ATTACHMENT 1

Undisclosed Conflicts

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For registered investment advisers ("RIAs"), recognizing, mitigating and disclosing potential, apparent and actual conflicts of interest is a vital component of a viable compliance program and an essential component of running a successful advisory business. Conflicts may arise from a variety of sources that must be continuously monitored. By way of example, RIAs have built in conflicts merely by virtue of having more than one client, particularly if multiple clients have similar investment objectives. In this context, the adviser's first conflict and challenge is how to allocate his time. Advisers need to be fair to all clients and not spend a disproportionate amount of time on one client to the detriment of other clients. The adviser also needs to consider how much time he will dedicate to all of his clients in the aggregate versus the time he will spend on outside business interests. As a fiduciary[1], the RIA's first obligation is to his clients. As a result of having multiple clients, other potential conflicts arise in making investment and expense allocation decisions. Trades between clients are also a concern.

Each year, many advisers either (i) fail to adequately disclose conflicts or (ii) fail to follow their policies and procedures with respect to resolution or mitigation of conflicts that have been disclosed.

Conflicts often arise in situations where a supervised person or firm has an incentive to serve one interest at the expense of another interest. This incentive is frequently financial but could also be the result of a personal, family or business relationship. The conflict might be an incentive to serve the interest of the firm over that of a client; alternatively, it could be an incentive to serve the interest of one client over that of another client. A conflict could also arise when a particular supervised person places his own interest above those of the firm or its clients.

Conflicts are like viruses. They come in a vast array of constantly mutating forms; if they are not eliminated, mitigated or disinfected by exposing them to sunlight (disclosed), even the simplest virus

[1] For a general discussion of registered investment advisers as fiduciaries, see Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Advisers Act Release No. 4889 (Apr. 18, 2018).

poses a mortal threat to the health and wellbeing of the RIA.[2] Nearly all bad behavior and violations of the securities laws by registered investment advisers can be explained in terms of conflicts of interest.

As a practical matter, an RIA must periodically assess the risks of running his business and then update disclosures in relevant offering documents and in the RIA's public registration statement on Form ADV.[3] Significant regulatory problems develop when important conflicts of interest are not disclosed and the RIA's investors are not aware of them. Undisclosed conflicts are the basis for dozens of SEC enforcement actions every year. Full disclosure requires not only that the adviser identify the conflicts it has or is likely to have but also how such conflicts are mitigated or handled. This generally involves disclosure of a specific policy or procedure, trade allocation, for example. It is absolutely essential that an adviser's (i) policies and procedures, (ii) disclosures in client governing documents and (iii) disclosures in Form ADV (particularly in Part 2A) are consistent and that they are followed.

A recent SEC case[4] stated that: "A 'fundamental purpose of [the Advisers Act is] to substitute a philosophy of full disclosure for the philosophy of caveat emptor [or buyer beware] and thus to achieve a high standard of business ethics in the securities industry.'[5] Accordingly, Section 206 [of the Advisers Act] imposes 'federal fiduciary standards' on investment advisers,[6] which means they have 'an affirmative duty of "'utmost good faith, and full and fair disclosure of all material facts.'"[7] Because Section 206 was designed 'to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested,'[8] the "[f]ailure by an investment adviser to disclose potential conflicts of interest to its clients constitutes fraud within the meaning of Sections 206(1) and (2).'"[9]

General Instruction 3 of Form ADV Part 2A is instructive: "Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that

[2] See October 22, 2012 speech by Carlo V. di Florio on Conflict of Interest and Risk Governance to the National Society of Compliance Professionals https://www.sec.gov/news/speech/2012-spch103112cvdhtm.

[3] The Compliance Rule (Advisers Act Rule 206(4)-7) requires RIAs to implement written policies and procedures reasonably designed (based on the risks of their particular business) to prevent violations of the Advisers Act. Those policies and procedures must be reviewed at least annually. Form ADV must be updated within 120 days of the end of the RIA's most recent fiscal year. Part 2A of Form ADV (the "Brochure") places a significant emphasis on identifying conflicts as well as how those conflicts are handled or mitigated by the RIA. General Instruction No. 2 of Part 2A cautions advisers against saying that they "may" have a conflict when in fact such conflict exists. For a case discussing the inappropriate use of "may" see *In the Matter of Jan Gleisner and Keith D. Pagan*, Advisers Act Release No. 4537 (Sept. 28, 2016).

[4] *In the Matter of The Robare Group, Ltd.,* Advisers Act Rel. No. 4566 November 7, 2016.

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

[6] *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979).

[7] *Capital Gains*, 375 U.S. at 194; see also *Montford & Co., Inc.,* Advisers Act Release No. 3829 (May 2, 2014) ("Section 206 prohibits 'failures to disclose material information, not just affirmative frauds.'")

[8] *Capital Gains*, 375 U.S. at 191-92.

[9] *Fundamental Portfolio Advisors, Inc.*, Exchange Act Release No. 48177 (July 15, 2003).

could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them…."

In addition to identifying and describing applicable conflicts, many specific items of Form ADV Part 2A also require RIAs to explain how those conflicts are addressed, handled or mitigated. In other words, it is not enough to simply identify that a conflict exists.

Consequently, every decision that a supervised person makes needs to be scrutinized to see if this critical question can be answered affirmatively: "Am I acting in the best interest of my firm's clients?" If a supervised person is about to embark on a course of action that relates to or affects the RIA's clients but is based on any factor other than the best interest of that client—perhaps because it will also benefit a friend, business partner or business interest or a family member—then the supervised person should pause and bring this matter to the attention of the firm's Chief Compliance Officer and senior management. This pause for review could result in concluding that the specific conflict that arises from a particular course of action is already disclosed to the RIA's investors through an offering document or in Form ADV. The result might be that the firm either amends its conflict disclosures or perhaps makes a different decision. Proper disclosure of conflicts can both powerfully protect an RIA and permit its investors to make an informed decision about whether or not to invest.

What follows is a suggested list of areas to review. Each RIA should conduct its own enterprise risk assessment and periodically monitor any conflicts of interest that are identified. RIAs cannot be complacent about known conflicts because changes in the business such as new supervised persons, funds, managed accounts, products, markets, sources of investment ideas, counterparties, affiliates, to name just a few, could sufficiently alter the conflict landscape to warrant alteration of an existing disclosure or policy or even necessitate new disclosures and policies.

In subsequent articles, we shall endeavor to highlight relevant SEC enforcement actions where an RIA failed to meet its obligations concerning conflict disclosure particularly with respect to the following areas:

Allocation of investment opportunities and expenses

Valuation

Conflicted Transactions: Principal Trades, Cross Trades, Agency Cross Transactions

Affiliations with and compensation from broker dealers, portfolio companies and other third parties

Incentives to benefit certain affiliates or invest in certain types of investments

Compliance program, including policies and procedures tailored to identified and monitored risks

Identification of specific authorization for all fees and expenses (including acceleration of fees) charged

Outside business interests such as the making of personal loans or serving on boards of directors of portfolio companies

Proxy Voting

In conclusion, RIAs need to be ever vigilant when it comes to conflicts. Existing conflicts evolve as the RIA's business changes. New conflicts come to the fore with the addition of new clients, new products, new markets and new counterparties. Hopefully supervised persons will be sufficiently trained to detect and report any potential conflicts as they go about trying to serve their firm's clients and investors in the best possible way. The solution for almost all conflicts that cannot be eliminated is to put policies and procedures in place to mitigate them and to thoroughly disclose the conflict. As Supreme Court Justice Louis D. Brandies once said: "Sunlight is the best disinfectant."

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