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First Circuit Limits SEC's Reach on Investment Advisers

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The First Circuit overturned an SEC win and disgorgement order against Commonwealth Equity Services for alleged violations of the Investment Advisers Act ("Advisers Act"). In a lengthy opinion, the court upheld traditional notions of materiality and rejected a "per se" rule for potential conflicts of interest, as well as finding related causation errors with the SEC's disgorgement calculation.

The Bottomline

Investment advisers have a better chance of challenging SEC arguments on materiality and disgorgement calculations, and thus more leverage in negotiating with the SEC over alleged disclosure violations under the Advisers Act.

The SEC will likely respond to this ruling by gathering more detailed information about an investment adviser's clients to establish materiality for conflicts of interest and prove up disgorgement.

Key Takeaways for Investment Advisers:

1. *There is no "per se" rule that potential conflicts of interest are material as a matter of law under the Advisers Act.*Materiality is generally a question of fact for a jury to decide. The district court skipped a "fact-specific inquiry" and "instead rested on a generalized per se conclusion that '[i]t is indisputable that potential conflicts of interest are material facts with respect to clients.'" The First Circuit rejected this per se rule and held that a reasonable jury could conclude that additional disclosures with more precise descriptions may not have so "significantly altered the 'total mix' of information made available that summary judgment was appropriate." In support, the court also pointed to SEC v. Jarkesy's statement that "every encroachment upon [the jury trial right] has been watched with great jealousy."
2. *The SEC cannot assume that all investors are identically situated when it comes to the significance they attribute to omitted information.* In determining that materiality is a question of fact for the jury, the SEC had "assumed that [Commonwealth's 319,000] investors were identically situated" in terms of how they would view the disclosures and the omitted information. Instead, the Court held that the SEC had to offer evidence based on the circumstances of the adviser's clients and the significance those clients attributed to the omitted information. However, the court also recognized that "the SEC [is] not required to prove that any investor actually relied on [the Adviser's] misrepresentations."
3. *Investors that rely on "sophisticated and independent" adviser representatives to make investment decisions may insulate themselves from the adviser's conflicts and render them immaterial.* One reason the SEC was not entitled to summary judgment was because "clients made their investment decisions through their representatives rather than Commonwealth's recommendations or pre-constructed portfolios." The court described the representatives as "sophisticated and independent members of the financial industry" and implied that these representatives impaired "Commonwealth's capacity to indirectly influence clients toward more profitable share classes," which was the basis of the SEC's claim.
4. *The SEC's disgorgement amount is limited to a reasonable approximation of profits causally connected to the underlying violation.* The SEC is not entitled to disgorge all profits associated with a defendant's conflict of interest when only "some" or "a few" investors would be impacted by the omitted information. The disgorged profits must be causally connected to only those investors who were impacted by the material omission (as distinguished from investors who would not find the omitted information to be material).
5. *Disgorgement amounts should exclude legitimate expenses that have value independent of fueling a fraudulent scheme.* The only exception to this exclusion rule is "when the entire profit of a business or undertaking results from the wrongdoing," but even then the court must find that the expenses are "inequitable," such as "extraordinary salaries."

Background:

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The SEC alleged that Commonwealth, a dual-registered broker-dealer and investment adviser, failed to disclose to clients that its agreement with a clearing broker created a conflict of interest by incentivizing Commonwealth to direct clients' investments to funds that produce revenue-sharing income for Commonwealth over others that could have been cheaper for Commonwealth clients.

The district court granted the SEC's motion for summary judgment and held that potential conflicts of interest are material as a matter of law. It also awarded the SEC's disgorgement of around $65.5 million for clients invested in funds that resulted in greater profit to Commonwealth, noting that "at least some" of those clients may have elected to move their money to lower-cost funds.

Related Capabilities

Securities Enforcement

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