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# DC Circuit Decision Against Investment Adviser Leaves Many Unanswered Questions

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On April 30, 2019, US Court of Appeals for the DC Circuit decided an important case involving the disclosure obligations of investment advisers.[1] The case decided that an adviser's disclosure that it "may" have a conflict of interest was inadequate, that the adviser acted negligently despite its reliance on compliance consultants, and that it could not be found to have "willfully" made false statements in its Form ADV unless it acted intentionally or recklessly. All of these holdings have significant implications for advisers.

## Background

In 2014, the Securities and Exchange Commission (the Commission) instituted two enforcement actions which were litigated against registered investment advisers alleging that the advisers failed adequately to disclose a "revenue sharing arrangement."[2] In both cases, the advisers received compensation from the custodians of their respective client accounts for maintaining client assets in certain mutual funds offered on the custodian's platform. While such arrangements are legal, the Commission takes the view that they must be disclosed by the advisers receiving the revenue sharing payments.

In both of the litigated cases, the amounts of the revenue sharing payments were small and the advisers had disclosed that they "may" receive such payments and the payments "may" create a conflict. The advisers indicated that they selected the word "may" to describe the receipt of these payments because many recommended mutual funds did not generate such payments. The recipients also argued that the receipt of these small payments did not influence their recommendations.

## In re Total Wealth Management, Inc.

*In re Total Wealth Management, Inc.* was tried before the Chief Administrative Law Judge who ruled in favor of the Division of Enforcement.[3] The Judge found that:

It was grossly inaccurate and misleading for an investment adviser to represent that revenue sharing agreements "may" happen, when they had in fact already happened and governed a substantial portion of client investments. . . . I reject Cooper's argument that it was appropriate to use the word "may" to disclose the revenue sharing and consulting agreements because an investor could potentially have a portfolio consisting entirely of funds without revenue sharing agreements. . . . This argument mischaracterizes the purpose of the disclosure. The disclosure is not intended to address whether a client's portfolio may include funds with revenue sharing agreements, but whether such revenue sharing agreements were in place at all. Because such agreements were in place, disclosing that such agreements may be in place was false and misleading; the disclosures failed to make clear there were actual, present conflicts of interest at play. . . . Cooper's argument also fails because under its own logic, disclosure of existing conflicts of interest is not necessary unless clients are wholly guaranteed to be subject to those conflicts. . . . ("not all of the private funds held by the Altus Funds had revenue sharing arrangements"). That is simply not the law. See *Vernazza*, 327 F.3d at 860 (investment advisers have a duty to disclose all potential conflicts of interest accurately).

This decision was not appealed and became final.

## In re The Robare Group Ltd.

The second case was against The Robare Group (TRG) and its principals and has been litigated to the DC Circuit. After trial, the Administrative Law Judge ruled in favor of TRG.[4] The decision is based largely upon a finding that TRG lacked a sophisticated understanding of its disclosure obligations and relied upon two compliance consultants who approved the disputed disclosures. The Judge also was persuaded by the fact that the amounts of the payments were small and that "[the two principals of TRG] credibly testified that they did not know which funds paid fees under the Program. They also denied ever making an investment based on the information they lacked."

On appeal, the Commission reversed and sanctioned TRG, although one of the commissioners dissented to the entry of the sanctions.[5] The Commission found that the alleged nondisclosures were material, apparently because all potential conflicts of interest are material: "'[E]conomic conflicts of interest, such as undisclosed compensation, are material facts that must be disclosed' by investment advisers." The Commission found that the adviser's disclosure of the arrangement— "may" have a conflict disclosure—was inadequate: "TRG's disclosure that it may receive selling compensation in the form of 12b-1 fees in no way revealed that TRG actually had an arrangement with Fidelity, that it received fees pursuant to the arrangement, and that the arrangement presented at least a potential conflict of interest." Finally, the Commission found that TRG was negligent. Rejecting the argument that TRG relied upon the advice of two compliance consultants, the Commission noted that "[n]either Respondents nor the law judge cite any case recognizing a defense of reliance on compliance consultants." The Commission then went on to note that "even were such a defense available on grounds analogous to a reliance on counsel defense, we find that Respondents cannot establish it" because the compliance consultants were not fully informed and were not explicitly asked to give advice on the adequacy of the disclosures.

On appeal to the DC Circuit, the Court affirmed most, but not all, of the Commission's findings. Without detailed analysis, the Court found that the alleged nondisclosures were material, leaving open the question of whether all undisclosed conflicts of interest are *per se* material. The Court also found that TRG's "may" disclosure was insufficient to alert clients to the potential conflict of interest.

The DC Circuit Court also agreed with the Commission that TRG had been negligent. "Because a reasonable adviser with knowledge of the conflicts would not have committed such clear, repeated breaches of its fiduciary duty, TRG and its principals acted negligently." The Court did not directly address the fact that TRG relied on compliance consultants but found that every adviser should be aware of its disclosure obligations, regardless of what any experts might say.

The Court reversed the Commission's finding of a violation of Section 207 of the Investment Advisers Act of 1940 because in its view there had been no showing TRG had acted "willfully." Section 207 provides that "[i]t shall be unlawful for any person *willfully* to make any untrue statement of a material fact in any registration application or report filed with the Commission under section 203 or 204, or *willfully* to omit to state in any such application or report any material fact which is required to be stated therein." Decades of earlier authorities found that the use of the word "willfully" in a regulatory statute does not require a finding of recklessness or intent. (For example, the word "willfully" is used in the statutory provisions that authorize the Commission to commence administrative proceedings and has consistently been interpreted in those statutes to require no showing of recklessness or intent.[6]) The Court did not follow these precedents. Rather, the Court held that "willful" requires some form of intent and "[i]ntent and negligence are regarded as mutually exclusive grounds for liability." Therefore the Court concluded "[b]ecause the Commission found the repeated failures to adequately disclose conflicts of interest on TRG's Forms ADV were no more than negligent for purposes of Section 206(2), the Commission could not rely on the same failures as evidence of ‘willful[]' conduct for purposes of Section 207." In other words, the Court found that negligence was insufficient to find that TRG acted "willfully."

## Precedent Set?

This last holding has potentially sweeping implications for the Commission's administrative proceedings. For more than fifty years, "willfully" in the relevant statutes has been interpreted to require no showing that the respondent acted recklessly or intentionally. This established precedent now seems under question. If recklessness or intentional conduct must be shown for the Commission to prove violations of these regulatory statutes, many cases that were successfully prosecuted in the past may no longer be successfully prosecuted. The Commission's ability to enforce the law through administrative proceedings could be significantly limited.

Left unresolved by the Court's decision are numerous critical questions, such as:

1. Are all potential conflicts of interest material?
2. Is disclosure that an entity "may" have a conflict of interest always insufficient?
3. Is reliance on advice of compliance consultants ever a defense to liability?
4. Do all statutory provisions that require a respondent acted "willfully" require a showing of intent, or is some lesser showing of scienter sufficient?

## Conclusion

In light of this important decision, clients should review their disclosure of conflicts of interest and consider enhancing that disclosure in light of the guidance from the DC Circuit. Clients also should review available defenses in pending SEC investigations to see if new defenses are available.

1 *The Robare Group, Ltd., et al. v. SEC*, No. 16-1453 (D.C. Cir. April 30, 2019), available here.

2 *In re Total Wealth Management, Inc., et al.*, Admin Pro. No. 3-15842 (April 15, 2014); *In re The Robare Group Ltd., et al.*, Admin Pro. No. 3-16047 (Sept. 2, 2014).

3 Initial Decision, Aug.17, 2015.

4 Initial Decision, June 4, 2015.

5 Opinion of the Commission, Nov. 7, 2016.

6 Investment Advisers Act of 1940, Section 203(e)(1). See also Securities Exchange Act of 1934, Section 15(b)(4)(A) for administrative proceedings against broker-dealers.



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