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SEC Examiners Focused on Fund Share Class Conflicts of Interest

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OCIE recently published a Risk Alert announcing that it will examine the potential conflict of interest created by registered investment advisers being financially incentivized to recommend certain share classes to clients.

On July 13, the ***US Securities and Exchange Commission's (SEC's) Office of Compliance Inspections and Examinations (OCIE)***, which conducts the SEC's National Exam Program, published a Risk Alert[1] announcing that, as part of its focus on the protection of retail investors, it will examine whether registered investment advisers are conflicted by financial incentives or other compensation arrangements when recommending certain share classes of financial products to clients. Of specific interest is advice surrounding investments in mutual funds and 529 plans,[2] which have share classes with significant sales loads or distribution fees.

Fiduciary Duties and Conflicted Interests

An investment adviser owes its clients a fiduciary duty pursuant to Section 206 of the Investment Advisers Act of 1940 (Advisers Act). This fiduciary duty includes the obligation of an adviser to act in its clients' best interests, to disclose material conflicts of interest and, in some circumstances, to obtain written consent to such conflicts. Furthermore, an adviser is required to implement written procedures to prevent violations of the Advisers Act and the rules thereunder.[3]

In the Risk Alert, OCIE offered the following situations as examples of a conflict of interest between an adviser and its clients:

- Where the adviser is also a broker-dealer or affiliated with a broker-dealer which receives fees from the sales of certain share classes
- When the adviser guides clients toward the purchase of more expensive share classes for which an affiliate of the adviser receives higher fees

As noted in the Risk Alert, both the SEC and Financial Industry Regulatory Authority (FINRA) have brought enforcement actions for breach of fiduciary duty against advisers and broker-dealers for recommending particular mutual fund share classes to clients when lower cost share classes existed within the same fund.

OCIE's Examinations

In the Risk Alert, OCIE indicated that its examinations of advisers' approaches toward share class recommendations will have a three-part focus—whether any actual violations have taken place, what client-facing disclosures are in place, and what internal policies and procedures are in place:

1. Best execution and fiduciary duty. SEC examiners are likely to review the investment practices of advisory firms to see whether they are acting in their clients' best interests and seeking best execution when recommending investments in mutual fund share classes and 529 plans.

2. Although concepts of best execution generally have not been applied to mutual fund shares that trade at their net asset value, SEC examiners will likely review advisers' records of mutual fund and 529 plan investments by clients alongside any compensation received by advisers or associated persons. The Risk Alert does not address whether it is reasonable to evaluate investment practices relating to advisory programs in light of the overall compensation earned by the adviser and its associated persons, including any offsets, credits, or similar adjustments for Rule 12b-1 fees.

3. Disclosures. To meet their fiduciary obligations, investment advisers must make full and fair disclosure of all material facts to clients, including any conflicts of interest that may affect the advisory relationship. In their Form ADV Part 2 (client-facing firm brochure), advisers must disclose whether they (or any of their supervised persons) accept compensation for sales of securities, including charges relating to the sale of mutual funds. If such arrangements exist, advisers must highlight the potential conflict created and how such conflict is appropriately managed.

4. Examiners are likely to assess whether advisers' disclosures of compensation in connection with sales of mutual fund shares and 529 plans, and the management of associated conflicts, are accurate and sufficiently detailed for clients to fully understand. In this regard, it is important that firms clearly disclose that clients will not receive the lowest available share class, if this is not the case.

5. Compliance. OCIE will consider whether firms' compliance policies and procedures are sufficiently adequate and effective for preventing violations of the rules promulgated under the Advisers Act and/or breaches of fiduciary obligations associated with advisers' selection of mutual fund share classes and recommendations of 529 plan investments.

Next Steps

In light of OCIE's announcement, investment advisers that recommend mutual funds and 529 plans to their clients should review policies and procedures relating to their assessment of available share classes and products, and the steps taken to ensure that the most appropriate share classes and 529 plans are recommended to their customers. To the extent investment advisers are dually-registered

or have an affiliated broker-dealer, such firms may wish to consider reviewing any payment streams or other benefits that flow from the sale of certain mutual fund share classes or 529 plans. Firms should review their current client-facing disclosure of any conflicts of interest, including in their Form ADV Part 2A, investment management agreement, account statements, marketing materials, websites, and other client-facing documentation. Finally, firms may want to review and/or test their recordkeeping function to ensure that they are prepared for any examination request that comes their way.

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[1] National Examination Program Risk Alert, Volume V Issue 2: OCIE's 2016 Share Class Initiative (July 13, 2016).

[2] A 529 plan is a tax-advantaged savings plan designed to encourage saving for future college costs. 529 plans, also called "qualified tuition plans," are sponsored by states, state agencies, or educational institutions and are authorized under Section 529 of the Internal Revenue Code.

[3] See Rule 206(4)-7 under the Advisers Act (requiring registered investment advisers to adopt and implement written policies and procedures designed to prevent violations of the Advisers Act and SEC rules adopted thereunder)

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