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Alert | Securities Litigation

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SEC Enforcement: Self-Reporting Share Class Selection Disclosure Initiative

On Feb. 12, 2018, the SEC's Enforcement Division announced a new self-reporting initiative called the Share Class Selection Disclosure Initiative (SCSD Initiative). *See* **SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors**. The Division's announcement states that the initiative seeks to protect investment advisory clients from undisclosed conflicts of interest and return money to investors. Pursuant to Section 206 of the Investment Advisers Act of 1940 (Advisers Act), investment advisers[1] have a fiduciary duty to act in the best interests of their clients. This duty includes disclosing material conflicts of interest to clients. In addition, Section 207 of the Advisers Act likewise requires such disclosure in reports filed with the SEC (*i.e.*, Forms ADV). A conflict of interest may arise when an adviser receives compensation, either directly or indirectly through an affiliated broker-dealer, for selecting a more expensive mutual fund share class for a client when a less expensive share class for the same fund is available and appropriate. Under the SCSD Initiative, the Division is offering potentially favorable settlement terms to investment advisers, including not recommending financial penalties against them, if they self-report violations of the federal

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[1] The announcement uses the term "investment advisers." An investment adviser that is not a broker-dealer or a registered representative and is not otherwise affiliated with a broker-dealer typically would not receive compensation for sales of fund shares, and therefore would not have a financial incentive to refer a client to a more expensive share class that pays a higher level of compensation. The scope of the duty of a registered representative who is not also an "investment adviser" may be more limited than the scope of the duty of a person acting in both capacities. The nature of the client also is significant because certain rules of the Department of Labor treat some types of accounts differently. This is a complex issue that should be discussed with counsel.

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securities laws relating to certain mutual fund share class selection issues and promptly return money to harmed clients.

The announcement states that the SEC has long been focused on conflicts of interest associated with mutual fund share class selection. The SEC has filed enforcement actions against investment advisers who failed to disclose conflicts of interest associated with the receipt of fees pursuant to Rule 12b-1 under the Investment Company Act of 1940 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. Of note, the Division points out that while many of the investment advisers charged in these actions did disclose that they “may” receive 12b-1 fees that “may” create a conflict of interest, they failed to disclose that they actually had a conflict of interest because many mutual funds offered a variety of share classes, including some that did not pay 12b-1 fees for eligible clients, and failed to disclose that they were, in fact, receiving 12b-1 fees.

According to the announcement, the SEC’s Office of Compliance Inspections and Examinations (OCIE) has repeatedly cautioned investment advisers to examine their share class selection policies and procedures and disclosure practices, including in OCIE’s i Share Class Initiative Risk Alert issued in July 2016. Nevertheless, “[t]here is significant concern that many investment advisers have not been complying with their obligation under the Advisers Act to fully disclose all material conflicts of interest related to their mutual funds share class selection practices, and that investor harm involving this lack of disclosure may be widespread.” As a result, the Enforcement Division has decided to roll out the SCSD Initiative for advisers that failed to adequately disclose conflicts of interest regarding share class selection in an effort to address the consequences of that behavior.

The announcement sets forth the conditions and terms of this self-reporting initiative. Investment advisers that have already been contacted by the Division about these issues are not eligible to participate, although advisers that are subject to pending examinations by OCIE are eligible. The deadline to self-report by notifying the Division is June 12, 2018. Following this notification, the adviser has ten business days to submit a questionnaire to the SEC that provides certain information, including information related to the 12b-1 fees the adviser, its supervised persons, or its affiliated broker-dealer or its registered representations received in excess of the lower-cost share class for the period of January 1, 2014 through the date the misconduct stopped, as well as a statement that the adviser intends to consent to the standardized settlement terms under the SCSD Initiative.

The standardized settlement terms include: the institution of an administrative and cease-and desist order under Sections 203(e) and 203(k) of the Advisers Act, on a neither admit nor deny basis, for violations of Section 206(2), which is a negligence-based antifraud provision, as well as Section 207 of the Advisers Act, based on the adviser’s failure to disclose the conflict of interest; a censure; disgorgement of ill-gotten gains plus prejudgment interest that will be distributed to the affected clients; undertakings to review and correct the relevant disclosure documents, evaluate whether existing clients should be moved to a lower-cost share class and move clients as necessary, evaluate, update, and review policies and procedures regarding disclosures, notify affected clients of the settlement terms, and provide the SEC with a compliance certification.

The Division takes the view that these terms are favorable because they do not include the recommendation of financial penalties against the self-reporting advisers. However, these terms are limited to the self-reported conduct under the SCSD Initiative and are not applicable to other potential misconduct. In addition, the Division is offering no assurances with respect to the liability of individuals associated with self-reporting entities, and the consequences for those associated persons who made a recommendation for a higher-cost share class could be problematic due to either SEC or FINRA actions

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that may follow up on the information disclosed in the SCSD Initiative. The Division also makes clear in its announcement that eligible advisers who do not self-report disclosure failures and are later identified by the staff may face greater penalties than those imposed in past cases involving similar conduct.

Of course, it remains to be seen how many investment advisers will ultimately partake in the SCSD Initiative. Given that the timeframe for determining whether to self-report is a relatively short four months and the assessment of the facts and evaluation of the issues may be both time-consuming and complex, it may be prudent for firms to consult with experienced SEC counsel who can help guide them through the analyses and, in particular, advise them on the potential collateral consequences that an SEC enforcement action may have on their business operations. Such collateral consequences may include disqualifications from various SEC safe harbor provisions and loss of the well-known seasoned issuer (WKSI) status for which waivers may need to be sought, as well as being subject to a statutory disqualification from membership with FINRA. Needless to say, even if an adviser determines after a fulsome review and analysis, that its disclosure may have been inadequate, it should nevertheless consult with counsel to carefully consider whether the potential benefits of self-reporting outweigh any possible downsides.

The SCSD Initiative, led by the Division's Asset Management Unit, is the second self-reporting initiative led by one of the Division's Specialized Units in recent years. Previously, the Division's Municipal Securities Unit led the Municipalities Continuing Disclosure Cooperation Initiative (MCDC Initiative), which offered similar favorable treatment to issuers and underwriters of municipal securities who self-reported continuing disclosure failures. Such efforts are viewed as a means for the Division to more effectively allocate its limited resources in order to capture a wider swath of alleged misconduct. The MCDC Initiative, which spanned approximately two years from 2014-2016, resulted in multiple waves of settled enforcement actions against underwriters and issuers, including 72 underwriting firms that comprised 96 percent of the market share for municipal underwritings.

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