Announcement

Share Class Selection Disclosure Initiative

Division of Enforcement

U.S. Securities and Exchange Commission

I. Introduction

Over the past several years, the Securities and Exchange Commission ("Commission") has filed numerous actions in which an investment adviser failed to make required disclosures relating to its selection of mutual fund share classes that paid the adviser (as a dually registered broker-dealer) or its related entities or individuals a fee pursuant to Rule 12b-1 of the Investment Company Act of 1940 ("12b-1" fee) when a lower-cost share class for the same fund was available to clients. The Share Class Selection Disclosure Initiative (the "SCSD Initiative") is intended to identify and promptly remedy potential widespread violations of this nature.[1]

As described below, under the SCSD Initiative the Commission's Division of Enforcement (the "Division") will recommend that the Commission accept favorable settlement terms for investment advisers that self-report to the Division possible securities law violations relating to their failure to make necessary disclosures concerning mutual fund share class selection.[2]

II. Background

Section 206(2) of the Investment Advisers Act of 1940 ("Advisers Act") 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," and 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). Under Section 206(2), an investment adviser has a fiduciary duty to disclose to its 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. A conflict of interest is a material fact that an investment adviser must disclose to its clients. *Id.* A violation of Section 206(2) may rest on a finding of simple negligence. *SEC v. Steadman*, 967 F.2d 636, 643n.5 (D.C. Cir. 1992).

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."

The Commission may file enforcement actions alleging violations of these provisions against investment advisers that fail to disclose to their clients conflicts of interest, including those conflicts associated with the receipt of 12b-1 fees 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. 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. Each share class of a fund represents an interest in the same portfolio of securities. Therefore, when there is a lower-cost share class available that does not charge a 12b-1 fee (or charges a lower 12b-1 fee), it is usually in the client's best interest to invest in the lower-cost share class rather than the 12b-1 fee paying share class because the client's returns would not be reduced by the 12b-1 fees.

Over the past several years, the Commission has filed numerous actions against investment advisers relating to the disclosure failures noted above. While many of the respondent investment advisers disclosed that they (as dually registered broker-dealers), their affiliated broker-dealer (or its registered representatives), or the investment adviser's supervised persons "may" receive 12b-1 fees from the sale of mutual fund shares and that such fees "may" create a conflict of interest, the firms failed to disclose that they had a conflict of interest because many mutual funds offered a variety of share classes, including some that paid 12b-1 fees and others that did not for eligible clients, and failed to disclose that they were, in fact, receiving 12b-1 fees due to the mutual fund shares they bought for or recommended to their clients.[3]

There 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 fund share class selection practices, and that investor harm involving this lack of disclosure may be widespread.

III. The SCSD Initiative

A. **Who Should Consider Self-Reporting to the Division?**

Investment advisers that did not explicitly disclose in applicable Forms ADV (*i.e.*, brochure(s) and brochure supplements) the conflict of interest associated with the 12b-1 fees the firm, its affiliates, or its supervised persons received for investing advisory clients in a fund's 12b-1 fee paying share class when a lower-cost share class was available for the same fund should consider self-reporting to the Division to take advantage of the SCSD Initiative.

> 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,[4] (2) its supervised persons received the fees, or (3) its affiliated broker-dealer[5] (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. For additional information regarding the adequacy of mutual fund share class selection disclosures see the following: *In the Matter of SunTrust Investment Services, Inc.*, Investment Advisers Act Rel. No. 4769 (Sept. 14, 2017); *In the Matter of Cadaret, Grant & Co.*, Investment Advisers Act Rel. No. 4736 (Aug. 1, 2017); *In the Matter of Credit Suisse Securities (USA) LLC,* Investment Advisers Act Rel. No. 4678 (April 4, 2017).

Investment advisers that have already been contacted by the Division as of the date of this announcement regarding possible violations related to their failures to disclose the conflicts of interest associated with mutual fund share class selection are not eligible for the SCSD Initiative. Investment advisers that are subject to pending examinations by the Commission's Office of Compliance Inspections and Examinations relating to this issue, but which have not been contacted by the Division, will be eligible to participate in the SCSD Initiative.

B. **When and What Must Investment Advisers Self-Report?**

To be eligible for the SCSD Initiative, an investment adviser must self-report by notifying the Division by 12:00 am EST on June 12, 2018. Notification can be made by email to SCSDInitiative@sec.gov or by mail to SCSD Initiative, U.S. Securities and Exchange Commission, Denver Regional Office, 1961 Stout Street, Suite 1700, Denver, Colorado 80294.

An adviser that has timely self-reported must then, within ten business days from the date of its notification to the Division, confirm its eligibility for the SCSD Initiative by submitting a completed questionnaire that provides certain information,[6] including the following:

- Identification and contact information of the Self-Reporting Adviser.

- To the extent applicable, identification and contact information of the Self-Reporting Adviser's affiliated broker-dealer.
- Any fact that the Self-Reporting Adviser would like to provide to assist the staff in understanding the circumstances that may have led to disclosure of these conflicts of interest not appearing in the Self-Reporting Adviser's Form ADV brochures and brochure supplements (*e.g.*, any information regarding other disclosure documents the Self-Reporting Adviser believes contain an adequate disclosure of the conflict).
- Information related to the 12b-1fees the Self-Reporting Adviser, its supervised persons, or its affiliated broker-dealer (or its registered representatives) received in excess of the lower-cost share class for the period January 1, 2014, through the date that the misconduct stopped ("Relevant Period").[7]
- A statement that the Self-Reporting Adviser intends to consent to the applicable settlement terms under the SCSD Initiative.

C. **Standardized Settlement Terms the Division Will Recommend**

To the extent an investment adviser meets the requirements of the SCSD Initiative and the Division decides to recommend enforcement action against the Self-Reporting Adviser ("eligible adviser"), the Division will recommend that the Commission accept a settlement that includes the terms described below.

1. *Types of Proceedings and Nature of Charges*

For eligible advisers, the Division will recommend that the Commission accept a settlement pursuant to which the firm consents to the institution of an administrative and cease-and-desist proceeding under Sections 203(e) and 203(k) of the Advisers Act for violations of Sections 206(2) and 207 of the Advisers Act based on the adviser's failure to disclose the conflict of interest. The Division will recommend a settlement in which the adviser neither admits nor denies the findings of the Commission.

2. *Cease-and-Desist Order and Censure*

For eligible advisers, the recommended settlement will include an order to cease and desist from committing or causing any violations and future violations of Sections 206(2) and 207 of the Advisers Act, and a censure.

3. *Disgorgement and Prejudgment Interest*

For eligible advisers, the recommended settlement will include disgorgement by the investment adviser of its ill-gotten gain and prejudgment interest thereon. Eligible advisers must certify to the accuracy of the information provided to staff in the Questionnaire and, as part of the settlement, agree to an order requiring the firm to make a respondent-administered distribution to affected clients.[8]

4. *Undertakings*

For eligible advisers, the recommended settled order will include either an acknowledgment that the adviser has voluntarily taken the following steps (if completed before the order is instituted), or order undertakings requiring that within 30 days of instituting the order, the eligible adviser:

- 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 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;
- Notify clients of the settlement terms in a clear and conspicuous fashion (this notification requirement applies to all affected clients); and
- Provide the Commission staff, no later than 10 days after completion, with a compliance certification regarding the applicable undertakings by the investment adviser.

5. *Civil Penalties*

For eligible advisers, the Division will recommend that the Commission not impose a penalty.

The standardized settlement terms set forth herein are only applicable to self-reported conduct that meets the requirements of the SCSD Initiative. Any other potential misconduct is subject to investigation and separate enforcement action, if appropriate. If enforcement action is taken as to the other potential misconduct, entities may be subject to additional remedies for that misconduct, including, but not limited to, additional financial sanctions. As in all cases, the Division will exercise its discretion in determining whether a recommendation for enforcement action is appropriate.

D. No Assurances Offered with Respect to Individual Liability

The SCSD Initiative covers only eligible advisers. The Division provides no assurance that individuals associated with these entities will be offered similar terms if they have engaged in violations of the federal securities laws. The Division may recommend enforcement action against such individuals and may seek remedies beyond those available through the SCSD Initiative. Assessing whether to recommend enforcement action against an individual for violations of the federal securities laws necessarily involves a case-by-case assessment of specific facts and circumstances, including evidence regarding the level of intent and other factors such as cooperation by the individual.

E. No Assurances for Entities That Do Not Take Advantage of the SCSD Initiative

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.[9] 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. As noted above, assessing whether to recommend enforcement action necessarily involves a case-by-case assessment of specific facts and circumstances.

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[1] The misconduct that we would expect investment advisers to self-report would be similar to the facts outlined in the cases previously brought by the Commission. *See e.g., In the Matter of Packerland Brokerage Services, Inc.,* Investment Advisers Act Rel. No. 4832 (Dec. 21, 2017); *In the Matter of SunTrust Investment Services, Inc.,* Investment Advisers Act Rel. No. 4769 (Sept. 14, 2017); *In the Matter of Envoy Advisory, Inc.*, Investment Advisers Act Rel. No. 4764 (Sept. 8, 2017); *In the Matter of Cadaret, Grant & Co., Inc.*, Investment Advisers Act Rel. No. 4736 (Aug. 1, 2017); *In the Matter of Pekin Singer Strauss Asset Management Inc.*, Investment Advisers Act Rel. No. 4126 (June 23, 2015); *In the Matter of Manarin Investment Counsel, Ltd.*, Investment Advisers Act Rel. No. 3686 (Oct. 2, 2013). The SCSD Initiative is limited to the conduct described in this announcement, and does not concern other (possibly similar or related) conduct (*e.g.*, where one share class is higher-cost than another share class but neither share class pays a 12b-1 fee or where the adviser has no financial conflict of interest). As always, firms can self-report possible violations of the securities laws to the Commission. Self-reported conduct outside the scope of this initiative would not be eligible for this initiative and would instead be evaluated on a case-by-case basis.

[2] Recommendations by the Division to the Commission are subject to approval by the Commission.

[3] In addition to violations of Section 206(2) and Section 207 of the Advisers Act for failing to disclose the conflict of interest, this 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. As noted below in Section III.C., for purposes of the SCSD Initiative, the Division intends to recommend that the Commission accept settlements that do not include those charges even where the facts would support these charges.

[4] To the extent a Self-Reporting Adviser directly received the 12b-1 fees but was not itself registered as a broker-dealer, the Division (as part of the SCSD Initiative) will not recommend that the Commission charge the investment adviser with registration violations under Section 15(a) of the Securities Exchange Act of 1934 based on the Self-Reporting Advisers' receipt of 12b-1 fees for its activity before it self reports its conduct to the Division pursuant to the SCSD Initiative.

[5] "Affiliated broker-dealer" means a broker-dealer that is a related person of the adviser as defined in Form ADV.

[6] The Division may grant an adviser an extension of time to submit the questionnaire. To obtain an extension, an adviser must email its request to SCSDInitiative@sec.gov at least two business days before its deadline.

[7] If an investment adviser anticipates submitting a production exceeding 15 mbs, an adviser must send an email to SCSDInitiative@sec.gov at least two business days before its deadline indicating such.

[8] "Affected clients" includes both current and former clients.

[9] *See 2018 National Exam Program Examination Priorities* (Feb. 7, 2018).

Related Materials

- SCSD Initiative Questionnaire
- Attachment to Questionnaire
- Press Release
- Frequently Asked Questions

Modified: May 1, 2018