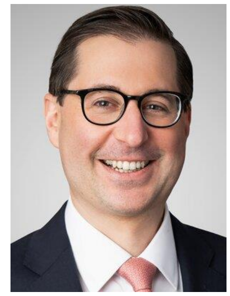
1st Circ. Ruling May Slow SEC Retail Investment Advice Cases

By **Andrew Dean, Chris Mulligan and Chelsea Spence** (April 22, 2025)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On April 1, the U.S. Court of Appeals for the First Circuit overturned a lower court's $93.3 million summary judgment ruling for the U.S. Securities and Exchange Commission against a retail adviser for its alleged failure to disclose conflicts of interest.

The First Circuit ruled that the question of materiality should have gone to a jury, and that the SEC needed to show more of a causal connection between the violation and the harm to investors in order to obtain the disgorgement amount of approximately $65 million. As discussed below, the First Circuit's decision may raise the bar for SEC enforcement actions.

Background

In SEC v. Commonwealth Equity Services LLC, the SEC alleged that, between 2014 and 2018, Commonwealth had failed to disclose conflicts of interest related to revenue sharing payments it received from a clearing broker when Commonwealth invested client assets in certain classes of mutual funds, in violation of Section 206(2) of the Investment Advisors Act of 1940.[1]

Commonwealth disclosed to clients the existence of the revenue sharing arrangement with the clearing broker — including the nature of the fees and the possibility that advisers may receive fees for making certain recommendations or investment decisions.

However, the SEC claimed that Commonwealth's disclosures were inadequate because they failed to disclose that the agreement created a conflict of interest, by incentivizing Commonwealth to direct its clients' investments to mutual fund share classes that produced revenue sharing income for Commonwealth instead of other share classes that could have been cheaper for its clients.

The U.S. District Court for the District of Massachusetts granted summary judgment in favor of the SEC on the basis that Commonwealth's disclosures were inadequate as a matter of law, reasoning that it is "well-settled" that conflicts of interest are material facts that investors would consider important in making decisions, and that Commonwealth's disclosures failed to provide important information about the potential conflict — including that other share classes of the same fund existed at lower costs.

The First Circuit disagreed, finding that the question of whether the alleged omission of certain statements was material constituted a jury issue.

The court stated that a reasonable jury could find, as Commonwealth argued, that additional disclosures coupled with the already-disclosed conflict of interest would not have been material to Commonwealth's clients. Indeed, the court noted that the SEC's evidence assumed that the investors were "identically situated" but a "reasonable jury could find those assumptions questionable and not substantiated," especially because "[t]he SEC did not provide testimony from any Commonwealth clients or representatives describing the significance they attribute to the omitted information."

The First Circuit also vacated the district court's award of disgorgement, ordering that, should a jury find Commonwealth liable, the court must reconsider whether the SEC adequately established a causal relationship between Commonwealth's profits and the violations, as well as whether Commonwealth is entitled to deduct its expenses from such an award.

The district court had held that the entire amount the SEC submitted as profits (approximately $65 million) represented an appropriate disgorgement amount, because at least some clients would have moved money to lower-cost funds had there been more robust disclosures around the conflict of interest.

But the First Circuit emphasized that disgorgement figures must be a reasonable approximation of the defendant's unjust enrichment, and found that the district court's analysis was much too attenuated to justify such a large disgorgement award.

It is worth noting that this decision also attracted industry attention. In particular, the Financial Services Institute, a trade association representing investment advisers and broker-dealers, argued in its amicus brief to the First Circuit that the case revolved around some "[c]omplicated empirical questions" that the district court had improperly "waived away or otherwise excused."

The FSI warned of the "significant implications" for investment advisers if the SEC's disgorgement authority was not "properly constrained by the requirement that disgorged profits bear a causal connection to unlawful activity."[2]

Takeaways

Speed Bump That May Slow Enforcement of Retail Advisers

Most significantly, the First Circuit's decision is a speed bump for this commission's focus on retail investors. The case against Commonwealth, filed in 2019, was part of the SEC's broader focus under then-Chairman Jay Clayton on issues affecting retail investors, and specifically the SEC's dedicated effort to address investment advisers' purported failures to disclose conflicts of interest.

Those efforts included the Division of Enforcement's share class selection disclosure initiative, which commenced in 2018 and is a cousin of the revenue sharing cases, which targeted investment advisers who failed to adequately disclose conflicts of interest related to their receipt of so-called 12b-1 fees.

The 12b-1 fees paid by mutual funds to advisers and/or their affiliates often meant that investors were being disadvantaged. As the SEC stated, "it is usually in the client's best interest to invest in the lower-cost share class rather than the 12b-1 fee paying share class, because the client's returns would not be reduced by the 12b-1 fees."[3]

In 2019 and 2020, following the Share Class Selection Disclosure Initiative self-report deadline, the commission issued orders against 98 investment advisers resulting from self-reported disclosure violations, resulting in roughly $139 million in total disgorgement.[4]

For parties that did not self-report, or did not choose to settle these types of retail cases, the SEC embarked on an enforcement path that included multiple litigated matters.[5]

As discussed below, the Commonwealth decision likely requires the SEC in similar types of cases to expend more resources to bring successful enforcement actions, meaning we could see a decrease in the number of settled or litigated actions. And during settlement negotiations, defense counsel will likely use the decision to push back against the SEC's disgorgement calculation.

Threshold for Materiality Findings

Retail adviser cases often involve hundreds or thousands or more of allegedly harmed investors; Commonwealth had over 300,000 investors and 2,300 representatives, for example.

As the First Circuit found there, those investors "differed in many categories of ways, including as to the types of investors, types of investments, types of investment goals they set, and what advice they received from their representatives." As a result, the court found that a reasonable jury could conclude that additional disclosures would not have significantly altered the mix of information.

While the circuit court acknowledged the reasonable investor standard and that the SEC did not need to prove reliance, the effect of the decision is that the SEC may need to show how different categories of investors would have reacted to the disclosures at issue.

This is a potentially significant requirement and it is not clear how many of the 300,000 investors the court would expect to testify in order for the SEC to demonstrate materiality.

It also raises the possibility that the defendant could call investors to testify that the information was not material to them. And because there are 300,000 investors, it likely would not be difficult to find a reasonable number of such investors. The fact that the adviser made tens of millions of dollars from the alleged lack of disclosure did not appear to be dispositive to the circuit court.

On the other hand, it is possible that the court was influenced by the role played by Commonwealth's independent adviser representatives, several of whom testified that cost was a factor, but not the only factor, in selecting a share class.

Another Setback to the SEC on Disgorgement

The decision also presents a setback to the SEC in proving disgorgement. Generally, to obtain disgorgement, the SEC need only show a reasonable approximation of ill-gotten gains.

As the First Circuit found, "[a]lthough 'a reasonable approximation' obviously need not be exact, it requires more analysis and connection than is provided to move from 'a few' investors to 'every' investor."

Similar to the materiality analysis, this puts the SEC in the position of deciding how far it needs to go to prove materiality.

Watch the Supreme Court

On March 5, in a case that was cited heavily by the First Circuit in Commonwealth, the U.S.

Supreme Court was asked to take up the issue of whether the SEC must prove that investors actually relied on the misrepresentation or omission, and if the investment adviser produces evidence of nonreliance, whether the materiality issue must then be determined by a jury.[6]

Last year, in that case, SEC v. Navellier, the First Circuit upheld a summary judgment order in favor of the SEC, refusing to consider the defendant's evidence that investors did not rely on the alleged misrepresentations.

The circuit court held that the misrepresentations were material because they were "obviously important to an investor" despite the evidence of nonreliance presented, noting that the SEC need not "prove that any investor actually relied on [the] misrepresentations."[7]

While the Supreme Court has yet to decide whether it will take the case, the First Circuit's decision in Commonwealth shows how proving materiality starts to overlap with demonstrating reliance, which is not currently required to be proven by the SEC as a matter of law.

Remediation May Obviate an Enforcement Action or a Penalty

As already signaled by the incoming commission, if retail advisers are able to fully remediate in connection with an SEC examination, there is an increased likelihood that the adviser can avoid an enforcement action.

At a minimum, similar to the Share Class Selection Disclosure Initiative, there is a much greater chance that if there is an enforcement action, such remediation will result in lower or no penalties.

Conclusion

While the First Circuit's decision may make it more difficult for the SEC to prove violations in these matters, the incoming commission's anticipated focus on investor protection will likely not dissuade the staff from pursuing these cases, even if it requires more investigative steps.

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[1] Section 206(2) prohibits advisers from engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," and as such requires full disclosure of all material facts, including conflicts of interest. 15 U.S.C. § 80b-6(2); see SEC v. Cap. Gains Res. Bur., 375 U.S. 180, 191-92 (1963) (finding that the Act "reflects . . . a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser — consciously or unconsciously — to render advice which was not disinterested.").

[2] Brief for Amicus Curiae FSI, dated Aug. 1, 2024, SEC v. Commonwealth Equity Servs. LLC, No. 23-1427 (2d Cir.).

[3] Share Class Selection Disclosure Initiative, SEC (May 1, 2018).

[4] 2019 Annual Report, SEC Div. of Enforcement, at 10-11; SEC Orders Three Self-Reporting Advisory Firms to Reimburse Investors, SEC (Apr. 17, 2020), https://www.sec.gov/newsroom/press-releases/2020-90.

[5] SEC v. Ambassador Advisors, No. 20-cv-02274 (E.D. Pa.) (SEC prevailed at trial, and in October 2022, the court granted SEC's request for $600,000 in disgorgement, accompanied by a $1.2 million civil penalty); SEC v. CapWealth Advisors, No. 20-cv-01064 (M.D. Tenn.) (defendants found not liable in November 2022 jury verdict); SEC v. Cambridge Inv. Res. Advs. Inc., No. 22-cv-00071 (S.D. Iowa) (March 2025 judgment in favor of the SEC following settlement, resulting in more than $13 million in disgorgement and prejudgment interest, accompanied by a $1.8 million civil penalty).

[6] Petition for Writ of Certiorari at 5, Navellier & Assocs. Inc. v. SEC, No. 24-949.

[7] SEC v. Navellier & Assocs. Inc., 108 F.4th 19, 37 (1st Cir. 2024).