CARLTON FIELDS

In Flannery v. SEC, First Circuit Rebukes Commission, Signals Departure from Deferential Review

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On December 8, 2015, the U.S. Court of Appeals for the First Circuit ruled in *Flannery v. SEC* that the Securities and Exchange Commission lacked substantial evidence in finding securities law violations by two executives in connection with the operation of a State Street Bank bond fund. The SEC's loss is significant because the substantial evidence test is highly deferential to agency fact-finders and is rarely cited for overturning agency decisions. Also, the First Circuit's reversal was the latest in a string of challenges to the SEC's authority in 2015. In this case, the Commission charged a chief investment officer and a vice president of State Street Global Advisers with materially misrepresenting the extent of subprime mortgage-backed securities exposure in the State Street Limited Duration Bond Fund. In October 2011, after an evidentiary hearing, the Commission's Chief Administrative Law Judge rejected those charges on two grounds. First, the ALJ concluded that the statements were not materially misleading and did not contain material omissions. Second, the statements at issue primarily consisted of fund fact sheets and a PowerPoint slide, and the two executives did not have ultimate authority over the content of those documents. Instead, other employees made the final decision regarding the content of the statements. The SEC's Division of Enforcement appealed to the full Commission, which, in a 3-2 decision, reversed the ALJ's ruling and found the two executives liable. In reversing the ALJ, the Commission found that (1) the statements at issue were materially misleading, and (2) the two executives had substantially participated in drafting them. The Commission suspended each individual from the investment advisory business for a year, and imposed over $70,000 in civil penalties between them. The executives appealed to the First Circuit. In vacating the SEC's Order, the First Circuit held that there was no substantial evidence in the record to support the Commission's imposition of liability. Specifically, the court found no evidence from the sole investor who testified to the materiality of the PowerPoint slide at issue, whereas the executive had presented expert testimony that rebutted both the materiality of and any justifiable reliance upon the slide. The court also found that the Commission had not identified any evidence regarding the materiality of the statements at issue in the other written materials, nor had the Commission shown that those statements were inaccurate. The court emphasized the interrelatedness of the materiality and scienter analyses for the allegedly misleading statements, when it stated: "Questions of materiality and scienter are connected. . . . If it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that defendants acted with the requisite intent or extreme recklessness in not disclosing the fact." The court further stated that such a "thin materiality showing [by the Commission] cannot support a finding of scienter." The First Circuit's reversal of the SEC in *Flannery* may herald a move by courts away from automatic approval of the Commission's actions. If nothing else, *Flannery* ended a contentious year for the agency, during which the SEC faced significant criticism over its administrative court system and suffered some setbacks in legal challenges to that system. It remains to be seen whether 2016 will continue that trend or whether the SEC will regain its footing.

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