A TOUCH OF CLASS: MUTUAL FUND SHARE CLASS DEVELOPMENTS (PART 2)

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IV. REGULATORS' FOCUS ON MUTUAL FUND SHARE CLASSES

As mutual funds began to increase the number of share classes they offered, regulators began to scrutinize whether the fee structures commonly associated with different share classes presented a potential conflict of interest between an investor's interests, on one hand, and an investment adviser's or broker-dealer's interest on the other. In a Notice to Members from 2005, the National Association of Securities Dealers ("NASD"), the predecessor agency to FINRA, alerted registered broker-dealers that transactions involving Class B and Class C shares, with their higher annual expenses than Class A shares, were "under increased scrutiny from all regulators."[109] FINRA also highlighted its focus on the application of sales charge waivers and breakpoints to certain mutual fund share classes in its 2015 and 2016 Regulatory and Examination Priorities Letters.[110] In connection with these priorities, FINRA began a sweep examination of member firms' mutual fund sales practices, which sought information from broker-dealers regarding their supervisory controls related to the application of sales charges and relevant waivers.[111]

Additionally, OCIE published a risk alert in 2016 notifying investment advisers that OCIE was undertaking a "Share Class Initiative," in which it "is seeking to identify conflicts of interests tied to advisers' compensation or financial incentives for recommending mutual fund and 529 Plan share classes that have substantial sales charges or distribution fees."[112] In February 2018, the Division of Enforcement (the "Division") announced that it was implementing a Share Class Selection Disclosure Initiative (the "Disclosure Initiative"), which is designed to encourage investment advisers to self-report conflicts of interest disclosure violations in connection with the sale of certain mutual fund share classes.[113] The Disclosure Initiative states that it is intended to identify and remedy situations in which an investment adviser "failed to make required disclosures relating to its selection of mutual fund share classes that paid the adviser (as a dually registered broker-dealer) . . . a fee pursuant to Rule 12b-1 of the [1940 Act] when a lower-cost share class for the same fund was available to clients" and violations of this nature.[114] Under the Disclosure Initiative, for investment advisers that self-report violations before June 12, 2018, the "Division will recommend settlements that will require the adviser to disgorge its ill-gotten gains and pay those amounts to harmed clients, but not impose a civil monetary penalty."[115] The Division stated that it will continue its focus on share class disclosure issues and may impose more onerous penalties on investment advisers that do not take advantage of the Disclosure Initiative and self-report.[116]

As noted below, FINRA has taken a similar approach to imposing penalties on broker-dealers that self-report violations. Shortly following the SEC's announcement of the Disclosure Initiative, FINRA staff announced plans to update guidance related to Rule 4530, the Extraordinary Cooperation Rule.[117]

A. Broker-Dealers

Many of the disciplinary actions brought by the NASD (now FINRA) against broker-dealers for mutual fund share class issues relate to broker-dealers obligation to only make suitable investment recommendations. Under NASD Rule 2310 ("Rule 2310"),[118] broker-dealers were required to "have a reasonable grounds for believing that the recommendation is suitable for such customer"[119] based on the investor's personal circumstances. Rule 2310 also imposed a burden on broker-dealers to make "reasonable efforts" to discern certain information about an investor before making a recommendation, including the investor's financial and tax status, investment goals, and other information that could be relevant to the recommendation.[120] The NASD brought enforcement actions where it believed that broker-dealers financially benefitted from unsuitable investment recommendations, which the NASD said caused broker-dealers to also violate NASD Rule 2110 ("Rule 2110").[121] Rule 2110 requires broker-dealers and their registered representatives to "observe high standards of commercial honor and just and equitable principles of trade."

In addition to suitability and conflicts of interest matters, the NASD and FINRA have brought enforcement actions against broker-dealers for failing to implement adequate controls to ensure that they are providing investors with suitable investment recommendations and are selling the least expensive share class for which they are eligible. NASD Rule 3010 ("Rule 3010"), which FINRA codified as Rule 3110 ("Rule 3110") in the same form, requires broker-dealers to implement policies and procedures "reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable NASD Rules."[122] Rule 3010 also provides that broker-dealers must implement policies and procedures specific to supervising the kinds of business activities in which it engages.[123]

1. Disciplinary Actions.[124]

This section of the outline summarizes some, but not all, of the enforcement actions in which the NASD, FINRA, or the SEC has found that a broker-dealer violated a NASD or FINRA Rule by failing to ensure that investors purchased the least expensive share class for which they were eligible.

a. Stifel, Nicolaus & Company, Inc.[125]

On September 25, 2015, FINRA accepted Stifel, Nicolaus & Company, Inc.'s ("Stifel") Letter of Acceptance, Waiver and Consent ("AWC") in connection with Stifel's failure to maintain adequate supervisory policies for the period between April 2010 and April 2015 (the "Relevant Period"). Stifel uncovered the issue on its own and self-reported to FINRA. FINRA acknowledged Stifel's self-reporting and cooperation during the investigation, and as such, limited Stifel's sanctions to a censure, payment of restitution totaling the amounts overcharged, and remediation of its compliance program.

Stifel is a registered broker-dealer that executes transactions in various mutual fund share classes, including Class A, Class B, Class C, and Class R. Certain of the mutual funds offered by Stifel waived the sales charge on Class A shares for eligible investors, like retirement plans and charities. For investors who qualified for the waiver, it was often in their interest to purchase Class A shares because the Class A shares generally had lower ongoing fees than the other share classes. As such, they would realize a greater return on their investments.

Stifel relied on its registered representatives to administer sales charge waivers on Class A shares for the eligible investors. However, during the Relevant Period, the AWC said that Stifel failed to implement policies that would adequately notify its registered representatives of the availability of a sales charge waiver, identify sales charge waivers that were disclosed in certain mutual fund prospectuses, or track when sales charge waivers were not provided to customers. Additionally, the AWC said that Stifel's registered representatives did not receive sufficient training that would allow them to properly administer sales charge waivers. Because of these failures, the AWC said that investors eligible for sales charge waivers either did not receive the waiver on Class A shares or purchased more expensive Class B or Class C shares on the recommendation of financial advisors who mistakenly thought those shares would be less expensive than Class A shares due to the misapplication of the waiver.

FINRA determined that Stifel violated Rule 3110[126] because it failed to implement policies and procedures to ensure its financial advisors were properly administering sales charge waivers, causing investors to unnecessarily overpay for their investments in mutual funds. Additionally, FINRA determined that Stifel's failure to maintain procedures to ensure the proper administration of sales charge waivers constituted a violated if Rule 2010 because certain customers were subjected unnecessarily from fees and expenses, limiting their investment returns.

b. Citigroup Global Markets, Inc.[127]

On March 22, 2005, the NASD settled charges against Citigroup Global Markets, Inc. ("Citigroup"), a registered broker-dealer for violations of its obligation to make suitable investment recommendations in accordance with NASD Rules 2110 and 2310. In connection with the settlement, Citigroup was censured and agreed to pay a fine of $6.25 million as well as hire an independent consult to conduct a review of its compliance program.

Through its registered representatives, Citigroup provided investment recommendations to customers seeking to invest in mutual funds. In connection with the execution of these recommendations, Citigroup and its registered representatives received commissions. Depending on the type of share class purchased by the customer, Citigroup was entitled to receive different amounts in commission. The cost of these brokerage commissions were generally covered by 12b1 fees charged by the different share classes.

In many instances, mutual funds would provide breakpoint discounts for large investments. As described earlier, the Class B shares on funds sold by Citigroup generally did not charge a front-end sales charge, but the Class B shares charged CDSCs and higher 12b-1 fees than Class A shares. The Class C shares sold by Citigroup typically also carried CDSCs and charged higher 12b-1 fees than Class A shares. Because of the fee structures, Citigroup and its registered representatives would earn greater commissions if customers purchased Class B or Class C shares.

Citigroup implemented procedures to require registered representatives to disclose certain information about Class B shares, including the kinds of fees charged, the availability of alternate share classes or breakpoints, options to reduce fees, and overall expense ratios. The procedures also required registered representatives to help investors determine which share class was the most appropriate for them. However, the AWC said that the procedures did not have a mechanism to ensure that registered representatives were making the required disclosures and informing customers that higher fees could adversely affect investment returns. Additionally, the AWC said that Citigroup's procedures did not provide a way to ensure that investors received breakpoints when they were eligible, nor did they require registered representatives to quantify the overall costs an investor would incur per share class. Because of these failures, the NASD found that investors overpaid approximately $12.5 million in commissions to Citigroup.

The NASD determined that Citigroup made unsuitable recommendations in violation of Rule 2310. According to the NASD, Citigroup necessarily did not have a reasonable basis to believe its recommendations to purchase Class B or Class C shares were suitable when there was a less expensive share class available. Additionally, because Citigroup did not have adequate procedures to ensure its registered representatives were: (i) recommending the share class that would be the most financially advantageous to shareholders, not to themselves; and (ii) providing a full picture of the overall costs associated with each share class, the NASD found that Citigroup violated Rule 3010 and Rule 2110.

B. Investment Advisers

Many of the SEC's recent enforcement actions against registered investment advisers for conduct relating to sales or recommendations involving mutual fund share classes stem from the SEC's allegations that the investment adviser breached its fiduciary duties.[128] Part of this fiduciary duty is a requirement that investment advisers seek best execution on behalf of their clients.[129] Additionally, certain conduct proscribed by the Advisers Act may also operate as a breach of advisers' fiduciary duties. Section 206(2) of the Advisers Act ("Section 206(2)") makes it unlawful for an investment adviser "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon a client."[130] Section 206(4) of the Advisers Act ("Section 206(4)") makes unlawful for investment advisers to engage in conduct that is "fraudulent, deceptive, and manipulative."[131] Pursuant to Section 206(4), the SEC has adopted Rule 206(4)-7 ("Rule 206(4)-7"), which requires investment advisers to adopt policies and procedures to prevent breaches of fiduciary duties and violations of the Advisers Act and the rules adopted thereunder.[132] Rule 206(4)-7 also requires investment advisers to review at least annually their compliance policies and to appoint a chief compliance officer responsible for administering the compliance policies required by the rule.

Apart from sales-related conduct and compliance violations, in enforcement actions against investment advisers for mutual fund share class issues, the SEC has also found that the advisers have failed to disclose certain conflicts of interest with respect to the sale or recommendation of certain mutual fund share classes. Section 207 of the Advisers Act ("Section 207") prohibits investment advisers from making "any untrue statement of material fact in any registration application or report filed with the [SEC] . . . omit[ting] to state in any such application or report any material fact which is required to be stated therein."[133] Investment advisers register with the SEC (and maintain such registration) by submitting (and updating) a Form ADV, which contains material information about how the investment adviser provides advice to clients. Investment advisers can also disclose information to clients through periodic reports or other means.

Although the Division acknowledged that different share classes facilitate many functions and relationships, it also reiterated its focus on the importance of disclosing conflicts of interests in connection with mutual fund share class selection in its announcement of the Disclosure Initiative in February 2018.[134] As part of the Disclosure Initiative, the Division asserted that although there may be sufficient facts to find violations of the duty of best execution, the Division will recommend that the SEC accept settlements pursuant to the Disclosure Initiative that do not contain such a charge. [135]

1. SEC Enforcement Actions.[136]

This section of the outline summarizes some, but not all, of the enforcement actions in which the SEC has found that an investment adviser violated the Advisers Act or a rule thereunder by breaching its fiduciary duties with respect to transactions in mutual funds. Each of the enforcement actions summarized below were settled before the inception of the Disclosure Initiative.

a. Credit Suisse Securities (USA) LLC.[137]

On April 4, 2017, the SEC settled charges against Credit Suisse Securities (USA) LLC ("Credit Suisse") in connection with the Credit Suisse's breach of its fiduciary duties owed to certain wrap fee clients. In connection with the settlement, Credit Suisse was censured and agreed to pay more than $3 million in civil money penalties and nearly $2.1 million in disgorgement.

Credit Suisse offered "wrap fee" programs to certain advisory clients through its Discretionary Managed Portfolio ("DMP"). Through the DMP, client assets were invested in various kinds of securities, including mutual fund securities. Credit Suisse operated many branches, and the manager of each branch was responsible for approving mutual fund investments for the DMP. According to the SEC order, in 2008, a relationship manager ("RM") at one of the branch offices realized that his team was not realizing income generated from transactions in mutual fund shares that charge 12b1 fees. The order states that Credit Suisse had instructed its clearing broker to block 12b-1 fees generated by advisory accounts, and the RM suggested that if Credit Suisse lifted the block on 12b-1 fees, Credit Suisse could realize the income generated by advisory clients' accounts', including DMP clients. After lifting the block, Credit Suisse approved purchases of Class A shares for DMP clients even though they were eligible to purchase either (i) less expensive institutional share classes or (ii) share classes that did not charge 12b-1 fees. Credit Suisse earned revenue from the sales of Class A shares to the DMP clients.

During this period, Credit Suisse disclosed on its Form ADV that there was a possibility that it may receive 12b-1 fees from the sale of certain mutual fund shares, but Credit Suisse's Form ADV did not disclose how or why certain share classes were selected for recommendation to DMP clients when less expensive share classes were available. Further, Credit Suisse's Form ADV did not disclose that mutual funds often offered discounts on fees charged by certain share classes to large investment programs, like the DMP. Credit Suisse's Form ADV also did not disclose that "12b-1 fees decreased the value of advisory clients' investments in mutual funds and increased the compensation paid to [Credit Suisse]." The order states that Credit Suisse inaccurately disclosed that its registered representatives only received a salary from Credit Suisse for their services when they in fact received sales commissions as well.

In addition, during this period, Credit Suisse's policies and procedures did not, according to the SEC order, provide adequate guidance to RMs regarding how to evaluate and compare mutual fund share classes when deciding how to invest client assets. Credit Suisse's policies and procedures required branch managers, when analyzing a mutual fund investment, to consider the overall cost of the investment when determining suitability. However, according to the order, Credit Suisse's policies and procedures did not require the branch manager to consider "information regarding the availability of institutional or less expensive share classes" in its approval analysis, nor did Credit Suisse's policies and procedures "provide for any cost comparison of available share class alternatives."

The SEC determined that Credit Suisse violated Section 206(2) when it purchased Class A shares when less expensive shares were available. Because Credit Suisse did not purchase the least expensive share class available for DMP clients, the SEC said it breached its duty of best execution. Further, the SEC said Credit Suisse failed to disclose to clients that it was not satisfying its duty of best execution in purchasing Class A shares. Failing to disclose these conflicts on its Form ADV, according to the SEC, constituted a violation of Section 207.

The SEC further found that Credit Suisse's policies and procedures provided "inadequate and incomplete guidance" regarding how to evaluate and compare mutual fund share classes and that these inadequate policies and procedures were not "consistently observed or enforced." Accordingly, the SEC concluded that Credit Suisse violated Section 206(4) and Rule 206(4)-7 thereunder.

b. Pekin Singer Strauss Asset Management Inc., et al.[138]

On June 23, 2015 the SEC settled charges against Pekin Singer Strauss Asset Management, Inc. ("PSS"), Ronald L. Strauss, President of PSS, William A. Pekin and Joshua A. Strauss, portfolio managers at PSS (collectively, the "Respondents") in what the order called Respondents' breach of fiduciary duties in the provision of investment advisory services to certain separately managed accounts ("SMAs") of high net worth individual clients. In connection with the settlement, among other sanctions, the Respondents were suspended or censured and agreed to pay $285,000 in civil money penalties.

In addition to advising the SMAs, the Respondents provided investment advisory services to the Appleseed Fund (the "Fund"), an investment company registered under the 1940 Act. The Fund, when initially launched in 2006, only offered one share class ("Investor Shares"). In 2011, the Respondents launched a less expensive share class to offer to institutional investors ("Institutional Shares"). The Investor Shares were 0.25 percent more expensive than Institutional Shares, and the additional expense was charged to cover fees charged by broker-dealers to put the Fund on their brokerage platforms. To allow more clients to be eligible to purchase Institutional Shares, the Respondents allowed advisers to aggregate total client investments when determining eligibility to purchase Institutional Shares: so long as an adviser invested at least $100,000 in the Fund, irrespective of how many assets were contributed by each client, the adviser was eligible to purchase Institutional Shares for each of its clients.

The Respondents managed the SMA assets prior to the launch of the Fund's Institutional Shares. After the Institutional Shares launched, the SMAs were eligible to convert their Investor Shares to the less expensive Institutional Shares. However, the order states that Respondents decided not to convert the SMAs' holdings of the Fund to Institutional Shares. According to the Respondents, the fees incurred by SMA clients invested in Investor Shares were comparable to investment advisory fees charged by other industry participants, so it was unnecessary to covert to Institutional Shares.

The order states that Respondents failed to disclose their justification for not converting SMA client holdings in the Fund to the least expensive share class available. However, the Respondents would convert SMA clients' Investor Shares to Institutional Shares upon request. Additionally, the Respondents did not adequately disclose that the Respondent would earn greater revenue from investing client assets in Investor Shares than in Institutional Shares.

The SEC found that the Respondents violated Section 206(2) by failing to "adequately disclose to their clients . . . that they were eligible to invest in [Institutional Shares]." Also, the SEC determined that the Respondents violated their duty to seek best execution of client trades when they purchased Investor Shares when clients were eligible to purchase a less expensive share class. Respondents further violated this duty by failing to disclose to clients that they "had a conflict of interest in selecting the [Investor Shares] for their clients." According to the SEC, the PSS's failure to have procedures to ensure it was seeking best execution by investing in the least expensive share class available was a violation of Section 206(4) and Rule 206(4)-7.

Additionally, the SEC found that PSS's Form ADV "did not address that [PSS] kept or placed its clients in a more expensive share class when a less expensive share class was available." Additionally, PSS's Form ADV discussed its duty to seek best execution, but it did not disclose that it was failing to seek best execution by investing client assets in the more expensive Investor Shares.

c. Barclays Capital Inc.[139]

On May 10, 2017 the SEC settled charges against Barclays Capital Inc. ("Barclays"), a dually registered broker-dealer and investment adviser, in connection with a finding that Barclays, among other things, breached its fiduciary duties owed to clients for failing to seek best execution for clients. In connection with the settlement, Barclays was censured and required to pay civil money penalties, including disgorging profits earned from offering a more expensive share class, totaling more than $90 million.

Barclays provided investment advisory and brokerage services to its clients, including retirement plans and certain charitable organizations ("Eligible Clients"). Barclays invested the assets of certain Eligible Clients in registered investment companies that offered various share classes. Some of these investment companies waived sales charges for eligible investors, and the fee structure differed across the share classes. Generally, the SEC order states that it would have been the most beneficial to the Eligible Clients if Barclays invested their assets either in: (i) shares that had sales charge waivers; or (ii) shares that charged lower ongoing fees because higher fees would reduce the Eligible Clients' overall return on investments. Conversely, Barclays would earn greater revenues if Eligible Clients were invested in share classes that charged sales charges or higher ongoing fees. The SEC order stated that Barclays generally recommended investments in Class A shares with sales charges or Class C shares with CDSCs and higher ongoing fees in lieu of Class R shares that generally had lower fees than Class A and Class C shares.

The SEC order said that over a six-year period between January 2010 and December 2015 (the "Relevant Period"), Barclays did not have adequate procedures to ensure that clients invested in investment companies: (i) received sales charge waivers when available; or (ii) purchased the least expensive share class that was available. As a result, in many transactions over the Relevant Period, the SEC said that Barclays failed to ensure that sales charge waivers were provided to clients who were eligible for them and "failed to provide [Eligible Clients] the opportunity to purchase Class R shares" when they were eligible. Additionally, the SEC said that during the Relevant Period, Barclays "failed to disclose to [Eligible Clients] its conflict of interest in that it would earn more revenue from customer purchases of Class A shares with an up-front sales charge or Class C shares with a CDSC and higher ongoing expenses." Barclays also failed to disclose to Eligible Clients that they would generally earn a lower return when invested in share classes with higher fees.

The SEC determined that Barclays violated Section 206(2) when it failed to disclose its interest in investing Eligible Client assets in share classes with higher fees. Barclays was able to earn approximately $110,000 from fees that Eligible Clients paid for shares with higher fees when a less expensive share class was available. Additionally, the SEC said that Barclays failed to disclose to Eligible Clients that they would generally earn a lower return on investments if they invested in share classes with higher expenses. As part of the settlement, Barclays disgorged the fees earned based on the pertinent transactions. The SEC found that because Barclays also failed to disclose this conflict in its Form ADV, or that investors generally would earn a lower return on investments, the firm violated Section 207.

The SEC also found that Barclays' policies and procedures were insufficient to detect which clients were eligible for sales charge waivers and when Barclays had to offer a share classes with lower expenses, causing Barclays to violate Section 206(4) and Rule 206(4)-7. Additionally, the SEC determined that Barclays violated sections 17(a)(2) and 17(a)(3) of the 1933 Act. Sections 17(a)(2) and 17(a)(3) prohibit a person from making an untrue statement of a material fact or omitting a material fact in connection with the offer or sale of a security. This was based on Barclays' failure to disclose (i) its interest in recommending share classes with higher expenses and (ii) that Eligible Clients would generally receive a lower return on their investments if they were invested in a more expensive share class.

d. Everhart Financial Group, Inc. et al.[140]

On January 14, 2016, the SEC settled charges against Everhart Financial Group, Inc. ("Adviser"), a registered investment adviser, Richard Scott Everhart, Adviser's Chief Compliance Officer, and Matthew James Romeo, registered representatives of the Adviser (collectively, "Respondents"), in connection with their breaches of fiduciary duties in failing to seek best execution on behalf of their clients. In connection with the settlement, the Respondents, among other things, were censured and were required to pay civil money penalties, including disgorging profits earned in violation of their fiduciary duties.

The SEC order states that the Adviser provided investment advisory services to individual clients, and was compensated by clients based on the total assets Adviser managed. It was Adviser's practice to generally recommend that clients invest in a particular mutual fund complex. The funds in this complex offered two types of share classes, and the main difference between the share classes was that one of them charged 12b-1 fees while the other did not. Adviser generally recommended that clients purchase shares of the class that charged 12b-1 fees.

Respondents Everhart and Romeo were registered representatives of a broker-dealer that provided brokerage services to Adviser's clients. Through this arrangement, Respondents Everhart and Romeo were able to receive a portion of the 12b-1 fees paid by Adviser clients who, on their recommendation, purchased the share class that charged 12b-1 fees. The SEC order states that Adviser did not disclose the conflict of interest in connection with Respondents Everhart's and Romeo's receipt of 12b-1 fees. Additionally, in portfolio reports provided to clients, Adviser only provided information about the mutual fund share classes that Adviser recommended to clients but not information about the expenses associated with other share classes offered by the fund.

Adviser and Respondent Everhart also failed to conduct annual reviews of Adviser's compliance program in six of seven years between 2008 and 2014. The broker-dealer with which Respondents Everhart and Romeo were registered conducted periodic compliance reviews to determine whether Adviser was satisfying contractual requirements, but these reviews were insufficient to determine whether Adviser was in compliance with the requirements of the Adviser's Act.

The SEC determined that Respondents Everhart and Romeo violated Section 206(2) because they "nearly always recommended a mutual fund share class that charged a 12b-1 fee" even when less expensive share classes were available, thereby failing to seek best execution. Additionally, the SEC determined that Respondents violated Section 206(2) when Respondents Everhart and Romeo recommended share classes with 12b-1 fees, knowing that they would ultimately receive a portion of that fee notwithstanding the fact that their clients would realize lower returns. Because the Adviser failed to disclose the conflict of interest in its Form ADV, the SEC concluded that Adviser violated Section 207 of the Advisers Act as well.

The SEC also found that by failing to conduct annual reviews to determine the adequacy of the Adviser's compliance policies, Adviser violated section 206(4) of the Advisers Act and Rule 206(4)-7.

e. JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC.[141]

On December 18, 2015, the SEC settled charges against J.P. Morgan Securities LLC ("JPMS") and an affiliated national bank in connection with advisory services provided to clients participating in the Chase Strategic Portfolio ("CSP Program"), a unified separately managed account offered to retail customers. In connection with the settlement, the SEC censured JPMS and required JPMS and its affiliated national bank to pay more than $130 million in civil money penalties.

JPMS and its affiliates developed the CSP Program to offer retail customers target risk portfolios consisting predominantly of registered mutual funds. According to the SEC order, since inception of the CSP Program, JPMS favored investing CSP Program assets in affiliated mutual funds, and the CSP Program received certain services, like distribution and administration, from affiliated service providers. The affiliated service providers offered their services to the CSP Program at a discount; they were able to earn substantial fees for services provided to the CSP Program.

The affiliated mutual funds in which CSP Program assets were invested generally offered multiple share classes with different fee structures. JPMS would negotiate with the mutual funds in which it sought to invest CSP Program assets for a discounted fee structure. In the Form ADV for the CSP Program, JPMS disclosed that fund shares purchased for the CSP Program were generally institutional shares or no-load Class A shares purchased at net asset value. Certain of the affiliated mutual funds in which JPMS invested CSP Program assets offered two different kinds of institutional share classes: Institutional Shares and Select Shares. Select

Shares were generally more expensive than Institutional Shares as a result of a separate shareholder services fee. The SEC order states that for the period between 2008 and 2013, JPMS's affiliates were able to earn greater revenues when JPMS used CSP Program assets to purchase Select Shares even though it could have purchased the less expensive Institutional Shares instead. During this time period, JPMS failed to disclose to CSP Program participants that a less expensive share class was available or that JPMS's affiliates stood to benefit from JPMS's choice to invest in Select Shares according to the SEC order. At the end of 2013, JPMS converted its Select Shares holdings of affiliated mutual funds to Institutional Shares.

The SEC found that JPMS violated Section 206(2) by causing the CSP Program to unnecessarily incur additional fees associated with Select Shares when a less expensive share class was available. In addition, the SEC determined that because JPMS did not have procedures in place to ensure that the share class with the lowest expenses were offered to the CSP Program, JPMS violated Section 206(4) and Rule 206(4)-7. Finally, by failing to include disclosure related to JPMS's and its affiliates' interest in the CSP Program investing in a more expensive share class in its Form ADV, the SEC determined that JPMS violated Section 207.

V. FIDUCIARY DUTIES UNDER ERISA

Apart from regulators' focus on issues related to the proliferation of share classes, retirement plan participants have also begun to raise issues related to the suitability of investing in certain share classes. As noted above, ERISA imposes fiduciary duties on certain retirement plan administrators, which requires them to act in the best interests of the participants. Among the duties owed to plan participants are the duty of loyalty, which prohibits self-dealing, and the duty of prudence, which requires fiduciaries to act as a reasonably prudent person would in a like situation.[142] In recent years, plan participants have brought actions under ERISA for breach of fiduciary duties in connection with the costs associated with retirement plan investing. The cases below illustrate the kinds of claims plaintiffs have brought against retirement plan fiduciaries regarding mutual fund share classes.

A. Krueger v. Ameriprise Financial, Inc.[143]

In Krueger, the plaintiffs were participants in the retirement plan administered by the defendant (the "Plan"). One of the investment options provided by the Plan was a self-managed brokerage account ("SMBA"), which allowed participants to choose from a menu of mutual funds managed by various investment advisers. A substantial number of the mutual funds offered through the SMBA were affiliated with the defendant-plan administrator. The plaintiffs alleged in their complaint that the defendant breached its fiduciary duties owed to participants for, among other reasons, offering excessively expensive mutual fund options through the SMBA. The plaintiffs asserted that the defendant-plan administrator stood to benefit from such investment options because its affiliates would collect the fees the funds charged shareholders. The defendant filed a motion to dismiss the plaintiffs' claim for failing to state a claim for breach of fiduciary duty.

The court denied the defendant's motion, finding that the plaintiffs' alleged sufficient facts to state a plausible claim for breach of fiduciary duty. In determining that the plaintiffs' complaint alleged sufficient facts to support a claim for fiduciary breach, the court noted that the Plan failed to offer the least expensive share class of certain affiliated mutual funds in the SMBA. The Plan offered participants class R4 shares of mutual funds affiliated with the defendant-administrator through the SMBA, which charged higher management fees than the class R5 shares for which the Plan was eligible. Additionally, the class R4 shares charged an administrative services fee, and the class R5 shares did not charge such a fee. Though the court did not address the merits of the plaintiffs' claims, the court found that the defendant's failure to make available to the Plan the least expensive share class of a mutual fund for which it was eligible, along with other facts, provided enough support for the plaintiffs' claim such that it could survive a motion to dismiss.

B. Terraza v. Safeway Inc.[144]

In Terraza, the plaintiff was a participant in the retirement plan administered by the defendant (the "Plan"). The Plan offered between 18 and 22 different investment options for plan participants. These options included separately managed accounts, defendant's common stock, common collective trusts, a money market fund, and mutual funds. Plaintiff alleged in her compliant that defendant breached its fiduciary duties in the administration of the Plan for, among other reasons, offering investment options with excessive fees. According to the plaintiff, the defendant-plan administrator had an obligation to monitor the investment options in the Plan and remove any imprudent investment options that would cause participants to incur unnecessarily high fees. The defendant moved to dismiss the plaintiff's claim for failure to state a claim.

The court denied the defendant's motion to dismiss, finding that the plaintiff stated a plausible claim for breach of fiduciary duty. In particular, the court noted that in her complaint, plaintiff alleged sufficient facts to state a plausible claim that defendant provided imprudent investment options to the Plan. Plaintiff alleged that one of the investment options the Plan offered was class C20 shares of JPMorgan target date funds. However, the Plan was eligible to invest in two other share classes of the JPMorgan target date funds that were less expensive than the class C20 shares. Though the court did not address the merits of the plaintiff's claims, the court determined that, among other facts, the Plan's failure to provide participants the opportunity to invest in the least expensive share class possible supported the plaintiff's claim such that it survive a motion to dismiss.

VI. FINAL THOUGHTS

Given the current regulatory uncertainty surrounding the Fiduciary Rule, Exemptions, and anticipated SEC standard of conduct proposal, the future of fund distribution and the structures of mutual fund share classes remain uncertain. Regardless of the ultimate outcome of these regulatory initiatives, the fiduciary duties of investment advisers and duties of intermediaries are areas on which regulators are, and will likely continue to be, focused. Mutual funds, investment advisers, broker-dealers and other industry participants should continue to monitor regulatory changes that may significantly impact their legal obligations with respect to disclosures and conduct as well as related business practices.

Notes

109 NASD Notice to Members 05-68 (October 2005), available at http://www.complinet.com/file_store/pdf/rulebooks/nasdw_015130.pdf.

110 FINRA 2016 Regulatory and Examination Priorities Letter (Jan. 5, 2016), available at http://www.finra.org/sites/default/files/2016-regulatory-and-examination-priorities-letter.pdf; FINRA 2015 Regulatory and Examination Priorities Letter (Jan. 6, 2015), available at http://www.finra.org/sites/default/files/p602239.pdf.

111 FINRA Mutual Fund Waiver Exam Letter (May 2016), available at http://www.finra.org/industry/mutual-fund-waiver. For additional information regarding FINRA's sweep examination, see Déjà Vu All Over Again – FINRA Takes Another Look at Mutual Fund Sales Charge Waivers, Dechert OnPoint. (June 2016).

112 SEC OCIE National Exam Program Risk Alert, OCIE's 2016 Share Class Initiative (July 13, 2016), available at https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf.

113 SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and Prompt Return of Funds to Investors (Feb. 12, 2018), available at https://www.sec.gov/news/press-release/2018-15.

114 Id.

115 Id.

116 Subsequent to the announcement of the Disclosure Initiative, the Division settled several enforcement proceedings regarding share class selection practices and, in addition to other penalties, the SEC imposed a civil money penalty in each case. These proceedings related to, among other things, breaches of fiduciary duties, violations of disclosure requirements and best execution obligations and compliance failures by investment advisers (and, in some cases, dually registered investment advisers and broker dealers). See, e.g., In re PNC Investments LLC, SEC Rel. No. IA-4878 (Apr. 6, 2018); In re Geneos Wealth Management, Inc., SEC Rel. No. IA-4877 (Apr. 6, 2018); and In re Securities America Advisors, Inc., SEC Rel. No. IA-4876 (Apr. 6, 2018).

117 See Remarks at SIFMA AML by Susan Schroeder, FINRA Executive Vice President of Enforcement (Feb. 12, 2018), available at http://www.finra.org/newsroom/speeches/021218-remarks-sifma-aml.

118 NASD Rule 2310 has been superseded by FINRA Rule 2111, which imposes a similar requirement on broker-dealers only to make investments recommendations that are suitable based on the specific investor's situation. Rule 2111 incorporates aspects of IM-2310-2 and includes more specific factors that broker-dealers must consider about customers when making an investment recommendation.

119 Rule 2310(a).

120 To provide guidance on its expectations under Rule 2310, the NASD adopted IM-2310-2. IM-2310-2 provides that all registered broker-dealers and their representatives have a "responsibility for fair dealing," and notes examples of kinds of trading activities that would violate this responsibility. Specifically with respect to mutual funds, IM-2310-2 provides that short-term trading in a customer's account in mutual fund shares is generally considered conduct that would violate Rule 2310.

121 FINRA has codified NASD Rule 2110 as FINRA Rule 2010 ("Rule 2010").

122 NASD Rule 3010(a).

123 Id. at 3010(b).

124 The discussion of the enforcement actions in this section is limited to broker-dealer conduct related to mutual fund share class matters.

125 FINRA AWC No. 2015045163601, Stifel, Nicolaus & Company, Inc. (Sept. 25, 2015). *See also* FINRA AWC 2016050260101, J.P. Turner & Company, LLC (Dec. 7, 2017); FINRA AWC 2016050259601, Investors Capital Corp. (Dec. 7, 2017); FINRA AWC 2015047977401, Investacorp, Inc. (Dec. 6, 2017); FINRA AWC 2016049977801, Questar Capital Corp. (Nov. 2, 2017); FINRA AWC No. 2015045354201, Edward Jones & Co., L.P. (Sept. 28, 2015) (FINRA determined that Edward Jones's policies and procedures were insufficient to ensure proper administration of sales charge waivers); FINRA AWC No. 2015045369801, AXA Advisors, LLC (Oct. 26, 2015) (FINRA determined that AXA Advisors' policies and procedures were inadequate to ensure that all investors eligible for sales charge waivers received them); FINRA AWC No. 2011029999301, Merrill Lynch, Pierce, Fenner & Smith Inc. (June 16, 2014) (FINRA determined that Merrill Lynch failed to apply sales charge waivers as required by fund prospectuses and failed to maintain adequate procedures to ensure that eligible customers received waivers). *Cf*. FINRA AWC No. 2016049976501, Woodbury Financial Services, Inc. (Dec. 20, 2017) (FINRA imposed a $75,000 fine as well as a censure, an obligation to pay remediation of amounts overcharged, and an obligation to remediate the Respondent's compliance program where the Respondent did not self-report).

126 Because FINRA Rule 3110 was not codified until April 2014, FINRA determined that Stifel was in violation of NASD Rule 3010 for violations during the Relevant Period that occurred prior to April 2014.

127 Citigroup Global Markets, Inc., NASD Letter of Acceptance, Waiver and Consent No. CE2050005 (Mar. 22, 2005); see also In re 1st Capital Global Corp., SEC Exchange Act Rel. No. 54754 (Nov. 15, 2006) (SEC determined that 1st Capital Global violated MSRB Rules G-17 (prohibition against unfair and deception trading practices) and G-19 (prohibition against making unsuitable investment recommendations) for failing to recommend the least expensive share class of a 529 Plan to investors). FINRA has also brought enforcement actions against individual registered representatives for failing to provide suitable investment recommendations. See In re Wilson, FINRA Disciplinary Proceeding No. 2007009403801 (Apr. 14, 2010) (FINRA determined that a representative violated NASD Rule 2310 by "switching" investors to a more expensive share class that charged 12b-1 fees, which fees would inure to the representative); In re Bailey, FINRA Disciplinary Proceeding No. 2006007058102 (July 19, 2011) (FINRA determined that a representative violated NASD Rule 2310 by making unsuitable, short-term trades in Class A and B shares of funds); In re Epstein, SEC Exchange Act Rel. No. 59328 (Jan. 30, 2009) (FINRA determined that a representative violated NASD Rule 2310 by recommending trades that caused customers to lose the opportunity to convert to a share class with lower expenses or that reset the holding period for shares with CDSCs).

128 See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (determining that investment advisers owe a fiduciary duty to their clients).

129 See e.g., Disclosure by Investment Advisers Regarding Soft Dollar Practices, Investment Advisers Act Release No. 1469 (Feb. 14, 1995).

130 15 U.S.C. § 80b-6(2) (2012).

131 Id. at § 80b-6(4).

132 17 C.F.R. 275.206(4)-7 (2017).

133 15 U.S.C. § 80b-7.

134 SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors, Division of Enforcement Press Release (Feb. 2018), available at https://www.sec.gov/news/press-release/2018-15.

135 Share Class Selection Disclosure Initiative Announcement, Division of Enforcement of the SEC (Feb. 12, 2018), available at https://www.sec.gov/enforce/announcement/scsd-initiative. The Division has stated that it will continue to pursue actions against investment advisers for violations relating to mutual fund share class disclosure failures. Id.

136 The discussion of the enforcement actions in this section is limited to investment adviser conduct related to mutual fund share class issues.

137 In re Credit Suisse Securities (USA) LLC, SEC Rel. No. IA-4678 (Apr. 4, 2017). See also In re SunTrust Investment Services, Inc., SEC Rel. No. IA-7469 (Sept. 14, 2017) (SEC determined that Respondent violated Section 206(2), Section 206(4), and Section 207 of the Advisers Act for breaching its duty of best execution and failing to disclose conflicts of interest with respect to share class options made available to certain wrap fee participants. Notably, the SEC acknowledged Respondent's efforts to rebate amounts overcharged to affected clients once the SEC began its investigation. Notwithstanding these remedial efforts, the SEC censured Respondent, required Respondent to disgorge ill-gotten revenues, and imposed a fine of more than $1.1 million.)

138 In re Pekin Singer Asset Management Inc., et al., SEC Rel. No. IA-4126 (June 23, 2011).

139 In re Barclays Capital Inc., SEC Rel. No. IA-4705 (May 10, 2017). See also In re Ameriprise Financial Services, Inc., SEC Rel. No. IA-4862 (Feb. 28, 2018) (SEC determined that Respondent violated Sections 17(a)(2) and 17(a)(3) of the 1933 Act for failing to make available the least expensive share class for which certain retirement plan customers were eligible); In re Envoy Advisory, Inc., SEC Rel. No. IA-4764 (Sept. 8, 2017) (SEC determined that Respondent violated Section 206(4) and Rule 206(4)-7 thereunder and Section 207 of the Advisers Act for failing to disclose to certain retirement clients that its affiliated broker-dealer stood to benefit from Respondent's recommendations to purchase shares that charged 12b-1 fees when the retirement clients were eligible to purchase shares that did not charge 12b-1 fees); In re UBS Financial Services Inc., SEC Rel. No. IA-4803 (Oct. 27, 2017) (SEC determined that Respondent, a dually registered broker-dealer and investment adviser violated Sections 17(a)(2) and 17(a)(3) of the 1933 Act for failing: (i) to implement adequate controls to ensure that customers were only offered the least expensive share class for which they were eligible; and (ii) to disclose its conflict of interest in customers purchasing share classes with sales charges or ongoing 12b-1 fees. Notably, Respondent

unilaterally made remediation payments to customers, plus interest, and converted all eligible shareholders to a less expensive share class. Notwithstanding Respondent's remediation efforts and cooperation, Respondent was censured and fined $3.5 million for its violations).

140 In re Everhart Financial Group, Inc., et al., SEC. Rel. No. IA-4314.

141 In re JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC, SEC. Rel. No. IA-4295 (December 18, 2015).

142 29 U.S.C. § 1104(a)(1) (2012).

143 2012 U.S. DIST. LEXIS 166191 (D. Minn. Nov. 20, 2012). The plaintiffs and defendant reached a settlement in April 2015.

144 2017 U.S. Dist. LEXIS 35732 (D.N.C. Mar. 13, 2017). [As of the date of this article], this case is still ongoing. See also Tracey v. Massachusetts Institute of Technology, 2017 U.S. Dis. LEXIS 165070 (D. Mass. Oct. 4, 2017) (affirming the denial of defendant-plan administrator's motion to dismiss because the plaintiff-retirement plan participants stated a plausible claim for breach of fiduciary duty resulting from, amongst other things, defendant's failure to make available the least expensive mutual fund share class for which plan participants were eligible).

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