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SEC Should Use Data-Driven Method For Materiality Standards

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A recent ruling in Robare Group Ltd. v. SEC by the U.S. Court of Appeals for the District of Columbia Circuit gave the U.S. Securities and Exchange Commission an apparent victory that may further fuel its ongoing efforts to use the "negligent fraud" theory in enforcement actions to determine what information is material, and thus required to be disclosed by investment professionals to their clients and customers.[1]

While the SEC has had mixed results in litigation to dictate what information is material and thus must be disclosed by investment advisers and broker-dealers, it has been successful in determining the disclosure standard via settled enforcement actions. In a number of these instances, the SEC characterized as fraud what many would view as disagreements over word choices and good-faith editing decisions.

But are SEC enforcement actions the right approach to help investors get the best information they actually need to make their investment decisions? A recent study commissioned by the SEC itself, along with a number of court decisions, indicates that investors may not actually care about or find useful information that the SEC has deemed to be material in its enforcement actions.

Instead of setting materiality standards by enforcement edicts, the SEC should gather additional data via studies and surveys of investor decision-making and habits, and work with investor groups and financial industry participants to find out what information investors really need. In short, the SEC should consider an approach driven by data.

Determining Disclosure Through Enforcement Actions

The SEC routinely uses the anti-fraud provisions of the federal securities law to go after industry participants for failing to disclose information that the agency deems to be material to the investing public.

The U.S. Supreme Court in TSC Industries Inc. v. Northway Inc.[2] states that in order for information to be material under the anti-fraud provisions, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." In other words, a person should not have to face the serious charge of securities fraud over failure to disclose trivial facts. Instead, the alleged omitted or misrepresented information must matter to a reasonable investor.

Yet the SEC has gone after investment advisers and broker-dealers for failure to disclose information that may not actually matter to reasonable investors. For instance, through a series of settled enforcement actions, the SEC has signaled to the industry that more details are required for disclosure of potential conflicts of interest, so that investors can have sufficient information to evaluate the magnitude and nature of the conflicts.

Under this approach, good-faith general disclosure of the potential for conflicted transactions could still constitute fraud. Indeed, the SEC has brought actions against industry participants using the word "may" as opposed to "is," and argued that the distinction was material.

In another example of the SEC's aggressive approach, the SEC found that an investment adviser violated anti-fraud provisions of the federal securities laws because the firm negligently failed to disclose to its clients a loan it received from a broker-dealer. However, the firm's Form ADV that was filed with the SEC did include a disclosure that it "may" have received a loan from a broker-dealer. Partly because the disclosure used "may" rather than "did," the SEC found that it did not include sufficient material information.

Mixed Results in Litigation

While successful in pushing this draconian approach via settlements, the SEC has had mixed results when challenged in litigation.

Even the SEC's recent victory in the D.C. Circuit had a tortured history. The SEC first charged the Robare Group and its principals with both intentional and negligent fraud for failing to disclose, in its Form ADV, a revenue-sharing agreement with a broker-dealer, and the resulting conflict of interest.

An SEC administrative law judge, after an extensive evidentiary hearing, dismissed the case. The ALJ found that Robare had sufficient general disclosure regarding its potential receipt of benefits from its broker-dealer that the alleged omission by the SEC was not material (nor had Robare acted negligently, let alone intentionally, in omitting the information).

The SEC commissioners, after de novo review, determined that Robare should have disclosed the specific information regarding the actual conflicted transaction. Generalized disclosure of potential payments and conflicts were insufficient. Nevertheless, the commission found that Robare did not act intentionally but only negligently.

One commissioner dissented on the sanctions, and stated that no civil penalties should be imposed against Robare. The D.C. Circuit generally affirmed the commission's view that Robare's disclosure did not include sufficient material information, but remanded the matter to the commission to determine appropriate sanctions, because the court found that Robare did not "willfully" violate one of the anti-fraud provisions.

Prior to Robare, the SEC suffered a significant defeat in connection with its aggressive position on materiality. In Flannery v. SEC,[3] the U.S. Court of Appeals for the First Circuit held that a disclosure may be materially sufficient if it puts investors on notice to seek additional information. The First Circuit found that an allegedly fraudulent PowerPoint slide, which presented "typical" and not "actual" sector allocations for a fund, was not materially misleading.[4]

Stating that "[c]ontext makes a difference[,]" the First Circuit cited to expert testimony that these types of presentations "serve as 'starting points,' after which due diligence is performed."[5] The First Circuit further cited to expert testimony that "a typical investor ... would understand that it could specifically request additional information regarding the fund."[6]

In addition, the SEC faced considerable headwind in litigation pushing for an aggressive interpretation of materiality when investors are considered sophisticated. For example, the SEC accused Lynn Tilton of fraud by, among other things, falling to properly disclose the deteriorating condition of some of the distressed private companies in which some of her funds invested.

Administrative Law Judge Carol Fox Foelak disagreed, finding that, contrary to the SEC's claims, Tilton did in fact disclose material information, focusing on the fact that Tilton's sophisticated investors would have had access to and the ability to review the information, negating the need for additional disclosure. Foelak cited United States v. Litvak,[7] emphasizing that "investor sophistication is a relevant consideration in assessing the adequacy of a defendant's disclosure."

But even if the SEC can support its aggressive views on materiality in future litigation, it does not mean that the agency's enforcement actions are actually improving investor understanding of information relevant to their investment decisions. One possible result of the SEC's hair-trigger approach to materiality is that industry participants may choose to err on the side of providing excessive data to investors in an effort to avoid getting dinged for insufficient disclosure. For example, a firm may choose to link or attach the underlying documentation relating to the transactions, resulting in an overwhelming amount of information for investors.

Study Commissioned by the SEC Raises Questions

A recent study commissioned by the SEC raises the question whether investors would in fact find those types of disclosures material. In November 2018, the SEC released a research report titled, "Investor Testing of Form CRS Relationship Summary."[8] The report, prepared by the RAND Corporation, followed the SEC's April 18, 2018, vote to propose rules intended to improve the quality and transparency of relationships that retail investors have with investment advisers and broker-dealers.

As part of the proposed rules, the SEC would require investment advisers and broker-dealers to provide "relationship summaries" to clients and customers, to help them understand the relationships and services a firm offers, the standard of conduct, the fees and costs associated with those services, and conflicts of interest a firm might have. In order to gather feedback on a sample relationship summary, the SEC's Office of the Investor Advocate engaged the RAND Corporation to conduct a nationwide survey and qualitative interviews of investors.

As part of the survey, respondents were asked to read a sample relationship summary and then complete a questionnaire. For purposes of this article, we will focus on the questions relating to the conflicts of interest section of the relationship summary provided in full below:

Broker-Dealer Services **Brokerage Accounts**	***Investment Adviser Services*** **Advisory Accounts**
Conflicts of Interest. *We benefit from the services we provide to you.*	
· We can make extra money by selling you certain investments, such as mutual funds, either because they are managed by someone related to our firm or because they are offered by companies that pay our firm to offer their investments. Your financial professional also receives more money if you buy these investments. · We have an incentive to offer or recommend certain investments, such as mutual funds, because the manager or sponsor of those investments shares with us revenue it earns on those investments. · We can buy investments from you, and sell investments to you, from our own accounts (called "acting as principal"). We can earn a profit on these trades, so we have an incentive to encourage you to trade with us.	· We can make extra money by advising you to invest in certain investments, such as mutual funds, because they are managed by someone related to our firm. Your financial professional also receives more money if you buy these investments. · We have an incentive to advise you to invest in certain investments, such as mutual funds, because the manager or sponsor of those investments shares with us revenue it earns on those investments. · We can buy investments from you, and sell investments to you, from our own accounts (called "acting as principal"), *but only with your specific approval on each transaction*. We can earn a profit on these trades, so we have an incentive to encourage you to trade with us.

Respondents were asked to select the two most informative and two least informative sections with respect to "helping you decide which types of investment accounts and services are right for you." Respondents were more likely to choose the conflicts of interest section as one of the least informative sections than as one of the most informative sections.
More than one-third of respondents found the conflicts of interest section to be difficult or very difficult

to understand, with 31.0% of respondents finding it "difficult" and 2.4% of respondents finding it "very difficult." Furthermore, when asked whether a respondent would add more detail, keep as is, shorten or delete, 47.5% of respondents would keep as is, 28.3% would shorten and 2.2% would delete. That leaves only 22% of respondents who would add more detail to the conflicts of interest section. Ironically, the sample disclosure above may actually constitute negligent fraud, in light of recent enforcement actions demanding more details.

Given that only 22% of survey respondents would include additional information in the conflicts of interest section, and that respondents were more likely to find this section one of the least informative

sections, it is questionable that the additional detailed disclosures the SEC has required through enforcement actions are, in fact, of interest to investors.

A Data-Driven Deliberative Process

Instead of dictating disclosure through what it views to be "material" information in the context of settled or litigated enforcement actions, the SEC should consider a data-driven deliberation process to determine what information would be helpful and meaningful to investors. Using the RAND study as a starting point, the SEC should commission additional studies and surveys to find out what investors want, including getting answers to the following questions:

- Are investors actually reading disclosures in documents such as Form ADV in making investment decisions?

- Do they care about or understand the information provided in such disclosures? What other information would they want that they are not getting?

- Is there a better format, in lieu of bulky forms and brochures, to get investors the information they need?

- Do different types of investors, e.g., retail versus institutional or retirees versus millennials, want different types of information?

Instead of lawyers fighting in court over whose opinions of materiality are correct, it would be much more productive if the SEC, investor groups and industry participants review such data and discuss and debate what information would best serve investors.

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[1] Robare Grp. Ltd. v. SEC, No. 16-1453, 2019 WL 1907220 (D.C. Cir. Apr. 30, 2019).

[2] TSC Industries Inc. v. Northway Inc., 426 U.S. 438, 449 (1976).

[3] Flannery v. SEC, 810 F.3d 1, 4 (1st Cir. Dec. 8, 2015).

[4] Id. at 10-11.

[5] Id. at 11.

[6] Id.

[7] United States v. Litvak, 808 F.3d 160, 185 (2d Cir. 2015).

[8] See https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationship-summary.pdf.