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Client Alert

February 20, 2018

SEC Share Class Selection Disclosure Initiative to Encourage Self-Reporting

By James G. Lundy and Mary P. Hansen

On February 12, 2018, the U.S. Securities and Exchange Commission (SEC) announced a "Share Class Selection Disclosure Initiative" ("SCSD Initiative"), led by the Asset Management Unit of the Division of Enforcement ("Enforcement"). To encourage self-reporting and participation in the SCSD Initiative, Enforcement advises 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 also warns 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 deadline for self-reporting is June 12, 2018. Firms contacted by Enforcement before the 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 program. Firms that are subject to pending SEC examinations, but that have not been contacted by Enforcement, will be eligible. Importantly, Enforcement specifically offers no assurances with respect to the potential liability of involved individuals.

Below we summarize the SCSD Initiative, explore the direct and indirect messages being sent by the SEC, and provide practical strategic guidance for affected firms to consider.

Initial Strategies – What to Do

By way of background, the SEC has long been focused on Rule 12b-1 fees paid by a mutual fund on an ongoing basis for shareholder services, distribution, and marketing expenses. As with any fee, 12b-1 fees have the potential to reduce a client's returns. In recent years, the SEC has brought several enforcement actions against investment advisers, finding 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.

What firms should consider the SCSD Initiative? 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 share class when a lower-cost share class was available for the same fund. Enforcement provides more specific guidance as follows:

> 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.

Evaluating and assessing these factors for purposes of determining whether to self-report pursuant to the SCSD Initiative will be resource-intensive and will likely involve analyzing complex legal, factual and reputational issues. Thus, firms should first consult with in-house or outside counsel. One of the benefits of involving counsel at the start – 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 evaluation and assessment and then elect not to self-report, preserving the attorney-client and attorney work product privileges will allow firms to protect their work from discovery by regulators or third parties.

With the oversight of counsel, the firm should consider developing and implementing a project plan, due to the anticipated resource-intensive nature of what will be required. The project plan should involve analyzing whether the firm failed to disclose conflicts of interest associated with the receipt of 12b-1 fees by the adviser, its affiliates, or its supervised persons for investing advisory clients in a 12b-1 fee-paying share class when a lower-cost share class of the same mutual fund was available for the advisory clients. More specifically, this involves conducting detailed analyses of each fund, fund class, the 12b-1 fees associated with the share classes, and all of the related disclosures.

Settlement Terms – What You Need to Know

Enforcement uses the description "favorable settlement terms" in its announcement, in order to entice participation. Firms, however, need to understand that self-reporting under the SCSD Initiative will undoubtedly result in a settled enforcement action, and that the terms will include the SEC's typical terms, with the exception of a civil penalty. Firms should also consider the nature of the charges and their potential impacts, as discussed below.

Terms may include a cease-and-desist order and a censure, likely along with an SEC release touting the settlement as a successful result of the SCSD Initiative. Settlement terms will include full disgorgement by the investment adviser of its ill-gotten gains and prejudgment interest thereon. It is not clear from the announcement how Enforcement will calculate disgorgement, but it will likely be based on the 12b-1 fees received. The firm will also need to agree to a self-administered distribution to its affected clients, thereby assuming all of the internal or external costs associated with such a distribution. 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:

- 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 its 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.

The charges in the settlement order would be considered non-scienter and negligence-based, but the plain statutory language reads much harsher. 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, 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. 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, these are by no means technical-type violations. Firms need to consider their exposure to reputational harm and other collateral damage. Moreover, a Self-Reporting Adviser will have to disclose the institution and resolution of the charges in its Form ADV, as well as in response to requests for proposals and certain other information requests.

Finally, for those Self-Reporting Advisers participating in the SCSD Initiative, Enforcement will likely expect them to disclose information and produce evidence with respect to employees who were involved with the sale of 12b-1 class shares to clients, as well as those involved in the Self-Reporting Adviser's disclosure of conflicts of interest. Accordingly, as advisers navigate their way through the process of determining whether it is in their best interest to participate in the SCSD Initiative, they should also be sensitive to the possibility that certain employees may need separate representation due to potential conflicts of interest that may arise.

Conclusion

The decision to self-report and participate in the SCSD Initiative deserves serious consideration, but there is no one-size-fits-all approach. As discussed, the decision-making process will be resource-intensive and involve complex and high-stakes legal, factual and reputational decisions, so firms should work closely with counsel. That said, here are five key takeaways for firms to consider:

- Engage with in-house or outside counsel at the start for the attorney-work product doctrine and attorney-client privilege to apply, subject to waiver by the firm if the determination is made to self-report.
- A project plan should be developed and implemented under the oversight of in-house or outside counsel to evaluate and assess whether the firm's practices and disclosures warrant consideration of self-reporting pursuant to the SCSD Initiative.
- Firms need to understand that, while avoiding a civil penalty, the settlement terms will include a cease-and-desist order and a censure; disgorgement, prejudgment interest, and the accompanying internal or external distribution costs; and the detailed undertakings discussed above.

- Firms also should recognize that settling to charges under Section 206(2) and Section 207 of the Advisers Act present reputational risks that need to be weighed, and collateral consequences that need to be considered.
- Lastly, firms that determine that they qualify as Self-Reporting Advisers should heed the SEC's warnings and self-report, or they will potentially expose themselves to the SEC pursuing significant monetary penalties and possible additional charges and remedies.

SEC and Regulatory Enforcement Defense Team

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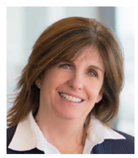

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