During the past several years, the US Securities and Exchange Commission (SEC) has settled more than a dozen cases where the SEC alleged (with the firms neither admitting nor denying the charges) that investment advisers failed to make required disclosures relating to the selection of mutual fund share classes that paid the adviser, as a dually registered broker-dealer, or its related entities or individuals a fee pursuant to Rule 12b-1 of the Investment Company Act of 1940 when a lower-cost share class for the same fund was available to clients. The SEC has brought other cases dealing with the inadequate disclosure of the receipt of revenue sharing payments. In February 2018, the SEC’s Division of Enforcement announced its Share Class Selection Disclosure Initiative to encourage firms to self-report violations. According to the SEC, “scores” of firms have self-reported pursuant to the Initiative.¹

In the face of the SEC’s settlements, one firm litigated against the SEC. Initially, in a trial before an SEC Administrative Law Judge (ALJ), the firm was successful.² The firm subsequently lost when the Division of Enforcement appealed the case to the full Commission.³ The firm then appealed the SEC’s opinion to the DC Circuit Court of Appeals.⁴ On January 23, 2019, the DC Circuit heard oral arguments, possibly providing some clues as to when the SEC can successfully charge a firm for inadequate disclosures.

Background

Since 2004, the firm (or, for part of the time, a broker-dealer) received payments from the firm’s custodian for certain eligible non-transaction fee (NTF) funds that the firm purchased through its custodian’s platform. The firm believed it was receiving 12b-1 fees but the custodian said the payments were shareholder service fees. In 2011, the SEC amended the Form ADV Part 2A, requiring more information and details on potential conflicts of interest. At that time, the firm engaged compliance consultants to assist the firm in updating its disclosures. The disclosure stated:

> Additionally, we may receive additional compensation in the form of custodial support services from [the custodian] based on revenue from the sale of funds through [the custodian]. [The custodian] has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity. This additional compensation does not represent additional fees from your account with us. (Emphasis added.)

Subsequently, the firm made a few additional modifications to its disclosures, including stating that its agreement with the custodian “may give rise to conflicts of interest, or perceived conflicts of interest, with our Custodian.” (Emphasis added.) It later added the following statement: the agreement “may give rise to conflicts of interest” because the firm

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would benefit more by recommending, or investing in, [non-transaction fee] funds for clients. . . . [T]his benefit may influence [the firm’s] choice of [the custodian] over custodian[s] that don’t furnish similar benefits and [non-transaction fee] funds over funds not covered by” the agreement. (Emphasis added.)

According to the SEC, these disclosures were inadequate, failing to disclose the material conflicts of interest.

ALJ and Commission Decisions

In June 2015, the ALJ dismissed all charges against the firm, determining that it sufficiently showed it complied with the applicable standards of care and industry standards during the time the disclosures were made. While the ALJ determined that the arrangement presented a potential conflict of interest, the ALJ found that the firm did not act negligently, relying on good faith advice from the compliance consultants. In November 2016, the Commission, on appeal, disagreed with the ALJ and found that the firm negligently failed to adequately disclose the material conflict of interest to its clients and additionally willfully omitted material facts from the Form ADV.

DC Circuit Oral Argument

During the oral argument, the judges focused on (1) whether the use of the word “may” was adequate in light of the potential conflict of interest and the arrangement with the custodian, (2) the appropriate standard of care, and (3) whether the firm acted willfully.

First, the judges focused on the use of the word “may” where the firm agreed that the payments and the arrangement with the custodian presented a potential conflict of interest. One judge called the payment a “kickback” and questioned why the firm’s disclosure language was so “cryptic” since, according to the judge, kickbacks should be disclosed. Counsel for the firm argued that the firm believed the relationship with the custodian was disclosed and that the use of the word “may” was adequate because the firm did not know every instance in which it would receive the payment. The judges pressed the firm about how an investor could make choices if it is not clear to them what “may” or may not occur. On the other hand, the judges questioned the SEC about how the firm could have sought guidance on what constituted “adequate disclosures.” The SEC argued that, as a fiduciary, the investment adviser had a duty to disclose all material conflicts of interest “fully and fairly,” and that the use of the word “may” did not constitute a full and fair disclosure. However, one judge asked the SEC how the firm could have used any language other than “may” since the firm did not know which investments would result in payments. The judge suggested that the firm had to use “may” in order to be accurate. The SEC argued that regardless of the word “may,” the firm falsely stated that it was not receiving any economic benefit from a non-client for investment advisory services.
Second, the judges asked the parties to articulate what the appropriate standard of care is that the firm should have followed. The firm argued that the SEC incorrectly concluded that the firm’s disclosures were inadequate because the SEC did not establish such a standard and did not provide evidentiary support that the firm failed to comply with that standard. The SEC argued that the firm needed to act reasonably and that the disclosure language should have been “straightforward” in terms of disclosing the relationship with the custodian. The firm asserted that it acted reasonably by engaging outside compliance consultants, however, the judges questioned whether that reliance was reasonable since the consultants may not have seen the agreement with the custodian and so were never aware of the payment arrangement. The firm also argued that it reasonably relied on a prior examination conducted by the SEC in 2008, which did not make any findings regarding the firm’s disclosures.

Finally, one judge focused on how the SEC could find a “willful” violation if the firm did not know that its disclosures were inadequate. The SEC responded that by willfully filling out the disclosures and submitting them without adequate disclosures, the firm acted willfully. However, the judge posed a hypothetical about whether a secretary could be found liable if his or her only job was to type up the disclosures and file them with the SEC, without having any other knowledge of the arrangements with the custodian.

Going Forward

In the past, firms have relied on prior SEC exams, industry practice, and compliance consultants (as well as law firms) to help them determine what practices are reasonable, including what disclosures firms are required to make. For example, it appears that many firms used the word “may” in good faith, believing that term was consistent with industry practice and regulatory guidance. The fact that the SEC will be sanctioning “scores” of firms for similar conduct appears to prove that point (assuming that there’s no evidence that the firms intended to commit fraud). Regardless of how the Circuit Court decides this case, its decision will likely affect how firms draft disclosure documents in the future.

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Legal Alert: The SEC’s litigation against a firm for allegedly inadequate disclosure of shareholder service fees and 12b-1 fees continued