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An Important Question For SEC Nominees

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As the U.S. Senate continues its vetting of the two presidential nominees for the vacant positions of U.S. Securities and Exchange Commission commissioners, the nominees should be asked to discuss their views regarding a practice commonly known as "rulemaking by enforcement." This practice involves a government agency, such as the SEC, using an enforcement action (often in the form of a settled case) to establish a new standard of disclosure or conduct that arguably should be established through rulemaking, accompanied by due process and deliberations required by law.

Current SEC Commissioner Michael S. Piwowar has expressed concerns that the SEC would use enforcement measures to "create new interpretations of the laws or regulations or impose new regulatory requirements" to circumvent rulemaking. In doing so, the SEC avoids requirements of rulemaking that may be resource-intensive and time-consuming, but provide key due process protections for those who may ultimately be subjected or affected by the rule. For instance, the rulemaking process requires an agency such as the SEC, before finalizing the rule, to issue a release of the proposed rule, solicit and consider public comments, perform a cost/benefit analysis of the rule, and amend the proposed rule if necessary. As part of this process, anyone who may be subject to the rule will also have adequate notice and warning so that he/she can take steps to comply with the rule before it is promulgated.

Of course, it is not rulemaking by enforcement if the SEC is applying the federal securities laws to a novel fact pattern that nevertheless clearly involves fraud or other illegalities. For instance, no one would dispute the fairness of the SEC going after 32 individuals last year for hacking into newswire services to facilitate insider trading, even though the matter involved new and unusual facts and circumstances.

Unfortunately, rulemaking by enforcement may become a more tempting shortcut because of certain developments within the SEC's enforcement program. Typically, it is not easy for the SEC to establish a new standard through enforcement action if it has to prove that someone had intentionally committed securities fraud. Presumably, it would be hard to prove intent to deceive if the alleged misconduct was not already known to be improper. However, since the financial crisis, the SEC has increasingly been willing to bring enforcement actions based on the theory of "negligent fraud," i.e., that a person or entity committed fraud by failing to meet a certain standard of conduct or disclosure that the SEC views as "reasonable."

This approach provides the SEC a great deal of room to define reasonable standards through

enforcement action. In addition, by offering charges based on negligence as opposed to intent, entities considering both potential reputational damage and cost of a trial would more likely settle as opposed to taking the case to trial or risk the SEC alleging intent to deceive.

Consider as an example the Kafkaesque nightmare experienced by a relatively small, family-run investment adviser firm in Texas called the Robare Group. In 2014, the SEC charged the firm and two of its principals, Robert Robare and his son-in-law, for both intentional and negligent fraud. The SEC enforcement staff alleged that the Robare Group failed to disclose in an SEC form (Form ADV) a revenue sharing agreement the Robare Group had with an outside broker-dealer custodian firm when recommending mutual funds offered by that broker-dealer firm. According to the SEC, the undisclosed information would have alerted investors that the Robare Group had a conflict of interest in serving its clients. But here is the rub. The SEC went after Mr. Robare and his firm even though there was disclosure that the firm "may" receive compensation from the broker-dealer. The disclosure was prepared based on advice from two outside compliance consulting firms with expertise on the Form ADV.

According to an interview of Mr. Robare by an industry publication, he and his firm "came under a lot of pressure to settle, and could have with more benign charges." No doubt the "more benign charges" involved just negligence as opposed to the more serious intentional fraud. Instead of rolling over, Mr. Robare took the SEC to trial in the form of an SEC administrative hearing, even though it resulted in the SEC enforcement staff alleging intentional, as well as negligent, fraud. The SEC enforcement staff argued during the hearing that the word "may" was misleading. Presumably, the SEC wanted Mr. Robare to use the word "is" or "does" in disclosing receipt of compensation from outside parties. Such wordsmithing was the basis for a federal government agency charging a small business owner with fraud. Fortunately, last year, SEC in-house administrative law judge James Grimes dismissed all charges after an evidentiary hearing. But Mr. Robare's ordeal continues as the SEC enforcement staff is now appealing Judge Grimes' decision before the SEC commissioners.

It is hard to believe that the SEC would use the full might of its enforcement power against a small investment adviser firm over what amounts to an editing disagreement. Instead, whether or not intended by the SEC commissioners, many in the financial industry are likely interpreting the Robare action as the SEC disfavoring revenue sharing between an investment advisory firm and its broker-dealer on sale of mutual funds. The apparent message is that no amount of disclosure will satisfy the SEC staff. Keep in mind the practice is not prohibited by any SEC rule and may benefit investors in lowering costs. Thus a de facto rule is made without the laborious work of rulemaking.

So a simple question to the two SEC nominees: Is this fair?

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