

First Circuit Questions Materiality in SEC's Case Against Commonwealth Equity Services

WRITTEN BY

Jay A. Dubow | Ghillaine A. Reid

On April 1, the U.S. Court of Appeals for the First Circuit [vacated](#) a summary judgment ruling in favor of the Securities and Exchange Commission (SEC) against Commonwealth Equity Services, LLC, also known as Commonwealth Financial Network (Commonwealth). The case, which involved allegations of inadequate disclosure of potential conflicts of interest, was remanded for further proceedings.

Background

Commonwealth, an SEC-registered broker-dealer and investment advisor, offers advisory services through a network of approximately 2,300 investment advisor representatives. These representatives operate independent advisory businesses but are affiliated with Commonwealth. They are responsible for identifying prospective clients, managing clients' accounts, and offering only those products approved by Commonwealth.

From 2014 to 2018, Commonwealth had a revenue-sharing arrangement with National Financial Services, LLC (NFS), a clearing broker. Under this arrangement, NFS paid Commonwealth a portion of the fees it received from mutual fund companies participating in its No Transaction Fee (NTF) and Transaction Fee (TF) programs. The SEC alleged that Commonwealth failed to adequately disclose this arrangement, which created a conflict of interest by incentivizing Commonwealth to direct clients' investments to mutual fund share classes that produced revenue-sharing income for Commonwealth. During that period, NFS paid Commonwealth approximately \$189.1 million, which included both revenue-sharing payments and payments for other expenses. As a result, the parties disagree as to what portion of total payments were paid pursuant to the revenue-sharing agreement.

District Court Proceedings

The SEC initiated a civil enforcement action against Commonwealth, alleging violations of Sections 206(2) and (4) of the Investment Advisers Act of 1940 and SEC Rule 206(4)-7. The district court granted the SEC's motion for summary judgment on liability and awarded approximately \$93 million in disgorgement, prejudgment interest, and civil penalties.

The district court held that Commonwealth's disclosures were inadequate as a matter of law, reasoning that the revenue-sharing arrangement was a material fact that should have been disclosed. The court also found that Commonwealth's failure to disclose the arrangement constituted a negligent breach of its fiduciary duty.

Appeal and First Circuit Decision

Commonwealth appealed the district court's decision, arguing that the issue of materiality should have been decided by a jury. The First Circuit agreed, vacating the summary judgment and the disgorgement order, and remanding the case for further proceedings.

The First Circuit emphasized that materiality is typically a question for the jury. The court noted that determining whether an omitted fact is material requires delicate assessments of the inferences a reasonable investor would draw from a given set of facts. The court found that a reasonable jury could conclude that additional disclosures with more precise descriptions would not have significantly altered the "total mix" of information available to investors. The court described some of the relevant evidence:

But clients made their investment decisions through their representatives rather than Commonwealth's recommendations or pre-constructed portfolios. These representatives were themselves sophisticated and independent members of the financial industry who recommended to their clients the funds and share classes to be purchased. Four of the six representatives conducted independent research to determine what share class was best for a particular client. One representative testified that he never used Commonwealth's preconstructed portfolios or Mutual Fund Resource Guide. There is no evidence that Commonwealth limited or otherwise affected representatives' ability to research and assess the comparative cost of funds. Further, representatives looking to purchase a fund could use that fund's publicly available prospectus to compare the various share classes and find one that best suited their clients' investment strategy.

The court also addressed the district court's error in applying a per se rule that all potential conflicts of interest are material. The First Circuit clarified that the correct test for materiality requires a fact-specific inquiry, and the district court's generalized conclusion was insufficient.

Disgorgement Award

The First Circuit also vacated the disgorgement award, finding that the SEC had not adequately shown a reasonable approximation of Commonwealth's unjust enrichment. The court noted that the district court's reasoning was incompatible with the requirement that disgorgement represent a reasonable approximation of the defendant's unjust enrichment. The court instructed the district court to consider whether the SEC had established causal relationships between Commonwealth's profits and its alleged violations and whether Commonwealth was entitled to deduct its expenses from any disgorgement awarded.

Conclusion

The First Circuit's decision in *Commonwealth Equity Services, LLC v. SEC* underscores the importance of jury determinations in assessing materiality and the need for a fact-specific inquiry in securities enforcement actions. The decision also is important for determinations of appropriate disgorgement amounts. The case has been remanded for further proceedings, and it remains to be seen how the district court will address the issues identified by the First Circuit.

RELATED INDUSTRIES + PRACTICES

- Corporate
- Corporate Governance
- Financial Services
- Securities Investigations + Enforcement
- Securities Litigation
- White Collar Litigation + Investigations