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Legal Update

SEC Settles Charges with 79 Self-Reporting Advisers in Share Class Selection Disclosure Initiative

On March 11, 2019, the US Securities and Exchange Commission ("SEC") announced that it settled charges against 79 investment advisers who self-reported violations in connection with the SEC's Share Class Selection Disclosure Initiative (the "SCSD Initiative").[1] The SCSD Initiative, which the SEC's Division of Enforcement (the "Division") announced on February 12, 2018,[2] gave advisers an opportunity to avoid financial penalties if they (i) self-reported possible violations of the Investment Advisers Act of 1940 (the "Advisers Act") related to mutual fund share class selection (as described below) by June 12, 2018, (ii) agreed to promptly compensate harmed advisory clients and (iii) agreed to review and correct relevant disclosures.

If the avoidance of financial penalties was insufficient motivation for advisers to self-report, significant additional incentives were provided by the Division by way of the following blunt warning to advisers choosing not to participate in the SCSD Initiative (emphasis added):

> For advisers that would have been eligible for the terms of the SCSD Initiative but did not participate, the Division expects in any proposed enforcement action to recommend *additional charges*, if appropriate, and the imposition of penalties. Eligible advisers are cautioned that staff from the Commission's Office of Compliance Inspections and Examinations and the Division of Enforcement plan to continue to make mutual fund share class selection practices a priority, and plan to proactively seek to identify investment advisers that may have failed to make the necessary disclosures related to mutual fund share class selection. Enforcement actions outside of the SCSD Initiative will likely result in the staff *recommending violations and remedies beyond those described in the Initiative*, including penalties. A settlement against an eligible adviser that fails to self-report under the SCSD Initiative may include *greater penalties* than those imposed in past cases involving similar disclosure failures.

Below, we explore the SCSD Initiative and the eligibility requirements for advisers in detail, discuss the regulatory activity in this area prior to the announcement of the SCSD Initiative and describe the settled enforcement actions against these 79 self-reporting advisers.

The SCSD Initiative Generally

In the Press Release, the SEC stated that the SCSD Initiative was intended to address the SEC's ongoing concerns that, despite the

fiduciary duty imposed by the Advisers Act, an OCIE risk alert, Form ADV reminders and numerous individual SEC enforcement actions, investment advisers were either not adequately disclosing, or not acting consistently with their disclosures regarding, conflicts of interest arising from mutual fund share class selection practices.

In our view, the Press Release's references to fiduciary duty, the risk alert, the reminders and the numerous enforcement actions reflect the SEC's mounting frustration and growing impatience with advisers regarding share class selection issues at the time the SCSD Initiative was announced.[3]

In the SCSD Announcement, the Division stated that the SEC believes advisers violate Advisers Act Sections 206(2)[4] and 207[5] if they fail to disclose to their clients conflicts of interest associated with the receipt of Rule 12b-1 fees[6] for investing client funds in, or recommending that clients invest in, a 12b-1 fee paying share class when a lower-cost share class was available to clients for the same fund.

The Division also stated the SEC believes that even if an adviser discloses that it or its affiliates "may" receive 12b-1 fees from the sale of mutual fund shares and that such fees "may" create a conflict of interest, the adviser nevertheless violates the above provisions of the Advisers Act if it fails to disclose that it *in fact* has a conflict of interest because many mutual funds offer a variety of share classes, including some that pay 12b-1 fees and others that do not, and it fails to disclose that it or its affiliates were *in fact* receiving 12b-1 fees due to the mutual fund shares they bought for or recommended to their clients.[7]

In addition to violations of Section 206(2) and Section 207 of the Advisers Act for failing to disclose the conflict of interest, the Division noted that the above conduct has often also led to charges that the investment adviser failed to seek best execution and, in violation of Section 206(4) and Rule 206(4)-7 thereunder, failed to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act.[8] However, the Division stated that under the SCSD Initiative it would recommend that the SEC accept settlements that do not include those charges, even where the facts would support them.[9] This provided yet another incentive to advisers to self-report their share selection conduct through the SCSD Initiative.

The SCSD Initiative represented a more narrow regulatory focus regarding share class selection issues as compared with the related enforcement actions that preceded it. The prior share class enforcement actions set out a variety of violations, including failure to meet disclosure, best execution and compliance policy obligations. But in the SCSD Initiative, the Division focused solely on the adviser's disclosure obligations. This is particularly interesting given the SEC's recent proposed interpretation of an adviser's fiduciary duty,[10] which appears to call into question whether and to what extent an adviser can fully rely on disclosure to "cure" conflicts of interest under the Advisers Act.

Lastly, based on the terms of the SCSD Initiative, the Division would recommend to the SEC a settlement in which the adviser would neither admit nor deny the SEC's findings. Other recommended, standardized terms included a cease and desist order, censure and disgorgement of "ill-gotten" gains (including prejudgment interest thereon).

The Division stated that the SCSD Initiative does not address possibly similar or related conduct, such as where one share class is higher-cost than another share class but neither share class pays a 12b-1 fee or where the adviser otherwise has no financial conflict of interest. However, an adviser should not ignore other possible scenarios and related regulatory concerns regarding share class selection. For example, even in the absence of a financial conflict, an adviser nevertheless has a duty to seek best execution when selecting mutual fund share classes for advisory clients (particularly where a client might be eligible to purchase more than one share class of the same fund). Further, a financial conflict could exist even in the absence of a 12b-1 fee if the adviser or an affiliate receives other fees or benefits from the fund or its service providers.

SCSD Initiative Eligibility Requirements

An adviser is eligible for the SCSD Initiative if it "received" (as described further below) 12b-1 fees in connection with recommending, purchasing or holding 12b-1 fee paying mutual fund share classes for its advisory clients when a lower-cost share class of the same fund was available to those clients, and it failed to disclose *explicitly* in its Form ADV the conflicts of interest associated with the receipt of such fees (as discussed below).[11]

An adviser "received" 12b-1 fees if:

- It directly received the fees;
- Its supervised persons received the fees; or
- Its affiliated broker-dealer or its registered representatives received the fees.

Notably, if the reporting adviser directly received 12b-1 fees but was not itself registered as a broker-dealer, the Division stated that as part of the SCSD Initiative it would not recommend that the SEC charge the adviser with broker-dealer registration violations under Section 15(a) of the Securities Exchange Act of 1934 (the "Exchange Act") based on the adviser's receipt of 12b-1 fees for its activity *before* it self-reported its conduct to the Division under the SCSD Initiative. This provided a *fourth* incentive for advisers to self-report.[12]

Advisers (other than dual-registrants) that continued to receive 12b-1 fees after self-reporting thus have enforcement risk for violations of Exchange Act Section 15(a). Interestingly, as acknowledged by the Division in the SCSD Announcement,[13] a "12b-1 fee" might be paid to compensate intermediaries, including advisers, for providing shareholder or other services that do not raise broker-dealer status concerns. Ultimately, the nature of the services provided by recipients of a mutual fund's 12b-1 fees are dictated by the terms and conditions of the fund's written "12b-1" plan and related agreements.

The Division believes that for purposes of the SCSD Initiative an adviser "explicitly" disclosed in its Form ADV the conflicts of interest related to the receipt of these fees if the disclosures *clearly* described the conflicts of interest associated with:

- Making investment decisions in light of the receipt of the 12b-1 fees; and
- Selecting the more expensive 12b-1 fee paying share class when a lower-cost share class was available for the same fund.

Although what constitutes "clear" disclosure certainly is a debatable point, advisers could voluntarily include in the self-report any facts that might assist Division staff in understanding the circumstances that may have led to the omission of share class selection conflicts of interest disclosures from the adviser's Form ADV brochures and brochure supplements (*e.g.*, any information regarding other disclosure documents the adviser believes contain an adequate disclosure of the conflict).

Notably, although the SCSD Initiative covered self-reporting investment advisory entities, it explicitly did *not* cover individuals associated with these entities. Specifically, the Division provided no assurance that individuals associated with self-reporting advisers would be offered similar terms if they have engaged in violations of the federal securities laws. The Division explicitly warned that it may recommend enforcement action against such individuals and may seek remedies beyond those available through the SCSD Initiative.

Also outside the scope of the SCSD Initiative were advisers that had already been contacted by the Division as of the date of the SCSD Announcement regarding possible violations related to failures to disclose the conflicts of interest associated with mutual fund share class selection. However, advisers that were at that time subject to pending OCIE examinations relating to this issue, but which had not yet been contacted by the Division, were eligible to participate.

Lastly, the Division warned that the SCSD Initiative's standardized settlement terms would apply only to self-reported conduct that meets the requirements of the SCSD Initiative and that any other potential misconduct would be subject to possible investigation and separate enforcement action (with the imposition of additional remedies including, but not limited to, financial penalties).

The SCSD Initiative presented a difficult choice for some advisers, particularly for those whose eligibility was unclear or who had potential violations for conduct unrelated to or outside the scope of the SCSD Initiative. The SCSD Announcement made clear that self-reported conduct outside the scope of the SCSD Initiative would not be eligible for the initiative and would instead be evaluated on a case-by-case basis. Thus, advisers hoping to receive the same leniency afforded by the SCSD for conduct similar, but not identical, to that covered by the initiative would have to self-report first and learn their fate afterwards. Conversely, failing to self-report at all could lead to even larger sanctions down the road—particularly if the SEC concluded in hindsight that the violation had been eligible for the SCSD. Navigating the correct course through these types of obstacles, whether within a specific SEC initiative like this one or more generally (e.g., general self-reporting decisions), is a highly fact-specific endeavor that requires the assistance of experienced counsel.

Prior Regulatory Activity

Since at least 2013, the SEC has brought numerous enforcement actions against investment advisers for, among other things (e.g., best execution), failing to disclose conflicts of interest and failing to implement reasonably designed policies and procedures relating to mutual fund share classes, in violation of the Investment Advisers Act.[14] In those actions, the advisers generally were required to pay disgorgement, as well as penalties, and make distributions to affected clients.

Then, in 2016, reflecting the SEC's continued and increasing concerns about share class selection, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a risk alert regarding share class selection. In the alert, OCIE warned advisers that its staff would be focusing on an adviser's practices related to share class recommendations and compliance oversight of those practices, including the adviser's:

- Investment practices, to determine whether it is acting in its clients' best interest and seeking best execution when recommending or selecting mutual fund investments to clients.

- Books and records, to identify share classes held and purchased in client accounts and any compensation received by the adviser or any of its associated persons related to such investments.
- Disclosures regarding compensation for the sale of shares and the conflicts of interest created, to determine the accuracy, adequacy and effectiveness of those disclosures.
- Written policies and procedures regarding share class selection to evaluate their adequacy and effectiveness.

In this risk alert, OCIE specifically noted the SEC's view that an investment adviser has failed to uphold its fiduciary duty when it causes a client to purchase a more expensive share class of a fund when a less expensive class of that fund is available.[15] It also specifically noted that the SEC previously highlighted the need for advisers making mutual fund share class selections to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act, including those that govern their selection process.[16]

Share class selection issues received only indirect, minor attention in OCIE's examination priorities for 2013 and 2014 (mentioned as part of a broad priority), with no attention given to this subject in the priorities announced for 2015 and 2016. However, OCIE specifically set out share class selection as a stand-alone examination priority for 2017. This examination focus has continued from that time to the present.[17]

Summary of the Self-Reporting Settlements

With respect to the 79 advisers at issue in these settlements, the SEC stated that each had directly or indirectly received 12b-1 fees for mutual fund investments selected for their advisory clients without adequate disclosure or with disclosures that were inconsistent with the advisers' actual practices. Specifically, the SEC found that each adviser had placed its clients' assets in mutual fund share classes that charged 12b-1 fees (which are recurring fees deducted from the mutual fund's assets) when lower-cost share classes of the same fund were available to their clients and, further, that the adviser had done so without adequately disclosing that the higher cost share class would be selected. According to the SEC, the 12b-1 fees were routinely paid to the investment advisers or their affiliates or certain personnel, which created a conflict of interest with their clients.

Collectively, the 79 advisers will return approximately $125 million to clients (mostly retail clients, the protection of which is a continuing priority for the SEC).[18] The SEC's orders found that the settling advisers violated Section 206(2) and, except with respect to state-registered only advisers, Section 207 by failing to:

- Include adequate disclosure regarding the receipt of 12b-1 fees; and/or
- Adequately disclose 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.

Consistent with the settlement terms outlined in the SCSD Initiative, without admitting or denying the findings, each of the settling investment advisers consented to cease-and-desist orders, agreed to a censure and agreed to disgorge the improperly disclosed fees and distribute these monies, with prejudgment interest, to affected advisory clients.[19]

As dictated by the terms of the SCSD Initiative, each adviser has also undertaken to complete the following tasks within 30 days of the entry of the settlement order:

- Review and correct all relevant disclosure documents concerning mutual fund share class selection and 12b-1 fees and to

evaluate whether existing clients should be moved to an available lower-cost share class and move clients, as necessary.

- Evaluate, update (if necessary) and review for the effectiveness of their implementation policies and procedures to ensure that they are reasonably designed to prevent violations of the Advisers Act in connection with the adviser's disclosures regarding mutual fund share class selection; and
- Notify affected clients of the settlement terms in a clear and conspicuous fashion (affected clients are former and current clients who, during the relevant time period (as set out in the settlement order) of inadequate disclosure, purchased or held 12b-1 fee paying share class mutual funds when a lower-cost share class of the same fund was available to the client).

Also consistent with the terms of the SCSD Initiative, the SEC did not impose any penalties. However, if at any time following the entry of the settlement order the Division obtains information indicating that the respondent knowingly provided materially false or misleading information or materials to the SEC—or in a related proceeding—the Division may, at its sole discretion, petition the SEC to reopen this matter and seek an order directing that the respondent pay a civil money penalty.

Conclusion

The settled enforcement actions against these 79 investment advisers will not be the end of this protracted share class selection story. The SEC staff continues to evaluate SCSD Initiative self-reports that it received before the SCSD Initiative's cut-off date on June 12, 2018, indicating that additional settled actions are likely forthcoming. In addition, advisers with share class selection issues that chose not, or were not eligible, to participate in the SCSD Initiative continue to have regulatory risk in this area. Individuals associated with advisers that have share class selection issues are also at risk.

For advisers that have not yet reviewed their share class selection practices, disclosures, policies and procedures or have not otherwise explored conflicts of interest in connection with recommended investment products and the sponsors and service providers thereof (and related controls, practices and policies), we strongly recommend that they do so, promptly.

If you have any questions about the topics raised in this Legal Update or would like assistance with SEC enforcement or regulatory matters related to share class selection or otherwise, please contact any of the following lawyers:

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Endnotes

[1] *See SEC Share Class Initiative Returning More Than $125 Million to Investors,* SEC Press Release dated March 11, 2019 (the "Press Release") and Investment Advisers Act Release Nos. 5155, 5175, 5165, 5130, 5169, 5151, 5141, 5160, 5170, 5142, 5131, 5159, 5182, 5143, 5132, 5176, 5191, 5197, 5166, 5144, 5123, 5124, 5161, 5156, 5192, 5183, 5145, 5149, 5133, 5134, 5135, 5157, 5146, 5184, 5185, 5186, 5171, 5152, 5153, 5187, 5136, 5193, 5162, 5158, 5172, 5163, 5167, 5137, 5138, 5177, 5173, 5154, 5178, 5125, 5164, 5147, 5126, 5194, 5198, 5148, 5139, 5127, 5140, 5195, 5179, 5180, 5188, 5128, 5196, 5189, 5168, 5181, 5129, 5150, 5190, 5199 and 5174 (March 11, 2019).

[2] *See Share Class Selection Disclosure Initiative*, SEC Division of Enforcement Announcement dated February 12, 2018 (the "SCSD Announcement"). The SCSD Initiative is led by the Division's Asset Management Unit.

[3] In fact, Steven Pekin, Division Co-Director, referred to the share class selection disclosure issue that the SCSD Initiative was designed to address as "a pervasive problem." *See Press Release.* The Press Release also noted that OCIE has *for years* identified deficiencies on these issues. The SCSD Announcement echoed these sentiments.

[4] Section 206(2) prohibits an investment adviser, directly or indirectly, from engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." This section imposes a fiduciary duty on investment advisers to act for their clients' benefit, including an affirmative duty of utmost good faith and full disclosure of all material facts. *See SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 194 (1963). It also imposes a fiduciary duty on investment advisers to disclose to clients all conflicts of interest which might incline an investment adviser consciously or unconsciously to render advice that is not disinterested. *Id.* at 191-92.

[5] Section 207 of the Advisers Act makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission . . . or willfully to omit to state in any such application or report any material fact which is required to be stated therein." Form ADV specifically requires advisers to disclose the compensation and fees that they and their supervised persons receive, including from asset-based charges and service fees.

[6] According to the SCSD Announcement, a "12b-1" fee is a fee paid by a mutual fund on an ongoing basis from its assets for shareholder services, distribution and marketing expenses.

[7] *See SCSD Announcement.*

[8] *Id.*

[9] *Id.*

[10] *See* Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 4889 (April 18, 2018).

[11] In May 2018, the Division of Enforcement published answers to "frequently asked questions" about the Initiative, which provided detailed information about eligibility requirements, disgorgement calculations and other matters: https://www.sec.gov/enforce/educationhelpguidesfaqs/share-class-selection-disclosure-initiative-faqs.

[12] The other three incentives included: the waiver of penalties in the SCSD Initiative; the possibility (and likelihood) of more severe treatment for not self-reporting through the SCSD Initiative; and the elimination of best execution and compliance policy and procedure violations for self-reporting advisers, even where facts would support those violations.

[13] *See* footnote 6, above.

[14] Specifically, the SEC usually found violations of not only Sections 206(2) and 207, but also Section 206(4) and Rule 206(4)-7. *See e.g.*, Investment Advisers Act Release No. 4878 (April 6, 2018); Investment Advisers Act Release No. 4877 (April 6, 2018); Investment Advisers Act Release No. 4876 (April 6, 2018); Investment Advisers Act Rel. No. 4832 (Dec. 21, 2017); Investment Advisers Act Rel. No. 4769 (Sept. 14, 2017); Investment Advisers Act Rel. No. 4764 (Sept. 8, 2017); Investment Advisers Act Rel. No. 4736 (Aug. 1, 2017); Investment Advisers Act Release No. 4351 (March 14, 2016) ("Release 4351"); Investment Advisers Act Release No. 4314 (January 14, 2016); Investment Advisers Act Rel. No. 4126 (June 23, 2015); Investment Advisers Act Rel. No. 3686 (Oct. 2, 2013) ("Release 3686"). *See also* Investment Advisers Act Release No. 5090 (December 21, 2018) ("Release 5090"); Investment Advisers Act Release No. 4678 (April 4, 2017); Investment Advisers Act Release No. 5083 (December 20, 2018) ("Release 5083"); Investment Advisers Act Release No. 5084 (December 20, 2018) ("Release 5084"). Consistent with the Division's warnings, in the enforcement actions that were announced after the close of the SCSD self-reporting deadline, e.g., Releases 5090, 5083 and 5084, the SEC imposed civil penalties and found violations of Sections 206(2), 206(4) and 207 and of Rule 206(4)-7.

[15] *See* Release 3686.

[16] *See* Release 4351.

[17] *See* OCIE Examination Priorities for 2013 (February 21, 2013); OCIE Examination Priorities for 2014 (January 9, 2014); OCIE Examination Priorities for 2015 (January 15, 2015); OCIE Examination Priorities for 2016 (January 11, 2016); OCIE Examination Priorities for 2017 (January 12, 2017); OCIE Examination Priorities for 2018 (February 7, 2018); and OCIE Examination Priorities for 2019 (December 20, 2018). *See also On the Radar for 2017 Exams of US-Regulated Investment Advisers and Broker-Dealers*, Mayer Brown Legal Update.

[18] *See* OCIE Examination Priorities for 2019 (December 20, 2018). *See also OCIE's 2019 Examination Priorities and 2018 Enforcement Actions: Practice Points for Advisers to Consider*, Mayer Brown Legal Update (February 19, 2019); https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/02/ocie2019exampriorities_v5.pdf.

[19] The amount to be distributed to affected clients was calculated in accordance with the terms of the SCSD Initiative and varied for each adviser, depending on the facts and circumstances relevant to such adviser.

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