SEC Share Class Selection Disclosure (SCSD) – A New Enforcement Remediation

By John Ivan & Christine Cornejo

The regulatory enforcement environment has always been challenging for Broker-Dealers and Investment Advisers regarding investment company products, due to the wide variety of mutual fund and ETF features, most often involving fees and expenses. Beginning with the breakpoint Remediations in 2002-2003, there has been a continuous flow of industry-wide enforcement matters. More recently, there was widespread remediation for failure to apply available NAV waivers to retirement and charitable accounts, based on prospectus provisions. Firms also continue to address and remediate ‘C’ share transactions for 529 Plan accounts with younger beneficiaries. The most recent regulatory focus is mutual funds with 12b-1 fees included in investment adviser programs, when lower cost share classes may be available.

The issue and the cases are spelled out clearly in the SEC’s recent announcement of an amnesty program for self-reporting and remediation (https://www.sec.gov/news/press-release/2018-15). In summary, the receipt of 12b-1 fees where lower cost share classes are available constitutes a breach of an adviser’s fiduciary duty, if not appropriately disclosed. To avoid monetary sanctions, a firm may self-report by June 12th, and enter into a settlement to have remediated client 12b-1 fees received by it or an affiliate since 2014.

A number of articles, of course, have been written about the various legal issues that need to be addressed (was disclosure sufficient, what does “available” lower cost share class mean and does “best execution” theory of lowest share class need to be considered), about the considerations and consequences of self-reporting and about facing more serious potential enforcement action for failing to do so. NSCP held a February 27 Webinar on the SCSD.

In this article, we focus on the data analytics challenges, assessing the magnitude of the issue and conducting the Remediation outlined by the SEC in connection with the SCSD. The devil is in the details! Firms should assess their ability to gather the required data and analyze it, in order to complete the responses in the SCDS Initiative Questionnaire within the given time period. We recommend this undertaking be completed early in the process. There are four primary components for the data analysis that warrant careful consideration:

1. Gathering accurate and complete data
2. Defining your business rules that can withstand regulatory scrutiny
3. Validating the results to address errors
4. Developing and implementing new controls to prevent future violations

1. Gathering accurate and complete data:

Ironically, the Investment Companies added new share classes, partly in response to some of the regulatory scrutiny that was occurring and also, distributors’ demands. Inadvertently, this has created new challenges for firms. Firms’ (or their mutual fund platform provider’s) systems have not always kept pace with the proliferation of share classes and other features that require tracking and analyses.

A firm’s ability to develop a solid remediation plan, will be dependent on capturing accurate and complete data. It may be assumed that firms can easily identify 12b-1 fees; regrettably this may not be the case. IAs using Fund Supermarkets (omnibus accounts) may have tiered payment structures. In these cases, the combination of fees may be applied so that any payments are first made for 12b-1 fees. Without careful analysis, this may result in inaccurate calculations and possibly, over-remediation.

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Firms should validate the 12b-1 payments to determine if the fees are accurately classified. This can be accomplished by spot checking prospectuses or running a comparison query, if prospectus information is contained in the remediation database. As an example of data complexity, several short-term bond mutual funds waived the 12b-1 fee for a period of time. If records indicated receipt of a 12b-1 fee during this time, further research is warranted.

Finally, as with any fund-related remediation, a series of standard data gathering queries need to be undertaken to account for direct transactions with funds, closed account protocols, firm custodian platform mapping, and affiliate and successor firm mapping.

2. Defining business rules that can withstand regulatory scrutiny

Developing business rules for the analysis is critical; each firm may have situations that could negatively impact the settlement, if not appropriately accounted for in this evaluation. For example, most firms rebated 12b-1 fees for Qualified accounts for many years. Additionally, firms may have rebated fees for IRA or other discretionary accounts in preparation of the DOL Fiduciary Duty. Firms may have started rebating all 12b-1 fees, based on the National Exam Program Risk Alert, OCIE’s 2016 Share Class Initiative issued on July 13, 2016. Firms need to establish a matrix on when and how rebates were processed and account for this in their analysis, to avoid making duplicate 12b-1 remediation calculations.

Rules for identifying covered accounts is an important factor. This is especially true for dually registered BDs/IAs, who keep the same account number for transferred and now investment adviser accounts. In other words, for some of the SCSD period the account may have been a BD account, and the receipt of 12b-1 fees completely appropriate. The firm should consider excluding 12b-1 fees from its remediation, for the time in which the account was a BD account.

The business rules for determining the lower available mutual fund share class analysis requires contemplation. Not all mutual fund share classes may have been available based on the firm’s selling agreements or offered on the system/application used for mutual fund transactions. Also, firms should consider the lower class share inception date, since it may not have been available at the time of the purchase. Generally, most funds had institutional shares classes available for several years.

3. Validating results to address errors

Based on the approximate four year time period for the review, the number of accounts, the number of 12b-1 payments and other required data elements, the total size of this data set could be much larger than the firm anticipated. Size alone, coupled with the limited time frame that the firm has to complete this analysis, will undoubtedly lead to potential errors associated with business rules or programming. Firms need to validate their results to ensure accuracy. Firms fortunate enough to have a Quality Control Group, should get them involved at the beginning of this process with a full understanding of the business rules. For those without one, testing and validation is still required, so plan accordingly. Firms should expect the SEC will review results and possibly request details regarding the firm’s assessment.

Documenting the remediation business rules, organizing data into consistent formatted fields, cataloging the sources of data and any criteria that impacted your results will make developing validation test scripts easier. We suggest setting aside sufficient time for testing, which will vary depending on the complexity and size of the firm. Firms should be expected that the SEC will review results and may request details regarding the firm’s assessment, including testing.

4. Developing and implementing new controls to prevent future violations

One of the undertakings is to “Evaluate, update (if necessary), and review for the effectiveness of their implementation policies and procedures to ensure that they are reasonably designed to prevent violations of the Advisers Act in connection with the adviser’s disclosures regarding mutual fund share class selection.” This is where the best laid plans often go awry. While it may be easy to update written policies and procedures, it will be far more challenging to implement. The systems/applications are often not aligned for precise share class analysis, and there is a lack of standardization for processing fees, payments and data for mutual funds. Although it is clear that the SEC has focused on the differences between the mutual fund distribution and sub-accounting fees for years, it appears
that the SEC may have underestimated the complexity of implementing a 12b-1 solution, in order to prevent future violations based on this amnesty condition.

The business rules and the data analytics utilized in determining the amount of remediation should be incorporated into the processes and procedures to prevent future violations. This is another important benefit to the thorough documentation referred to in the validation process. Regular updates of these rules will usually serve as the cornerstone to the effective updating and testing required in the new controls, and will be expected by the regulators.

**SCSD Compliance Certification**

The remediation, with its data analytic challenges, is of course only part of the entire SCSD undertakings and related certification. The Principal signing the compliance certification on behalf of the firm needs to be involved in this process from the beginning. The firm should make a full assessment of each of the five undertakings outlined below, before signing. It may make sense to divide up the tasks to the appropriate Principals to help ensure that the firm is ready to certify.

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<td>Review and correct as necessary the relevant disclosure documents;</td>
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<td>Evaluate whether existing clients should be moved to a lower-cost share class and move clients as necessary;</td>
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<tr>
<td>Evaluate, update (if necessary), and review for the effectiveness of their implementation policies and procedures to ensure that they are reasonably designed to prevent violations of the Advisers Act in connection with the adviser's disclosures regarding mutual fund share class selection;</td>
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<td>Notify clients of the settlement terms in a clear and conspicuous fashion (this notification requirement applies to all affected clients); and</td>
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<td>Provide the Commission staff, no later than 10 days after completion, with a compliance certification regarding the applicable undertakings by the investment adviser.</td>
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**Conclusion**

A careful and rigorous data analytical approach to remediation will hopefully lead to the most efficient SCSD result, if the firm chooses to participate. It will also form the basis for improved controls. Equally as important, the firm should stay abreast of developments within the industry. Each industrywide mutual fund enforcement action has generally led to fundamental developments and changes for investment companies, broker-dealers/investment advisers and other market participants.

It may be advantageous to participate in industry groups to address some of these challenges and proposed solutions arising from the SCSD. For example, the SEC acknowledged that mutual fund fees are referred to in various ways by different fund complexes and may cover a variety of services. (1) Without industrywide standardization, it will be difficult for firms to identify, track and complete comparisons. Also, if firms utilize fund supermarkets, it might be worthwhile to see if there will be any system enhancements to help the firm achieve compliance.

Firms need to understand their ability to gather, analyze and evaluate data in order to achieve a successful remediation.

*NSCP recently formed the SEC Share Class Disclosure Initiative Ad Hoc Committee for NSCP members to discuss how their firms are approaching the disclosure initiative. If you're interested in continuing the discussion on this topic, and would like to join the Ad Hoc Committee, please contact Jessica Austin at jessica@nscp.org for more information.*