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Robare v. SEC: The D.C. Circuit "May" Have Punted on Key Disclosure Question, but Takes Clear Stand on "Willful" Conduct

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On April 30, 2019, the U.S. Court of Appeals for the D.C. Circuit issued a long-awaited decision in *Robare Group, LTD. v. SEC*, providing valuable insight for investment advisers as to the level of detail courts expect to see in disclosures—both to clients and the Commission—with respect to conflicts of interest. The *Robare* court also concluded that the SEC cannot sustain a charge of "willfulness" with merely negligent conduct.[1] This distinction—which runs in conflict with the SEC's historical position on what constitutes "willful" conduct—may impact the SEC's charging decisions in the months and years to come, and may limit its ability to seek certain remedies in settlements under the Investment Advisers Act of 1940 (the "Advisers Act") and possibly other securities laws.

I. Background

The Robare Group ("TRG") is an independent investment adviser based in Houston, Texas, run by the father-son-in-law team of Mark Robare and Jack Jones. As of 2013, TRG advised approximately 350 separately managed accounts.

In 2004, TRG signed onto a "revenue sharing arrangement" with Fidelity Investments ("Fidelity"), through which TRG received payments of "shareholder servicing fees" from Fidelity when TRG's clients invested in certain "eligible" non-Fidelity, non-transaction fee funds offered through Fidelity's on-line platform. Critically, only certain non-Fidelity, non-transaction fee funds were considered "eligible" under the arrangement. Although TRG's Form ADV disclosed that TRG "may receive selling compensation…as a result of the facilitation of certain securities transactions on Client's behalf...," the Form ADV did not describe the Fidelity revenue-sharing arrangement or mention Fidelity by name until December 2011,[2] and did not disclose the payment formulas or other details of the revenue-sharing arrangement that might be relevant to understanding when TRG would receive a fee until April 2014.[3]

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[1] No. 16-1453 (D.C. Cir., Apr. 30, 2019).

[2] TRG's December 2011 Form ADV read, in relevant part, "[W]e may receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity…" It did not specify that **only certain** "no transaction fee mutual fund assets in custody with Fidelity" were eligible under the arrangement while other similar "no transaction fee mutual fund assets in custody with Fidelity" would not result in TRG getting a revenue share fee.

[3] TRG's April 2014 disclosures as they related to the Fidelity arrangement were significantly more robust. Critically, the April 2014-updated Form ADV (1) was definitive as to TRG's receipt of fees from Fidelity, (2) described in detail the specifics of the fee-sharing arrangement and (2) stated explicitly that the arrangement might incentivize TRG to direct client assets to eligible funds over non-eligible funds:

"Additionally, we receive additional compensation in the form of back-office, administrative, custodial support and clerical services from Fidelity based on revenue from the sale of certain funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely No Transaction Fee ("NTF") mutual fund assets in custody with Fidelity. NTF mutual funds are mutual funds that are offered through advisors or brokers without any transaction charge. Robare simply receives additional compensation over and above our asset management fee to recommend such mutual funds. Fidelity Funds are excluded from this arrangement, meaning Robare does not receive this fee on any Fidelity Funds recommended or purchased for client accounts. Robare is paid from 2 to 12 basis points (or from $.02 to $.12 for every $100 every year), depending on the amount of eligible assets, on applicable client assets held at Fidelity on an ongoing basis for participating in this agreement with Fidelity…[T]his arrangement may give rise to conflicts of interest, or perceived conflicts of interest, as Robare would benefit more by recommending, or investing in, NTF funds for clients. Clients should be aware that Robare's receipt of additional compensation from Fidelity creates a potential conflict of interest since this

The SEC's Division of Enforcement (the "Division") initiated administrative proceedings against TRG and its principals in September 2014, alleging that TRG's pre-April 2014 disclosures of the Fidelity arrangement were insufficient, in violation of Sections 206 (1), 206 (2), and 207 of the Advisers Act, 15 U.S.C. §§ 80b-6, 80b-7. Section 206 proscribes fraud against clients. Section 206 (1) requires a showing of scienter, while Section 206 (2) requires only negligent conduct.[4] Section 207 governs advisers' disclosures to the SEC, and requires "willful" conduct (which may include willfully omitting to state a material fact required to be stated in a form filed with the Commission).[5]

Following an evidentiary hearing, an administrative law judge ("ALJ") dismissed the charges entirely, concluding that the Enforcement Division had failed to show that Robare and Jones acted with any intent to defraud in their disclosures of the Fidelity arrangement. The ALJ also determined that TRG and its principals had not acted negligently.[6]

The Enforcement Division sought *de novo* review by the Commission, which determined that TRG and its principals "failed adequately to disclose material conflicts of interest" and "in so doing they acted negligently (but without scienter)" in violation of Section 206 (2) but not Section 206 (1). The Commission also determined that the same conduct and disclosures constituted a violation of Section 207, which, as noted above, requires willful misconduct.[7] TRG and its principals sought review of the Commission's decision by the D.C. Circuit.

II. The D.C. Circuit's Opinion

In reviewing the Commission's decision with respect to Section 206 (2), the court looked closely at the evolution of TRG's disclosures. It agreed with the Commission that "no reasonable client reading" of TRG's Forms ADV prior to December 2011—the first time the Fidelity was mentioned by name—could have revealed the existence of the revenue-sharing agreement with Fidelity. Further, the court agreed with the Commission that TRG's December 2011 update to its Form ADV, disclosing fees from Fidelity on "no transaction fee mutual fund assets in custody with Fidelity," was insufficient because it failed to inform investors that only certain funds meeting this description were "eligible" under the revenue-sharing arrangement and thus failed to inform investors of TRG's incentive to invest specifically in the eligible funds.

The court further concluded that TRG and its principals behaved negligently in failing to adequately disclose the relationship with Fidelity. Importantly, the court found TRG's argument that its disclosures conformed to or exceeded industry standards unavailing. Negligence, the court opined, "is judged against 'a standard of reasonable prudence, whether [that standard] usually is complied with or not.'"[8] Because TRG knew of and acknowledged the potential conflicts inherent in the Fidelity relationship but failed to disclose them to investors in sufficient detail, they were liable under Section 206 (2).

With respect to the charges under Section 207, however, the court diverged from the Commission and departed from the SEC's historical interpretation of the "willfulness" standard under the securities laws. The court assumed, without

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benefit may influence Robare's choice of Fidelity over custodians that don't furnish similar benefits and NTF funds over funds not covered by this arrangement…."

[4] In relevant part, Section 206 reads:

"It shall be unlawful for any investment adviser…directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client…."

15 U.S.C. § 80b-6.

[5] Section 207 provides: "It 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 80b-3 or 80b-4 of this title, or willfully to omit to state in any such application or report any material fact which is required to be stated therein." 15 U.S.C. § 80b-7.

[6] *Robare Grp., Ltd.*, Initial Decision Release No. 806 at 39, 42-44, 111 SEC Docket 3765, 2015 WL 3507108 (June 4, 2015).

[7] *Robare Grp., Ltd.*, Investment Advisers Act Release No. 4566, 115 SEC Docket 2796, 2016 WL 6596009 (Nov. 7, 2016).

[8] *See supra* n.1, quoting *Beard v. Goodyear Tire & Rubber Co.*, 587 A.2d 195, 199 (D.C. 1991).

deciding, that the definition of "willful" conduct espoused in *Wonsover v. SEC*[9]—that "willfully" means "intentionally committing the act which constitutes the violation" but does not require that "the actor…be aware that he is violating" the law—was the appropriate standard. The *Robare* Court made clear, however, that the "intent" required by this standard could not be established by merely negligent conduct. Although TRG's principals "willfully" reviewed and approved the content in TRG's Forms ADV, the court opined, their omission of the details of the Fidelity relationship was merely negligent, not intentional, and thus was not sufficient to sustain a charge under Section 207.

III. Key Takeaways

- ***"May" may or may not be sufficient—but disclosure of potential conflicts is essential.*** From an operations perspective, the *Robare* decisions further hones our understanding of the level of detail necessary in advisers' disclosure of potential conflicts of interest to clients and the SEC.

  For example, both the ALJ and the Commission's decisions focused on the word "may" in TRG's disclosures related to the Fidelity arrangement, leaving many advisers questioning whether disclosures that an adviser "may" receive fees or compensation are ever sufficient to fully and fairly inform investors of a conflict of interest where an adviser *in fact* receives such compensation. In exams and in at least one other enforcement settlement, the SEC staff has been clear that it believes that stating an event "may" occur when it is, in fact, occurring is insufficient disclosure.[10] The *Robare* Court was silent on this issue.[11] The court was clear, however, that to the extent receipt of a fee may impact an adviser's substantive decisions about how and where to invest client assets, advisers must describe the specific contours of the conflict—not just potential receipt of a fee itself—to investors. Advisers would do well to continue to evaluate their conflict of interest disclosures to ensure that they are providing investors and the SEC with sufficient information to identify and evaluate each specific conflict and should consider whether to use a formulation such as "is and will likely in the future" versus "may" to describe existing conflict situations.

- ***"Industry Standard" is not necessarily enough.*** Additionally, *Robare* makes clear that alignment with market practice is not, on its own, sufficient to overcome charges of negligence. While industry standards still serve as an important guide post for adequacy, the D.C. Circuit made clear that they are no substitute for a fully informed, common sense assessment of disclosures to ensure that investors are receiving the appropriate level of detail to evaluate potential conflicts of interest. Consider the old maxim—just because it's "industry standard" to jump off a bridge does not mean it's reasonably prudent to do so. In light of this reminder, advisers should review disclosures to confirm that they are not only in line with market practice but also reasonable based on the advisers' specific circumstances.

- ***"Willfulness" and "Negligence" are mutually exclusive.*** From an enforcement perspective, perhaps the most remarkable aspect of the *Robare* decision is the D.C. Circuit's departure from the SEC's historical interpretation of the *Wonsover* standard. The SEC has, in the past, traditionally used negligent omission in conjunction with intentional conduct (i.e., signing off on a Form ADV or approving a disclosure) to satisfy the "willfulness" requirement for charges under Section 207 in cases involving material omissions. The *Robare* decision suggests that they now need more. By interpreting the "willfulness" requirement of Section 207 as being tied to the act of omission itself—and not simply to submission of the Form ADV to the Commission—the court made clear that negligent omissions on their own could not sustain a charge under Section 207.

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[9] 205 F.3d 408 (D.C. Cir. 2000).

[10] *See, e.g., Daniel R. Lehl*, Securities Act Release No. 8102, 2002 WL 1315552, at *11 (May 17, 2002) ("[T]he disclosure that persons associated CFS and WSW 'may' receive compensation…is misleading and inadequate when they in fact received or contracted to receive compensation.").

[11] It is worth noting, however, that TRG's the April 2014 Form ADV—of which the Court and the Commission appear to agree contained sufficient detail—removed the word "may" with respect to TRG's receipt of fees from Fidelity. *See supra* n.3.

Because the *Wonsover* standard has been relied on to establish "willfulness" under a variety of provisions under the Advisers Act and other securities laws, the implications of this decision may have an even broader reach. For example, for years, the SEC has relied on the *Wonsover* standard to justify censure under Section 203(e)(5) of the Advisers Act[12] in settlements for negligence-based violations of the securities laws, importing language suggesting intent into these otherwise negligence focused agreements. *Robare* throws this practice into question. Similar provisions under other securities regimes could extend *Robare*'s impact to settlement agreements beyond the investment adviser space as well.[13]

It remains to be seen how the Commission will react to this decision, but it is difficult to imagine that *Robare* will not meaningfully impact settlement agreements and charging decisions in the months and years to come. For current enforcement matters, advisers and their counsel should evaluate whether the core conduct at issue in any Section 207 charge or other charge requiring "willfulness" is intentional or merely negligent.

[12] Section 203(e)(5) reads, in relevant part, "The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such investment adviser, or any person associated with such investment adviser, whether prior to or subsequent to becoming so associated…has willfully violated any provision of the Securities Act of 1933 [15 U.S.C. 77a et seq.], the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.], subchapter I of this chapter, this subchapter, the Commodity Exchange Act [7 U.S.C. 1 et seq.], or the rules or regulations under any such statutes or any rule of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision."

[13] *See, e.g.*, 15 U.S.C. § 78o(b)(4) (the provision at issue in *Wonsover*)