

LEGAL UPDATE

Share Class Selection Disclosure Initiative

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On February 12, 2018, the SEC issued a press release announcing its Share Class Selection Disclosure (SCSD) Initiative, to encourage investment advisors to self-report certain violations of the Investment Advisors Act (Act) relating to mutual fund shares. Section 206(2) of the Act prohibits advisors from engaging in fraudulent transactions that courts have interpreted to require a duty to disclose conflicts of interest to clients. In particular, the SCSD Initiative is intended to incentivize advisors to report failures to disclose conflicts of interest with respect to 126-1 fees by offering them "settlements that will require the adviser to disgorge its ill-gotten gains but not impose a civil monetary penalty?"

Investment advisors have until June 12, 2018, to self-report to the Division of Enforcement (Division) any conflict of interest situations in which clients were placed in more expensive share classes of mutual funds and advisors received 12b-1 fees, without proper disclosure, when lower-cost shares of the same funds were available. In its announcement, the Commission cited "potential widespread violations of this nature." The Division will recommend that the Commission accept a settlement and will not recommend penalties against the advisor if client funds (plus interest) are promptly returned. Investment advisors that have already been contacted by the Division as of February 12, 2018, about possible violations of share class selection are not eligible to take part in the SCSD Initiative. However, those subject to pending examinations by the Office of Compliance Inspections and Examinations (OCIE) related to this issue, but who have not been contacted by the Division, are eligible to participate.

To take part in the SCSD Initiative, advisors should self-report by notifying the Division by 12:00 am EST by June 12, 2018. Advisors must then complete a questionnaire confirming eligibility under the program within 10 business days of notification. The settlement will include the following terms depending upon the advisor's eligibility: (i) the firm's consent to an administrative and cease-and-desist proceeding for violations of Sections 206(2) and 207 of the Advisers Act, where the advisor neither admits nor denies the Commission's findings; (ii) an order to cease and desist from committing or causing any violations and future violations of Sections 206(2) and 207 and a censure; (iii) disgorgement of the "ill-gotten gain" and prejudgment interest, along with a certification as to the accuracy of the questionnaire, and agreement to an order requiring the firm to make a respondent-administered distribution to affected clients; (iv) either an acknowledgment that the advisor has taken certain prescribed steps or an order requiring the advisor to complete such steps within 30 days, which includes correcting disclosure documents, evaluating whether clients should be moved to lower-cost share class,

and so on; and (v) a recommendation by the Division that the Commission not impose a penalty on the advisor. Because the SCSD Initiative covers only eligible individual advisors, other individuals associated with the same firm have no assurance that they will be offered similar terms for violations.

The Commission states that eligible advisors who choose not to participate in the SCSD Initiative may face stiffer consequences than those provided under the initiative. It cautions that OCIE and Division staff "plan to continue to make mutual fund share class selection practices a priority, and plan to proactively seek to identify investment advisors that may have failed to make the necessary disclosures related to mutual fund share class selection."

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