The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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SEC Staff Issues Guidance Regarding Investment Adviser Disclosure of 12b-1 Fees and Revenue Sharing

[32021]

October 24, 2019 TO: ICI Members
Investment Company Directors
Bank, Trust and Retirement Advisory Committee
Broker/Dealer Advisory Committee
Operations Committee
Sales and Marketing Committee
SEC Rules Committee
Small Funds Committee
Transfer Agent Advisory Committee SUBJECTS: Compensation/Remuneration
Compliance
Disclosure
Fees and Expenses
Investment Advisers
Operations RE: SEC Staff Issues Guidance Regarding Investment Adviser Disclosure of 12b-1 Fees and Revenue Sharing

On October 18, the SEC Division of Investment Management staff issued guidance for investment advisers about disclosing conflicts of interest related to the compensation advisers receive in connection with their recommendations to clients.[1] Although the guidance broadly discusses compensation and fees, the staff specifically highlighted advisers' duty to disclose 12b-1fees or revenue sharing related to particular fund families, funds, or share classes. The guidance references the SEC's recent investment adviser fiduciary interpretation throughout.[2] The staff suggests that the guidance was issued to address concerns arising from SEC examinations and enforcement actions regarding investment advisers that have not appropriately addressed conflicts of interest.

As discussed below, the guidance identifies conflicts of interest arising from compensation practices and provides examples of how advisers may satisfy their fiduciary duty to provide full and fair disclosure of those conflicts of interests.

Conflicts of Interest Arising from Compensation

The staff notes a broad array of direct or indirect compensation[3] from third parties to

advisers that could create a conflict of interest for an adviser, including:

- 12b-1 fees,
- revenue sharing,
- service fees from clearing broker-dealers,
- marketing-support payments from mutual funds (or their advisers),
- transaction fees,
- offsets, credits, waivers of fees from broker-dealers or custodians, and
- payments from mutual fund advisers to defray the costs of education or training.

Specifically, with respect to 12b-1 fees, when an adviser receives those fees in connection with recommending a mutual fund to its client, the adviser has a financial incentive to recommend that the client invest in a share class that pays those fees. That financial incentive creates a conflict of interest for the adviser, especially if share classes of the same fund that do not pay 12b-1 fees are "available" to the client. The staff defines "available" share classes as those:

> . . . offered by the relevant fund for which the particular client is eligible (based on, for example, minimum investment amounts) at the time of a recommendation (including a recommendation to continue holding current investments) except to the extent the adviser or the adviser's service provider imposes limitations on the availability of a share class to certain types of clients and the adviser provides full and fair disclosure and receives informed consent from the client with respect to those limitations.[4]

Full and Fair Disclosure of Compensation-Related Conflicts of Interest

The staff lists two sources of an adviser's obligation to make full and fair disclosure of compensation-related conflicts of interest: an adviser's fiduciary duty and the Form ADV disclosure obligations, including the Part 2 brochure. The staff also notes the upcoming requirements for Form CRS, which will require advisers and broker-dealers to retail customers to disclose material conflicts, including third-party payments such as shelf space and revenue sharing arrangements.[5]

While the staff advises that an adviser must make a full and fair disclosure to its clients of all material facts relating to the advisory relationship, it also warns that any disclosure must be concise and in plain English. The staff provides examples of disclosures that acknowledge:

- the existence and effects of different incentives and resulting conflicts (e.g., the fact that an adviser has a financial interest in the choice of share classes that conflicts with the interests of its clients),
- the nature of the conflict (e.g., whether the conflict arises as a result of differences in compensation that the adviser or its affiliates receive), and
- how the adviser addresses the conflict (e.g., whether the adviser has a practice of offsetting or rebating some or all of the additional costs to which a client is subject, such as 12b-1 fees).

Consistent with the Fiduciary Interpretation, the SEC cautions advisers from stating that they "may" have a conflict as a result of receiving compensation in connections with the adviser's recommendations when that conflict actually exists.

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endnotes

[1] *Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation*, Division of Investment Management Staff (Oct. 18, 2019), *available at* https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation.

[2] *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248 (June 5, 2019) ("Fiduciary Interpretation"), *available at* https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

[3] For example, the staff notes that advisers can receive 12b-1 fees directly or indirectly, including through " (a) advisers that are also registered broker-dealers and receive 12b-1 fees or other compensation, (b) advisers whose affiliated broker-dealers receive 12b-1 fees or other compensation or (c) advisers whose supervised or associated persons receive 12b-1 fees or other compensation as registered representatives of affiliated or unaffiliated broker-dealers."

[4] It is not clear whether the SEC staff intends for this definition of "available" to be consistent with the SEC discussion in the Regulation Best Interest rulemaking concerning the "reasonably available alternatives" that a broker-dealer must consider in fulling its care obligation to its customers. The release adopting Regulation Best Interest states that a "broker-dealer generally should consider reasonably available alternatives offered by the broker-dealer," and does not discuss customer informed consent regarding alternative investments that the broker-dealer may not offer on its platform. For broker-dealers that materially limit the range of products or services that they offer, Regulation Best Interest requires broker-dealers to have reasonably designed policies and procedures to identify and disclose conflicts of interest, and to prevent conflicts of interest from causing the broker-dealer to make recommendations that place the interest of the broker-dealer ahead of the interest of the retail customer. *See Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Release No. 86031 (Jun. 5, 2019), *available at* https://www.sec.gov/rules/final/2019/34-86031.pdf.

[5] *Form CRS Relationship Summary; Amendments to Form ADV*, Exchange Act Release No. 86032 (Jun. 5, 2019), *available at* https://www.sec.gov/rules/final/2019/34-86032.pdf.