Client Update
SEC's Division of Enforcement Announces Self-Reporting Program for Advisers Who Failed to Disclose Conflicts in Share Class Selection

The U.S. Securities and Exchange Commission's Division of Enforcement on February 12, 2018 announced a self-reporting initiative—led by its Asset Management Unit—for investment advisers who failed to disclose conflicts of interest in selecting or recommending mutual fund share classes to clients.[1] Under its Share Class Selection Disclosure Initiative ("SCSD Initiative"), the Enforcement Division will recommend a settled enforcement action with standardized terms (including a fraud charge) to investment advisers who self-report their failure to disclose conflicts of interest associated with the receipt of 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. Settlement terms will include, among others, disgorgement of ill-gotten gains (which must be self-distributed back to the affected client accounts), but no civil penalty.

BACKGROUND

Section 206(2) of the Investment Advisers Act of 1940 ("Advisers Act")[2] imposes an affirmative duty on advisers to fully disclose all material facts necessary for a client to make an investment decision—including all conflicts of interest that may lead an adviser to render investment advice that is not disinterested.[3]

In July 2016, the SEC's Office of Compliance Inspections and Examinations ("OCIE") announced an initiative to identify conflicts of interest related to advisers' compensation or

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

[2] 15 U.S.C. 80b-1 et seq.

[3] *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 190–194 (1963).

incentives for recommending mutual funds share classes that have substantial loads or distribution fees. OCIE focused on conflicts where an adviser is also a broker-dealer (or is affiliated with a broker-dealer) that receives fees from sales of certain share classes, and the adviser recommends that clients purchase the more expensive share classes, generating additional fees for the adviser's affiliate.[4] A number of enforcement cases resulted from OCIE's initiative, leading to the Division of Enforcement's SCSD Initiative, which is designed "to identify and promptly remedy potential widespread violations of this nature."

THE SCSD INITIATIVE

The SCSD Initiative targets investment advisers that did not expressly disclose conflicts of interest associated with recommending 12b-1 fee-paying share classes when a lower-cost share class was available. According to the staff, disclosing only that an adviser "may" receive 12b-1 fees and that receipt of such fees "may" create a conflict of interest is not sufficient.

For "eligible" advisers (i.e., those with inadequate disclosure concerning these conflicts that have not already been contacted by the Enforcement Division), the SCSD Initiative creates a self-reporting framework under which an adviser would agree to a no-admit, no-deny settled order that includes the standard package of terms sought in these cases:

- cease-and-desist order from violations of Sections 206(2) and 207 of the Advisers Act;
- censure;
- disgorgement of ill-gotten gains and payment of prejudgment interest (to be returned to affected clients in a respondent-administered distribution); and
- undertakings e.g., to review and correct relevant disclosures; to evaluate whether current clients should be moved to a lower-cost share class and reclassifying as necessary; to evaluate, update and review policies and procedures related to disclosures; to clearly notify all affected clients of the settlement terms; and to provide the Commission with a compliance certification).

For the first time in the advisers' space, however, the SCSD Initiative offers a tangible carrot to self-reporting advisers: no civil penalty.

There are, of course, sticks: advisers with inadequate disclosures that fail to self-report and are later identified by the staff may face higher penalties than those imposed in prior cases involving similar disclosure failures. This is a real stick, as it is likely that OCIE (and Enforcement) staff can use data analytics to quickly determine what share classes an adviser is recommending and whether less expensive share classes are available.

[4] https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf.

The SCSD Initiative seems to apply only to the reporting investment adviser. It offers no assurances with respect to how individuals associated with these entities will be handled if they have engaged in violations of the federal securities laws. And, of course, self-reporting always carries with it the risk that staff, once investigating narrow self-reported conduct, will discover other, unrelated issues that cause the investigation to balloon.

WHAT SHOULD ADVISERS DO?

Advisers that recommend to clients share classes with 12b-1 fees should immediately consult with experienced SEC counsel to (i) assess current conflicts disclosures in light of the advisers' share class recommendation practices and—if those disclosures are potentially inadequate—(ii) evaluate whether to self-report under the SCSD Initiative and (iii) determine whether the settlement will trigger any collateral consequences (such as a loss of "well-known seasoned issuer" status under the Securities Act of 1933 that may require a waiver from the SEC or its staff). "Eligible" advisers must self-report by June 12, 2018, so advisers should move quickly to consider their conflicts disclosures.

* * *

Please do not hesitate to contact us with any questions.

WASHINGTON, D.C.

Kenneth J. Berman
kjberman@debevoise.com

Robert B. Kaplan
rbkaplan@debevoise.com

Julie M. Riewe
jriewe@debevoise.com

Jonathan R. Tuttle
jrtuttle@debevoise.com

NEW YORK

Andrew J. Ceresney
aceresney@debevoise.com