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August 23, 2021

SEC Sanctions Robo Adviser for Inadequate Conflicts Disclosures, Failure to Consider Tax Impact of Proprietary ETFs

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Not long after we released our recent alert titled SEC Continues Focus on Conflicts Disclosures in Enforcement Actions Totaling $106 Million in Fines and Disgorgement, the U.S. Securities and Exchange Commission (the "***Commission***") entered into another consent order (the "***Order***") with an internet-based registered investment adviser ("***Robo Adviser***") that sanctioned the adviser for failing to provide full and fair disclosure regarding conflicts of interest relating to proprietary products, and for failing to consider tax consequences associated with trades made within an automated advisory program.[i] This Order serves as another example of the Commission's continuing focus on the importance of firms identifying, and then accurately disclosing, actual or potential conflicts of interest and how those conflicts could impact clients.

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

Case Summary

On August 19, 2021, the Commission sanctioned Robo Adviser for failing to adequately disclose conflicts of interest related to newly-created, proprietary ETFs sponsored by the adviser's parent company, and related alleged breaches of the adviser's fiduciary duty. According to the Order, Robo Adviser provided clients advisory services through an automated investment program (the "Invest program") using various ETF-based strategies with products sponsored and managed by third parties. In early 2019, Robo Adviser's affiliate began sponsoring two of its own proprietary ETFs with the intention that these products would replace two third-party ETFs used in the adviser's Invest program. According to the Order, Robo Adviser used its clients' assets to infuse cash into the two proprietary ETFs on the second day of trading, thereby increasing liquidity for the new ETFs and making the product more marketable. Using advisory clients' assets to fund the proprietary ETFs on the second day of trading effectively paid back the proprietary ETFs' authorized participant the day after the launch.

After the proprietary ETFs were approved by Robo Adviser's investment committee for inclusion in the Invest program (but before the proprietary ETFs began trading on an exchange), the adviser amended its Form ADV to disclose that it would use its investment discretion to invest clients in a mix of ETFs "that represent the broad asset allocation determined by these strategies, which *may* include ETFs for which [Robo Adviser's affiliate] is the sponsor"[ii] (emphasis added). The Commission found this disclosure inadequate because Robo Adviser's investment committee had already approved the two proprietary ETFs to replace two third-party ETFs previously used in the strategy and, according to the Order, the investment committee did not consider other third-party ETFs as replacements.[iii]

Further, the Order found that Robo Adviser's Form ADV disclosure was inadequate because it failed to disclose to clients that the adviser's financial interest in the proprietary ETFs presented a conflict of interest that could influence its decision to invest clients' assets in these proprietary ETFs. [iv] The Commission concluded that the adviser had a financial interest[v] in the proprietary ETFs even though the fees associated with the proprietary ETFs were waived (resulting in a net expense ratio of 0%).[vi]

Additionally, the Order states that the Robo Adviser failed to disclose that one of its motivations for investing client assets in these proprietary ETFs was to help market the adviser's parent company's brand as offering a broad array of financial products and services beyond the student loan refinancing and personal loans for which the company is best known. The Order also found that Robo Adviser failed to update its written policies and procedures to address issues specific to recommendations to invest in proprietary products.

Lastly, when Robo Adviser used its discretion to sell the third-party ETFs held by 20,000 of its client accounts and used the proceeds of such sales to purchase positions in the two proprietary ETFs (which had a different asset allocation than the original ETFs) the adviser inadvertently created capital gains tax liability for approximately 75% of the clients totaling more than $1.4 million. The Order finds that Robo Adviser did not perform any pre-trade analysis to determine the potential tax consequences to accounts, and in so doing failed to meets its fiduciary duty of care to its advisory clients.[vii] The Order acknowledged that Robo Adviser had disclosed to clients in the Invest program that "its algorithms did not take into account the specific tax situation of individual clients." However, the Commission apparently was not persuaded that this disclosure entirely removed the adviser's duty to consider potential tax consequences when exercising its discretion to effect an investment decision across the accounts.

Sanction

Robo Adviser was ordered to pay a civil penalty of $300,000 and to complete several compliance-related undertakings.

Takeaways

- The Division of Enforcement has a consistent, fervent suspicion of the accuracy of disclosures that include the word "may". If you're still using "may" in your conflicts disclosures, consider revising the language.

- A conflict of interest can arise from benefits other than a cash revenue stream. In this case, Robo Adviser was found to have financial incentives that created conflicts of interest because:
  - the investment decision made on behalf of its clients was intended to bolster the proprietary ETFs' marketing campaign and the parent company's overall brand (by showcasing the breadth of products and services offered by the adviser, its parent and affiliates); and
  - the proprietary ETF's sponsor (the adviser's parent company) received a substantial benefit from its ability to leverage the adviser's clients' funds to create liquidity for its new ETFs.
- Recommendations of proprietary products always raise conflicts of interests that require careful attention to full disclosure. Advisers acting with discretion need to be particularly cautious when moving clients from a third-party product to a proprietary product.
- When determining whether a transaction is suitable, financial professionals (investment advisers and registered representatives of broker dealers) must consider the potential tax impact of the transaction on the client(s).

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If you have any questions about conflicts of interest disclosure obligations or about the regulation of registered investment advisers, 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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[i] In the Matter of SoFi Wealth, LLC, LLC, SEC Release No. IA-5826 (August 19, 2021), https://www.sec.gov/litigation/admin/2021/ia-5826.pdf.

[ii] *Id*. at 3 (emphasis added).

[iii] *Id.*

[iv] *Id.* 3-4.

[v] According to the Order, Robo Adviser is not the adviser to the proprietary ETFs, but pursuant to an agreement with the adviser, Robo Adviser's parent company is entitled to receive a fee based on the total management fee earned by the adviser to the proprietary ETFs. *Id.* at 4.

[vi] The Commission found that waiving the management fee did not resolve the financial conflict of interest because: (1) the prescribed amount of the management fee for the proprietary ETFs was higher than the third-party ETFs they replaced and the waiver could be withdrawn in the future; and (2) the ability to characterize the products as no-fee ETFs bolstered the Robo Adviser's marketing campaign for the proprietary ETFs and the parent company's branding campaign. Accordingly, Staff seems to have found that even though there was no cash revenue stream generated, the adviser still had actual and potential financial interests in the proprietary ETFs that created a conflict of interest that required full and fair disclosure to advisory clients. *See id*.

[vii] After the Enforcement Division commenced its investigation, the Robo Adviser voluntarily paid its clients the costs associated with the capital gains liability created by the move from the third-party ETFs to the proprietary ETFs. *Id.*