SEC Share Class Selection Disclosure Initiative: Practical Considerations and Lessons Learned

By Amy Doberman, WilmerHale*

The Securities and Exchange Commission ("SEC") has made a concerted effort over the last several years to address investment advisers' conflicts of interests and to establish standards for associated disclosure failures (unfortunately) through a series of settled enforcement actions. Many of these enforcement actions have focused on insufficient conflict disclosures regarding mutual fund share class selection, and the failure by advisers to use in wrap programs or otherwise the least expensive mutual fund share class for which the client or program is eligible, ostensibly so that the adviser or its broker-dealer affiliate could collect Rule 12b-1 fees. In February, the SEC's Division of Enforcement ("Division") announced that it was providing registered investment advisers an opportunity to self-report instances of inadequately disclosed conflicts relating to the selection of mutual fund share classes and receipt of 12b-1 fees. By self-reporting, eligible advisers stand to gain favorable settlement terms including: (i) institution of an administrative and cease-and-desist proceeding in which the investment adviser neither admits nor denies the findings of the SEC; and (ii) the payment of remediation to clients without incurring any civil penalties.

Amy Doberman, WilmerHale

"The Division cautioned that advisers eligible for the initiative that do not participate should expect to have additional charges recommended and penalties imposed in enforcement proceedings and that the penalties may be larger than those imposed in past actions."

Recent Enforcement Initiatives

In the past few years, and as recently as this past April, the SEC has settled several enforcement actions against registered investment advisers for failing to make adequate conflict disclosures in connection with investing their clients in mutual fund share classes that paid the adviser (or an affiliate) 12b-1 fees when a lower-cost share class was available. *See, e.g., In the Matter of Securities America Advisors, Inc.,* Investment Advisers Act Release No. 4876 (Apr. 6, 2018); *In the Matter of Geneos Wealth Management, Inc.,* Investment Advisers Act Release No. 4877 (Apr. 6, 2018); *In the Matter of PNC Investments,* Investment Advisers Act Release No. 4878 (Apr. 6, 2018).

The actions were premised on the theory that the adviser breached its fiduciary duty to clients by failing to specifically disclose that share class decisions were made based on the adviser's ability to receive Rule 12b-1 fees, which benefits the adviser to the detriment of its clients when a less expensive share class was available. The orders also claim that the adviser breached its duty of best execution in connection with the selection of share classes (a claim that arguably has no basis in law and makes little sense in the context of a security whose price is determined by its net asset value and is not traded on an exchange). These actions have required the adviser to consent to findings of willful violations of the securities laws, including violations of Section 206(2) (non-scienter-based fraud), Section 206(4) and Rule 206(4)-7 thereunder (failure to maintain adequate policies and procedures) and Section 207 (misrepresentations made in Form ADV) of the Investment Advisers Act of 1940 ("Advisers Act"). The orders also typically required the adviser to agree to a cease-and-desist order from further violations of the applicable sections of the Advisers Act, to accept a censure, disgorge ill-gotten gains by remediating clients and incur substantial civil monetary penalties.

The Initiative and Eligibility

On February 12, 2018, the Division of Enforcement announced an Initiative to encourage self-reporting of conflict disclosure failures related to share class selection and the receipt of 12b-1 fees. The Initiative is intend-

Continued on page 14

Continued from page 13

ed to identify and promptly remedy the potentially widespread violations and obtain prompt payment of restitution to affected advisory clients.

To have sufficient disclosure relating to this conflict, the Division has stated that disclosures in an adviser's brochure must have clearly described the conflicts associated with:

- Making share class decisions based on the receipt of 12b-1 fees; *and*
- Selecting a more expensive share class when a cheaper class is available.

The Division clearly indicated that disclosing that an investment adviser or its affiliated broker-dealer "may" receive 12b-1 fees and that receipt of such fees "may" create a conflict, does not fulfill the adviser's obligation to fully disclose all material conflicts related to mutual fund share class selection and renders the adviser eligible for the initiative.

Whether a cheaper class is "available" is facts and circumstances dependent, but the Division provided a non-exhaustive list in FAQs (dated May 1, 2018) for when it would consider a cheaper share class "available." These circumstances include when the client could have purchased a cheaper share class because the client met the investment minimums; when a prospectus explained that a fund "will" waive certain minimums for a lower cost share class of the same fund for advisory clients; and when the adviser failed to make reasonable inquiry about the availability of less expensive share classes. Therefore, in the Division's view, the omission of a less expensive share class on the broker-dealer/adviser's platform or in a selling agreement in and of itself does not provide a defense to the failure to disclose.

Terms of the Initiative

If an adviser's facts allow it to meet the definition of "Self-Reporting Adviser" in the announcement and it had not already been contacted by the Division as of the date of the announcement regarding possible violations related to share class selection, the Division will recommend favorable settlement terms for those advisers that self-report. The initiative enumerated that the standard terms would include:

- Institution of an administrative order in which the adviser neither admits nor denies the findings of the SEC;
- A cease-and-desist order from future violations of Sections 206(2) and 207 (interestingly, the Division noted that it will not seek a charge for best execution failures, or compliance violations, as in the settled enforcement actions);
- A censure;
- Disgorgement of ill-gotten gains with prejudgment interest and a distribution to affected clients; and
- An acknowledgement of the completion of certain remedial steps or an undertaking to take such steps, including corrected disclosures, client notice of settlement terms in a clear and conspicuous manner, evaluation of current share class selection and movement of clients as necessary, and evaluation and revision of policies and procedures.

Amy Doberman recently participated in an IAA Briefing Call to review the details of the SEC's Share Class Selection Disclosure self-reporting initiative, and also to discuss more generally issues relating to self-reporting to regulators – including factors to consider before self-reporting and inherent risks and potential consequences of self-reporting. A recording of that call – free to members and associate members – is available on the IAA website at **Events>>Webinars.**

Importantly, the Division stated that "for eligible advisers, the Division will recommend that the Commission not impose a penalty." However, the Division has confirmed that its settlement recommendation to the SEC will require that an adviser agree to a "willful" violation of the Advisers Act, which may trigger collateral consequences for certain advisers and their affiliates. The Division has made clear that any misconduct outside of the scope of the initiative remains subject to investigation and enforcement action by the Division. In addition, the Division retains the right to recommend enforcement action against individuals associated with eligible advisers if such individuals have engaged in violations of the federal securities laws.

The Division cautioned that advisers eligible for the Initiative that do not participate should expect to have additional charges recommended and penalties imposed in enforcement proceedings and that the penalties may be larger than those imposed in past actions. Further, the Division noted that these conflict issues will be a continued priority after the completion of the initiative for the Office of Compliance Inspections and Examinations and the Division.

Participation in the Initiative and Practical Considerations

An adviser was required to self-report by June 12, 2018, to take advantage of the Initiative. After sending an initial notification of intention to participate, an adviser must complete a questionnaire providing certain identifying information, information related to both the 12b-1 fees received in excess of lower cost share classes and total 12b-1 fees received during the relevant period (January 1, 2014 through the date of correction), and the proposed amount of disgorgement. The Division has acknowledged that an extension may be provided with respect to submission of the questionnaire (technically required by June 26), and in fact already has granted brief

Continued on page 15

extensions. While the Staff is receptive to granting extensions, any requests for longer periods of time should carefully detail the burdens and challenges associated with data collection and its analysis, particularly where the retention of a third party is necessary.

A number of questions have surfaced in connection with assessing the need to self-report, as well as the scope of information requested. Some, but not all, have been addressed in the Staff's FAQs. As an initial matter, the Initiative applies only to advisers that had or have an *actual, undisclosed* conflict of interest relating to mutual fund share class selection. There may be instances where the disclosure was adequate as to the nature of the conflict and its consequences to the client, although the SEC has set a high bar in this regard. Questions have also been raised about whether third-party platform share class selection should be imputed to the adviser for purposes of the Initiative, and whether 12b-1 fees received through these platforms need to be disgorged. Similarly, if an adviser uses class A shares but systematically rebated all 12b-1 fees to clients, the availability of a cheaper share class becomes largely irrelevant to the client and thus, arguably, there is no conflict of interest that warrants self-reporting. There are also questions about how and which 12b-1 fees must be reported. The Staff has made it clear that only revenues associated with 12b-1 fees are part of the Initiative; sub-transfer agency fees and marketing support revenues are out of scope. Similarly, 12b-1 fees received through brokerage relationships, as opposed to advisory relationships, are also out of scope and do not have to be reported or remediated as part of this exercise, even if the adviser is a dual registrant.

Lessons Learned

These enforcement actions and the Division's subsequent settlement initiative emphasize that advisers need to be clear and unequivocal in their disclosure of conflicts of interest. Conflicts disclosure has always been required, but with this Initiative the SEC emphasizes that sufficient disclosure includes a description of the conflict as well as the implications or adverse impact on clients that are triggered by the conflict. With respect to mutual fund share class selection, the adviser is expected to perform reasonable diligence regarding the availability of a more advantageous share class to determine whether there is a potential conflict of interest. Advisers also should consider evaluating whether other forms of revenue arrangements with mutual fund complexes trigger similar conflicts of interest.

**Amy Doberman is a Partner in the New York office of WilmerHale. She has more than 25 years of experience providing legal advice to asset management and wealth management clients. She can be reached at amy.doberman@wilmerhale.com or (212) 295-6270.*