

SEC Probes Share Class Recommendations

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In July, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE) announced an initiative to identify instances where registered investment advisers may be improperly influenced by conflicts of interests when they decide what class of mutual fund or Section 529 plan shares to recommend to their retail clients. OCIE is focused particularly on conflicts that may exist when an adviser recommends a share class that has "substantial" loads or distribution fees, and

- undisclosed compensation or incentives are being paid to the adviser or its associated person or affiliate. For example, if the adviser (or its affiliate) is a registered broker-dealer, they may be receiving compensation in that capacity; or
- a less costly share class is available that would have provided less compensation/incentives to the adviser or to its associated person or other affiliate.

Accordingly, OCIE says its initiative will focus on questions such as:

- whether the adviser's share class recommendations comply with the adviser's duty to seek "best execution" and otherwise act in the clients' best interest;
- whether the adviser (a) has satisfied all of Form ADV's disclosure requirements relating to compensation and (b) more generally, has made "full and fair disclosure of all material facts, including all material conflicts of interest that could affect the advisory relationship"; and
- whether the adviser's written compliance policies and procedures are adequate and effective, as relevant to share class recommendations.

Some variable annuity contracts make available more than one "share class." Although OCIE's announcement did not address the question, it is prudent to assume that SEC staff would find

recommendations concerning such variable annuity share classes present issues similar to those outlined above.

Authored By



Thomas C. Lauerman

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