The First SEC Share Class Selection Disclosure Settlements: What We Learned & What's Next?

79 Firms, $125 Million, & More To Come

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Introduction

After almost 13 months since the Share Class Selection Disclosure Initiative ("SCSD Initiative") Announcement, the SEC released settlements against 79 investment advisers that the SEC touted will result in the return of more than $125 million to clients. The settlement release stated that, "[t]he orders issued today address advisers who directly or indirectly received 12b-1 fees for investments selected for their clients without adequate disclosure, including disclosures that were inconsistent with the advisers' actual practices." SEC Chairman Jay Clayton shared his perspective, noting, "I am pleased that so many investment advisers chose to participate in this initiative and, more importantly, that their clients will be reimbursed. This initiative will have immediate and lasting benefits for Main Street investors, including through improved disclosure." (*See* SEC Press Release available at https://www.sec.gov/news/press-release/2019-28.)

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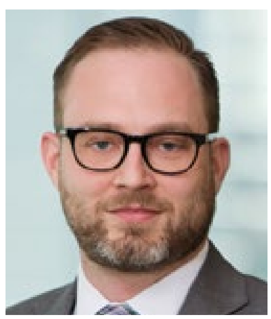

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Settlement Terms and Distribution Funds

Looking back, true to the advertised "favorable settlement terms," the charges against these settling investment advisers were limited to Section 206(2) and Section 207 of the Investment Advisers Act of 1940 for "failing to include adequate disclosure regarding the receipt of 12b-1 fees; and/or failing to adequately disclose additional compensation received for investing clients in a fund's 12b-1 fee paying share class when a lower-cost share class was available for the same fund." As noted in the Announcement, the firms agreed to:

- Review and correct as necessary the relevant disclosure documents concerning mutual fund share class selection and 12b-1 fees.
- 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 firms' 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—both current and former).
- Provide the staff, no later than 10 days after completion, with a compliance certification regarding the applicable undertakings by the investment adviser.

In addition to the undertakings in the settlement order, the offers of settlement included additional obligations imposed on the settling firms related to certain SEC requirements for the settling investment advisers' "Distribution Fund." While not discussed in the Announcement, the Distribution Fund and corresponding obligations continue to subject the settling firms to the scrutiny of the SEC over the next year.

In addition to releasing the first settlements on March 11, 2019, that same day, the SEC also issued orders entitled *In the Matter of Certain Investment Advisers Participating in the Share Class Selection Disclosure Initiative.* This "waiver order" provided the settling firms with collateral consequence waivers that included waivers from

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disqualification under Regulations A, D, E, and Crowdfunding, and waivers from being ineligible issuers under Rule 405 of the Securities Act of 1933.

What's Next for the SCSD Initiative

Over the coming months, we can also expect to see the SEC release additional settlements against investment advisory firms that voluntarily participated in the SCSD Initiative, but, for certain reasons, were not positioned to participate in the round of settlements released on March 11, 2019. While it is unclear at this time if the SEC will also release the next settlements as a group, many presume (and for these affected firms, hope) that there will be a second "round" or "wave" of settlements. Indeed, at the IAA's 2019 Compliance Conference, SEC Co-Director of the Division of Enforcement **Stephanie Avakian** described this initial group of settlements as a "first" round.

Takeaways from SEC Staff Remarks about the SCSD Initiative

The timing of the IAA's 2019 Compliance Conference provided Avakian a forum three days after the release of the first SCSD Initiative settlements to share her thoughts with the industry on the conference's panel on "Exams & Enforcement: A Conversation with SEC Division Directors." She described the SCSD Initiative in positive terms, noting that it was "a huge success," and the voluntary self-reporting format was "incredibly effective," and "a really effective way" to attack what the staff perceived as an industry-wide problem. Additional key takeaways from Avakian's statements include:

- Looking back at the impetus for the SCSD Initiative, one of the reasons for the SCSD Initiative was that the Division of Enforcement had instituted approximately a dozen similar cases and had another dozen investigations pending in relation to disclosure and conflicts around 12b-1 fees.

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  At the same time, OCIE's examination teams were continuing to see similar concerns during their investment adviser examinations. Thus, the SEC determined that action was needed to address these concerns more efficiently, rather than take two years to investigate and resolve them on a firm-by-firm basis.

- While the staff considered this initiative effective, the staff views self-reporting initiatives such as the SCSD Initiative as appropriate only in very limited circumstances.
- There are no other initiatives planned or "in the works" but she repeated her belief in the effectiveness of self-reporting initiatives.

Beyond the SCSD Initiative: Revenue Sharing

The SEC Enforcement Asset Management Unit's attention and priority is also clearly focused on revenue sharing and the related disclosures, although this is not another self-reporting initiative. As reported in prior *IAA Newsletters*, in December 2018, the Division of Enforcement sent requests to firms seeking documents and data regarding their revenue sharing practices and disclosures. Surprisingly, even firms that had self-reported and worked through the SCSD Initiative received similar document requests at that time. These revenue sharing enforcement efforts have the palpable feel of an aggressive SEC Enforcement "sweep." Specifically, Enforcement appears to be investigating: the agreements between advisers and their custody/clearing firms; revenue sharing disclosures; policies, procedures, and practices regarding share class selection and revenue sharing (including NTF share classes); and revenue sharing payments. Borrowing from the SCSD Initiative, SEC Enforcement even requested that the revenue sharing data be produced in a tabular format similar to the tabular format required of the participants in the SCSD Initiative.

What About Firms that Did not Self-Report?

Finally, Enforcement has already turned its attention to the firms that qualified under the broad definitions of the SCSD Initiative, but elected not to self-report. There may have been initial views that the SEC would not follow-up with firms that did not self-report during the pendency of the SCSD Initiative, or that OCIE would have to eventually ferret out these firms through the SEC's examination program—but that is not the case. Enforcement investigations have already been opened and are being pursued aggressively.

Conclusion

In conclusion, the release of the first SCSD Initiative settlements do not appear to bring the industry as close to closure in these areas as initially anticipated. Rather, there appears to be more ahead of us than behind us. Specifically, over the coming months and year we should expect the following:

- Additional settlements for firms that were unable to participate in the "first round" of settlements, with many of these firms likely hoping for a second round grouping.
- An increase in actions against firms involving disclosures and practices

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related to revenue sharing. There is hope that the SEC will apply its discretion and attempt alternative resolutions for those voluntary SCSD Initiative participant firms that, unfortunately, learned that they were also the subject of an additional SEC investigation while proactively and cooperatively participating in the SCSD Initiative.

- Actions against firms that qualified, but elected not to self-report and participate in the SCSD Initiative. With certain of these firms, depending on the facts and circumstances, there is a risk that they will be made examples of and be subjected to significant monetary penalties, additional charges, and perhaps charges against individuals.
- With respect to mutual fund share classes, OCIE exam staff's continued scrutiny of financial incentives for financial professionals that may influence their selection of particular share classes.

The main takeaway of all of this is that advisory firms need to continue to be vigilant regarding their disclosures of conflicts related to the various revenue streams that they earn. The evolving and increasingly aggressive views of SEC Enforcement and OCIE in these areas appear to be here to stay. Thus, the prudent thing for firms to do regarding their disclosures is to err on the side of robust, specific, and transparent disclosures.

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