CARLTON FIELDS

SEC Pressures Advisers on Undisclosed Conflicts

February 06, 2020

We are actively looking for circumstances where an adviser is financially conflicted by incentives that could affect investment recommendations to clients. ... And I will tell you: the more we look, the more undisclosed or inadequately disclosed financial conflicts we find.

Those ominous words were part of SEC Division of Enforcement Co-Director Stephanie Avakian's keynote remarks at a November securities regulation conference. While her remarks focused on the investment advisory space, Avakian made clear that the division's interest in identifying and addressing undisclosed conflicts applies "across the securities markets."

Share Class Self-Reporting Initiative

As an example of the type of conflicts she was talking about, Avakian referred to the division's recent share class selection disclosure self-reporting initiative, which was designed to identify and address harm resulting from undisclosed conflicts of interest in the selection of mutual fund shares by investment advisers. The initiative resulted in 95 enforcement actions against firms that had the choice of investing their clients' money in different classes of the same investment and chose the more expensive option without fully disclosing that this option paid the firm additional compensation. These settled actions ordered the return of more than $135 million to investors and required that the advisers' practices be reflected in their disclosures to clients.

While these actions represent a small fraction of the overall registered adviser population, Avakian's remarks also suggest that at least some advisers were able to avoid the types of disclosure failures seen in these cases by having fulsome disclosure, choosing not to take 12b-1 fees, rebating fees or crediting fees back to clients, or recommending the lower-cost share class.

If the division is truly discovering widespread deficiencies in conflicts disclosures, as Avakian's remarks seem to suggest, it would not be surprising to see the division launch additional self-reporting initiatives like the share class selection initiative.

Other Types of Conflicts in SEC Crosshairs

According to Avakian, the division is also actively looking for and finding undisclosed conflicts in other areas. These include:

- Revenue-sharing arrangements in which a clearing broker pays a portion of the fees it charges mutual funds for access to its platform to (a) an investment adviser that is also registered as a broker-dealer (a "dually registered adviser") or (b) an adviser's affiliated introducing broker-dealer.
- Cash sweep arrangements in which a dually registered adviser or an adviser's affiliated broker-dealer may receive additional compensation for recommending one cash investment over another.
- Bank deposit cash sweep programs in which a bank or the bank's affiliated clearing broker pays a portion of the revenue the bank earns on investor deposits to a dually registered adviser or an adviser's affiliated broker-dealer.
- Unit investment trusts that are sold with one fee structure for broker-dealer customers and another for investors who will hold the UIT in a fee-based advisory account, where a dually registered adviser or an adviser's affiliated broker-dealer may generate more revenue by recommending UIT interests with one fee structure over the other.

Section 403(b) Plan Initiative

Avakian also noted that, as part of an agencywide initiative, the division is looking at the administration of teacher retirement plans (i.e., "403(b) plans") as another area in which there may be undisclosed conflicts. In particular, as has been widely reported, the division is looking at the compensation and sales practices of the plans' third-party administrators, as well as the practices of their affiliated advisers and broker-dealers.

Avakian was careful to specify certain things the division is not doing. In particular, she made clear that the division is not making value judgments on financial incentives, the scope of services provided, or the fees charged to investors. Rather, the division is looking only at issues that "may directly affect an investor's return on an investment."

FAQ on Adviser Compensation Disclosure

Avakian's remarks followed by several weeks — and beat the same drum as — "Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation" published by the staff of the Division of Investment Management. The FAQ represent the staff's view regarding the disclosure obligations of advisers with respect to conflicts

of interest that result when an adviser receives compensation, directly or indirectly, in connection with the investments the adviser recommends.

Among other things, the FAQ remind advisers of their general disclosure obligations and the specific disclosure requirements in Form ADV. When such a conflict exists, for example, an adviser must disclose how the adviser addresses the conflict and include in the adviser's disclosure "sufficiently specific facts" to allow clients to understand the conflict and the adviser's business practices and give informed consent or reject them. An adviser's fiduciary duty may also require the adviser to make disclosures to clients that are in addition to those required in Form ADV.

Elimination or Mitigation of Conflicts

The SEC staff's current aggressive initiative against undisclosed conflicts, coupled with the staff's public articulation of the fiduciary standards and specific requirements that conflicts disclosures must meet, may push advisers to favor business models that eliminate, or at least mitigate, conflicts over models that rely on the disclosure of conflicts alone. Indeed, the SEC staff may be seeking that result, as it would tend to harmonize the practices of investment advisers with those of broker-dealers under Regulation Best Interest, which is now looming on the horizon.

In contrast to advisers, broker-dealers recommending securities transactions will be required by Reg BI to adopt business models that eliminate or at a minimum mitigate specified types of conflicts, and dually registered advisers may be hard pressed not to operate under the higher Reg BI standard. As for other advisers, it remains to be seen what impact Reg BI and the current spotlight on undisclosed conflicts will have on their business practices going forward. What is certain, however, is that advisers and broker-dealers should be proactive in evaluating potential conflicts and assessing disclosures in light of their current practices and changing regulatory and business landscapes.

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