SEC announces results of share class selection disclosure initiative

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Abstract

Purpose – *To explain the SEC's Share Class Selection Disclosure Initiative (SCSD Initiative), the purpose it seeks to serve, the results it has generated, and its broader implications for the asset management industry.*

Design/methodology/approach – *Explains the newly announced results of the SEC's Share Class Selection Disclosure Initiative. Provides background on the principles underlying the initiative, the mechanics by which the initiative's self-reporting program operated, and industry reaction to the initiative. Analyzes the results the initiative generated, in terms of both aggregate disgorgement and the terms of settlement offered to self-reporting advisers. Draws conclusions and provides key takeaways.*

Findings – *Although the terms of the actual settlements were consistent with the framework of standardized settlement terms set forth in the SCSD Initiative, whether the standardized terms of settlement offered under the SCSD Initiative ultimately will be viewed as favorable will depend in large part upon how the SEC continues to treat advisers that did not self-report.*

Originality/value – *Expert analysis from experienced lawyers in the mutual fund and investment advisory industries.*

Keywords *US Securities and Exchange Commission (SEC), Enforcement, Self-reporting, Mutual fund share class selection, Disclosure of conflict of interest, 12b-1 fees.*

Paper type *Technical paper*

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Earlier this year, the US Securities and Exchange Commission (SEC) announced that it had settled charges against 79 investment advisers in connection with its Share Class Selection Disclosure Initiative (SCSD Initiative)[1]. More recently, on September 30, 2019, the SEC announced an additional round of settled charges pursuant to this initiative against 16 additional advisers[2]. The SCSD Initiative was an enforcement program offering standardized settlement terms for investment advisers that self-reported circumstances in which they did not adequately disclose certain conflicts of interest relating to the sale of more expensive mutual fund share classes when lower-cost share classes of the same fund were available. According to the SEC, the self-reporting advisers, some of whom were dually registered as broker-dealers, did not adequately disclose either their receipt of 12b-1 fees[3] or "additional compensation received for investing clients in a fund's 12b-1 fee-paying share class when a lower-cost share class was available for the same fund." Per the terms of settlements under the SCSD Initiative, self-reporting advisers were found to have violated Section 206(2)[4] and, except for advisers registered with a state and not the SEC, Section 207[5] of the Investment Advisers Act of 1940.

Background

The SEC's Division of Enforcement (Division) announced the SCSD Initiative in February 2018, citing a "significant" concern of the SEC Staff that advisers across the industry were not fully disclosing all material conflicts of interest relating to mutual fund share class

selection practices in a manner consistent with their obligations as fiduciaries under the Advisers Act.

In announcing the SCSD Initiative, the Division noted that Section 206(2) imposes an affirmative duty on advisers to disclose material conflicts of interest to their clients[6]. The Division explained that such a conflict of interest may arise where an adviser invests client funds, or recommends that clients invest, in a 12b-1 fee-paying mutual fund share class when a lower-cost share class of the same fund is available. The Division added that, as among multiple share classes in the same fund (and thus the same portfolio of securities), "it is usually in the client's best interest to invest in the lower-cost share class." According to the Division, whether an adviser receives compensation in the form of 12b-1 fees, directly or indirectly, amounts to a material fact that needs to be disclosed explicitly in the adviser's Form ADV[7].

The SEC had brought a number of enforcement actions involving this type of disclosure issue in the several years preceding the SCSD Initiative[8]. Dating back to October 2013, these enforcement actions involved allegations that the defendant advisers either:

- did not make disclosure regarding the conflicts of interest arising from their share class selection practices; or
- made selective, inadequate disclosures that generally suggested a potential conflict of interest, without explicitly notifying clients of actual conflicts of interest[9].

In addition to these cases, the SEC Staff also articulated its view of an adviser's disclosure obligations in this area through a 2016 OCIE Risk Alert[10]. In the view of the Division, these developments placed the investment advisory industry on notice regarding the issues and principles raised by the SCSD Initiative[11].

Led by the Division's Asset Management Unit, the SCSD Initiative sought to address these issues on an industry-wide basis by offering to recommend standardized and less severe terms of settlement as an incentive for advisers to self-report. As part of the SCSD Initiative, the Division indicated that it would recommend that the SEC accept settlements in which the self-reporting adviser would be required to disgorge ill-gotten gains and pay prejudgment interest, but would face no civil monetary penalty. Additionally, the standardized terms of settlement would not require a self-reporting adviser to admit or deny the SEC's findings, nor would they include charges of failure to seek best execution or violations of policies and procedures. However, the standardized terms of settlement would require the self-reporting adviser to make certain undertakings with respect to its share class selection practices and to review and correct its disclosure documents.

By contrast, the Division warned advisers that it would recommend more severe sanctions, including civil monetary penalties, in future enforcement actions against advisers that did not self-report when they were eligible to do so. The SCSD Initiative also offered no assurances with respect to individual liability.

Eligibility for Share Class Selection Disclosure Initiative

To qualify for the SCSD Initiative, an adviser had to have directly or indirectly received 12b-1 fees in connection with "recommending, purchasing, or holding" 12b-1 fee-paying share classes for advisory clients when a lower-cost share class of the same fund was available to the clients. In order to have "received" 12b-1 fees for purposes of the SCSD Initiative, the adviser had to have, during the period beginning January 1, 2014:

- Directly received the fees;
- Supervised persons who received the fees; or
- Been affiliated with a broker-dealer that received the fees.

In addition, the adviser had not to have disclosed this conflict of interest explicitly on Form ADV. An adviser's disclosure of this conflict of interest is sufficient for purposes of the SCSD Initiative when it "clearly" describes the conflict of interest with respect to both:

- the effect the receipt of 12b-1 fees has on the adviser's investment decision-making; and
- the adviser's selection of the more expensive 12b-1 fee-paying share classes for advisory clients when a lower-cost share class of the same fund was available.

In the interest of helping advisers determine whether they were eligible to participate in this self-reporting initiative, the Division issued responses to certain frequently asked questions in May 2018, covering topics such as the scope of conduct to which the SCSD Initiative would apply and how to properly calculate disgorgement, as well as providing examples of circumstances in which a lower-cost share class would be deemed to have been available[12].

Industry Commentary and Fiduciary Interpretation

On December 21, 2018, both the American Securities Association (ASA) and the Securities Industry and Financial Markets Association (SIFMA) submitted comment letters challenging the SCSD Initiative[13]. The ASA's letter to the SEC's Commissioners[14] and SIFMA's letter to the Division[15] each contended that the SEC had provided insufficient notice to advisers as to the scope of their disclosure obligations in the share class selection disclosure context, and that the standard set forth under the SCSD Initiative amounted to "regulation by enforcement." According to the ASA and SIFMA, even though the SEC brought some related enforcement actions in this area in the several preceding years, and similarly articulated its position in the 2016 OCIE Risk Alert, the SEC's underlying interpretation of an adviser's disclosure obligations in the context of share class selection had not been subjected to the traditional administrative process. Thus, the ASA and SIFMA maintained, this left unaddressed significant operational questions as to how advisers should bring their practices into compliance. The letters discussed the logistical challenges advisers would face if the principles of the SCSD Initiative were broadly enforced with regard to mutual fund share class disclosure. These included:

- considering investor eligibility for new mutual fund share classes as soon as they have been added to a fund's prospectus (*i.e.*, ongoing monitoring requirements, changes to existing eligibility criteria);
- negotiating selling agreements;
- disclosing share class selection practices in Form ADV (*i.e.*, placement of disclosure); and
- disclosing share class selection where a third-party manager (rather than the current adviser) selected the share class.

On June 5, 2019, the SEC adopted a final interpretation of the standard of conduct for an investment adviser under the Advisers Act. The proposed interpretation, published in April 2018, discussed an adviser's disclosure obligations when advising clients to invest in a particular mutual fund share class when less expensive options are available[16]. However, this discussion has been omitted from the final interpretation. Nonetheless, advisers are still required to provide full and fair disclosure of all material conflicts of interest, which the SEC and Staff will almost certainly view as including conflicts related to share class selection, so that clients can provide informed consent.

Results

As part of the settled charges, the self-reporting advisers agreed, without admitting or denying the SEC's findings, to return, in the aggregate, more than $135 million[17] to their

respective affected advisory clients and to undertake certain remedial actions concerning their relevant disclosure documents. The terms of the actual settlements were consistent with the framework of standardized settlement terms set forth in the SCSD Initiative.

In announcing these settlements, the SEC has reiterated its view of advisers' obligations to disclose conflicts of interest that arise in connection with advisers' receipt of 12b-1 fees. SEC Chairman Jay Clayton has emphasized that, "[r]egardless of the scope and duration of the investment advisory services, investment advisers are fiduciaries and, as such, their duties of care and loyalty require them to disclose their conflicts of interest, including financial incentives."[18] Division leadership also has noted that most of the advisory clients affected by the alleged disclosure failures have been retail investors, with Division Co-Director Stephanie Avakian explaining in March that "[a]n adviser's failure to disclose these types of financial conflicts of interest harms retail investors by unfairly exposing them to fees that chip away at the value of their investments."[19] Co-Director Avakian has also observed that the principles at issue in the SCSD Initiative are applicable to other contexts as well, such as revenue sharing, various cash sweep arrangements and investments in Unit Investment Trusts[20].

SEC Commissioner Hester Peirce, by contrast, has criticized the SCSD Initiative, stating that "when we see a widespread problem that is affecting investors, we–the Commission–should issue our own guidance or promulgate a rule and put an end to the problem before it hurts investors further" rather than "waiting many years to bring a large enforcement initiative."[21] Perhaps related to those and similar criticisms, the SEC's Division of Investment Management has recently issued a set of responses to frequently asked questions concerning investment advisers' disclosure obligations with respect to financial conflicts of interest arising from investment adviser compensation[22].

Implications

The SEC Staff has stated that it continues to evaluate self-reports received prior to the June 12, 2018 self-reporting deadline[23]. Whether the standardized terms of settlement offered under the SCSD Initiative ultimately will be viewed as favorable will depend in large part upon how the SEC continues to treat advisers that did not self-report. In conjunction with the second announcement of settled charges, the SEC also announced charges against an adviser that had been eligible for self-reporting under the SCSD Initiative but had not done so. The SEC charged the non-self-reporting adviser with best execution and policy and procedures violations on top of disclosure violations and ordered a $300,000 civil monetary penalty in addition to $1 million in disgorgement and prejudgment interest[24].

Accordingly, many observers expect that the SEC will continue to bring enforcement actions against investment advisers that did not self-report similar violations with more severe terms and sanctions, including potential charges under Section 206(1) that the adviser acted with fraudulent intent, as well as civil monetary penalties[25]. The SEC has also recently pursued advisers for alleged disclosure violations regarding revenue sharing and other payments outside the scope of the SCSD Initiative[26].

Advisers seeking to avoid enforcement action may consider adopting disclosures that meet the Staff's criteria for sufficiency under the SCSD Initiative, i.e., "clearly" describing conflicts of interest with respect to both:

- the effect on the adviser's investment decision-making; and
- the adviser's selection of the more expensive share classes when a lower-cost share class of the same fund was available.

It is possible that the SCSD Initiative will contribute to the trend toward the direct charging of service fees to clients rather than receiving indirect payments from funds in which those clients invest. Some advisers may decide that even reasonable disclosures about conflicts

of interest associated with their receipt of 12b-1 fees leave open the risk of enforcement action, and that the associated regulatory burdens (such as those outlined by the ASA and SIFMA) outweigh any potential benefits, and instead choose to charge service fees directly.

The SCSD Initiative also may have an impact on the broader SEC enforcement program. After years of criticism that the benefits of self-reporting to the Division were illusory, the perceived success of the initiative may make it more likely that the Division will consider offering standardized settlement terms for registrants that self-report in other circumstances.

Notes

1. Press Release: SEC Share Class Initiative Returning More Than $125 Million to Investors ("Initial Announcement of Settled Charges") (Mar. 11, 2019).
2. Press Release: SEC Orders an Additional 16 Self-Reporting Advisory Firms to Pay Nearly $10 Million to Investors (Sept. 30, 2019).
3. 12b-1 fees are recurring fees paid from a mutual fund's assets for shareholder services, distribution, and marketing expenses. Under Rule 12b-1 promulgated pursuant to the Investment Company Act of 1940, mutual funds may only engage "directly or indirectly in financing any activity which is primarily intended to result in the sale of shares issued by such company" if all payments are made "pursuant to a written plan describing all material aspects of the proposed financing of distribution."
4. 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." Unlike Section 206(1) of the Advisers Act, Section 206(2) does not require scienter—an intent to defraud—as an element of a violation.
5. Section 207 prohibits any person from either willfully making untrue statements of a material fact "in any registration application or report filed with the Commission" or willfully omitting any material fact "required to be stated therein."
6. Securities and Exchange Commission, Division of Enforcement, Announcement: Share Class Selection Disclosure Initiative (Announcement) (Feb. 12, 2018) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963)). For further information on the SCSD Initiative, please refer to *Dechert OnPoint*, SEC Announces Share Class Selection Disclosure Initiative, available at: https://info.dechert.com/10/10161/march-2018/sec-announces-share-class-selection-disclosure-initiative.asp
7. Item 5(e) of Form ADV, Part 2A, requires that advisers: (i) disclose whether they or their supervised persons "[accept] compensation for the sale of securities or other investment products"; (ii) "[e]xplain that this practice presents a conflict of interest and gives [. . .] an incentive to recommend investment products based on the compensation received, rather than on a *client's* needs" (emphasis in original); and (iii) describe generally how the adviser addresses conflicts that arise.
8. *See* In the Matter of Packerland Brokerage Services, Inc., Investment Advisers Act Rel. No. 4832 (Dec. 21, 2017) (adviser recommended a share class with a service fee but did not disclose either its receipt of an annual service fee in its capacity as a broker-dealer or the availability of a lower-cost, but otherwise identical, share class); In the Matter of Cadaret, Grant & Co., Inc., Investment Advisers Act Rel. No. 4736 (Aug. 1, 2017) (adviser invested client assets in a 12b-1 fee-paying share class when less-expensive share classes in the same funds were available, but did not disclose on Form ADV its conflicts of interest related to its receipt of 12b-1 fees or additional marketing support fees it received when investing clients in 12b-1 fee-paying share classes); In the Matter of Pekin Singer Strauss Asset Management Inc., Investment Advisers Act Rel. No. 4126 (Jun. 23, 2015) (Form ADV did not address that an adviser kept or placed clients in a more expensive share class when a less-expensive institutional share class became available); see also In the Matter of Envoy Advisory, Inc., Investment Advisers Act Rel. No. 4764 (Sept. 8, 2017) (adviser made general disclosure about potential receipt of 12b-1 fees but did not make explicit Form ADV disclosures to IRA holders regarding 12b-1 fees received by affiliated broker-dealer); In the Matter of Manarin Investment Counsel, Ltd., Investment Advisers Act Rel. No. 3686 (Oct. 2, 2013) (adviser disclosed on Form ADV that representatives of affiliated broker-dealer were "typically entitled to receive" a portion of 12b-1 fees but not that the adviser would select share classes paying 12b-1 fees even when lower-cost share classes were available).
9. For example, the Division has taken the view that an adviser's disclosure that it "may" receive 12b-1 fees, or that the receipt of such fees "may" pose a conflict of interest, does not adequately disclose

a material conflict of interest. *See* Announcement. In the June 5, 2019 Commission Interpretation Regarding Standard of Conduct for Investment Advisers, the SEC stated "disclosure that an adviser "may" have a particular conflict, without more, is not adequate when the conflict actually exists [. . .] the use of "may" would be inappropriate if it simply precedes a list of all possible or potential conflicts regardless of likelihood and obfuscates actual conflicts to the point that a client cannot provide informed consent." Investment Advisers Act Rel. No. 5248.

10. *See* Office of Compliance Inspections and Examinations, OCIE's 2016 Share Class Initiative (Jul. 13, 2016).
11. The Division had recently offered a similar self-reporting program in the municipal securities context. *See* SEC Launches Enforcement Cooperation Initiative for Municipal Issuers and Underwriters, SEC News Release 2014-46 (Mar. 10, 2014).
12. Securities and Exchange Commission, Division of Enforcement, Share Class Selection Disclosure Initiative – FAQs (May 1, 2018).
13. *See* ASA letter re: Rulemaking by Enforcement (Dec. 21, 2018); SIFMA letter re: SEC Mutual Fund Share Class Selection Disclosure Initiative (Dec. 21, 2018).
14. According to the ASA, "there is no language in these cases clearly articulating the specific disclosure obligations of investment advisers who elect to receive 12b-1 fees [. . .]".
15. SIFMA observed that the "Commission's notice to the industry was considerably less than clear in 2014."
16. "For example, if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other available options when the adviser is receiving compensation that creates a potential conflict and that may reduce the client's return, the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client and obtain informed client consent to the conflict." Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation (Apr. 18, 2018), Investment Advisers Act Rel. No. 4889.
17. The $135 million received represents the amount of 12b-1 fees received in excess of the 12b-1 fees (if any) that would have been collected had the adviser placed the client in the lowest-cost share class available, as well as prejudgment interest.
18. *See* Initial Announcement of Settled Charges.
19. *Id.*
20. *See* Stephanie Avakian, "What You Don't Know Can Hurt You" (Nov. 5, 2019)
21. *See* Hester M. Peirce, "Reasonableness Pants" (May 8, 2019).
22. *See* Division of Investment Management, *Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation* (Oct. 19, 2019).
23. *See* Initial Announcement of Settled Charges.
24. *See* In the Matter of Mid Atlantic Financial Management Inc., Investment Advisers Act Rel. No. 5397 (Sept. 30, 2019).
25. *See also Securities and Exchange Commission v. Cetera Advisors, LLC and Cetera Advisor Networks* LLC, Civil Action No. 1:19-cv-02461 (D. Colo., filed Aug. 29, 2018, amended Oct. 11, 2019); *Securities and Exchange Commission v. Bolton Securities Corporation d/b/a Bolton Global Asset Management*, Civil Action No. 4:19-cv-40143 (D. Mass., filed Nov. 4, 2019).
26. *See also Securities and Exchange Commission v. Commonwealth Equity Services, LLC d/b/a Commonwealth Financial Network*, No. 1:19-cv-11655 (D. Mass. filed Aug. 1, 2019).

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