash sweep revenue sharing.

SG-IA subsequently amended its Form ADV again to: (i) state that SG-BD received cash sweep revenue, but that SG-IA and its individual advisory representatives did not receive any portion of that revenue; and (ii) identify the financial conflict of interest arising from the cash sweep revenue sharing, in that it could cause SG-IA to provide investment advice that was not disinterested regarding the best client sweep account.

Sanction

SG-IA was ordered to pay disgorgement, pre-judgement interest, and a civil penalty totaling \$1,925,000.

Takeaways

- *Disclosures.*
 - If an event will occur at least sometimes, then the Commission will likely consider a disclosure ineffective or misleading if the disclosure states that the event "may" happen. Be very careful when using the word "may" in disclosures.
 - The Commission seems to expect registrants to spell out the impact of a disclosed conflict; it is likely insufficient to identify a conflict of interest without also explaining how the conflict, when present, operates to the client's detriment.

c. Disclosures Regarding Revenue Sharing with Brokers¹⁶

Case Summary

On June 9, 2021, the Commission sanctioned two RIAs (“KA” and “KP”, respectively, and together, “K”) for, among other actions, failing to provide adequate disclosures of conflicts regarding: (i) revenue sharing arrangements between K’s affiliated broker-dealer (“B”) and an unaffiliated clearing broker; and (ii) “fee-markups”, where B would have the clearing broker charge B’s customers (who were also K’s clients) fees that were higher than what the clearing broker charged B for the clearing broker’s services.

At issue were several instances where the clearing broker would share revenue with B in an amount tied to B’s customers’ (K’s clients’) assets invested in certain mutual fund share classes, but would not share revenue with B for other mutual funds or share classes of mutual funds.¹⁷ For example, B had a sharing arrangement with the clearing broker where B would receive a portion of the recurring fee the clearing broker received from mutual fund investments that were a part of the clearing broker’s “no transaction fee program.”¹⁸ B’s revenue share percentage increased with the level of B’s customers’ (including K’s clients’) assets invested in the mutual fund share classes that were a part of this program. Meanwhile, B would have received lower or no revenue sharing payments from the clearing broker for lower-cost share classes of the same funds.¹⁹

The Commission also found that B marked up its brokerage fees for several services. For example, B had the clearing broker charge B’s customers \$20.00 more for an annual custody fee than what the clearing broker charged B for custodial service, and charged a higher rate of interest on margin lending.

K initially failed to disclose that B shared any revenue with the clearing broker based on K’s clients’ investments. In subsequent Form ADVs, K disclosed the different revenue sharing agreements, but the Commission found that these disclosures generally were insufficient. The Orders offer little detail about the deficiencies other than to say that disclosures never included an explanation that some mutual funds, and certain share classes of other mutual funds, that were available to K’s clients did not generate any revenue share for B. Further, the Orders state that K never identified any of these new disclosures in the summary of material changes section of the Form ADV, and thus existing clients were not notified of the new disclosures.

The Commission similarly found that K initially failed to adequately disclose the conflicts that arose when K recommended that clients use B and, in some instances, execute transactions that K recommended through B.²⁰ K later updated its Form ADV to disclose these fee markup conflicts, but again did not identify these disclosures in the summary of material changes provided to existing clients.

Sanctions

KA was ordered to pay disgorgement of \$7,229,802, prejudgment interest of \$1,273,370, and a civil penalty of \$1,500,000, while KP was ordered to pay disgorgement of \$208,187, prejudgment interest of \$31,382, and a civil penalty of \$60,000.

Takeaways

- *Specific Disclosures.* When considering conflicts, especially ones that deal with elaborate revenue sharing arrangements involving third parties and affiliates, it is important to keep in mind the standard

upon which an RIA's conflicts disclosures are judged: To meet its fiduciary obligation, an RIA is required to "provide its advisory clients with full and fair disclosure that [is] sufficiently specific so that [advisory clients can] understand the conflicts of interest concerning [the investment adviser's] advice and have an informed basis on which to consent to or reject the conflicts."²¹

- **Highlighting Material Changes.** Don't forget the last step to disclosure amendments: highlighting the amendments in the material changes section of the Form ADV. Otherwise, clients are not likely to review the updated disclosures and the Commission will give the disclosures (significantly) less weight.

If you have any questions about conflicts of interest disclosure obligations or about the regulation of RIAs, broker-dealers, and registered investment companies generally, please feel free to contact us.

By the [Investment Management and Broker-Dealer Team](#) at **Kilpatrick Townsend & Stockton**

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Footnotes

¹ In the Matter of TIAA-CREF Individual and Institutional Services, LLC, SEC Release No. IA-5772 (July 13, 2021), <https://www.sec.gov/litigation/admin/2021/33-10954.pdf>.

² Per the Order, Portfolio Advisor is a wrap-fee advisory program with customized models utilizing mutual funds and ETFs, for which clients are assessed a quarterly advisory fee, based on assets under management in the account. *Id.* at 4.

³ At the outset of the Order, the Commission explained that the RIA's representatives were "frequently confused about their various roles, including whether they were acting as an investment adviser representative or registered representatives when recommending rollovers into Portfolio Adviser." *Id.* at 4. Later, the Order notes that the RIA attempted to train its representatives not to present themselves as fiduciaries in connection with product recommendations, but the training did not eliminate the confusion. *Id.* at 7. The commonality of this type of confusion was a major impetus for Regulation Best Interest.

⁴ *Id.* at 2.

⁵ *Id.* at 2 and 8.

⁶ *Id.* at 10 (describing training materials unique to a specific region that contained these directives).

⁷ *Id.* at 3 (emphasis added).

⁸ The Commission found that there was inadequate basis for this explanation.

⁹ The relevant time period for the conduct at issue was 2013 to 2018. While the conclusion would likely be the

same, the analysis of these facts would vary today given the now-applicable standards for Regulation Best Interest.

¹⁰ See *id.* at 8.

¹¹ *Id.* at 10.

¹² In the Matter of St. Germain Investment Management, Inc., SEC Release No. IA-5767 (July 8, 2021), <https://www.sec.gov/litigation/admin/2021/ia-5767.pdf>.

¹³ SG-IA was also charged with failing to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. *Id.* at 5-6.

¹⁴ *Id.* at 4. The Order acknowledges that effective conflicts disclosures may be made outside of the Form ADV. For example, the Order explains that SG-IA could have relied on the written disclosure statements from the clearing broker that were provided to SG-IA clients if such statements provided a full and fair disclosure to clients of all material facts regarding the cash sweep revenue sharing. However, in this case, the disclosure statements apparently did not address potential conflicts from the perspective of an investment adviser such as SG-IA.

¹⁵ The Order provides that during the relevant period, cash sweep revenue was paid to SG-BD, but SG-IA's February 2019 amended Form ADV stated that "St. Germain does receive a monthly payment from its sweep program". SG-IA did not differentiate where cash sweep revenue was received until its December 2019 amended Form ADV. See *id.*

¹⁶ In the Matter of Kestra Private Wealth Services, LLC, SEC Release No. IA-5771 (July 9, 2021), https://www.sec.gov/litigation/admin/2021/ia-5771.pdf?utm_medium=email&utm_source=govdelivery; In the Matter of Kestra Advisory Services, LLC, SEC Release No. IA-5770 (July 9, 2021), https://www.sec.gov/litigation/admin/2021/ia-5770.pdf?utm_medium=email&utm_source=govdelivery (hereinafter, the "KA Order").

¹⁷ KA Order at 3.

¹⁸ The clearing broker generally charged mutual fund families a higher recurring fee for share classes sold through this program, resulting in higher expense ratios compared to share classes sold outside of the program. *Id.* at 4.

¹⁹ B also had revenue sharing arrangements with the clearing broker related to a transaction fee program and an institutional no transaction fee program, which similarly tied B's compensation to B's customers' (K's clients') assets invested in such programs. *Id.* at 4-5.

²⁰ According to the Order, KA also indicated in its Form ADV Part 2A that "[w]e typically do not charge you any commissions for transactions in mutual funds" when B had the clearing broker apply a fee markup for mutual fund transactions. Although KA later updated its disclosures to disclose the transaction charge assessed on mutual funds, it did not identify this disclosure in the summary of material changes. *Id.* at 7.

²¹ *Id.* at 5 (emphasis added).

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