

SEC Releases FAQ on RIA Revenue Sharing, 12b-1 and Other Compensation Disclosures

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Last Friday, the staff of the SEC Division of Investment Management (the "Staff") released an [FAQ](#) on disclosures of conflicts related to investment adviser compensation (the "FAQ").¹ The FAQ specifically focused on compensation from 12b-1 fees and revenue sharing arrangements in connection with mutual fund share class selection practices, along with compensation in the form of "the reduction or avoidance of expenses that an investment adviser incurs or otherwise would incur."² As discussed below, all advisers should review the FAQ carefully and revise their Form ADV disclosures accordingly.

Background

As many are aware, the SEC has prioritized advisers' mutual fund share class selection practices in its examination program and enforcement proceedings. The SEC's recent Share Class Selection Disclosure Initiative (the "Initiative") caused just under 100 investment advisers to self-report and submit to settlement agreements related to their share class selection practices and receipt of 12b-1 fees from such practices. Separately, the SEC has brought numerous enforcement actions against advisers that declined to participate in the Initiative. At issue in both the Initiative and enforcement actions has been an adviser's receipt of compensation as a result of recommending³ that a client invest in or remain invested in a share class that does not incur the lowest cost for the client, but pays 12b-1 trails to the adviser, and the adviser's disclosures regarding the same.

As revealed through the Initiative and enforcement actions, these share class selection practices were widespread and an industry norm. Critics of the Initiative and the SEC's related enforcement actions have pointed to this widespread practice as evidence that the SEC failed to provide sufficient guidance to the industry regarding its expectations for advisers regarding disclosure of share class selection practices and receipt of compensation from these practices. In this vein, firms contesting the SEC's allegations argue that none of the SEC rules or guidance clearly delineated the disclosure standard for conflicts related to compensation in this space. The co-director of the SEC's Enforcement Division, Steven Peikin, recently pushed back on these critics, noting that he is "perplexed" by their criticism and that the investment advisers at issue, as fiduciaries, should have known their disclosures were inadequate.⁴ Nonetheless, in what appears to be a direct (albeit delayed) response to critics, the FAQ seeks to clarify the disclosure standard for compensation-related conflicts.

Key FAQ Takeaways

The FAQ includes several key takeaways for disclosures, including the following:

- An adviser should be extremely careful using the word "may." If the adviser knows that it has an agreement in place that will affect even some clients or recommendations at some time, it must clearly explain the existence of the agreement, who will be impacted, and when and in what circumstances they will be impacted. In the Staff's view, simply describing the conflict as one that "may" occur fails to fully satisfy the adviser's fiduciary duty.
- Any update regarding share class recommendations or revenue sharing arrangements in an adviser's Form ADV annual update must be identified and discussed in Item 2 - Summary of Material Changes.
- "Compensation" that requires full and fair disclosure in the Form ADV includes "the reduction or avoidance of expenses that an adviser incurs or otherwise would incur."⁵
- An adviser must also disclose any limitations on the products it has available to recommend to clients due to the platform utilized by the adviser.
- As with any other conflict disclosed in an adviser's Form ADV, the disclosure of compensation resulting from share class selection must be sufficiently described so that the client understands the conflict, which may require an adviser to disclose more information than is otherwise required.
- Conflict of interest disclosures should describe the existence, nature and effect of the conflict, adviser incentives involved in the conflict, and how the adviser addresses the conflict.⁶

The FAQ also provides some examples of material facts that, in the Staff's view, an adviser should disclose when receiving compensation from share class selection if such facts are applicable to the adviser:⁷

- The fact that different share classes are available and that different share classes of the same fund represent the same underlying investments;
- How differences in sales charges and transaction fees will affect the client's overall returns;
- The fact that the adviser has a financial interest in the choice of share class that conflicts with the client's interest;
- The reason the conflict arises (e.g., incentives shared by the adviser and clearing broker or custodian);
- Any agreement to receive payments from a clearing broker for recommending that a client invest in a no-transaction-fee mutual fund share class;
- Any limitations on the availability of share classes resulting from the adviser's or a service providers' business; and
- The circumstances in which the adviser recommends share classes with different fee structures and the factors considered when evaluating share classes with different fee structures.⁸

Practical Effect

We encourage investment advisers to thoughtfully review their share class selection, revenue sharing, and other compensation practices and to carefully consider whether these practices might result in conflicts of interest. An investment adviser should include in this review any services it performs or receives that result in an economic benefit to the adviser from someone who is not a client. Finally, an investment adviser should examine whether amendments are necessary to its Form ADV in order to satisfy its disclosure obligation in light of the SEC's guidance.⁹ Experienced legal counsel can help advisers in understanding their disclosure obligation and assist in drafting Form ADV disclosures.

If you have any questions about the FAQ or an adviser's disclosure obligations in its Form ADV, please feel free to contact us.

Footnotes

¹ SEC, Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation, *available at* <https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation> ("FAQ").

² *Id.* at note 9.

³ Recommendation in this context, consistent with the FAQ, means both recommendations made to non-discretionary accounts and purchases made on behalf of accounts for which the adviser has discretionary authority. *Id.* at note 6.

⁴ Mark Schoeff Jr., *SEC Official Pushes Back Against Criticism of Share-Class Crackdown*, Investment News (Oct. 23, 2019), [https://www.investmentnews.com/article/20191023/FREE/191029968/sec-official-pushes-back-against-criticism-of-share-class-crackdown?utm_source=Morning-20191024&utm_medium=email&utm_campaign=investmentnews&utm_visit=727420&itx\[email\]=7c13633e8ea3d2a5955024a0cb89b3147bfca39e6b8481beddd086ad4c7a69f3%40investmentnews](https://www.investmentnews.com/article/20191023/FREE/191029968/sec-official-pushes-back-against-criticism-of-share-class-crackdown?utm_source=Morning-20191024&utm_medium=email&utm_campaign=investmentnews&utm_visit=727420&itx[email]=7c13633e8ea3d2a5955024a0cb89b3147bfca39e6b8481beddd086ad4c7a69f3%40investmentnews).

⁵ FAQ at note 9.

⁶ *Id.*

⁷ The Staff has observed a variety of practices with respect to this type of disclosure. The list is not comprehensive and is based on practices the Staff observed while administering Form ADV and conducting compliance examinations and enforcement investigations. *Id.*

⁸ *Id.*

⁹ *Id.*

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