LATHAM & WATKINS

Client Alert Commentary

Latham & Watkins Financial Institutions Industry Group June 25, 2019 | Number 2516

Key Appellate Court Ruling Ups the Ante for Investment Advisers Act Violations

In* Robare*, the D.C. Circuit clarifies the negligence and willfulness standards under Sections 206 and 207 of the Act.

On April 30, 2019, the United States Court of Appeals for the District of Columbia Circuit issued its decision in *The Robare Group, Ltd., et al. v. Securities and Exchange Commission*. The court's ruling upheld the Securities and Exchange Commission's (the Commission's or the SEC's) holding that the defendants violated Section 206(2) of the Investment Advisers Act (the Act) by negligently failing to disclose their conflict of interest arising from an incentive arrangement in place with Fidelity Investments Inc. (Fidelity) and reversed the Commission's holding that the defendants violated Section 207 of the Act by willfully filing Form ADV, which did not mention the conflict of interest.

The ruling is instructive to registrants in two key respects. First, it essentially converts Section 207 into a scienter-based violation. Second, it reinforces the ease with which the SEC can establish negligence under Section 206(2) for conduct that plainly falls short of compliance with an adviser's fiduciary duty to clients.

The ruling is a mixed bag for the Commission and for registrants. *Robare* clearly ups the ante on Section 207 violations, which will cut both ways. For example, while the SEC will have a harder time proving that a registrant violated Section 207 by omitting a conflict of interest from its Form ADV, a settlement that includes a Section 207 violation may now trigger collateral consequences such as a Regulation D bad actor disqualification. The decision also might make defending against Section 206(2) charges more difficult for registrants, as *Robare* lightens the SEC's burden of proving the standard of care for undisclosed conflicts. While the impact *Robare* will have on any particular matter depends on the facts, registrants should be aware of the potential implications in any future investigations or enforcement actions involving exposure under the Act.

Background on *Robare*

The Robare Group (TRG) is a Texas-based investment adviser that first registered with the Commission in 2003. In 2004, TRG entered into a revenue-sharing agreement with Fidelity in which Fidelity paid TRG when TRG's clients invested in certain qualifying funds offered on Fidelity's platform.

In 2014, the Commission instituted cease-and-desist proceedings against TRG and its two principals for alleged violations of Sections 206(1), 206(2), and 207 of the Act for failure to disclose adequately to its clients the revenue-sharing arrangement with Fidelity. Following an evidentiary hearing, an administrative law judge dismissed all charges against TRG and the principals on the basis that the Commission failed to establish the requisite scienter, negligence, or willfulness standards under Sections 206(1), 206(2), and 207, respectively. The Commission's Enforcement Division sought review of the administrative law judge's ruling before the Commission, and on de novo review, the Commission determined that TRG and its principals acted negligently, but without scienter, thus finding liability under Section 206(2), but not Section 206(1). The Commission further held that in light of the non-disclosure of the conflict on TRG's Form ADV, TRG and its principals also violated Section 207.

TRG and its principals appealed the Commission's ruling, arguing with respect to Section 206(2) that (1) the Robare Group provided all necessary disclosures and (2) even if the disclosures were insufficient, the Commission failed to establish negligent behavior. Regarding Section 207, TRG argued that the Commission failed to establish a willful violation. As further discussed below, the D.C. Circuit upheld the Commission's holding that TRG acted negligently and was liable under Section 206(2), but reversed the Commission's holding that TRG acted willfully and was liable under Section 207.

The Court's Ruling on Section 207

In addressing Section 207 liability, the court first acknowledged that it had yet to address the meaning of "willfully" in the context of Section 207, but assumed, without deciding, that the definition applied by the D.C. Circuit in *Wonsover v. SEC* in the context of Section 15(b)(4) of the Securities Exchange Act should govern. In *Wonsover*, the D.C. Circuit held that "willfully" means "intentionally committing the act which constitutes the violation" and specifically rejected an interpretation requiring that the actor must "also be aware that he is violating one of the Rules or Acts."

Building on *Wonsover*, the court then addressed whether the intentionality requisite inherent in "willfully" related to the drafting and submission of the Form ADV (as the Commission argued) or something greater (as TRG argued). The court sided with TRG, holding that willfully in the context of Section 207 requires an intent to deceive. The court explained that "willfully" in the statutory text is tied to the act of omitting the disclosure, rather than the act of completing or filing a Form ADV. The court further reasoned that reading "willfully" to apply to the omission, rather than the mere filing, ensures that a respondent like TRG cannot be found to have acted without scienter under Section 206(1), but nonetheless held liable for a "willful" violation under Section 207.

This holding squarely rejects the long-accepted view that the Commission need only show that the Form ADV was intentionally *filed* — a standard that, in practice, had been no bar at all. Indeed, before *Robare* the SEC repeatedly took the now-erroneous position that Section 207 did not impose any scienter requirement with respect to the underlying omission and that violations could be predicated on the mere submission of a deficient Form ADV alone.

The Court's Ruling on Section 206(2)

In ruling on TRG's Section 206(2) arguments, the court quickly dispensed with TRG's position that it had provided all necessary disclosures. While TRG's Form ADV mentioned it may receive certain "sales commissions" or "selling compensation", the court held that even if the payments from Fidelity fit those terms (which was disputed), TRG breached its fiduciary duty to its clients by failing to adequately alert them to the underlying arrangement it had in place with Fidelity.

In its alternative argument under Section 206(2), TRG principally contended that the Enforcement Division failed to establish a duty of care from which TRG could be found to have deviated. In support, TRG claimed that the standard of care for Form ADV disclosures is not self-evident and must be established with third party support such as expert testimony. The court rejected this argument, holding that regardless of how one defines the standard of care imposed by Form ADV, TRG's non-disclosure violated its fiduciary duty to its clients and that the breach was sufficiently obvious that a trier of fact could find negligence as a matter of common knowledge, even without the aid of expert testimony. Moreover, the court rejected TRG's notion that it had complied with industry standards, noting that "[e]ven assuming the TRG principals' conduct was like that of most other investment advisers at the time would not require the Commission to find that they acted reasonably." In other words, TRG's non-disclosure was held to be sufficiently egregious to warrant a negligence finding, regardless of countervailing expert testimony or evidence of industry standards.

Key Takeaways

Robare will change the landscape for registrants facing possible enforcement charges related to Form ADV disclosures. The required showing of "intent to deceive" will likely deter the Commission from charging Section 207 violations except in straightforward enforcement cases. When the Commission pursues Section 207 charges, it is more likely to name individuals in an enforcement action so that it can hold accountable whomever the Commission's staff believes had the intent to deceive. Additionally, now that the court has determined that Section 207 violations are scienter-based, Section 207 charges will likely trigger significant collateral consequences. For example, a Commission cease-and-desist order that includes a scienter-based violation subjects the respondent to a Regulation D bad actor disqualification.

Looking beyond Section 207, the ruling may also impact the construction of other sections of the Act and other federal securities laws that employ similar "willful" language, including Section 203 of the Act, Sections 15(b)(4) of the Securities Exchange Act of 1934, and Section 9(b) of the Investment Company Act of 1940.

Robare may also make defending against negligence charges more difficult for investment advisers. Before *Robare*, few cases discussed the standard of care that applied to advisers or how the Commission could establish negligence. *Robare* now provides the staff with an important precedent to argue that — regardless of countervailing industry standards or expert testimony — an investment adviser's failure to disclose a material conflict of interest breaches the standard of care that applies to fiduciaries.

We expect *Robare* to impact the Commission's approach to charging decisions and settlement negotiations. Registrants should consult with experienced SEC counsel as they consider their options in an SEC enforcement investigation.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

John J. Sikora Jr.
john.sikora@lw.com
+1.312.993.2625
Chicago

Jack M. McNeily*
jack.mcneily@lw.com
+1.312.876.6520
Chicago

**Admitted to practice in New York only.*

You Might Also Be Interested In

Supreme Court Ruling Extends Reach of Primary Liability for Securities Fraud

SEC Ends 2018 Signaling Its Approach to Regulating the Cryptocurrency Markets

9th Circuit Puts to Rest Decade-Old Northstar Litigation