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SEC Enforcement Q&A On Its Cooperation Initiative for Investment Advisers

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The SEC's Division of Enforcement issued Frequently Asked Questions and Answers or FAQs for its Share Class Selection Disclosure Initiative (or SCSD Initiative), initially announced in February 2018.[1] The SCSD Initiative is a cooperation program under which investment advisers may receive favorable treatment concerning disclosure failures relating to the conflict that arises when the adviser (as a dually registered broker-dealer or its affiliate) is paid 12b-1 fees and there is a lower cost mutual fund share class available to the client for the same fund. The FAQs clarify and, in part, reiterate the terms of the initial SCSD announcement. Investment Advisers seeking to self-report under the SCSD program must do so by the program's termination on June 12, 2018.

The SCSD Announcement

The SCSD Initiative offers advisers who failed to make the proper disclosures significant incentives to self-report, repay investors and resolve the issues in a manner which is reminiscent of Division's very successful outreach to those involved with municipal offerings – the Municipalities Continuing Disclosure Cooperation Initiative or MCDC through which 85 firms self-reported in 2016. *See* Share Class Selection Disclosure Initiative (Feb. 12, 2018).[2]

The Initiative seeks to build on a series of enforcement actions brought by the Commission in which dually registered investment advisers, or those who work in conjunction with an affiliated broker-dealer, failed to disclose that they were being paid 12b-1 fees by a mutual fund. The undisclosed conflict creates an incentive for the adviser to put the client into fund shares that are more expensive because of the fees paid than others available that did not carry the fees. As the SCSD Initiative announcement emphasizes, the enforcement actions on which it is based made it clear that disclosure by the adviser which stated that there “may” be fees paid and there “may” be conflicts when in fact these occurred are both not sufficient – the fees and conflict must be fully disclosed.

The SCSD Initiative, consistent with the Division’s retail investor focus, seeks to leverage the resources of the Enforcement Division by essentially resolving the cases based on self-reporting and using a standard set of terms without conducting the usual investigation. The terms detailed in the announcement (and reflected in a form attached which can be used for self-reporting) are:

Self-report: The adviser must self-report and fully disclose the conduct;

Deadlines: The adviser must make the report on or before June 12, 2018;

Standard terms: The adviser must agree to the standard terms which include: a cease and desist order based on Investment Advisers Act sections 206(2) and 207; paying disgorgement and prejudgment interest to clients involved; agreeing to implement a series of undertakings which include correcting all disclosure documents, moving clients to the lower cost shares, updating the pertinent policies and procedures and notifying clients; and certifying compliance to the Commission; and

No penalty: In return, the Commission will agree not to recommend a penalty.

There is no assurance, however, that any associated individuals or other entities involved will not be charged. OCIE will also continue to focus on the question of conflicts and share selection in its inspections, according to the announcement. Any advisers discovered who chooses not to participate in the initiative may be named in an enforcement action in which the sanctions will likely be more severe than under the SCSD Initiative.

The FAQs

The Frequently Asked Questions seeks to clarify the terms of the SCSD Initiative. Key points in the Release include:

Application: The SCSD Initiative and its standardized terms apply only to the specific conduct covered by the SCSD Initiative, that is, the receipt of 12b-1 fees without adequate disclosure. It has no application to other possible disclosure and/or conflict issues.

Terms: The standardized terms of the arrangement will apply if the reporting advisor meets the terms of the proposal.

Reporting: The adviser must self-report in the manner proscribed on or before June 12, 2018 to be eligible. Reporting to OCIE or being the subject of an OCIE examination is not a substitute. If the adviser has not been contacted by the Division as of February 12, 2018 regarding possible violations related to their failures to disclose the conflicts of interest associated with mutual fund share class selection, it is eligible for the program.

Conflicts reported: The self-reporting adviser will be required to report the conflict in view of the receipt of the 12b-1 fees and, if applicable, selecting the more expensive 12b-1 fee paying share class when a lower-cost share class was available for the same fund.

Lower cost shares: The question of whether there are lower cost shares available is fund specific. For example, if the client could purchase a lower cost share class for the same fund because its investment met the applicable investment minimum, or there was a provision stating that a waiver of the minimum investment for lower cost shares was available, then there are lower cost shares. These are only examples, however.

Disgorgement: The initiative requires the payment of disgorgement. The questionnaire that must be filled out asks certain questions about this. The goal is the disgorgement of ill-gotten gains. The Division staff anticipates having a dialogue with each self-reporting adviser on this topic. In certain instances if the adviser reduced or off-set advisory fees because of the amount of the 12b-1 fees this may be considered.

Inability to pay: The Division will consider the potential for significant financial consequences to the adviser and its clients in satisfying the monetary commitments of the program. If a difficulty is anticipated the adviser should note it in the questionnaire. Any payment plan must be approved by the Commission.

Deadline: The Division does not expect to extend the deadline.

Comment

The Initiative can be a win-win for the advisers and the Enforcement Division. For the advisers it avoids the burdens and costs of an enforcement investigation and guarantees a resolution which is less severe than what might be expected absent the Initiative. For the SEC it offers the resolution of what could be a series of cases – the MCDC resulted in 85 self-reporting firms – without the time and expense of an enforcement investigation. Stated differently, it is an effective way to leverage scarce resources and focus on retail investors – two key goals of the program announced by Enforcement in November 2017.

While the proposal is creative, and may prove to be very effective, there is one caveat – the individuals and perhaps the affiliated entities involved with the reporting adviser. By self-reporting the conduct, advisers will be detailing facts that may involve individuals and perhaps affiliated entities. As the SCSD Initiative makes clear, it does not apply to those individuals and entities. What the adviser gains – certainty and no penalty — could become significant sanctions for individuals at the advisory and/or an affiliate. This is particularly true given the focus on holding individuals accountable.

Finally, naming individuals and other entities would be inconsistent with five of the cases cited in the announcement on which the program is built. One case cited in the announcement, however, did in fact name an individual and another entity as Respondents. Accordingly, naming individuals or entities other than the self-reporting adviser in an enforcement action would be consistent with the SCSD Initiative's terms and past practice. This potential may undercut the effectiveness of what could otherwise be a very effective initiative.

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[1] See https://www.sec.gov/enforce/educationhelpguidesfaqs/share-class-selection-disclosure-initiative-faqs.

[2] https://www.sec.gov/news/press-release/2018-15.