The SEC SCSD Initiative – Lessons Learned To Date

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The U.S. Securities and Exchange Commission ("SEC" or "Commission"), as part of its ongoing efforts to encourage disclosure of conflicts of interest by investment advisers, on February 12, 2018, announced the "Share Class Selection Disclosure Initiative" ("SCSD Initiative").[1] The SEC's "Announcement" noted that the SCSD Initiative would be led by the Asset Management Unit of the Division of Enforcement ("Enforcement"). To encourage self-reporting and participation in the SCSD Initiative, Enforcement advised in the release that it "will agree not to recommend financial penalties against investment advisers who self-report violations of the federal securities laws relating to certain mutual fund share class selection issues and promptly return money to harmed clients." Enforcement then warned that it expects to recommend stronger sanctions in any future actions against investment advisers that engaged in the misconduct but failed to take advantage of this initiative. The purpose of this article is to summarize certain aspects of the SCSD Initiative and to discuss some lessons learned to date.

Key Aspects of the SCSD Initiative

The SCSD Initiative put the industry on affirmative notice of several issues. For our purposes, the guidance embedded in the definition of the term "Self-Reporting Adviser" provided clarity regarding the required disclosures for registered investment advisers ("RIAs" or "Firms") that select and recommend 12b-1 fee-paying share classes. Specifically, this guidance states,

> A "Self-Reporting Adviser" is an adviser that received 12b-1 fees in connection with recommending, purchasing, or holding 12b-1 fee paying share classes for its advisory clients when a lower-cost share class of the same fund was available to those clients, and failed to disclose explicitly in its Form ADV the conflicts of interest associated with the receipt of such fees. The investment adviser "received" 12b-1 fees if (1) it directly received the fees, (2) its supervised persons received the fees, or (3) its affiliated broker-dealer (or its registered representatives) received the fees. *To have been sufficient, the disclosures must have clearly described the conflicts of interest associated with (1) making investment decisions in light of the receipt of the 12b-1 fees,*

and (2) selecting the more expensive 12b-1 fee paying share class when a lower-cost share class was available for the same fund.[2] (emphasis added)

RIAs and their attorneys will agree that the much-preferred way for the SEC to issue this type of industry disclosure guidance would have been through the regulatory notice mechanism already in place through the SEC's Division of Investment Management Guidance Updates (*see* https://www.sec.gov/investment/im-guidance-updates.html). Firms must nevertheless take notice of and apply this guidance regarding their 12b-1 fee disclosures going forward. This guidance provides more clear direction to RIAs than the Enforcement settlements discussed below provide, and Enforcement will undoubtedly use this guidance as the new bar to measure RIAs disclosure obligations regarding conflicts of interest.

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Expanding on the guidance provided in the "Announcement" on May 1, 2018, the SEC issued "Share Class Selection Disclosure Initiative FAQs."[3] The "SCSD FAQs" provided additional guidance for situations in which the Enforcement staff would consider the adviser to be in violation of the regulations because a lower-cost share class was "available." Specifically, Enforcement provided the following circumstances to be indicative of the availability of a lower-cost share class in FAQ 10:

- The client could have purchased a lower-cost share class for the same fund because the client's investment met the applicable investment minimum.
- There was or is language in the fund prospectus that says the fund will waive the investment minimum for a lower-cost share class for the same fund for advisory clients.
- There was or is language in the fund prospectus that says the fund may waive the investment minimum for a lower-cost share class for the same fund for advisory clients, and the adviser had no reasonable basis to believe the fund would not waive the investment minimum for a lower-cost share class for its advisory clients. An assumption by the adviser that a fund would not waive the investment minimum for his or her clients without taking steps to confirm this assumption would not constitute a reasonable basis.
- The investment adviser purchased a lower-cost share class of the same fund for other similarly situated clients.[4]

Background from Certain SEC Share Class Disclosure Settlements

By way of background, for several years, the SEC has been focusing on advisory fees and mutual fund fees along with their related disclosures. In particular, the Staff has been focused on 12b-1 fees and their use by mutual funds on an ongoing basis to finance shareholder services, distribution, and marketing expenses and on the corresponding disclosures.[5]

For several years now, the SEC has engaged in "regulation by enforcement" in this area by instituting settled administrative proceedings against RIAs with findings that they failed to disclose conflicts associated with the receipt of 12b-1 fees for investing client funds in a 12b-1 fee-paying share class when a lower-cost share class was available for the same fund. The SCSD Initiative clearly took its foundation from these settled actions.

Returning to Enforcement's prior regulation by enforcement, in one of its more significant actions, in 2015, First Eagle Investment Management paid nearly $40 million to settle with the Commission.[6] In this matter, the Commission found that for a period of more than six years, the First Eagle Funds used Fund assets to pay for distribution-related services, and the Funds' disclosures concerning payments for these services were not accurate. Specifically, the Funds prospectuses stated that to the extent that the distribution expenses were not covered by payments under the Rule 12b-1 plans, then the RIA's distributor or its affiliates would bear these expenses. In reality, however, it was the Funds that bore the additional distribution expenses not covered by the Rule 12b-1 plans. As part of the settlement, the Commission found that the Fund misappropriated $25 million in mutual fund assets to pay for the distribution and marketing of fund shares outside of a written, approved Rule 12b-1 plan.

In another matter last fall, the Commission settled with the investment services subsidiary of SunTrust Banks with a penalty of over $1.1 million plus disgorgement and interest because it charged its clients "avoidable fees" by "improperly recommending more expensive share classes of various mutual funds when cheaper shares of the same funds were available."[7] This conduct, stated the SEC, breached Suntrust's fiduciary duty to act in clients' best interests "by recommending and purchasing costlier mutual fund share classes" that charge a marketing and distribution fee without informing the investors that they were eligible for "less costly share class options that did not charge 12b-1 fees."

More recently, in April of this year, the Commission settled with three Firms for almost $15 million collectively, with $12 million paid to harmed clients.[8] The Commission found that PNC Investments LLC ("PNCI"), Securities America Advisors Inc., and Geneos Wealth Management Inc. "failed to disclose conflicts of interest and violated their duty to seek best execution by investing advisory clients in higher-cost mutual fund shares when lower-cost shares of the same funds were available." Further, Geneos received another charge for "failing to identify its revised mutual fund selection disclosures as a 'material change' in its 2017 disclosure brochure." Both PNCI and Geneos were also found to have failed to disclose a conflict of interest related to the compensation received from third parties for investing clients in particular mutual funds.

Finally, the Commission made findings in these settlements that certain respondents did not have adequate policies or procedures regarding share class selection and the related disclosures.

Lessons from the SEC's Other Self-Reporting Initiative

The deadline to participate in the Initiative has passed. We do not—and if past practice is any indicator likely will not—know how many firms self-reported violations through the Initiative. In the past, Enforcement has not made these statistics public. Based on anecdotal information, we understand that as many as several hundred firms may have self-reported.

By way of perspective, the SCSD Initiative is not the SEC's first self-reporting initiative. In 2014, the SEC instituted a Municipalities Continuing Disclosure Cooperation Initiative ("MCDC Initiative") for municipal issuers and underwriters of municipal securities that failed to adequately make accurate statements regarding continuing disclosures under Rule 15c2-12 of the Securities Exchange Act of 1934, as amended.[9] While the similarities between the municipal registrant entities affected by that initiative and RIAs are not aligned, nevertheless a look back at the MCDC Initiative shows that Enforcement provides certain useful information about SEC self-reporting initiatives. Looking back at the MCDC Initiative, we know that the SEC did not release any statistics on information related to participation in that initiative. Thus, we should not expect to see any interim data from the SEC on the SCSD Initiative. At the close of the MCDC Initiative and almost two years later, Enforcement announced that it had filed a total of 143 actions against 144 respondents for violations in municipal bond offerings.[10] Thus, as with the MCDC Initiative, we will know more about the results of the SCSD Initiative and the firms that are ultimately charged when we begin to see conclusions of investigations through settled and litigated actions.

Information Regarding the SCSD Initiative to Date

Consistent with Enforcement practices, the SCSD Initiative involves nonpublic investigative proceedings. That said, based on information and belief, we can generally report the following:

- While the due date for submission was June 12, 2018, Enforcement routinely granted reasonable requests for extensions to provide the detailed information requested to participate in the SCSD Initiative;

- As described in the Announcement, Enforcement staff in the "Asset Management" Specialty Unit were assigned to the Self-Reporting Advisers matters;
- The Asset Management Unit staff are communicating and coordinating across the SEC to apply consistent investigative strategies;
- As part of initial follow-up efforts, the Asset Management Unit staff are requesting detailed follow-up information to the information provided by the Self-Reporting Advisers;
- Not surprisingly, Enforcement is using information provided by the Self-Reporting Advisers clearing firms and custodians to assess the information provided in the submissions;
- Enforcement uniformly requested tolling agreements from apparently all of the Self-Reporting Advisers;
- The SEC may issue the settled actions over the course of several waves or phases; and
- Our understanding is that the Self-Reporting Advisers settlement orders will have consistent and similar core language.

What remains unclear are the timing and process for the eventual publicly released orders instituting proceedings for the settlements against the Self-Reporting Advisers. The SEC's fiscal year ended on September 30, 2018 and we are closing in on the end of 2018. Thus, it appears that we will be looking out to 2019 for Self-Reporting Advisers settlements to start being instituted.[11]

The SCSD Initiative Settlement Terms

Enforcement did provide clarity on the expected settlement terms and described them as "favorable settlement terms" in the Announcement, in order to entice participation.

It is reasonable to assume that the forthcoming actions to be released apply these favorable settlement terms against Self-Reporting Advisers and will include a cease-and-desist order, a censure, and full disgorgement of the "ill-gotten gains" plus prejudgment interest thereon. It is not clear from the Announcement, however, how Enforcement will calculate disgorgement, but one basis will surely be the 12b-1 fees that were generated. The settlement terms will also involve agreeing to a self-administered distribution to the impacted clients. Lastly, the settlement will either include an acknowledgment that the adviser has voluntarily taken the following steps (if completed before the order is instituted), or order that within 30 days of instituting the order, the eligible adviser shall take the following steps:

- Review and correct as necessary the relevant disclosure documents.
- Evaluate whether existing clients should be moved to a lower-cost share class and move clients as necessary.
- Evaluate, update (if necessary), and review for the effectiveness of implementation policies and procedures to ensure that they are reasonably designed to prevent violations in connection with the adviser's disclosures regarding mutual fund share class selection.
- Notify clients of the settlement terms in a clear and conspicuous fashion (this notification requirement applies to all affected clients).
- Provide the Commission staff, no later than 10 days after completion, with a compliance certification regarding the applicable undertakings by the investment adviser.

Pursuant to the Announcement, the settled charges will be non-scienter and negligence-based. Specifically, the statutes under which a Self-Reporting Adviser will be settling for the violative conduct are Section 206(2) and Section 207 of the Investment Advisers Act of 1940 ("Advisers Act"). Section 206(2) prohibits an investment adviser from directly or indirectly engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," and imposes a fiduciary duty on RIAs to act for their clients' benefit, including an affirmative duty of utmost good faith and full disclosure of all material facts. 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." Thus, based on the plain language of these statutes, Self-Reporting Advisers had to consider their potential exposure to reputational and any other collateral damage before self-reporting. Moreover, a Self-Reporting Adviser will need to disclose the charges in its Form ADV, as well as in response to requests for proposals and certain other information requests.

At this time, it is unclear whether Enforcement will expect Firms to disclose information with respect to employees who were involved with the sale of 12b-1 class shares to clients. However, as RIAs navigate their way through the process of the SCSD Initiative, they should consider the possibility that certain employees may need separate representation due to potential conflicts of interest that may arise.

For the Firms That Did Not Self-Report

For the RIAs that elected not to self-report, they will need to be prepared to explain their reasons during their next examination by the SEC's Office of Compliance Inspections and Examinations ("OCIE"). For the foreseeable future, RIA's should expect OCIE to cover this issue in the scope of their examinations. Certain firms may also be contacted directly by Enforcement, due to information that Enforcement obtains as part of its industry-wide investigative efforts.

We presume that the Firms that did not self-report fall into two categories. First, RIAs who assessed their 12b-1 fee practices and disclosures and reasonably and appropriately determined that the Firm did not qualify as a Self-Reporting Adviser. The other category is RIAs who could have qualified as a Self-Reporting Adviser, i.e., they did recommend 12b-1 fee-paying class shares, but decided not to self-report without conducting a reasonable analysis to support the decision. This latter group of Firms has potentially significant Enforcement exposure. In the Announcement, the SEC warned that Firms who qualify and do not self-report will be charged with additional violations and that Enforcement will pursue other relief against them, including significant civil monetary penalties. Thus, Firms who could have qualified as Self-Reporting Advisers should still consider engaging in a review of their disclosures and sales practices, under the leadership of in-house or outside counsel, to assess whether they qualified and to determine and execute any remedial measures that may be deemed necessary. One of the benefits of involving counsel at the initiation of this type of project—and throughout—is that it allows for the application of the attorney work product doctrine and attorney–client privilege. As a reminder, the majority of the cases interpreting these privileges have not extended them to compliance officers performing their duties as part of a firm's compliance operations. Thus, involving in-house or outside counsel is necessary to claim privilege. The Firm can ultimately decide to waive privilege if it elects to self-report. However, for the Firms that conduct this project, preserving the attorney–client and attorney work product privileges will allow the Firm to protect the work from discovery by regulators or third parties.

What remains unclear are the timing and process for the eventual publicly released orders instituting proceedings for the settlements against the Self-Reporting Advisers.

More specifically, the project should involve analyzing whether the Firm failed to adequately disclosed conflicts of interest associated with the receipt of 12b-1 fees by the RIA, its affiliates, or its supervised persons for investing clients in a 12b-1 fee-paying share class when a lower-cost share class of the same mutual fund was available for the clients. This should include conducting detailed analyses of the adviser's Form ADV brochure, each fund, fund class, the 12b-1 fees associated with the share classes, and all of the other related disclosures.

At the completion of the review, each Firm, with the assistance of counsel, should take proactive steps to remedy any disclosure issues and decide whether self-reporting outside of the SCSD Initiative is in its best interest.

Conclusion

Enforcement's interest in share class disclosures, 12b-1 fees, and other fee-related practices and related disclosures will likely not fade. Thus, Firms should take the guidance provided in the Announcement and the SCSD FAQs and improve their practices and disclosures accordingly. For the Firms that elected not to self-report, we recommend efficiently implementing a project as described above to assess the 12b-1 fee practices and related disclosures and remediate where necessary. Finally, and unfortunately for the SEC-regulated community, the SCSD Initiative will not likely be the last of its kind. The SEC considered the MCDC Initiative a success and is likely already considering the SCSD Initiative a success as well. While the industry of course prefers regulation by Commission rulemaking with the opportunity to submit comment letters and/or Division of Investment Management Guidance Updates, the SEC continues to "regulate by enforcement" where and when it deems appropriate. Consistent with this, it will not be surprising to see Enforcement pursue another self-reporting initiative in a different area at some point in the future.

ENDNOTES

* Mary Hansen represents clients in connection with investigations and litigation involving the U.S. Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), the National Futures Association (NFA) and the Department of Justice (DOJ).She also assists clients with internal investigations and compliance and prevention strategies. These clients include public and private companies, officers, directors and other employees, investment advisers, broker-dealers, registered representatives, mutual funds, hedge funds, private equity funds and independent trustees of mutual fund boards. Prior to joining the firm, Mary spent eight years in the Securities and Exchange Commission's Division of Enforcement. As an Assistant Director in the Division, Mary was responsible for supervising investigations and litigations conducted by attorneys and accountants in the Division's Market Abuse and Municipal Securities and Public Pensions Units.

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1 *See* https://www.sec.gov/enforce/announcement/scsd-initiative.

2 *See* Announcement, Share Class Selection Disclosure Initiative, https://www.sec.gov/enforce/announcement/scsd-initiative.

3 *See* Share Class Selection Disclosure Initiatives – FAQs, https://www.sec.gov/enforce/educationhelpguidesfaqs/share-class-selection-disclosure-initiative-faqs.

4 *Id.* at FAQ #10.

5 *See, e.g.*, Christopher Cox, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), available at https://www.sec.gov/news/speech/2007/spch041207cc.htm. (Chairman Cox, while speaking to the MFDF in 2007, noted that when the SEC adopted Rule 12b-1, the initial premise was that 12b-1 plans would be relatively short lived and that the Staff would be reviewing their use and ongoing evolution.)

6 *See In the Matter of First Eagle Investment Management, LLC, et al.* Admin. Proc. File No. 3-16823, https://www.sec.gov/divisions/enforce/claims/first-eagle.htm.

7 *See In the Matter of Suntrust Investment Services, Inc.*, Admin Proc. File No. 3-18178, https://www.sec.gov/litigation/admin/2017/34-81611.pdf.

8 *See* Press Release 2018-62, SEC Orders Three Investment Advisors to Pay $12 Million to Harmed Clients, https://www.sec.gov/news/press-release/2018-62.

9 *See* Municipalities Continuing Disclosure Cooperation Initiative, https://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml.

10 *See* Press Release 2016-166, SEC Charges 71 Municipal Issuers in Muni Bond Disclosure Initiative, https://www.sec.gov/news/pressrelease/2016-166.html.

11 It is possible, but unlikely, that settlements are issued prior to the publication of this article.