

**MEMO# 35058**

March 2, 2023

# **Commissioners Peirce and Uyeda Again Call Out SEC Engaging in Regulation by Enforcement Based on Best Execution Findings**

[35058]

March 02, 2023

TO: ICI Members

Chief Compliance Officer Committee

Investment Advisers Committee

SEC Rules Committee SUBJECTS: Compliance

Litigation & Enforcement RE: Commissioners Peirce and Uyeda Again Call Out SEC Engaging in Regulation by Enforcement Based on Best Execution Findings

Earlier this week, the SEC settled a case against a registrant that could have, but did not, self-report to the SEC pursuant to its 2018 Share Class Selection Disclosure Initiative<sup>[1]</sup> of the SEC's Enforcement Division.<sup>[2]</sup> The facts of this case are very similar to the fact pattern the Initiative was designed to address - i.e., registrants placing clients in mutual fund shares that provided the registrant greater compensation when lower cost, non-fee paying shares were available. Those cases that were self-reported pursuant to the Initiative were settled pursuant to the terms set forth in information the Division published regarding the Initiative - i.e., through the imposition of cease-and-desist orders, disgorgement, and undertakings, but no civil penalties. By contrast, the case just settled by the SEC included civil penalties totaling \$180,000. What is noteworthy about this case is the dissent filed by Commissioners Peirce and Uyeda based on their concerns that, in this settlement, "the Commission chooses to create novel regulatory interpretations through enforcement."<sup>[3]</sup>

Of particular concern to the Commissioners is the Commission finding in this case that the respondents, in part, "breached their duty to seek best execution." According to the Order, among other things, this breach occurred by the respondents failing to evaluate whether their receipt of advisory client transaction fees impacted the reasonableness of fees charged to advisory clients or whether such clients were receiving best execution.<sup>[4]</sup> The Dissent notes that, under the Investment Advisers Act, an adviser owes a fiduciary duty to its clients. This duty is comprised of a duty of care and a duty of loyalty. The three components of the duty of care described in the Order and summarized in the Dissent are:

1. The duty to provide advice that is in the best interest of the client;
2. The duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades [emphasis in the Dissent]; and
3. The duty to provide advice and monitoring over the course of the relationship.[\[5\]](#)

According to the Dissent,

[T]he [respondents'] conduct that implicates the duty to seek best execution is inapplicable to purchases of mutual fund shares for two reasons. First, mutual funds are required to sell and redeem their shares at a price based on the net asset value next calculated after the receipt of the purchase or redemption order. Accordingly, execution quality is not relevant to the selection of mutual fund share classes. Second, Rule 12b-1 fees are paid out of the assets of a mutual fund on an ongoing basis. These fees are unlike commissions that are paid to broker-dealers, which are transaction-based, meaning that they are charged by broker-dealers for facilitating the purchase or sale of a particular security at a particular point in time. . . . In other words, when an adviser selects a mutual fund share class for clients, there is no mechanism by which an intermediary can improve execution price . . . [Emphasis added.][\[6\]](#)

The Dissent next discusses how the Enforcement Division has misapplied the holding from the 2020 case SEC v. Ambassador Advisors.[\[7\]](#) In that case, the defendants were charged in federal district court with violating: (1) Section 206(2) of the Advisers Act based on their investing client assets in mutual fund share classes that charged a Rule 12b-1 fee, portions of which were paid back to the adviser; and (2) Section 206(4) and Rule 206(4)-7 thereunder by failing to adopt adequate compliance policies and procedures regarding conflict disclosures. One of the Commission's allegations under Section 206(2) was based on the adviser failing to seek best execution. According to the Dissent, "the court granted the Commission's motion for summary judgment as to the Section 206(4) and Rule 206(4)-7 allegations and denied the Commission's motion for summary judgment as to the section 206(2) allegations" - i.e., the best execution violations.[\[8\]](#) [Emphasis added.] In its memorandum opinion, "the court found that the duty to seek best execution falls within an adviser's duty of loyalty, not its duty of care." [Emphasis in original.]

In that regard, the court failed to grant summary judgment on the best execution allegation because it was not clear 'whether Defendants obtained their clients' consent to engage in this investment practices.' Importantly, the Court found that '[i]f Defendants did give their clients enough information to obtain their consent, then Defendants would not have violated their duties of best interest or best execution by following through with the arrangement.' This is at odds with the Commission's own interpretation regarding an investment adviser's standard of conduct, which places the duty to seek best execution within the duty of care.

Because the court framed the issue through the duty of loyalty, the court also ruled that adequate disclosure regarding the mutual fund share class selection arrangement at issue would have satisfied the adviser's duty to seek best execution, even if the adviser ended up selecting a more expensive share class than what otherwise was available.[\[9\]](#)

The Dissent notes that the current case "is only the latest in a long line of actions [by the SEC] alleging that mutual fund share class selection implicates the duty to seek best execution" and this "is problematic."[\[10\]](#) It concludes as follows:

If the Commission's interpretations regarding an adviser's standard of conduct are to have any meaning, the different categories of duties and the corresponding conduct that those duties implicate must be respected. Forcing a certain set of conduct into a category of duties that does not fit undermines the Commission's authority to interpret the statutory provisions that it seeks to enforce.

Incorrectly applying an adviser's fiduciary duty to a specific type of conduct is more than a matter of semantics. The ripple effect has tangible detrimental consequences for all regulated entities. The Commission only should allege violations that are supported by adequate legal authority.<sup>[11]</sup>

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#### Notes

[1] See <https://www.sec.gov/enforce/announcement/scsd-initiative>. Interestingly, footnote 3 of the SEC's Announcement of this Initiative notes the conduct targeted by it: "In addition to violations of Section 206(2) and Section 207 of the Advisers Act for failing to disclose the conflict of interest, this conduct has often also led to charges that the investment adviser failed to seek best execution and, in violation of Section 206(4) and Rule 206(4)-7 thereunder, failed to adopt and implement policies and procedures reasonably designed to prevent violations."

[2] See *In the Matter of Huntleigh Advisors, Inc., and Datatex Investment Services, Inc.*, Administrative Proceeding No. 3-21313 (February 27, 2023) (the "Order"), which is available at <https://www.sec.gov/litigation/admin/2023/ia-6251.pdf>.

[3] See Statement Regarding Huntleigh Advisors, Inc. and Datatex Investment Services, Inc., Commissioners Hester M. Peirce and Mark T. Uyeda (February 27, 2023) (the "Dissent") at p. 1. The Dissent is available at: <https://www.sec.gov/news/statement/peirce-uyeda-statement-huntleigh-datatex-022723>.

[4] Order at p. 2.

[5] Dissent at p. 1. The Dissent notes that to satisfy its duty of loyalty, "an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship, including eliminating or disclosing all conflicts of interests."

[6] Dissent at p. 2.

[7] See *Securities and Exchange omission v. Ambassador Advisors, LLC, et al.*, Civil No. 5:20-cv-02274 (E.D. Pa. filed May 13, 2020).

[8] Dissent at p. 3.

[9] *Ibid.*

[10] *Ibid.*

[\[11\]](#) Ibid.

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