

THE SEC IS FOCUSING MORE CLOSELY ON INVESTMENT ADVISER CONFLICTS OF INTEREST – AND SO SHOULD ADVISERS

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One lesson the wave of corporate and mutual fund scandals has reinforced for regulators is that conflicts of interest are likely to lead to abuses if they are not policed. Taking this lesson to heart, the Securities and Exchange Commission has made it known that it will be focusing even more closely on conflicts of interest in both examinations and enforcement investigations of investment advisers. In part, this focus stems from the SEC's evolving "risk based" approach to examinations and investigations. Under this approach the SEC is focusing on areas that it believes pose the greatest risk of violation – and conflicts of interest are definitely an area that the SEC sees as posing significant risks to investors.

“High risk” advisers will be examined more often

For examinations, this means SEC-registered investment advisers that fit certain risk profiles may find themselves being examined more often and more thoroughly. For example, firms that the SEC believes have weak internal controls or compliance functions are likely to be classified as high risk and examined more often. Similarly, firms that have custody of client assets, hold illiquid securities, have significant personal trading, manage both performance fee and asset based fee accounts, use extensive performance advertising, have disciplinary histories or significant customer complaints may be marked as higher risk advisers.

Examiners will scrutinize conflicts of interest

During an examination the SEC staff takes a broad look at an adviser's business – from record keeping, to trading practices, to disclosures. The examiners also try to understand an adviser's business practices and relationships to identify potential conflicts of interest, which will then be scrutinized more carefully. Examiners are looking for two things in situations where an adviser could face a conflict between its own interest and that of its clients. First, they want to make sure that clients are not being disadvantaged. Second, even if no clients are harmed, they will examine whether the potential conflict is clearly disclosed to clients. If the examiners find what they believe to be a significant problem, they may refer the matter to the Division of Enforcement which may then conduct an enforcement investigation.

The range of potential conflicts an adviser may face is almost limitless. Some examples from examinations and enforcement investigations we have recently handled include:

- Favoritism - situations where advisers favor one group of clients over another or employee accounts over client accounts. For example, the SEC looks closely at trading practices that disfavor one category of clients, inequitable allocations of IPOs and other trades among clients, and favoring performance fee accounts over asset based fee accounts.
- Personal trading - giving trading priority to employee or proprietary accounts.

- Expense shifting – instances where the adviser causes client accounts to incur expenses that may more properly be expenses of the adviser, including for example, soft dollar relationships, client referral relationships with brokers, directed brokerage arrangements, payment of certain types of expense by client accounts (especially funds) and trading error losses.

Identify and disclose conflicts

Some conflicts of interest are unavoidable for an adviser and cannot be eliminated. So, what should an adviser do to avoid conflicts from becoming an issue during an examination, and even worse, from becoming an enforcement action? The first step is to identify potential conflicts of interest. In addition, since even the appearance of a conflict can lead to a drawn-out examination or enforcement investigation, advisers should also identify instances where there is even the appearance of a conflict. Periodic compliance reviews offer an excellent opportunity to take the time to reflect on the firm's business practices and relationships with an eye toward identifying actual or potential conflicts between the clients' interests and those of the adviser. For example, consider your trading practices, allocations and other investment decisions – are some groups treated differently from others? Consider also your relationships with service providers, research sources, brokers and others. Do any of the relationships present a potential advantage for the adviser to the detriment of clients?

Once identified, potential conflicts need to be discussed internally and with counsel. Since conflicts may affect an adviser's ability to render disinterested advice, conflicts are material facts that must be disclosed to clients. Therefore, some conflicts may be addressed through straightforward disclosures in the firm's Form ADV or offering documents. Other conflicts may be significant enough that the

practices or relationships need to be modified. Where disclosure is an option, be sure that actual and potential conflicts are fully and clearly disclosed. Finally, don't rest on your laurels. The firm should review conflicts at least annually and promptly update its disclosures as needed. What was an accurate disclosure last year may become inaccurate because of new business relationships or changed circumstances.

Conclusion

With the increased regulatory focus on conflicts, advisers need to be ever more vigilant to identify and disclose conflicts of interest. The best way to do so is to have and follow internal procedures to periodically review the adviser's business practices and to make certain that all known conflicts are clearly disclosed to investors. In addition to ensuring proper disclosure, strong internal procedures will help avoid being labeled a high risk adviser and subject to more frequent examinations.

Since the SEC will be looking closely at conflicts, implementing and following a few simple procedures will go a long way toward ensuring that examinations go smoothly and, even more importantly, do not end up as enforcement actions.

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