

SEC Targets Advisers With New Cooperation Initiative

The SEC's Division of Enforcement announced a new cooperation initiative addressed to investment advisers who have failed to disclose conflicts arising from the receipt of 12b-1 fees from mutual funds. In essence, the 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 the Division's very successful outreach to those involved with municipal offerings - the Municipalities Continuing Disclosure Cooperation Initiative or MCDCI under which 85 firms self-reported in 2016. See Share Class Selection Disclosure Initiative (Feb. 12, 2018).

The Share Class Selection Disclosure Initiative or SCSDI seeks to build on a series of six enforcement actions brought by the Commission in which investment advisers who are also registered broker-dealers, or who worked in conjunction with an affiliated broker-dealer, failed to disclose that they were being paid 12b-1 fees by a mutual fund. Investors were then put into fund shares that were more expensive than others available that did not carry the fees. As the SCSDI announcement emphasizes, the actions on which it is based made it clear that disclosure which states there "may" be fees and there "may" be conflicts when they are both not sufficient – the fees and conflict must be fully disclosed.

The SCSDI, 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 Advisers Act sections 206(2) and 207; paying disgorgement

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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 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 chose 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 SCSDI.

The Initiative can be a win-win for the Enforcement Division and the advisers involved. For the advisers it avoids the burdens and costs of an enforcement investigation and insures a guaranteed result which is less severe than what might be expected without the initiative. For the SEC it offers the resolution of what could be a series of cases – the MDCI 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 affiliated entities involved. By self-reporting the conduct, advisers will be detailing facts that may involve individuals and perhaps affiliated entities. As the 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.



