Before the
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Petition for Rulemaking of: FINANCIAL SERVICES INSTITUTE, AMERICAN SECURITIES ASSOCIATION, COMPETITIVE ENTERPRISE INSTITUTE, and NEW CIVIL LIBERTIES ALLIANCE, Petitioners.	File No. __________

PETITION FOR RULEMAKING TO END THE COMMISSION'S BACKDOOR REGULATION OF 12b-1 FEES

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April 29, 2020

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INTRODUCTION

This petition is about the Securities and Exchange Commission's thirty-year effort to effectively outlaw Rule 12b-1 fees, and the concerted campaign of subregulatory sabotage upon which it embarked when it could not get its way through the proper channels.

It is no secret that the Commission has long opposed Rule 12b-1 fees—the fees that mutual funds use to compensate financial advisers for ongoing sales and marketing assistance. The agency has tried to repeal or otherwise undo the Rule for the better part of a decade. *See infra* pp. 7–10. But the Rule remains important to the broader investment community, accounting for nearly $10 billion a year in economic activity. *E.g.*, Mutual Fund Distribution Fees, Securities Act Release No. 9128, Exchange Act Release No. 62,544, Investment Company Act Release No. 29,367, 75 Fed. Reg. 47,064, 47,070 (Aug. 4, 2010). And the Commission has never been able to garner the political will needed to repeal it. So Rule 12b-1 is, and remains, the law. *See* 15 U.S.C. § 80a-12(b); 17 C.F.R. § 270.12b-1 (Rule 12b-1).

On paper, that is.

Although federal law requires agencies to conduct rulemaking in a transparent manner and to seek public input, agencies often overlook these mandates and impose their rulemaking through the backdoor. The Commission's actions here are a prime example of these practices. Having failed to repeal or seriously refashion Rule 12b-1 through conventional means, the Commission has turned to "guidance," coupled with "voluntary" self-reporting programs for those in violation of the "guidance," and punitive enforcement actions for those who refuse to turn themselves in. So with a few speeches, "initiatives," "frequently asked questions," and the like, the Commission has achieved what, through rulemaking, it could not—the effective repeal of Rule 12b-1. The law, however, does not countenance such guerilla governance.

Why does this matter? Yes, there are policy concerns. Rule 12b-1 helps funds to grow their asset base, lowering investors' average costs; it offers investors flexible payment options, and it helps to compensate intermediaries for valuable services. There is, in fact, abundant literature on the benefits of Rule 12b-1 that the Commission has ignored. *See infra* pp. 5–6. But more is at stake than policy.

This is about the rule of law. In this country, there is law that governs the government. For good reason. Agencies like the Commission wield massive power. They promulgate binding regulations. And they bring enforcement actions against private citizens. But their leaders are not elected, nor are they fully accountable to anyone who is. So we at least demand that these agencies act in the open and in accordance with the law. People who will have to comply with a new rule can bring their knowledge and experience to the table in shaping and improving a proposed rule. Congress can monitor the agency's actions. And, most important, the people can see the rules for themselves—and try to comply—*before* the agency initiates an enforcement action. This is fundamental, and it is the policy of the current Administration: "Regulated parties must know in advance the rules by which the Federal Government will judge their actions." Executive Order No. 13,892, 84 Fed. Reg. 55,239, 55,239 (Oct. 15, 2019).

None of that has happened here. In its latest guidance documents, the Commission announced a brand-new, detailed disclosure regime that the agency had previously failed to discern in existing law, was never mentioned in any rule, and which, presumably, the entire investment adviser industry has been violating for decades. Worse still, the Commission has used its newly minted standards, not only to impose obligations going forward (without notice-and-comment), but also to retroactively punish scores of firms for conduct that no one knew, or even could have known, was supposedly unlawful. That is not how the rule of law works.

The Commission's actions here go well beyond permissible "guidance." Its pronouncements do not merely "clarify or remind" investment advisers of their "preexisting duties." *Mendoza v. Perez*, 754 F.3d 1002, 1022 (D.C. Cir. 2014). Far from it. Here, the Commission's edicts "supplement" the existing regulatory regime "by imposing specific," newly minted "duties" on an entire industry, *id.*—duties that cannot fairly be traced to any "existing document," *id.* at 1021, and that are backed by the threat "of significant . . . civil penalties," *Army Corps of Eng'rs v. Hawkes Co.*, 136 S. Ct. 1807, 1815 (2016). Accordingly, these pronouncements should have been promulgated through notice and comment, should have been transmitted to Congress for review, and should have been discussed with the Office of Information and Regulatory Affairs. And in no event should the Commission have attempted to apply the guidance *retroactively*.

To correct these myriad errors, the Financial Services Institute, American Securities Association, Competitive Enterprise Institute, and New Civil Liberties Alliance petition the Commission to initiate a rulemaking to promulgate regulations to bring the Commission's guidance into compliance with applicable law. *See* 5 U.S.C. § 553(e); 17 C.F.R. § 201.192(a). Corrective rulemaking is imperative, as the Commission—in the words of its Co-Director of Enforcement—is "not resting on the success of" its misguided effort to regulate Rule 12b-1 fees out of existence; far from it, the Commission has just as improperly turned its attention to the longstanding, widespread, and previously uncontroversial practice of revenue sharing. Stephanie Avakian, Co-Director, Div. of Enforcement, U.S. SEC, What You Don't Know Can Hurt You: Keynote Remarks at the 2019 SEC Regulation Outside the United States Conference (Nov. 5, 2019), https://www.sec.gov/news/speech/speech-avakian-2019-11-05. This expanding effort to regulate without rulemaking must stop. The Commission should comply with its legal obligations and with the policy of this Administration—not open a new frontier. Indeed, if there were ever a time for the Commission to recommit itself to promoting regulatory certainty, this is it—a time when the financial services industry is fighting to regain its footing as the nation pulls itself out of the current crisis and gears up for the impending recovery.

BACKGROUND

A. Mutual Funds And 12b-1 Fees.

Investment advisers have long recommended mutual funds to their clients. Mutual funds give regular investors access to diversified, professionally managed portfolios of equities, bonds, and other securities. And they do so at low cost. *E.g.*, Comment Letter from Financial Services Institute 2, File No. S7-15-10 (Nov. 5, 2010) ("FSI Comment").

The key is economies of scale. Many expenses associated with running a mutual fund are constant. The same legal opinion, for instance, can guide a $50 million fund or a $500 million fund. The total cost is the same. But in the larger fund, the expense is spread over a greater asset base, meaning that each investor pays a smaller share per invested dollar. And with lower per-investor costs, come higher per-investor earnings.

Enter Rule 12b-1. Because growing fund size generates economies of scale, there are circumstances in which it may be appropriate for a mutual fund to use fund assets to fuel the sale of its own shares. *E.g.*, Comment Letter from American Bar Association Business Law Section 3, File No. S7-15-10 (Nov. 5, 2010); Comment Letter from Charles Schwab & Co. 5, File No. S7-15-10 (Nov. 5, 2010). And that is exactly what Rule 12b-1 allows, just as Congress intended when it first enacted Section 12(b) of the Investment Company Act of 1940. *See* Pub. L. No. 768, § 12(b), 54 Stat. 789, 809 (codified as amended at 15 U.S.C. § 80a-12(b)) (permitting mutual funds to participate in the distribution of their own shares in accordance with the "rules and regulations [of] the Commission"). Promulgated in 1980, Rule 12b-1 permits mutual funds to use fund assets to pay investment advisers and other intermediaries for providing services that are "primarily intended to result in the sale of [the fund's] shares." Bearing of Distribution Expenses by Mutual Funds, Securities Act Release No. 6254, Investment Company Act Release No. 11,414, 45 Fed. Reg. 73,898, 73,905 (Nov. 7, 1980) (codified at 17 C.F.R. § 270.12b-1(a)(2)). It remains the law.

And it remains "an integral part of the structure and strength of the mutual fund industry." Comment Letter from Prudential Investments, LLC 1, File No. S7-15-10 (Nov. 8, 2010). The Rule:

- **Expands investor choice.** By offering multiple classes of shares (some with 12b-1 fees, some without) mutual funds enable investors "to select the pricing option that best suits their needs." Comment Letter from Investment Company Institute 11, File No. 4-538 (July 19, 2007) ("2007 ICI Comment"). Some investors, for example, prefer class "A" shares. Those shares generally are sold with a "front-end" load, *see* 75 Fed. Reg. at 47,066 n.22—that is, a fee that pays the intermediary's "entire remuneration up front," at the time of the purchase, Comment Letter from Financial Planning Association 2, File No. S7-15-10 (Nov. 5, 2010) ("FPA Comment"). Other investors, however, prefer class "C" shares. *See id.* ("Class C shares are often the preferred vehicle for investing . . . ."). Those shares typically "avoid [the] high front-end loads" of class "A" shares, 75 Fed. Reg. at 47,068, and allow investors to pay "distribution costs over time," 2007 ICI Comment 1—usually in the form of an annual, "100 basis point 12b-1 fee," 75 Fed. Reg. at 47,070.

- **Benefits regular investors.** "For many investors, particularly those with relatively smaller amounts to invest, [12b-1 fee-paying] C shares have proven to be the best available option to obtain . . . the ongoing services of a financial professional." Comment Letter from Investment Company Institute 11, File No. S7-15-10 (Nov. 5, 2010) ("2010 ICI Comment"). The 12b-1 fees are "used to pay . . . for bundled financial planning advice[and] active account management" services, Comment Letter from Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce 3, File No. S7-15-10 (Nov. 5, 2010)—services that "investors with more modest amounts to invest" would not otherwise qualify for, 2010 ICI Comment 11 n.23. And "[e]ven if they [did] qualify," they would (without the option to pay in 12b-1 fees) "stand to pay substantially more by virtue of a minimum [account management] fee." *Id.* at 11; *see, e.g.*, Comment Letter from David A. Madsen, Financial Advisor, Bank of America-Merrill Lynch, File No. S7-15-10 (Sept. 17, 2010) (explaining that without "'C' shares," advisers would have to "abandon . . . smaller accounts" or transition them "into a much higher fee-based wrap account with base annual fees of $500.00 per year," which "would be prohib[i]tive to the small investor"); *see also* Comment Letter from Securities Industry and Financial Markets Association 5, File No. S7-15-10 (Nov. 5, 2010) ("SIFMA Comment") ("[S]mall investors[ ] may be forced to select investment advisory account alternatives . . . at significantly higher cost.").

- **Aligns incentives.** "12b-1 fees support and encourage . . . ongoing relationships" between investment advisers and investors. FSI Comment 5. If, for example, "a small client purchases a front-end load share class," the adviser may have less of an "incentive to provide ongoing service." Comment Letter from Commonwealth Financial Network 3, File No. S7-15-10 (Nov. 5, 2010) ("Commonwealth Comment"). Not so with 12b-1 fees. *See, e.g.*, Investment Company Institute Cost-Benefit Analysis of SEC Rule 12b-1 Reform Proposal 13, File No. S7-15-10 (Dec. 1, 2010) ("ICI Cost-Benefit Analysis") (explaining that 12b-1 fees "act as an incentive for financial professionals to continue to provide [ongoing] services"); Commonwealth Comment 3 ("The main advantage for C-shares to small investors is that it gives their advisor an incentive to continue to service their account.");

FPA Comment 2 (stating that 12b-1 fees are "highly effective at providing agents with the compensation necessary for them to service smaller accounts").

- **Unlocks freedom of movement.** Investors "may not want to buy class A shares" if they "have a short or uncertain time horizon." 2010 ICI Comment 11; *see also* ICI Cost-Benefit Analysis 24–25 (explaining that total cost "depends on [investors'] holding periods"). Because investors are "free to liquidate a C-share in one fund family and purchase a C-share in another," without the upfront costs of purchasing an A-share, many investors "may be willing to pay [the 12b-1 fees associated with a C-share] for the freedom to move along fund families." Commonwealth Comment 3.

- **Diversifies distribution channels.** Rule 12b-1 has "resulted in an increase of available distribution channels for mutual funds," FSI Comment 5, with funds fashioning "share classes that incur fees that reflect the different services investors receive through [different] distribution channel[s]," ICI Cost-Benefit Analysis 5. Investors "seeking advice and assistance" can purchase share classes designed for that experience through "securities firms, banks, insurance agencies, and financial planning firms," *id.*, while investors seeking a more "self-directed model" can access other share classes through "fund supermarkets," SIFMA Comment 2.

- **And fosters competition.** "The ability of funds to assess [12b-1 fees] has allowed many small fund groups to remain competitive by allowing them to gain access to a wider array of distribution channels, such as fund supermarkets, than they otherwise would have through traditional front-end sales load structures." ICI Cost-Benefit Analysis 5; *accord, e.g.*, *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 108th Cong., 2004 WL 715513 (Mar. 31, 2004) (statement of Thomas O. Putnam, Founder & Chairman, Fenimore Asset Mgmt.). Small funds simply "could not exist without the existence of the 12b-1 fee to grow the funds." Div. of Inv. Mgmt.: Rule 12b-1 Roundtable Tr. 67:16–17 (June 19, 2007) (statement of Mellody Hobson, President, Ariel Capital Mgmt.), https://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf; *see id.* at 68:12–15 ("[I]t's the only reason, having that 12b-1 fee plan, that we can be in the plans at Wal-Mart and General Motors, alongside other gigantic mutual fund companies, like Fidelity and others.").

"Investing is not a 'one-size-fits-all' proposition . . . ." Commonwealth Comment 3. And Rule 12b-1 recognizes that reality, fostering an environment in which investors can take account of "many factors, such as account size, time horizon, . . . impact of paying front-end vs. level . . . charges, and the flexibility to move from one fund family to another, when determining the share class or account type that is more suitable" to their needs. *Id.*

B. The Commission's Failed Two-Decade-Long Effort To Modify Or Repeal Rule 12b-1.

Despite the benefits of Rule 12b-1, the SEC has long been skeptical of its own Rule. From day one, the Commission announced that it would "monitor the operation of" Rule 12b-1 and its companion rules "closely and [would] be prepared to adjust the rule[ ] in light of experience." 45 Fed. Reg. at 73,901.

Within eight years, the Commission was complaining about "the innovative use of rule 12b-1," and the "wide variety of increasingly complex . . . arrangements" that "were not or could not have been anticipated when the rule was drafted." Payment of Asset-Based Sales Loads By Registered Open-End Management Investment Companies, Investment Company Act Release No. 16,431, 53 Fed. Reg. 23,258, 23,274 (June 21, 1988). For example, in 1988, many funds had begun offering shares with "contingent deferred sales loads," or CDSLs. *Id.* at 23,266 & n.69. Unlike a traditional "front-end" load, where an investor pays a sales commission at the time of the purchase, a CDSL is paid when an investor redeems his or her shares. *Id.* The Commission worried that these plans were increasing 12b-1 fees. So it proposed to eliminate certain arrangements that facilitated the CDSLs' operations. But "[m]any commenters opposed the proposed amendments, arguing that spread load plans benefited investors by permitting them to defer their distribution costs and avoid high frontend loads." 75 Fed. Reg. at 47,068. And the Commission backed down, "never adopt[ing] [its proposed] amendments." *Id.*

The story is familiar. Over the years, the Commission has repeatedly complained that the market has evolved since 1980 and that Rule 12b-1 should therefore be "reexamine[d]" (2002), "re-fashion[ed]" (2004), or "replace[d]" (2010). *See* Mutual Fund Distribution Fees, Securities Act Release No. 9128, Exchange Act Release No. 62,544, Investment Company Act Release No. 29,367, 75 Fed. Reg. 47,064, 47,064 (proposed Aug. 4, 2010); Prohibition on the Use of Brokerage Commissions to

Finance Distribution, Investment Company Act Release No. 26,356, 69 Fed. Reg. 9726, 9731 (proposed Mar. 1, 2004); Harvey L. Pitt, Chairman, U.S. SEC, Remarks Before the Investment Company Institute (May 24, 2002), https://www.sec.gov/news/speech/spch562.htm. But, time and again, the Commission's efforts fell short. Consider:

- By 2000, the Commission's staff was pushing its own reforms, advocating for "modifications" to the Rule "to reflect . . . the experience" that they had "gained from observing how [the Rule had] operated since it was adopted in 1980." Div. of Inv. Mgmt., U.S. SEC, *Report on Mutual Fund Fees and Expenses* pt. IV.B.2. (2000), https://www.sec.gov/news/studies/feestudy.htm.

- Within two years (2002), the Chairman had taken up the staff's cause. Market practices had "changed," the Chairman declared, so it was time for a thorough "reexamin[ation]" of Rule 12b-1. Pitt, Remarks Before the Investment Company Institute, *supra*.

- In 2004, the Commission proposed "refashion[ing]"—or even repealing—Rule 12b-1 to address "issues that [had supposedly] arisen under the rule." 69 Fed. Reg. at 9731–32. But the Commission soon retreated. *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26,591, 69 Fed. Reg. 54,728, 54,731 (Sept. 9, 2004) ("We are not adopting any further changes to rule 12b-1 today.").

- In 2007, the Commission was still "further explor[ing]" its options. 75 Fed. Reg. at 47,071. Chairman Cox proclaimed that "today's uses of 12b-1 fees ha[d] strayed from the original purposes underlying the rule, and [that] it [was] time for a thorough re-evaluation." Commission Announces Roundtable Discussion Regarding Rule 12b-1, Press Release No. 2007-106 (May 29, 2007), https://www.sec.gov/news/press/2007/2007-106.htm. And the agency convened a roundtable to discuss whether Rule 12b-1 had "outlived its purpose." Agenda for Rule 12b-1 Roundtable (June 19, 2007), https://www.sec.gov/spotlight/rule12b-1/rule12bagenda-061907.htm.

- The next year (2008), the Chairman stressed that "repeal or reform of rule 12b-1" was still "on the Commission's front burner." "[I]n the coming days," he said, "you can look for the SEC to open up the hood of this old jalopy and start cleaning out the gunk. When the overhaul is done, I predict there won't be a 12b-1 anymore. . . . [W]e can throw [it] out . . . in favor of modern regulation that is more consistent with economic realities." Christopher Cox, Chairman, U.S. SEC, Keynote Address to the Investment Company Institute 4th Annual Mutual Fund Leadership Dinner (Apr. 30, 2008), https://www.sec.gov/news/speech/2008/spch043008cc.htm.

- In 2009, the Commission expressly addressed 12b-1-style payments—the payments a fund makes to a "broker-dealer or other financial intermediary . . . for the sale of Fund shares." Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End

Management Investment Companies, Securities Act Release No. 8998, Investment Company Act Release No. 28,584, 74 Fed. Reg. 4546, 4557 (Jan. 26, 2009). But the Commission admitted that it would be "more appropriate" to set standards for "describ[ing] . . . rule 12b-1 fees . . . in the context of [the supposedly forthcoming] full reconsideration of . . . rule 12b-1." *Id.* at 4555–56.

- By 2010, the Commission had "carefully considered" the views that "emerged from the [2007] roundtable discussion." 75 Fed. Reg. at 47,073. And the agency advocated scrapping the allegedly "outdated" Rule 12b-1 in its entirety and starting over. *Id.* at 47,064. Seemingly every Commissioner agreed:

  - Chairman Schapiro asserted the need to "modernize" Rule 12b-1, which she said was "borne of a period in the late 1970s . . . as a short-term solution." Mary L. Schapiro, Chairman, U.S. SEC, Opening Statement at the SEC Open Meeting—12b-1 Fees (July 21, 2010), https://www.sec.gov/news/speech/2010/spch072110mls-12b1.htm.

  - Commissioner Casey opined that "Rule 12b-1 has evolved from its original, more limited purpose" and that new rules were needed to "reflect the realities of . . . the market." Kathleen L. Casey, Comm'r, U.S. SEC, Statement at SEC Open Meeting—Mutual Fund Distribution Fees (July 21, 2010), https://www.sec.gov/news/speech/2010/spch072110klc-12b1.htm.

  - Commissioner Paredes supported the "far-reaching" new proposal. Troy A. Paredes, Comm'r, U.S. SEC, Statement at Open Meeting to Propose Amendments Regarding Mutual Fund Distribution Fees (July 21, 2010), https://www.sec.gov/news/speech/2010/spch072110tap-12b1.htm.

  - Commissioner Walter stated that "[i]n my view, and I know that the staff shares it as well, reforming our regulatory approach to 12b-1 fees is an initiative whose time has come." Elisse B. Walter, Comm'r, U.S. SEC, Opening Statement at SEC Open Meeting—Mutual Fund Distribution Fees (July 21, 2010), https://www.sec.gov/news/speech/2010/spch072110ebw-12b1.htm.

  - And Commissioner Aguilar endorsed the proposed "paradigm shift in the regulatory framework." Luis A. Aguilar, Comm'r, U.S. SEC, Working Toward Fairness and Transparency in Distribution Costs (July 21, 2010), https://www.sec.gov/news/speech/2010/spch072110laa-12b1.htm.

- Yet in 2015, "12b-1 fees were [still] in [the Commission's] sightline," the 2010 rulemaking having been inexplicably abandoned. M. Waddell, *12b-1 Fees in Crosshairs at SEC—and DOL*, ThinkAdvisor (Feb. 1, 2016), https://www.thinkadvisor.com/2016/02/01/12b-1-fees-in-crosshairs-at-sec-and-dol/ (discussing Chairman White's statements).

Throughout this time, the Commission recognized the vital importance of following proper procedures given the significant economic interests at stake in this area. For example, Commissioner

Casey noted that "[g]iven the significance of the 12b-1 fees to the mutual fund market, it is vital that the Commission fully understand the potential impact of changes in this area"; "[w]e need to hear from investors and others as to the consequences—either positive or negative—of [changing Rule 12b-1]." Casey, Statement at SEC Open Meeting, *supra*. But nothing happened. Having begun the required process of notice-and-comment rulemaking, and received over 1500 public comments along the way (*see* 75 Fed. Reg. at 47,071), the Commission chose not to proceed down that path. Rule 12b-1 survived, more or less unscathed. And it is still the law today.[1]

C. The Commission's Alternate Plan: Eliminate 12b-1 Fees Through The Backdoor.

1. "We promise that if we find [you] later we will punish [you] more severely."

In 2018, having failed through notice-and-comment procedures to reshape Rule 12b-1, the "SEC Launche[d]," in its words, a so-called "Initiative." SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors, Press Release No. 2018-15 (Feb. 12, 2018), https://www.sec.gov/news/press-release/2018-15 (Exhibit 1) ("Share Class Selection Initiative"). This "Share Class Selection Disclosure Initiative" had not gone through notice-and-comment rulemaking, had not been reviewed by Congress, and had not been discussed with the Office of Management and Budget's Office of Information and Regulatory Affairs. Nevertheless, the Initiative targeted "widespread" industry practice—and tried to change it virtually overnight.

1 During this time, the Commission knew how to use its rulemaking authority. The agency *adopted* amendments to rules which improved disclosures of conflicts of interest, in both: (A) the requirements of Form ADV Part 2A; and (B) the prospectus rules. *See* Amendments to Form ADV, Advisers Act Release No. 3060, 75 Fed. Reg. 49,234 (Aug. 12, 2010); Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8998, Investment Company Act Release No. 28,584, 74 Fed. Reg. 4546 (Jan. 26, 2009). The Commission only abandoned this rulemaking process—and turned to "guidance"—when its efforts to repeal or modify Rule 12b-1 through the rulemaking process fell short.

For decades, investment advisers had disclosed 12b-1 fees. The disclosures were simple and straightforward: because the investment adviser received 12b-1 fees in connection with a client's investment, the adviser faced a conflict of interest: to recommend mutual funds that paid a higher fee. Armed with this information, investors could decide how best to proceed. No statute, regulation, or litigated case questioned these straightforward disclosures. And they became the standard method of discussing 12b-1 fees—all $10 billion a year worth, 75 Fed. Reg. at 47,070.

Until the Initiative. The Initiative proclaimed that virtually every investment adviser had been violating federal law, presumably for decades, based on the Enforcement Division's *opinion* of what the disclosures should contain. Even though advisers disclosed that they placed their clients in a 12b-1 fee paying share class, and that the receipt of 12b-1 fees created a potential conflict of interest, the Initiative declared that advisers had *more* to do. Advisers were "required" to state explicitly, in very particular language, that "a lower-cost share class was available."[2] Share Class Selection Initiative pts. Introduction, III.A (Feb. 12, 2018), https://www.sec.gov/enforce/announcement/scsd-initiative; *see*

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[2] The Commission's amendments to Form ADV do not require such a level of detail. An adviser need only provide "sufficient information" for an investor to "make an informed decision about whether to engage [the] adviser":

> [The U.S. federal securities laws do not] preclude advisers from having substantial conflicts of interest that might adversely affect the objectivity of the advice they provide. Rather, investors have the responsibility, based on disclosure they receive, for selecting their own advisors, negotiating their own fee arrangements, and evaluating their advisers conflicts. Therefore, it is critical that clients and prospective clients receive *sufficient information* about the advisor and its personnel to permit them *to make an informed decision about whether to engage an adviser, and having engaged the adviser, how to manage that relationship.*

Amendments to Form ADV, Exchange Act Release No. 57,419, Advisers Act Release No. 2711, 73 Fed. Reg. 13,958, 13,958 (Mar. 14, 2008) (emphasis added).

Later amendments confirm that an adviser has no obligation to discuss, in intricate detail, every business practice that could even conceivably give rise to a conflict. The adviser's obligation is simply to "provide clients with a narrative plain English brochure that describes the adviser's business, conflicts of interest . . . and other important information that would help clients make an informed decision about whether to hire or retain that advisor." Amendments to Form ADV, Advisers Act Release No. 3060, 75 Fed. Reg. 49,234, 49,235 (Aug. 12, 2010).

id. pt. II (quibbling over the use of the word "may" versus the word "will").[3] But the Commission could find no statute, regulation, or litigated case that had ever mentioned such an *additional* disclosure.

Even so, the Initiative "encourage[d]" advisers—presumably, *all of them*—to "self-report" their violations of the "clear," yet heretofore unknown, "legal and regulatory *requirements*" announced in the Initiative. Press Release No. 2018-15, *supra* (emphasis added). Behind the "encouragement" was an explicit threat: "For advisers that would have been eligible for the terms of [the Initiative] but did not participate, the Division [of Enforcement] *expects* . . . *to recommend additional charges* . . . *and the imposition of penalties*. . . . A [case] against an eligible adviser that fails to self-report under the . . . Initiative may include *greater penalties* than those imposed in past cases . . . ." Share Class Selection Initiative pt. III.E (emphasis added). Or as the Co-Director of Enforcement put it: "*we promise that if we find [an adviser] later we will punish [it] more severely*." S. Garmhausen, *SEC to Advisors: Don't Test Us*, Barron's (Mar. 2, 2018), https://www.barrons.com/articles/sec-to-advisors-dont-test-us-1520021433 (emphasis added).[4] The directive to the industry was clear: (A) you are all violating the law; (B) the smart ones among you will take our "offer" and settle with us; and (C) we will sue the rest of you and you will be penalized not just for the alleged legal violation but also for not "cooperating" with us.

Industry got the message. Within a year, 79 investment advisers responded to the Initiative's "incentive[s]," self-reporting their "violations" and coughing up "more than $125 million" in refunded 12b-1 fees. SEC Share Class Initiative Returning More Than $125 Million to Investors, Press Release No. 2019-28 (Mar. 11, 2019), https://www.sec.gov/news/press-release/2019-28. More settlements

[3] Despite debating advisers' use of the word "may" instead of the word "will" to describe potential conflicts of interest, the Commission is no stranger to equating the two words. The Initiative itself proclaims that a "settlement against an eligible adviser that fails to self-report under the . . . Initiative *may* include greater penalties." Share Class Selection Initiative pt. III.E (emphasis added). But by "may," the Commission evidently meant "will": "we *promise* that if we find [you] later we *will* punish [you] more severely." S. Garmhausen, *SEC to Advisors: Don't Test Us*, Barron's (Mar. 2, 2018), https://www.barrons.com/articles/sec-to-advisors-dont-test-us-1520021433 (emphasis added).

[4] The Initiative expired after 120 days—and that is when the Commission started to deliver on its "promise" to "punish [the holdouts] more severely."

have been announced since. *See* SEC Orders Three Self-Reporting Advisory Firms to Reimburse Investors, Press Release No. 2020-90 (Apr. 17, 2020), https://www.sec.gov/news/press-release/2020-90 (declaring that the Commission has ordered a return of "more than $139 million"); Div. of Enforcement, U.S. SEC, *2019 Annual Report* 2 (2019), https://www.sec.gov/files/enforcement-annual-report-2019.pdf (announcing that 95 investment advisers had "voluntarily self-reported" to the Commission); *see also RBC Capital Mkts. LLC*, Securities Act Release No. 10,777, Exchange Act Release No. 88,745, Advisers Act Release No. 5487 (Apr. 24, 2020), https://www.sec.gov/litigation/admin/2020/33-10777.pdf (announcing settlement). Plainly, because the Initiative uses mandatory language, it "speaks" with the force and effect of law. There is nothing in it that suggests it is not mandatory.

Underscoring the need for this petition, more investigations are underway, built on the settlements wrenched out of the "voluntary" self-reporters. *See* SEC Press Release 2020-90, *supra* (promising to "continue to actively pursue" these cases); *see also* D. Michaels, *Focus on Sale of Higher-Fee Mutual Funds Fuels 30-Year High for SEC Enforcement Actions*, Wall St. J. (Nov. 6, 2019), https://www.wsj.com/articles/focus-on-sale-of-higher-fee-mutual-funds-fuels-30-year-high-for-sec-enforcement-actions-11573043400 (discussing the Commission's "'sweep[ ],' or industrywide enforcement campaign[ ]"). Staff now claim that these nonbinding settlements put industry on notice of the Commission's newly minted standards—even for conduct that occurred *before* the Initiative-derived settlements were announced. *See* Peter Driscoll, Dir., Office of Compliance Inspections & Examinations, How We Protect Retail Investors (Apr. 29, 2019), https://www.sec.gov/news/speech/speech-driscoll-042919 (stating that inspectors "frequently" seek "deficiencies that were consistent with recent settled actions the Commission has instituted"). *See generally* Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement*, 7 Yale J. on Reg. 149, 270 (1990) (explaining how the Commission tries to "'bootstrap[ ]' a negotiated" settlement "into a substantive rule of law").

Moreover, as part of the Initiative, investment advisers "voluntarily" "[e]valuate[d]" whether their existing clients "should be moved to a lower cost share class and move[d] clients as necessary." Share Class Selection Initiative pt. III.C.4. Again, the Commission cited no statute, regulation, or litigated case that required investment advisers to move their clients out of higher-12b-1-fee-class shares. For seemingly obvious reason: as the Commission itself has stated, "there is no legal requirement for [share-class] conversion." 75 Fed. Reg. at 47,070 n.86.

In sum, even though Rule 12b-1 is still the law, the Commission has pressured more than 100 investment advisers to refund over $100 million in 12b-1 fees *and* to move their clients into mutual fund share classes that pay lower 12b-1 fees.

2. "No rational firm . . . welcomes a government audit."

But the Commission was not finished. Next up as part of the pressure campaign against 12b-1 fees were the "Frequently Asked Questions," or FAQs. The Commission doubled down on its claim that investment advisers are required to—they "must"—disclose that "more than one mutual fund share class is available." Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation (Oct. 18, 2019), https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation (Exhibit 2) ("Frequently Asked Questions"). But, once again, the Commission cited no statute, regulation, or litigated case that mentioned such a disclosure. Nor did the Commission seek input from the public or industry.

Undeterred, the Commission went further. The FAQs add nearly 4,000 clarifying (but "not . . . comprehensive") words to the regulatory arena. And they warn that more inspections and examinations are forthcoming. *See* Frequently Asked Questions 4 (discussing "compliance examinations"); *see also* Share Class Selection Initiative pt. III.E ("Eligible advisers are cautioned that staff from the Commission's Office of Compliance Inspections and Examinations and the Division of Enforcement plan to continue to make mutual fund share class selection practices a priority, and plan to proactively seek to identify investment advisers that may have failed to make the necessary disclosures related to mutual fund share class selection."); Jay Clayton, Chairman, U.S. SEC, Remarks at the PLI 49th Annual Institute on Securities Regulation (Nov. 8, 2017), https://www.sec.gov/news/speech/speech-clayton-2017-11-08 ("I expect that our Enforcement Division will continue to be active in pursuing cases . . . .").

Unless, of course, the adviser "eliminat[es]" the conflict. Frequently Asked Questions 1, 2. After all, if the adviser does not place clients in funds with 12b-1 fees then there is no conflict. And for that reason, there is no 4,000-word regulatory gauntlet to run, and no risk that the impending inspections, under the Commission's ever-evolving standards, will find shortcomings in need of the Commission's swift remediation. *See id.* at 2 (informing advisers that they "must . . . expose through full and fair disclosure" "*or*" "*eliminate* . . . all conflicts of interest" (emphasis added)); Avakian, Keynote Remarks at the 2019 SEC Regulation Outside the United States Conference, *supra* (praising firms that "chose not to take 12b-1 fees and did things like rebate the fees"); *see also* Frequently Asked Questions 2 ("encourag[ing]" investment advisers to "be proactive" in anticipating changes in the staff's views as "[m]arket practices evolve").

Thus, having tried to make rules, but having failed for decades, the Commission, through a combination of the Initiative, enforcement actions, and the FAQs, has coerced regulated entities to surrender to its view that the Rule 12b-1 fees it approved through notice-and-comment rulemaking should not exist at all. The hydraulic pressure to give up 12b-1 fees is undeniable. *Cf. Lutheran Church-Missouri Synod v. FCC*, 141 F.3d 344, 353 (D.C. Cir. 1998) (recognizing that because "[n]o rational firm . . . welcomes a government audit," purportedly nonbinding guidance often becomes the "*de facto*" law).

D. The Commission Is A Full Participant In This Backdoor Effort To Undo Rule 12b-1.

The Commission is well aware of the backdoor effort to undo Rule 12b-1. Both the Director of Enforcement (who announced the Initiative) and the Director of Investment Management (the FAQs) are "responsible to the Commission" for the fulfillment of the duties in their respective areas. *See* 17 C.F.R. §§ 200.19b, 200.20b. The Commission knows full well what is happening.[5]

When the Commission failed to "adopt[ ] any further changes to rule 12b-1" through proper channels in 2004, 69 Fed. Reg. at 54,731, the agency openly "asked the staff to explore" possible "alternatives," *id.* at 54,730. And after a decade of these alternatives failed to repeal or seriously undo Rule 12b-1, as detailed above, *see supra* pp. 8–9, the staff turned to the Initiative—a strategy approved at the highest levels of the Commission. *See, e.g.*, *CFTC/SEC Budgets: Hearing Before the S. Subcomm. on Fin. Servs. & Gen. Gov't of the S. Appropriations Comm.*, 116th Cong., 2019 WL 6493245 (May 8, 2019) (statement of Jay Clayton, Chairman, SEC) (calling the Initiative "out for commendation"); *see also* SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors, Press Release No. 2017-176 (Sept. 25, 2017), https://www.sec.gov/news/press-release/2017-176 ("When Stephanie and Steve approached me with the[ir] initiatives, I endorsed them wholeheartedly." (quoting Jay Clayton)); Steven Peikin, Co-Director, Div. of Enforcement, Keynote Speech at Southeastern Securities Conference 2019 (Sept. 6, 2019), https://www.sec.gov/news/speech/peikin-keynote-speech-southeastern-securities-conference-2019 (describing the projects "undertaken under Chairman Clayton").

5 In fact, two commissioners have brushed aside, to put it delicately, concerns that the Commission is engaged in regulation by enforcement. Such complaints are "bullshit," said Commissioner Jackson. M. Schoeff, *Commissioners Fire Back at SEC Critics*, Investment News, 2019 WLNR 38081006 (Dec. 16, 2019). "The people who are making this argument are in favor of neither regulation nor enforcement." *Id.* Commissioner Lee agreed. "The next time someone comes to her office to assert rulemaking by enforcement, [Commissioner] Lee said she will be ready with a response": "I hear those talking points, too. . . . Now I have a talking point: 'That's bullshit.'" *Id.*

Indeed, far from being an aloof observer of the Commission's activities, the Chairman has displayed an intimate familiarity with the staff's plans. A few months before the Initiative even launched, the Chairman announced that he "expect[ed]" the Division of Enforcement to pursue share class cases (i.e., the Initiative); and he added that the Commission was "also exploring whether more can be done to clarify fee disclosures" (i.e., the FAQs). Clayton, Remarks at the PLI 49th Annual Institute on Securities Regulation, *supra*.

Chairman Clayton is not alone; other members of the Commission are also well aware of the staff's backdoor effort to undo Rule 12b-1. The Commissioners have voted—*more than 100 times*—to settle cases involving alleged violations of the standards announced in the Initiative and the FAQs. *2019 Annual Report*, *supra*, at 2; *see also* Press Release 2019-28, *supra*. And these settlements could not have come at a better time. 2017 was a low point for the Commission's enforcement stats. *See* D. Michaels, *SEC Says Don't Judge Its Enforcement Strength Solely on Volume of Cases, Fines*, Wall St. J. (Sept. 20, 2018), https://www.wsj.com/articles/sec-says-dont-judge-enforcement-strength-solely-on-volume-fines-1537451398. And 2018 was not looking much better; the Supreme Court had just reminded the Commission that it was bound by the statute of limitation, *see Kokesh v. SEC*, 137 S. Ct. 1635 (2017), a real drag on Commission's plans, *see, e.g.*, Steven Peikin, Co-Director, Div. of Enforcement, U.S. SEC, Remedies and Relief in SEC Enforcement Actions (Oct. 3, 2018), https://www.sec.gov/news/speech/speech-peikin-100318 (noting that *Kokesh* "will continue to be" "felt across [the] enforcement program"). But with the Initiative's "efficient approach" to "maximize" disgorgement penalties "in light of . . . the Supreme Court's decision," Peikin, Keynote Speech at Southeastern Securities Conference, *supra*, the Commission soon found itself raking in penalties at thirty-year highs, *see* Michaels, *Focus on Sale of Higher-Fee Mutual Funds Fuels 30-Year High for SEC Enforcement Actions*, *supra*; R. Sinay, *SEC Initiative Spurs Record Enforcement Against Public Cos.*, Law360 (Nov. 20, 2019), https://www.law360.com/compliance/articles/1221898, a performance the Commission has touted to Congress as the very definition of success, *see* Jay Clayton, Chairman, Robert J. Jackson Jr., Hester M. Pierce, Elad L. Roisman & Allison Herren Lee, Commissioners, U.S. SEC, Oversight of the Securities and Exchange Commission: Wall Street's Cop on the Beat, Before the U.S. H.R. Comm. on Fin. Servs. (Sept. 24, 2019), https://www.sec.gov/news/testimony/testimony09-24-2019 (jointly touting the $125 million that the Commission wrenched out of the Initiative's "cooperat[ors]").

THE PETITIONERS

A. Financial Services Institute

The Financial Services Institute ("FSI") was founded in 2004 with a clear mission: to ensure that all individuals have access to competent and affordable financial advice, products, and services delivered by a growing network of independent financial advisers and independent financial services firms. FSI's members are independent broker-dealers and their registered representatives who operate as independent contractors. FSI has over 90 broker-dealer member firms with more than 138,000 affiliated registered representatives who serve more than 19 million American households. FSI also has more than 33,000 independent "financial advisor" members, who are independent contractors of a broker-dealer. Independent financial advisers are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Thus, these financial advisers have a strong incentive to make the long-term achievement of their clients' investment objectives their primary goal. FSI members participated in the Share Class Selection Disclosure Initiative and have been subject to follow-on SEC Enforcement inquiries.

B. American Securities Association

The American Securities Association ("ASA") is a trade association that represents the retail and institutional capital markets interests of regional financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans on how to create and preserve wealth. The ASA's mission is to promote trust and confidence among investors, facilitate capital formation, and support efficient and competitively balanced capital markets. This mission advances financial independence, stimulates job creation, and increases prosperity. The ASA has a geographically diverse membership base that spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States.

C. Competitive Enterprise Institute

Founded in 1984, the Competitive Enterprise Institute ("CEI") is a nonprofit research and advocacy organization that focuses on regulatory policy from a pro-market perspective. CEI has promoted its views through regulatory comments, congressional testimony and litigation, and over the years many of its policy solutions have been incorporated into bipartisan legislation.

CEI has long been concerned with regulatory barriers that affect investor choice and access to capital, especially when it comes to small investors. CEI has also been heavily involved in analyzing administrative transparency and the need to assure that agency actions are taken with public notice and input, rather than through backdoor mechanisms that produce regulatory "dark matter." This petition addresses both of these concerns.

D. New Civil Liberties Alliance

The New Civil Liberties Alliance ("NCLA") is a nonpartisan, nonprofit civil rights organization founded to defend constitutional rights from violations by the Administrative State through original litigation, amicus curiae briefs, and other means, including participating in the rulemaking process at federal agencies.[6] The "civil liberties" of the organization's name include rights at least as old as the

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[6] NCLA is indifferent to the development or implementation of statutory or regulatory policy regarding Rule 12b-1 fees—or any other securities regulation, for that matter. NCLA joins this Petition solely because the mechanism SEC is using to regulate Rule 12b-1 fees is unlawful. Moreover, SEC would not currently be using guidance to control Rule 12b-1 fee usage had SEC acted upon NCLA's July 30, 2018 Petition for Rulemaking Prohibiting the Issuance, Reliance on, or Defense of Improper Agency Guidance, File No. 4-726 ("First Petition"). NCLA's proposed rule would have ended SEC's unlawful usage of informal interpretations, advice, statements of policy, and other forms of "guidance" to coerce persons or entities outside the federal government into taking or refraining from any action beyond what is required by the terms of the applicable statute or regulation. NCLA hereby renews its demand that SEC end its use of coercive guidance.

United States Constitution itself, such as trial by jury, due process of law, the right to live under laws made by the nation's elected lawmakers rather than by prosecutors or bureaucrats, and the right to be tried in front of an impartial and independent judge.

Although Americans still enjoy the shell of their Republic, there has developed within it a very different sort of government—a type, in fact, that the Constitution was framed to prevent. This unconstitutional Administrative State that has developed within the United States violates more rights of more Americans than any other aspect of American law, and it is therefore the focus of NCLA's efforts.

Even where NCLA has not yet brought a suit to challenge an agency's unconstitutional exercise of administrative power, it encourages agencies themselves to stop the unlawful use of guidance. Independent agencies and commissioners have a duty to follow the law, not least by avoiding unlawful modes of governance and coercion of regulated parties. NCLA therefore advises SEC to examine whether its modes of rulemaking, guidance, adjudication, and enforcement comply with the APA and with the Constitution.

DISCUSSION

No statute, rule, or litigated case has ever required the type of disclosure mandated by the Initiative or the FAQs. Instead, the Commission is improperly using the Initiative and the FAQs—and the threat of enforcement actions for violating them—to pressure investment advisers into eschewing 12b-1 fees altogether, all without engaging in notice-and-comment rulemaking. The Commission's actions are unwise and unlawful. The SEC's coordinated pressure campaign—including the Initiative and the FAQs—created a "rule." A "rule" is defined "very broadly," *Sugar Cane Growers Coop. of Fla. v. Veneman*, 289 F.3d 89, 95 (D.C. Cir. 2002), to mean "the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy," 5 U.S.C. § 551(4). That, of course, is exactly what the Commission tried to do here. And for that reason (given that the Commission's actions qualify for no relevant exceptions), the Commission's pronouncements should have been issued through notice-and-comment rulemaking, should have been submitted to Congress, and should have been discussed with the Office of Information and Regulatory Affairs. Moreover, the Commission should never have attempted to apply these pronouncements retroactively, violating bedrock constitutional and administrative law principles of due process and fair notice. *See also* Executive Order No. 13,892, 84 Fed. Reg. at 55,239, 55,241.

I. Federal Agencies, Including The Commission, Increasingly Use Guidance Documents To Circumvent Rulemaking Requirements, Impeding Public Participation In The Lawmaking Process.

The rulemaking process is "fundamental to an agency's effectiveness." Hester Peirce, *Backdoor and Backroom Regulation*, The Hill (Nov. 10, 2014), https://thehill.com/blogs/pundits-blog/finance/223472-backdoor-and-backroom-regulation. The rulemaking procedures "enable[] the agency promulgating the rule to educate itself before establishing rules and procedures which have a substantial impact on those who are regulated." *Batterton v. Marshall*, 648 F.2d 694, 704 (D.C. Cir. 1980). Indeed, public input is "critical to identifying the benefits and costs of regulatory actions, including situations where a [proposed] rule's effects may not be consistent with expectations." Jay Clayton, Chairman, SEC, Remarks at the Economic Club of New York (July 12, 2017), https://www.sec.gov/news/speech/remarks-economic-club-new-york; *see also Attorney General's Manual on the Administrative Procedure Act* 9 (1947) (explaining that one of the "basic purposes" of the Administrative Procedure Act was to "provide for public participation in the rulemaking process").

The rulemaking process is also fundamental to an agency's legality. The Constitution vests "[a]ll legislative powers" in the Congress. U.S. Const. art. I, § 1. So even if Congress could authorize an agency to exercise some type of quasi-legislative power, *but see, e.g.*, *Dep't of Transp. v. Ass'n of Am. R.Rs.*, 135 S. Ct. 1225, 1246 (2015) (Thomas, J., concurring in the judgment), the "agency literally has no power to act . . . unless and until Congress confers power upon it," *La. Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374 (1986). And when that happens, the Administrative Procedure Act, or APA, establishes *how* the agency must act. *See* 5 U.S.C. § 553. Generally, the APA requires the agency, before imposing binding rules on society, to solicit and consider public input. Besides the effectiveness benefits mentioned above, the APA's procedures "protect[ ]" (at least somewhat, for independent agencies) "a free people from the danger of coercive state power undergirding pronouncements that lack the essential attributes of deliberativeness present in statutes." *Cmty. Nutrition Inst. v. Young*, 818 F.2d 943, 951 (D.C. Cir. 1987) (Starr, J., concurring in part and dissenting in part).

Unfortunately, agencies often evade the APA's requirements by imposing new, substantive rules in the form of "guidance" documents—the letters, memos, blog posts, and the like, that stream out of the administrative state each and every day.[7] Although guidance documents are supposed to be nonbinding clarifications of *existing* law, it has long been recognized by the courts, Congress, and scholars that agencies frequently use guidance documents to engage in "backdoor" lawmaking—that is, agency lawmaking "without transparency and broad public input." Hester Peirce, Regulating Through the Back Door at the Commodity Futures Trading Commission 4 n.5 (Mercatus Working Paper, 2014). From its perch overseeing the wide range of agency action, the D.C. Circuit has witnessed the problem over and over:

> The phenomenon we see in this case is familiar. Congress passes a broadly worded statute. The agency follows with regulations containing broad language, open-ended phrases, ambiguous standards and the like. Then as years pass, the agency issues circulars or guidance or memoranda, explaining, interpreting, defining and often expanding the commands in the regulations. . . . Law is made, without notice and comment, without public participation, and without publication in the Federal Register or the Code of Federal Regulations.

Appalachian Power Co. v. EPA, 208 F.3d 1015, 1020 (D.C. Cir. 2000).

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7 This deluge has driven the Administration's interest in "regulatory reforms that will better safeguard due process in the regulatory enforcement . . . settings." OMB Improving Regulatory Enforcement and Adjudication, 85 Fed. Reg. 5483, 5483 (Jan. 30, 2020).

Congress has similarly been troubled by agency attempts to "circumvent[ ]" public notice and comment requirements "by issuing unofficial rules as 'guidance documents.'" 159 Cong. Rec. S8189-01 (daily ed. Nov. 19, 2013) (statement of Sen. Collins). A report by the House Committee on Government Reform, for example, "found that some guidance documents were intended to bypass the rulemaking process and expanded an agency's power beyond the point at which Congress said it should stop." *Non-Binding Legal Effect of Agency Guidance Documents*, *Committee on Government Oversight and Reform*, H.R. Rep. No. 106-1009, at 1 (2000). And a Senate subcommittee has held hearings to ensure that agency guidance "is not used as a shortcut to reinvent or to restate current regulation in a way that is inconsistent with . . . the law." *Examining the Use of Agency Regulatory Guidance, Part II Before the Subcomm. on Regulatory Affairs and Federal Mgmt. of the S. Comm. on Homeland Security and Gov. Affairs*, 114th Cong. 2 (2016) (statement of Sen. Heitkamp).

Scholars have also observed this alarming trend: "[G]uidance documents have long since ceased to be mere information. They have become process-free vehicles for agency declarations of explicit standards and principles that have a real, direct, and potentially devastating impact." Gwendolyn McKee, *Judicial Review of Agency Guidance Documents*, 60 Admin. L. Rev. 371, 377 (2008); *see also* Philip Hamburger, *Is Administrative Law Unlawful?* 260 (2014) ("When agencies want to impose restrictions they cannot openly adopt as legislative rules . . . they typically place the restrictions in guidance, advice, or other informal directives."). Of course, the use of "guidance" also avoids the hard work that should be attendant to adopting any regulation—the work that some of the agency's seniormost representatives have publicly admitted the Commission strives to avoid. *See, e.g.*, Barry P. Barbash & Jai Massari, *The Investment Advisers Act of 1940: Regulation By Accretion*, 39 Rutgers L.J. 627, 653 (2008) (former Director of the Division of Investment Management explaining that the SEC uses "enforcement actions as a means of establishing rules of conduct for investment advisers" because "[e]nforcement-action rulemaking can . . . be undertaken quickly and almost certainly is a faster form of proceeding that traditional rulemaking, which contemplates the Commission's publishing a rule proposal, receiving and responding to public comment, and adopting a final rule"); Pitt & Shapiro, 7 Yale J. on Reg. at 270 (former Chairman describing how the Commission has "bootstrapp[ed]" settled enforcement actions "into a substantive rule of law" as a means of "bypass[ing] the notice and hearing requirements of the Administrative Procedure Act"); *see also* Roberta Karmel, *Regulation By Prosecution* (1981) (former Commissioner criticizing the Commission's regulation by enforcement).

The Securities and Exchange Commission is no exception to this phenomenon, as the Initiative and the FAQs lay bare; the Commission intentionally structured these in an attempt to deny regulated parties the opportunity to participate in the rulemaking process. *See also Examining the Use of Agency Regulatory Guidance*, 114th Cong. at 59–62 (statement of Clyde Wayne Crews, Jr.) (listing significant guidance documents issued by the SEC and others). Petitioner NCLA raised similar concerns with the Commission a year and a half ago and proposed to the Commission a straightforward rule that would have eliminated this unlawful practice. *See* Petition for Rulemaking to Promulgate Regulations Prohibiting the Issuance, Reliance on, or Defense of Improper Agency Guidance 26, No. 4-726 (July 30, 2018) (urging the Commission to "commit to prohibiting the issuance . . . of improper agency guidance"). Nevertheless, the Commission ignored NCLA's petition and instead doubled down on its practice of unlawful rulemaking through guidance and enforcement.

II. The Initiative And Its Associated Pressure Campaign Improperly Circumvent Virtually Every Check On The Commission's Authority.

As shown above, the APA provides an important check on the Commission's otherwise broad rulemaking authority. Various parts of the Congressional Review Act, along with policies adopted by the current Administration, impose additional checks as well. The Commission has flouted them all.

A. The Initiative And The FAQs Are Legislative Rules That Should Have Gone Through Notice And Comment.

1. The Initiative And The FAQs Are Legislative Rules Because They Add New Duties To The Prior Regulatory Framework And Are Binding As A Practical Matter.

The Initiative and the FAQs—key parts of the SEC's larger effort here—are legislative rules. These pronouncements do not simply "clarify or remind" investment advisers of their "preexisting duties." *Mendoza*, 754 F.3d at 1022. Nor do they "'merely track[ ]' preexisting requirements and explain something the statute or the regulation already required." *Id.* at 1021 (alteration in original) (quoting *Nat'l Family Planning & Reprod. Health Ass'n, Inc. v. Sullivan*, 979 F.2d 227, 236–37 (D.C. Cir. 1992)). To the contrary. The Initiative and the FAQs "supplement" the existing regulatory regime "by imposing specific," newly minted "duties" on an entire industry, *id.* at 1022—duties that cannot fairly be traced to any "existing document," *id.* at 1021. In these circumstances, the Commission "may not escape the notice and comment requirements" simply "by labeling a major substantive legal addition to a rule a mere interpretation." *Appalachian Power*, 208 F.3d at 1024; *accord, e.g.*, *U.S. Telecom Ass'n v. FCC*, 400 F.3d 29, 34–35 (D.C. Cir. 2005) ("[F]idelity to the rulemaking requirements of the APA bars courts from permitting agencies to avoid [notice-and-comment] requirements by calling a substantive regulatory change an interpretive rule."); *C.F. Commc'ns Corp. v. FCC*, 128 F.3d 735, 739 (D.C. Cir. 1997) (holding that the FCC "may not bypass [the APA's notice-and-comment] procedure by rewriting its rules under the rubric of 'interpretation'").[8] The law sees through the labels; the Initiative and the FAQs are substantive rules.

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[8] To be clear, FSI does not challenge the staff 's practice of issuing "no-action" letters. In fact, FSI has previously sought no-action relief, and recognizes the important regulatory clarity that this relief provides. A "no-action" letter is a legitimate exercise of the Commission's enforcement discretion. *See Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 423 (D.C. Cir. 1992) (citing *Kixmiller v. SEC*, 492 F.2d 641, 645 (D.C. Cir. 1974)); *see also Heckler v. Chaney*, 470 U.S. 821, 831 (1985) ("[A]n agency's decision not to prosecute or enforce . . . is generally committed to an agency's absolute discretion."). It simply states that "the staff will not recommend that the SEC sue" the letter's recipient for engaging in specified conduct. *N.Y. City Emps. Ret. Sys. v. SEC*, 45 F.3d 7, 12 (2d Cir. 1995). Unlike the Commission's actions here—which, as detailed below, are "couched in mandatory language," *Gen. Elec. Co. v. EPA*,

The Initiative and the FAQs alter the legal obligations of hundreds of investment advisers. Before the Initiative and the FAQs, precedent and the Commission's rules required simple conflict disclosure about "the transaction" into which an adviser's client was entering, not *other* possible transactions into which he might enter. *Belmont v. MB Inv. Partners, Inc.*, 708 F.3d 470, 503 (3d Cir. 2013). The instructions to Form ADV, for example, required advisers to disclose the fact that they received 12b-1 fees for a transaction, and that the receipt of 12b-1 fees "present[ed] a conflict of interest" (pt. 2A, item 5(E)(1)), *see* 75 Fed. Reg. at 49,293, which gave the adviser "an incentive to recommend investment products based on" the receipt of such a fee (pt. 2B, item 4(A)(2)), *see* 75 Fed. Reg. at 49,311. *See also* Form ADV (Paper Version), Part 2, https://www.sec.gov/about/forms/formadv-part2.pdf. Neither the cases, nor the rules, said anything about a detailed discussion of other possible transactions, much less about transactions involving different classes of mutual fund shares.

The Initiative and the FAQs, by contrast, set forth an entirely different regulatory regime. Out went the straightforward disclosure that 12b-1 fees "present[ed] a conflict of interest"; in came a detailed regime requiring disclosure of, among other things:

- "The fact that different share classes are available";
- "The fact that the adviser has financial interests in the choice of share classes that conflict with the interests of his clients";
- "Whether there are any limitations on the availability of share classes to clients that result from the business of the adviser or the service providers that the adviser uses";
- "Whether an adviser's practices with regard to recommending share classes differs when it makes an initial recommendation to invest in a fund as compared to: (a) when it makes recommendations regarding whether to convert to another share class; or (b) when it makes recommendations to buy additional shares of the fund";

290 F.3d 377, 383 (D.C. Cir. 2002)—a "no-action" letter does not even purport to "impose or fix a legal relationship," *N.Y. City Emps.*, 45 F.3d at 12 (citing *Amalgamated Clothing & Textile Workers Union v. SEC*, 15 F.3d 254, 257 (2d Cir. 1994)), much less carry the threat of significant monetary penalties. So, unlike here, there is no need for a "no-action" letter to run the full rulemaking gauntlet, with all the protections that the APA has to offer.

- “The circumstances under which the adviser recommends share classes with different fee structures and the factors that the adviser considers in making recommendations to clients”; and

- “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 and/or sales charges), the impact of such offsets or rebates, and whether that practice differs depending on the class of client, advice, or transaction.”

Not one of these requirements appears in any rule, statute, or litigated case. The Initiative and the FAQs made substantive legal additions to the regulatory framework, and are thus legislative rules.

The Commission disagrees. It maintains that its FAQs “create[d] no new or additional obligations,” Frequently Asked Questions 1, and that its Initiative addressed only conduct that was previously “required,” Share Class Selection Initiative at Introduction.[9] But, tellingly, the Commission cannot cite *any* statute, regulation, or litigated case that requires such detailed disclosures. Not one. The Commission does cite a few *settled* cases. But settlements cannot “impose[ ] obligations on a party that did not consent to the decree.” *Local No. 93, Int’l Ass’n of Firefighters v. City of Cleveland*, 478 U.S. 501, 529 (1986). And the fact that the Initiative relied on such non-binding authority confirms that there was no “require[ment]” at all.

Indeed, the sheer number of advisers whose disclosures allegedly fell short of the Commission’s standards is itself strong evidence that the Commission’s newly minted interpretation seeks to substantively change the law. The Commission has found that nearly 100 advisers violated its share class disclosure standards. *2019 Annual Report*, *supra*, at 2. But courts “will not lightly presume *an entire industry* negligent.” *In re City of New York*, 522 F.3d 279, 285 (2d Cir. 2008) (emphasis added). And while it “may be ‘possible’” that an “entire industry” was “in violation of the [Investment Advisers Act] for a long time without the [Commission] noticing,” the “more plausible hypothesis is that the

[9] As noted below, such efforts at dodging accountability and disguising an agency’s true activity are nothing new to the D.C. Circuit, and have been roundly rejected by that court. *See, e.g.*, *Appalachian Power*, 208 F.3d at 1023.

[Commission] did not," until recently, "think the industry's practice was unlawful." *Christopher v. SmithKline Beecham Corp.*, 567 U.S. 142, 158 (2012) (quoting *Dong Yi v. Sterling Collision Ctrs., Inc.*, 480 F.3d 505, 510–11 (7th Cir. 2007)); *see also Util. Air Reg. Grp. v. EPA*, 573 U.S. 302, 324 (2014) ("When an agency claims to discover in a long-extant statute an unheralded power to regulate a significant portion of the American economy, we typically greet its announcement with a measure of skepticism." (citation and quotation marks omitted)); *Chamber of Commerce v. Dep't of Labor*, 885 F.3d 360, 380 (5th Cir. 2018) ("[T]hat it took DOL forty years to 'discover' its novel interpretation further highlights the Rule's unreasonableness.").

The Commission also may claim that the Initiative and the FAQs are exempt from notice-and-comment rulemaking because they are supposedly nonbinding. But courts routinely look beyond "boilerplate" disclaimers that guidance is nonbinding, recognizing that agencies often use such disclaimers as a "charade[ ] intended to keep . . . courts at bay." *Appalachian Power*, 208 F.3d at 1023 (internal quotation marks omitted); *see also Gen. Motors Corp. v. EPA*, 363 F.3d 442, 448 (D.C. Cir. 2004) ("eschewing the notion that labels are definitive"). The question is whether the agency pronouncement is "binding as a practical matter." *Elec. Privacy Info. Ctr. v. Dep't of Homeland Sec.*, 653 F.3d 1, 7 (D.C. Cir. 2011) (quoting *Gen. Elec. Co. v. EPA*, 290 F.3d 377, 383 (D.C. Cir. 2002)). And for two independent reasons, the Initiative and the FAQs both are.

First, the Initiative and the FAQs are binding as a practical matter because regulated "private parties are reasonably led to believe that failure to conform" to the Initiative's and the FAQs' mandates "will bring adverse consequences." *Gen. Elec.*, 290 F.3d at 383 (quoting Robert A. Anthony, *Interpretive Rules, Policy Statements, Guidances, Manuals, and the Like*, 41 Duke L.J. 1311, 1328 (1992)). Here, the Initiative's and the FAQs' mandatory terms are all but dispositive: "It commands, it requires, it orders, it dictates." *Appalachian Power*, 208 F.3d at 1023; *accord Gen. Elec.*, 290 F.3d at 383 ("If the document is couched in mandatory language, or in terms indicating that it will be regularly applied, a binding intent is strongly evidenced."); *see, e.g.*, Frequently Asked Questions 2 ("An adviser *must* eliminate" (emphasis added)); *id.* at 4 ("An adviser has a conflict of interest that it *must* disclose" (emphasis added)); *id.* ("an adviser *must* also disclose" (emphasis added)); Share Class Selection Initiative pt. III.A ("the disclosures *must* have clearly described" (emphasis added)); *id.* pt. III.B ("an investment adviser *must* self-report" (emphasis added)). Regulated parties will reasonably—indeed, necessarily—interpret the Initiative and the FAQs as "marching orders." *Appalachian Power*, 208 F.3d at 1023; *see also Lutheran Church*, 141 F.3d at 353 (recognizing that because "[n]o rational firm . . . welcomes a government audit," purportedly non-binding guidance often becomes the "*de facto*" law). And failure to comply with these newly minted marching orders may lead to civil penalties. Indeed, the agency here explicitly threatened—"promise[d]"—that failure to accede to the Initiative's mandates would result in greater punishment.[10] Garmhausen, *supra* (quoting the Co-Director of Enforcement); *see also* Share Class Selection Initiative pt. III.E ("[T]he Division expects in any proposed enforcement action to recommend additional charges . . . and the imposition of penalties."). Under these circumstances, any reasonable regulated party would understand that refusing to comply with the Initiative or the FAQs would run "the risk of significant . . . civil penalties." *Hawkes*, 136 S. Ct. at 1815.

Second, regardless of the documents' language, the Initiative and the FAQs are binding as a practical matter because the Commission "bases enforcement actions on the policies or interpretations formulated in the document[s]." *Appalachian Power*, 208 F.3d at 1021; *see also Chamber of Commerce v. U.S. Dep't of Labor*, 174 F.3d 206, 213 (D.C. Cir. 1999) (requiring notice-and-comment rulemaking where the "effect of the rule is . . . not to 'announce[ ] the agency's intentions for the future,' . . . but to inform employers of a decision already made" (quoting *Am. Bus. Ass'n v. United States*, 627 F.2d 525, 531 (D.C. Cir. 1980))). As the Commission put it in a press release touting 79 separate enforcement

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[10] We expect that even cursory discovery would reveal what the Commission already knows—those who refused the "invitation" to settle have been investigated and may well be sued. *Q.E.D.*

actions, the "actions stem from the SEC's Share Class Selection Disclosure Initiative." Press Release 2019-28, *supra*; *see also 2019 Annual Report* 2 (touting 95 enforcement actions). Indeed, no other document could plausibly have sustained those actions, because no other document addresses share class disclosure.

In short, the Initiative and the FAQs create new legal obligations that are binding on regulated parties in every practical sense. They are thus legislative rules that should have been promulgated through notice-and-comment rulemaking, not snuck through the backdoor of guidance. Memorandum from Dominic J. Mancini, Acting Adm'r, Office of Info. & Regulatory Affairs, to Regulatory Policy Officers at Executive Departments and Agencies 2, 3 (Oct. 31, 2019) (explaining that "regardless of name or format," guidance documents "should never be used to establish new positions," because "any such requirements must be issued pursuant to applicable notice-and-comment requirements").

2. The Initiative And The FAQs Are Attributable To The Commission Itself.

The Initiative and the FAQs are attributable to the Commission itself. *See Bennett v. Spear*, 520 U.S. 154, 177–78 (1997). As just discussed, the Initiative and the FAQs are binding as a practical matter on regulated parties. *See also* Peirce, *Backdoor and Backroom Regulation*, *supra* ("Regardless of the language and the format, the effect is the same for regulated entities. The agency suggests that you do something—even if it says that it might suggest something different later—and you do it."). And they represent the Commission's—not just the staff's—settled determination. Yes, the Initiative and the FAQs purport to have issued solely from the staff. But no reasonable observer could believe for a second that these actions are not being undertaken with at least the implicit sanction of the Commission. The Commissioners have predicted and openly praised both the Initiative and the FAQs. *See supra* pp. 15–17; *see also* Jay Clayton, Chairman, U.S. SEC, Management's Discussion and Analysis of the SEC (Apr. 8, 2019), https://www.sec.gov/news/speech/speech-clayton-040819 (calling out the Initiative "for commendation"). And they have voted—more than 100 times—to settle cases involving alleged violations of the standards announced in the Initiative and the FAQs. *2019 Annual Report*, *supra*, at 2; *see also* Press Release 2019-28, *supra*. Since no other binding document discusses the broad disclosure requirements applied in those more than 100 settlements, the Commission must have been applying the Initiative and the FAQs. In these circumstances, no court would believe that the "Commission has neither approved nor disapproved" the announced standards. Frequently Asked Questions 1.

The Initiative and the FAQs are attributable to the Commission.

B. The Commission Violated The Congressional Review Act.

1. The Initiative And The FAQs Should Have Been Sent To Congress For Review.

Even if the Commission's Initiative and FAQs were exempt from notice-and-comment rule-making—and they are not—those pronouncements still flouted the strictures of the Congressional Review Act ("CRA"), and on that basis alone are void. The CRA is intended to give the people's representatives in Congress a say over the activities of the administrative state. The Act's requirements are clear: No rule can "take effect" unless the issuing agency has submitted "a copy of the rule" to "each House of the Congress" for review. 5 U.S.C. § 801(a)(1)(A).

The CRA takes a "very broad" view of the term "rule," reaching virtually all agency pronouncements, not only those "that must be promulgated according to the notice and comment requirements" of the APA. Hon. Orrin Hatch, B-323772, 2012 WL 3801373, at *2 (Comp. Gen. Sept. 4, 2012); *accord, e.g.*, Hon. Doug Ose, B-287557, 2001 WL 522025, at *4 (Comp. Gen. May 14, 2001) ("[W]e must be mindful that Congress intended that the CRA should be broadly interpreted both as to the type and scope of rules covered."). The Act reaches binding and "non-binding" documents alike. Hatch, 2012 WL 3801373, at *4; *see also* Hon. David M. McIntosh, B-281575, at 4 (Comp. Gen. Jan. 20, 1999). And the Comptroller General of the United States has, in fact, applied the CRA to a vast array of agency documents—from booklets, to letters, to interim, nonbinding guidance. *See, e.g.*, Hon. John D. Rockefeller, IV, B-316048, 2008 WL 1795346 (Comp. Gen. Apr. 17, 2008) (letter); Hon. James A. Leach, B-286338, 2000 WL 1568268 (Comp. Gen. Oct. 17, 2000) (booklet); McIntosh, B-281575 (interim, nonbinding guidance). The Initiative and the FAQs are not somehow exempt.

Recently, for example, the Comptroller General ruled that multiple supervisory guidance letters from the Board of Governors of the Federal Reserve were, in fact, rules under the CRA. *See* Hon. Thom Tillis, B-331324, 2019 WL 5448290 (Comp. Gen. Oct. 22, 2019); Congressional Requestors, B-330843, 2019 WL 5448291 (Comp. Gen. Oct. 22, 2019). Just like the Initiative and the FAQs, the purportedly non-binding guidance letters were: (1) "agency statement[s]" that were (2) "of future effect," as they "provided new guidance," and (3) "designed to implement, interpret, or prescribe law." *Id.* at *4; *see also* Tillis, 2019 WL 5448290, at *3. Just like the guidance letters, therefore, the Initiative and the FAQs were required to be submitted to Congress under the CRA. And because they were not, the Commission is "not compliant with the *Congressional Review Act*." Majority Staff Report of H.R. Comm. on Oversight & Government Reform, 115th Cong., Shining Light on Regulatory Dark Matter 4 (2018) (explaining that the Commission is apparently "confused with respect to the definition of guidance" and the Commission's legal obligations).

2. The Initiative And The FAQs Should Have Been Sent To The Office Of Information And Regulatory Affairs For Review.

The Commission should also have sent the Initiative and the FAQs to the Office of Information and Regulatory Affairs, or OIRA. The CRA creates a special category of "major rule[s]," which may not go into effect until 60 days after the rule is sent to Congress or published in the *Federal Register*. 5 U.S.C. § 801(a)(3)(A). Whether a rule is "major," however, is not a question for the agency; OIRA makes the call. *See id.* § 804(2). And so "Federal agencies, including the historically independent agencies" such as the Commission, "*must* coordinate with OIRA regarding a major determination" for all of their rules. Memorandum from Russell T. Vought, Acting Director, Off. of Mgmt. & Budget, to Heads of Executive Departments and Agencies 3, 4 (Apr. 11, 2019) (emphasis added). That is so even though the Commission does not "otherwise" submit its rules for OIRA "regulatory review," and even though the Commission believes that the rules may be "guidance documents, general statements of policy, . . . interpretive rules," and the like. *Id.* at 3. The CRA "encompasses a wide range of . . . regulatory actions," *id.*, including the Initiative and the FAQs.[11]

III. The Commission's Retroactive Application Of The Initiative And The FAQs Violates The Investment Advisers Act, Bedrock Principles Of Fair Notice And Due Process, And The Policy Of This Administration.

Although investment advisers have long disclosed that they receive 12b-1 fees and that receipt of those fees presents a conflict of interest, as per the Commission's actual regulations, the Commission has recently claimed that investment advisers are (and were) *also* required to state specifically that some clients were placed in more expensive share classes where less expensive share classes were available. But, as discussed above, this type of broad disclosure has never been required by any of the Commission's rules, or any litigated cases.

Indeed, it goes well beyond a conflict disclosure requirement. To disclose a conflict is to disclose a divergence of interest and the fact that it could tempt an adviser to act differently than if

[11] Administrative law is moving in one direction: a return to the law. Recognizing the danger posed by extra-legal lawmaking, the Executive Branch has called on agencies to act *only* through proper procedures—namely, notice-and-comment rulemaking. *See, e.g.*, Exec. Order No. 13,891, 84 Fed. Reg. 55,235, 55,235 (Oct. 15, 2019). Likewise, the Supreme Court has indicated that it is time for the people's elected representatives in Congress to reclaim their seat at the legislative table. *See, e.g.*, *Paul v. United States*, 140 S. Ct. 342, 342 (2019) (Kavanaugh, J., statement respecting the denial of certiorari); *Gundy v. United States*, 139 S. Ct. 2116, 2131 (2019) (Gorsuch, J., joined by Roberts, C.J., and Thomas, J., dissenting); *id.* at 2130 (Alito, J., concurring in the judgment). But the Commission—by ignoring the CRA and sidestepping the APA—is marching in a different direction; it should get back on track.

The APA and the CRA are essential checks on agency power. Independent agencies like the Commission "enjoy in practice a significant degree of independence" from the people's elected representatives, *City of Arlington v. FCC*, 569 U.S. 290, 313 (2013) (Roberts, C.J., dissenting), forming "in effect, a headless fourth branch of the U.S. Government," *PHH Corp. v. CFPB*, 881 F.3d 75, 165 (D.C. Cir. 2018) (Kavanaugh, J., dissenting); *see also* Final Report of the Attorney General's Committee on Administrative Procedure 206 (1941) ("They constitute a headless 'fourth branch' of the Government, a haphazard deposit of irresponsible agencies and uncoordinated powers." (citation omitted)). In these circumstances, compliance with checks that exist on the agency's power is imperative—and the Commission's failure to comply with any of those checks is particularly distressing.

the divergence were absent. Conflict disclosure does not require identifying specific alternative investments or investment terms that might be offered in the absence of a conflict. On the contrary, the disclosure serves to notify the customer that, because of the conflict, such alternatives may never be identified or offered.

The Commission's newly minted standards thus stretch the concept of "conflict disclosure" beyond all recognition, and attempt even to outlaw 12b-1 fees entirely. Any enforcement action brought against an investment adviser on this basis would violate the Investment Advisers Act along with bedrock principles of fair notice and due process, not to mention an Executive Order.

That would be intolerable in the best of times—and we are far from that. The nation is "facing an unprecedented national challenge—a health and safety crisis that requires all Americans . . . to significantly change their daily behavior and, for many, to make difficult personal sacrifices." Jay Clayton, Chairman, SEC, The Deep and Essential Connections Among Markets, Businesses, and Workers and the Importance of Maintaining Those Connections in Our Fight Against COVID-19 (Mar. 24, 2020), https://www.sec.gov/news/public-statement/statement-clayton-covid-19-2020-03-24. In this time of crisis, individuals and businesses need ready and efficient access to our financial markets. *Id.* That is an "essential component of our national response to, and recovery from, COVID-19." *Id.* The Commission should thus free those markets from the unnecessary uncertainty that its "regulation by enforcement" has inflicted—not continue to weigh them down.

A. The Investment Advisers Act Expressly Protects Those Who Act In Good Faith Reliance On The Commission's Rules.

In the Investment Advisers Act, Congress expressly created a safe harbor for any person who acted in good faith reliance on the Commission's rules.

> No provision . . . imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission, notwithstanding that such rule, regulation, or order may, after such act or omission, be amended or rescinded . . . .

15 U.S.C. § 80b-11(d). Here, there is no question that advisers acted in conformity with the Commission's Form ADV. As detailed above, that form required advisers to disclose the fact that they received 12b-1 fees for a transaction, and that the receipt of 12b-1 fees "present[ed] a conflict of interest," which gave the adviser "an incentive to recommend investment products based on" the receipt of such a fee. For decades, advisers disclosed just that.

The Commission cannot turn around now and claim—with the threat of retroactive punishment—that *more* needed to be done. In *Basham v. Finance American Corp.*, 583 F.2d 918 (7th Cir. 1978), for example, the court assumed that a lender had in fact violated the Truth in Lending Act by "fail[ing] to disclose the actual proceeds" of its loan. *Id.* at 923. But the court nevertheless held that "no civil liability [could] be imposed." *Id.* Why? Because, like the Advisers Act, the Truth in Lending Act offered a safe harbor to any person who acted "in good faith in conformity with any [applicable] rule, regulation, or interpretation." *Id.* (quoting 15 U.S.C. § 1640(f)). And, like the advisers here, the defendants in that case had issued "disclosures [that] followed the requirements" of the applicable regulation. *Id.* So, even if the regulation-conforming disclosures were otherwise "found violative of [federal law]," as here, "no claims [could] exist[ ] on [that] basis." *Id.*; *accord Warren v. Credithrift of Am., Inc.*, 599 F.2d 829, 831–32 (7th Cir. 1979) ("[N]o civil liability may be imposed upon defendant for failing to make the disclosure required by section 1639(a)(1) because the disclosure made meets the requirements of Regulation Z."); *see also, e.g.*, 74 Fed. Reg. at 4573 (explaining that "a person that provides investors with a mutual fund Summary Prospectus in good faith compliance with rule 498 will be able to rely on section 19(a) of the Securities Act," an analogous good-faith provision).

B. The Commission Is Bound By An Executive Order And Principles Of Constitutional And Administrative Law Requiring Fair Notice.

The Commission is bound by an Executive Order and principles of constitutional and administrative law requiring fair notice. "Traditional concepts of due process incorporated into administrative law preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule." *Satellite Broad. Co. v. FCC*, 824 F.2d 1, 3 (D.C. Cir. 1987); *accord Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1329 (D.C. Cir. 1995). In fact, the President of the United States has forbidden such unfair surprise. *See* Exec. Order No. 13,892, 84 Fed. Reg. 55,239 (Oct. 15, 2019). "An agency *must avoid unfair surprise* not only when it imposes penalties but also whenever it adjudges past conduct to have violated the law." *Id.* at 55,241 (emphasis added). The President's Order is binding on the Commission. *See* U.S. Const. art. II, § 1, cl. 1; *id.* art II, § 3; *see also Meyer v. Bush*, 981 F.2d 1288, 1297 (D.C. Cir. 1993) ("[T]he President has a constitutional duty to see that the laws are faithfully executed, and, therefore, a duty to oversee the regulatory policies produced by the departments and agencies."); *Pub. Citizen v. Burke*, 843 F.2d 1473, 1477 (D.C. Cir. 1988) ("[The] President, by virtue of Article II's command that he take care that the laws be faithfully executed, quite legitimately guides his subordinates' interpretations of statutes . . . .").[12]

The President has instructed that an agency's understanding of "unfair surprise" "should be informed" by the Supreme Court's decision in *Christopher v. SmithKline Beecham Corp.*, 567 U.S. 142 (2012). 84 Fed. Reg. at 55,240. That case is right on point. There, as here, an agency's "interpretation" was "preceded by a very lengthy period of conspicuous inaction" in the face of an "industry's decades-long practice." 567 U.S. at 157–58. And there, as here, an agency's novel interpretation created an "acute" "potential for unfair surprise." *Id.* at 158.

Indeed, the Commission's actions here are even broader and more troubling than the agency action at issue in *Christopher*. In that case, the Supreme Court castigated the agency for inflicting "unfair surprise" and "potentially massive liability" by announcing a new interpretation of a rule affecting 90,000 sales workers in the pharmaceutical industry. 567 U.S. at 155, 158. Here, by contrast, the

[12] The Executive Order, on its face, applies to the Commission. The order applies to any "Executive agency," 84 Fed. Reg. at 55,239, which includes an "independent establishment," 5 U.S.C. § 105, like the Commission, *see id.* § 104(1) (defining an "independent establishment" as any "establishment within the executive branch . . . which is not" within a few exceptions not relevant here); *see also Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 511 (2010) ("[T]he Commission is a freestanding component of the Executive Branch . . . .").

Commission's 12b-1 "guidance" threatens to upend decades-old practices in the investments of mutual funds, which together hold over $20 trillion in combined assets from nearly 60 million households in the United States. *See* Inv. Co. Inst., Trends in Mutual Fund Investing, September 2019, https://www.ici.org/research/stats/trends/trends_09_19; Inv. Co. Inst., Characteristics of Mutual Fund Investors, 2019, https://www.ici.org/pdf/per25-09.pdf. The unfair surprise from the Commission's actions is thus several orders of magnitude greater than the already "massive" agency unfairness previously condemned by the Supreme Court and the President.

The Commission should avoid unfair surprise, not weaponize it.

Tellingly, the Commission has had multiple opportunities over the last two decades to require the type of share class-specific disclosure that it now demands. In 2004, for example, the Commission adopted new requirements on the disclosure of mutual fund expenses, *see* Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. 11,244, 11,246 (Mar. 9, 2004), and barred certain broker-dealer practices that it thought "pose[d] conflicts of interest," *see* 69 Fed. Reg. at 54,728. But the Commission declined to "adopt[ ] any further changes to rule 12b-1." *Id.* at 54,731. Likewise, in 2009, the Commission tried "to increase awareness of potential conflicts of interest" by requiring express notification to investors "that a conflict of interest may exist with respect to [a] broker-dealer's recommendation." 74 Fed. Reg. at 4558. But, again, the Commission refused to consider *additional* disclosures, even though "commenters [had] suggested . . . alternative terms to describe . . . rule 12b-1 fees." *Id.* at 4555. The Commission admitted that it would be "more appropriate to consider [such] changes in the context of a full reconsideration of . . . rule 12b-1," *id.* at 4555–56—a reconsideration that never came.

In short, the Commission has repeatedly promulgated rules that address mutual fund fee disclosure requirements and related conflicts of interest. But it has never adopted, or even proposed, a rule requiring the specific share class disclosures that the Commission—through the Initiative and the

FAQs—has said were always really required. Such detailed disclosures have never been the law. And the Commission cannot pretend otherwise, retroactively punishing firms for violating rules that the Commission never adopted. The new "guidance isn't law—it's just paper." Claire McCusker Murray, Principal Deputy Assoc. Att'y Gen., Remarks at the Compliance Week Annual Conference (May 20, 2019), https://www.justice.gov/opa/speech/remarks-principal-deputy-associate-attorney-general-claire-mccusker-murray-compliance.

IV. The Commission Should Adopt Rules To Bring Its Actions Into Compliance With Applicable Law, Not Open New Frontiers.

The Commission is at a fork in the road. Emboldened by "the success of the Share Class Initiative" in achieving through guidance what the agency could not—for decades—achieve through rulemaking, Avakian, What You Don't Know, *supra*, the Commission has doubled down on the 12b-1 investigations and litigation, *see, e.g.*, SEC Press Release 2020-90, *supra* (promising to "continue to actively pursue" these cases); *RBC Capital Mkts.*, *supra* (announcing settlement); J. Nancarrow, *More Cases Over High Investor Fees Expected, SEC Official Says*, Bloomberg Law (June 26, 2019), https://news.bloomberglaw.com/banking-law/more-cases-over-high-investor-fees-expected-sec-official-says; *see also* Complaint, *SEC v. Commonwealth Equity Servs., LLC*, No. 1:19-cv-11655-ADB (D. Mass. Aug. 1, 2019). And it has gone further still, turning its attention to longstanding, widespread, and previously uncontroversial industry practices—like revenue sharing—that could even "be construed" as a form of 12b-1 fee. 75 Fed. Reg. at 47,608 n.65; *see* Avakian, What You Don't Know, *supra* ("Let me assure you, we are looking for other . . . conflicts—and we are finding them. . . . One is revenue sharing."); Frequently Asked Questions 6 (citing "the staff's views" while adding novel disclosure requirements for "[s]imilar" practices like "revenue-sharing"). And not settling there, the Commission has announced the counterintuitive proposition that the "avoidance of expenses" has (apparently) always been a form of "compensation," which *also* needed to be disclosed. All of this, of course, has been done "without notice and comment, without public participation, and without publication in the Federal Register or the Code of Federal Regulations." *Appalachian Power*, 208 F.3d at 1020.

This subregulatory sabotage must end. The Commission should not turn its flawed 12b-1 playbook into standard operating procedure, much less bootstrap its coerced settlements into a never-ending parade of similar misadventures. As part of its assault on revenue-sharing, the Commission is actually suggesting that the *same* companies it strong-armed into settling the 12b-1 Initiative should now pay an additional fine for supposed violations of the *same* statute, during the *same* period, for alleged conflicts in the selection of the *same* product class—if not, the *same* product—for, in many cases, the *same* clients. That is blatantly unfair and inappropriate. The Commission should get out of this "business of gotcha," guidance-based enforcement. T. Longo, *SEC's Battle with Brokers Over 'Regulation By Enforcement' Flares at Senate Hearing*, Financial Advisor (Dec. 11, 2019), https://www.fa-mag.com/news/battle-between-sec-and-industry-over--regulation-by-enforcement--breaks-into-open-at-senate-hearing-53183.html (quoting Chairman Clayton). "[I]f the commission feels some way about" the state of the law, it "should articulate it"—in an actual rule. *Id.* (quoting Chairman Clayton). And in no event should the Commission "be relying on staff guidance." *Id.* (quoting Chairman Clayton).

To correct the myriad errors described throughout this Petition, and to prevent future abuses the Commission is on course to commit, the agency should initiate a rulemaking to promulgate regulations to bring its guidance into compliance with applicable law. *See* 5 U.S.C. § 553(e); 17 C.F.R. § 201.192(a). Other agencies have already taken similar action. *See* DOT Administrative Rulemaking, Guidance, and Enforcement Procedures, 84 Fed. Reg. 71,714, 71,731–32 (Dec. 27, 2019) (barring the Department from using "its enforcement authority to convert agency guidance documents into binding rules" (to be codified at 49 C.F.R. § 5.85)). This provides an easy and clear path to follow. To keep pace with its peers, the Commission must make clear that investment advisers, like all Americans, are bound only "through duly enacted statutes or through regulations lawfully promulgated under them," not through the backdoor of regulatory "guidance." Exec. Order No. 13,891, 84 Fed. Reg. 55,235, 55,235 (Oct. 15, 2019). Thus, in the context of Rule 12b-1, the Commission must affirmatively "distin[guish]" between "rules and regulations, on the one hand, and staff views on the other." Jay Clayton, Chairman, U.S. SEC, Statement Regarding SEC Staff Views (Sept. 13, 2018), https://www.sec.gov/news/public-statement/statement-clayton-091318. Specifically:

- The Commission should adopt a clear statement: "Apart from issues concerning the compensation of individual employees, if a financial services firm discloses a conflict of interest, then that firm is not required to take affirmative steps to eliminate the disclosed conflict."

- The Commission should adopt a clear statement: "Customers have a duty to inform themselves about the features of particular mutual funds and share classes within those funds, as long as the information is readily available and clearly disclosed (*e.g.*, in a prospectus)."

- The Commission should propose amendments to Form ADV Part 2, and Form N-1A, to make clear exactly what forms of compensation are or are not disclosable.

- The Commission should acknowledge that compensation disclosures in a prospectus are the equivalent of compensation disclosures in Form ADV Part 2.

- The Commission should adopt a statement that compliance with the disclosure requirements set forth above triggers the safe harbor of section 211(d) of the Investment Advisers Act.

- The Commission should clarify that "best execution" principles do not apply to actions under section 206 of the Investment Advisers Act.

CONCLUSION

Americans should never be at the mercy of independent agencies' extralegal "guidance," particularly when that guidance seeks to retroactively coerce compliance outside the rule-making process prescribed by Congress and impose massive penalties on them for failure to conform to such extralegal standards. The Commission should initiate a rulemaking to promulgate the proposed rules and end these unlawful "regulation by enforcement" practices. The Commission must resolve this petition "within a reasonable time," 5 U.S.C. § 555(b), which is "typically counted in weeks or months, not years," *In re Am. Rivers & Idaho Rivers United*, 372 F.3d 413, 419 (D.C. Cir. 2004). Petitioners look forward to the Commission's prompt action on this important petition.

Dated: April 29, 2020

Respectfully submitted,

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Exhibit 1

Announcement

Share Class Selection Disclosure Initiative

Division of Enforcement

U.S. Securities and Exchange Commission

I. Introduction

Over the past several years, the Securities and Exchange Commission ("Commission") has filed numerous actions in which an investment adviser failed to make required disclosures relating to its selection of mutual fund share classes that paid the adviser (as a dually registered broker-dealer) or its related entities or individuals a fee pursuant to Rule 12b-1 of the Investment Company Act of 1940 ("12b-1" fee) when a lower-cost share class for the same fund was available to clients. The Share Class Selection Disclosure Initiative (the "SCSD Initiative") is intended to identify and promptly remedy potential widespread violations of this nature.[1]

As described below, under the SCSD Initiative the Commission's Division of Enforcement (the "Division") will recommend that the Commission accept favorable settlement terms for investment advisers that self-report to the Division possible securities law violations relating to their failure to make necessary disclosures concerning mutual fund share class selection.[2]

II. Background

Section 206(2) of the Investment Advisers Act of 1940 ("Advisers Act") prohibits an investment adviser, directly or indirectly, from engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," and imposes a fiduciary duty on investment advisers to act for their clients' benefit, including an affirmative duty of utmost good faith and full disclosure of all material facts. *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). Under Section 206(2), an investment adviser has a fiduciary duty to disclose to its clients all conflicts of interest which might incline an investment adviser consciously or unconsciously to render advice that is not disinterested. *Id.* at 191-92. A conflict of interest is a material fact that an investment adviser must disclose to its clients. *Id.* A violation of Section 206(2) may rest on a finding of simple negligence. *SEC v. Steadman*, 967 F.2d 636, 643n.5 (D.C. Cir. 1992).

Section 207 of the Advisers Act makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission . . . or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

The Commission may file enforcement actions alleging violations of these provisions against investment advisers that fail to disclose to their clients conflicts of interest, including those conflicts associated with the receipt of 12b-1 fees for investing client funds in, or recommending that clients invest in, a 12b-1 fee paying share class when a lower-cost share class was available to clients for the same fund. A 12b-1 fee is a fee paid by a mutual fund on an ongoing basis from its assets for shareholder services, distribution, and marketing expenses. Each share class of a fund represents an interest in the same portfolio of securities. Therefore, when there is a lower-cost share class available that does not charge a 12b-1 fee (or charges a lower 12b-1 fee), it is usually in the client's best interest to invest in the lower-cost share class rather than the 12b-1 fee paying share class because the client's returns would not be reduced by the 12b-1 fees.

Over the past several years, the Commission has filed numerous actions against investment advisers relating to the disclosure failures noted above. While many of the respondent investment advisers disclosed that they (as dually registered broker-dealers), their affiliated broker-dealer (or its registered representatives), or the investment adviser's supervised persons "may" receive 12b-1 fees from the sale of mutual fund shares and that such fees "may" create a conflict of interest, the firms failed to disclose that they had a conflict of interest because many mutual funds offered a variety of share classes, including some that paid 12b-1 fees and others that did not for eligible clients, and failed to disclose that they were, in fact, receiving 12b-1 fees due to the mutual fund shares they bought for or recommended to their clients.[3]

There is significant concern that many investment advisers have not been complying with their obligation under the Advisers Act to fully disclose all material conflicts of interest related to their mutual fund share class selection practices, and that investor harm involving this lack of disclosure may be widespread.

III. The SCSD Initiative

A. **Who Should Consider Self-Reporting to the Division?**

Investment advisers that did not explicitly disclose in applicable Forms ADV (*i.e.*, brochure(s) and brochure supplements) the conflict of interest associated with the 12b-1 fees the firm, its affiliates, or its supervised persons received for investing advisory clients in a fund's 12b-1 fee paying share class when a lower-cost share class was available for the same fund should consider self-reporting to the Division to take advantage of the SCSD Initiative.

A "Self-Reporting Adviser" is an adviser that received 12b-1 fees in connection with recommending, purchasing, or holding 12b-1 fee paying share classes for its advisory clients when a lower-cost share class of the same fund was available to those clients, and failed to disclose explicitly in its Form ADV the conflicts of interest associated with the receipt of such fees. The investment adviser "received" 12b-1 fees if (1) it directly received the fees,[4] (2) its supervised persons received the fees, or (3) its affiliated broker-dealer[5] (or its registered representatives) received the fees. To have been sufficient, the disclosures must have clearly described the conflicts of interest associated with (1) making investment decisions in light of the receipt of the 12b-1 fees, and (2) selecting the more expensive 12b-1 fee paying share class when a lower-cost share class was available for the same fund. For additional information regarding the adequacy of mutual fund share class selection disclosures see the following: *In the Matter of SunTrust Investment Services, Inc.*, Investment Advisers Act Rel. No. 4769 (Sept. 14, 2017); *In the Matter of Cadaret, Grant & Co.*, Investment Advisers Act Rel. No. 4736 (Aug. 1, 2017); *In the Matter of Credit Suisse Securities (USA) LLC,* Investment Advisers Act Rel. No. 4678 (April 4, 2017).

Investment advisers that have already been contacted by the Division as of the date of this announcement regarding possible violations related to their failures to disclose the conflicts of interest associated with mutual fund share class selection are not eligible for the SCSD Initiative. Investment advisers that are subject to pending examinations by the Commission's Office of Compliance Inspections and Examinations relating to this issue, but which have not been contacted by the Division, will be eligible to participate in the SCSD Initiative.

B. **When and What Must Investment Advisers Self-Report?**

To be eligible for the SCSD Initiative, an investment adviser must self-report by notifying the Division by 12:00 am EST on June 12, 2018. Notification can be made by email to SCSDInitiative@sec.gov or by mail to SCSD Initiative, U.S. Securities and Exchange Commission, Denver Regional Office, 1961 Stout Street, Suite 1700, Denver, Colorado 80294.

An adviser that has timely self-reported must then, within ten business days from the date of its notification to the Division, confirm its eligibility for the SCSD Initiative by submitting a completed questionnaire that provides certain information,[6] including the following:

- Identification and contact information of the Self-Reporting Adviser.
- To the extent applicable, identification and contact information of the Self-Reporting Adviser's affiliated broker-dealer.
- Any fact that the Self-Reporting Adviser would like to provide to assist the staff in understanding the circumstances that may have led to disclosure of these conflicts of interest not appearing in the

Self-Reporting Adviser's Form ADV brochures and brochure supplements (*e.g.*, any information regarding other disclosure documents the Self-Reporting Adviser believes contain an adequate disclosure of the conflict).

- Information related to the 12b-1fees the Self-Reporting Adviser, its supervised persons, or its affiliated broker-dealer (or its registered representatives) received in excess of the lower-cost share class for the period January 1, 2014, through the date that the misconduct stopped ("Relevant Period").[7]
- A statement that the Self-Reporting Adviser intends to consent to the applicable settlement terms under the SCSD Initiative.

C. **Standardized Settlement Terms the Division Will Recommend**

To the extent an investment adviser meets the requirements of the SCSD Initiative and the Division decides to recommend enforcement action against the Self-Reporting Adviser ("eligible adviser"), the Division will recommend that the Commission accept a settlement that includes the terms described below.

1. *Types of Proceedings and Nature of Charges*

For eligible advisers, the Division will recommend that the Commission accept a settlement pursuant to which the firm consents to the institution of an administrative and cease-and-desist proceeding under Sections 203(e) and 203(k) of the Advisers Act for violations of Sections 206(2) and 207 of the Advisers Act based on the adviser's failure to disclose the conflict of interest. The Division will recommend a settlement in which the adviser neither admits nor denies the findings of the Commission.

2. *Cease-and-Desist Order and Censure*

For eligible advisers, the recommended settlement will include an order to cease and desist from committing or causing any violations and future violations of Sections 206(2) and 207 of the Advisers Act, and a censure.

3. *Disgorgement and Prejudgment Interest*

For eligible advisers, the recommended settlement will include disgorgement by the investment adviser of its ill-gotten gain and prejudgment interest thereon. Eligible advisers must certify to the accuracy of the information provided to staff in the Questionnaire and, as part of the settlement, agree to an order requiring the firm to make a respondent-administered distribution to affected clients.[8]

4. *Undertakings*

For eligible advisers, the recommended settled order will include either an acknowledgment that the adviser has voluntarily taken the following steps (if completed before the order is instituted), or order undertakings requiring that within 30 days of instituting the order, the eligible adviser:

- Review and correct as necessary the relevant disclosure documents;

- Evaluate whether existing clients should be moved to a lower-cost share class and move clients as necessary;
- Evaluate, update (if necessary), and review for the effectiveness of their implementation policies and procedures to ensure that they are reasonably designed to prevent violations of the Advisers Act in connection with the adviser's disclosures regarding mutual fund share class selection;
- Notify clients of the settlement terms in a clear and conspicuous fashion (this notification requirement applies to all affected clients); and
- Provide the Commission staff, no later than 10 days after completion, with a compliance certification regarding the applicable undertakings by the investment adviser.

5. *Civil Penalties*

For eligible advisers, the Division will recommend that the Commission not impose a penalty.

The standardized settlement terms set forth herein are only applicable to self-reported conduct that meets the requirements of the SCSD Initiative. Any other potential misconduct is subject to investigation and separate enforcement action, if appropriate. If enforcement action is taken as to the other potential misconduct, entities may be subject to additional remedies for that misconduct, including, but not limited to, additional financial sanctions. As in all cases, the Division will exercise its discretion in determining whether a recommendation for enforcement action is appropriate.

D. **No Assurances Offered with Respect to Individual Liability**

The SCSD Initiative covers only eligible advisers. The Division provides no assurance that individuals associated with these entities will be offered similar terms if they have engaged in violations of the federal securities laws. The Division may recommend enforcement action against such individuals and may seek remedies beyond those available through the SCSD Initiative. Assessing whether to recommend enforcement action against an individual for violations of the federal securities laws necessarily involves a case-by-case assessment of specific facts and circumstances, including evidence regarding the level of intent and other factors such as cooperation by the individual.

E. **No Assurances for Entities That Do Not Take Advantage of the SCSD Initiative**

For advisers that would have been eligible for the terms of the SCSD Initiative but did not participate, the Division expects in any proposed enforcement action to recommend additional charges, if appropriate, and the imposition of penalties. Eligible advisers are cautioned that staff from the Commission's Office of Compliance Inspections and Examinations and the Division of Enforcement plan to continue to make mutual fund share class selection practices a priority, and plan to proactively seek to identify investment advisers that may have failed to make the necessary disclosures related to mutual fund share class selection.[9] Enforcement actions outside of the SCSD Initiative will likely result in the staff recommending violations and remedies beyond those described in the Initiative, including penalties. A settlement against an eligible adviser that fails to self-report under the SCSD Initiative may include greater penalties than those imposed in past cases involving similar disclosure failures. As noted above, assessing whether to recommend enforcement action necessarily involves a case-by-case assessment of specific facts and circumstances.

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[1] The misconduct that we would expect investment advisers to self-report would be similar to the facts outlined in the cases previously brought by the Commission. *See e.g., In the Matter of Packerland Brokerage Services, Inc.,* Investment Advisers Act Rel. No. 4832 (Dec. 21, 2017); *In the Matter of SunTrust Investment Services, Inc.,* Investment Advisers Act Rel. No. 4769 (Sept. 14, 2017); *In the Matter of Envoy Advisory, Inc.*, Investment Advisers Act Rel. No. 4764 (Sept. 8, 2017); *In the Matter of Cadaret, Grant & Co., Inc.*, Investment Advisers Act Rel. No. 4736 (Aug. 1, 2017); *In the Matter of Pekin Singer Strauss Asset Management Inc.*, Investment Advisers Act Rel. No. 4126 (June 23, 2015); *In the Matter of Manarin Investment Counsel, Ltd.*, Investment Advisers Act Rel. No. 3686 (Oct. 2, 2013). The SCSD Initiative is limited to the conduct described in this announcement, and does not concern other (possibly similar or related) conduct (*e.g.*, where one share class is higher-cost than another share class but neither share class pays a 12b-1 fee or where the adviser has no financial conflict of interest). As always, firms can self-report possible violations of the securities laws to the Commission. Self-reported conduct outside the scope of this initiative would not be eligible for this initiative and would instead be evaluated on a case-by-case basis.

[2] Recommendations by the Division to the Commission are subject to approval by the Commission.

[3] 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. As noted below in Section III.C., for purposes of the SCSD Initiative, the Division intends to recommend that the Commission accept settlements that do not include those charges even where the facts would support these charges.

[4] To the extent a Self-Reporting Adviser directly received the 12b-1 fees but was not itself registered as a broker-dealer, the Division (as part of the SCSD Initiative) will not recommend that the Commission charge the

investment adviser with registration violations under Section 15(a) of the Securities Exchange Act of 1934 based on the Self-Reporting Advisers' receipt of 12b-1 fees for its activity before it self reports its conduct to the Division pursuant to the SCSD Initiative.

[5] "Affiliated broker-dealer" means a broker-dealer that is a related person of the adviser as defined in Form ADV.

[6] The Division may grant an adviser an extension of time to submit the questionnaire. To obtain an extension, an adviser must email its request to SCSDInitiative@sec.gov at least two business days before its deadline.

[7] If an investment adviser anticipates submitting a production exceeding 15 mbs, an adviser must send an email to SCSDInitiative@sec.gov at least two business days before its deadline indicating such.

[8] "Affected clients" includes both current and former clients.

[9] *See 2018 National Exam Program Examination Priorities* (Feb. 7, 2018).

Related Materials

- SCSD Initiative Questionnaire
- Attachment to Questionnaire
- Press Release
- Frequently Asked Questions

Modified: May 1, 2018

Exhibit 2

Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation

The following represents the views of the staff of the Division of Investment Management. The following does not alter or amend applicable law and has no legal force or effect, and it creates no new or additional obligations for any person. This is not a rule, regulation, guidance, or statement of the Commission and the Commission has neither approved nor disapproved this information.

Compensation that an investment adviser, its affiliates or its associated persons receives in connection with the investments it recommends and related services it provides can result in the investment adviser having interests that conflict with those of its clients.[1] Many investment advisers appear to have recognized these conflicts and responded through practices designed to address them, including through elimination, disclosure or a combination of disclosure and mitigation. However, SEC examinations staff have observed and enforcement cases have illustrated that, in some instances, investment advisers have not appropriately addressed these conflicts of interest.

In the FAQs below, we discuss certain compensation arrangements and related disclosure obligations arising from both the investment adviser's fiduciary duty and Form ADV.

While the FAQs illustrate the application of these disclosure obligations in the context of certain types of compensation that investment advisers receive, such as 12b-1 fees and revenue sharing,[2] many of the same principles and disclosure obligations apply to other forms of compensation. These may include, among other forms of compensation, an investment adviser's direct or indirect receipt of service fees from its clearing broker-dealer, marketing-support payments from a mutual fund's investment adviser, transaction fees, or receipt of payments from a mutual fund's investment adviser to help defray the costs of educating and training its personnel regarding certain investment products. Depending on the nature of the compensation, the resulting financial incentives would give rise to conflicts relating to, for example, the types of investments, the fund families, the particular funds and the share classes of individual funds that the adviser recommends, as well as the extent of trading it recommends. The staff does not intend the examples below to be comprehensive or to provide model or preferred disclosure language for the compensation arrangements discussed. Market practices evolve regularly, including with respect to compensation arrangements and fund sales practices more generally. Accordingly, the staff encourages investment advisers to be proactive in reviewing their practices concerning the compensation that they, their affiliates or their associated persons receive in connection with the investments they recommend and related services they provide to identify conflicts of interest regardless of whether we specifically identify those practices below.

These FAQs focus on the identification and disclosure of certain conflicts of interest and are not a comprehensive discussion of an investment adviser's fiduciary duty with respect to these or other conflicts. For example, an investment adviser owes its clients a duty of care that requires it to provide investment advice that is in the best interest of the client based on the client's objectives.[3] In addition, investment advisers are required to adopt and implement policies and procedures reasonably designed to prevent violations of the Investment Advisers Act and the rules thereunder.[4] While we do not discuss these obligations here, additional information can be found in the relevant Commission releases on these topics.[5]

If you have questions or would like to provide feedback on these FAQs, or if you have questions the staff should consider for future FAQs, please contact the Division's Chief Counsel's Office at (202) 551-6825 or IMOCC@sec.gov.

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What requirements must an investment adviser consider with respect to disclosure of conflicts of interest related to compensation that it, its affiliates or its associated persons receive in connection with the investments it recommends?[6]

An adviser must look to both its general disclosure obligations as a fiduciary and to the specific disclosure requirements in Form ADV. In particular, in seeking to meet its duty of loyalty as a fiduciary, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship.[7] An adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest that might incline it – consciously or unconsciously – to render advice that is not disinterested.[8]

An adviser that receives, directly or indirectly, compensation in connection with the investments it recommends has a financial incentive to make recommendations that result in the receipt of that compensation.[9] Depending on the nature of the compensation, this financial incentive would give rise to conflicts relating to, for example, the types of investments, the fund families, the particular funds and the share classes of individual funds that the adviser recommends, as well as the extent of trading it recommends. For instance, when an adviser receives, directly or indirectly, 12b-1 fees in connection with mutual fund recommendations, it has a financial incentive to recommend that a client invest in a share class that pays 12b-1 fees. The resulting conflict of interest is especially pronounced when share classes of the same funds that do not bear these fees are available to the client.[10]

Form ADV provides further direction concerning the information that an adviser must disclose about these types of conflicts.[11] For example:

- General Instruction 3 for Part 2 reminds an adviser of its fiduciary duty and the related disclosure obligations described above.
- General Instruction 3 for Part 2 also reminds an adviser that disclosure must include "sufficiently specific facts" to allow clients to understand the adviser's conflicts and business practices and give informed consent or reject them.[12] This may require an adviser to disclose "information not specifically required by" the Form or more detail than the Form otherwise requires. For example, an adviser disclosing that it "may" have a conflict is not adequate disclosure when the conflict actually exists.[13]
- General Instruction 2 for Part 2 instructs advisers that, if a conflict or practice exists with respect to only certain classes of clients, advice or transactions, an adviser must "indicate as such rather than disclosing that [the adviser] 'may' have the conflict or engage in the practice."[14] For example, if an adviser engages in a practice of recommending share classes with 12b-1 fees for clients in one advisory program, the adviser must fully disclose the practice with respect to that program even if it represents a minority of the adviser's assets under management.

Several items on Form ADV provide additional, relevant instruction. For example:

- Under Item 5.E of the firm brochure (Part 2A of Form ADV), an adviser must disclose if it or its supervised persons accepts sales compensation, including asset-based sales charges or service fees. This item includes several specific disclosures, including information about the conflict, how the adviser addresses the conflict and whether the adviser offsets the compensation against its advisory fees.
- Item 4 of the brochure supplement (Part 2B of Form ADV) requires an adviser to disclose other business activities of its supervised persons. Under Item 4.A(2), if an adviser's supervised person "receives commissions, bonuses or other compensation based on the sale of securities or other investment products, including as a broker-dealer or registered representative, and including distribution or service ('trail') fees from the sale of mutual funds, [the adviser must] disclose this fact" in its brochure supplement.

An adviser's fiduciary duty and these instructions require the adviser to disclose in Form ADV the conflict of interest that results when it receives compensation, directly or indirectly, in connection with the investments it recommends.[15] Where this conflict exists, an adviser must also disclose how it addresses the conflict.[16] An adviser's fiduciary duty may also require it to make disclosures to clients that are in addition to those required in Form ADV.[17] An adviser should consider these disclosure obligations with respect to both recommendations to purchase and recommendations to continue holding an investment.[18]

Advisers should bear in mind that the brochure is, first and foremost, a document "designed to promote effective communication between [an adviser] and [its] clients."[19] The SEC intended brochures to be concise, direct, appropriate to the level of financial sophistication of the adviser's clients and written in plain English. As a result, *longer* disclosures may not be *better* disclosures.

What are some examples of material facts that, in the staff's view, an adviser should disclose about its practices related to recommending investments or services with different adviser compensation characteristics, such as mutual fund share classes, and the related conflicts, if applicable, in light of the principles and disclosure requirements discussed above?

The general disclosure obligations arising from the availability of multiple mutual fund share classes are well-established and are illustrative of the principles that apply to compensation-related conflicts more generally. An adviser has a conflict of interest that it must disclose when more than one mutual fund share class is available to a client and the adviser receives, directly or indirectly, compensation based on the share class it recommends.[20] An adviser that has this conflict of interest should carefully consider the material facts that it needs to disclose in light of the requirements and principles discussed above.[21]

In the course of administering Form ADV, as well as conducting compliance examinations and enforcement investigations, the staff has observed a range of practices with respect to this type of disclosure. Following are some examples of material facts that, in the staff's view, an adviser should disclose about its practices and conflicts, if applicable. These disclosures should be concise and in plain English. This is not a comprehensive list, and an adviser may need to disclose different or additional facts depending on its circumstances.

Examples of material facts related to share class conflicts:

- *The existence and effect of different incentives and resulting conflicts*.
    - 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, transaction fees and ongoing fees would affect a client's investment returns over time.

  - The fact that the adviser has financial interests in the choice of share classes that conflict with the interests of its clients.
- *The nature of the conflict.*
  - For example, whether the conflict arises: (a) as a result of differences in the compensation the adviser and its affiliates receive; or (b) from the existence of any incentives shared between the adviser and the clearing broker or custodian (such as offsets, credits, or waivers of fees and expenses).
  - Whether there are any limitations on the availability of share classes to clients that result from the business of the adviser or the service providers that the adviser uses. These may include, for example:
    - Limitations that a fund or the adviser's clearing broker or custodian imposes (for instance, where a custodian's platform only makes certain share classes available or a fund or platform has minimum investment requirements);[22] and
    - Limitations that the adviser imposes (for instance, by type or class of clients, advice, or transactions).
  - Whether an adviser's practices with regard to recommending share classes differs when it makes an initial recommendation to invest in a fund as compared to: (a) when it makes recommendations regarding whether to convert to another share class; or (b) when it makes recommendations to buy additional shares of the fund. For example, the adviser could consider disclosing its practices for reviewing, in conjunction with its periodic account monitoring, whether to convert mutual fund investments in existing or acquired accounts to another share class.
- *How the adviser addresses the conflict.*
  - The circumstances under which the adviser recommends share classes with different fee structures and the factors that the adviser considers in making recommendations to clients.
    - For example, where the adviser would bear the cost of a transaction fee, how the adviser evaluates the differences between, on the one hand, a share class with a 12b-1 fee but no transaction fee and, on the other, a share class of the same fund with a transaction fee but no 12b-1 fee.
  - 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 and/or sales charges), the impact of such offsets or rebates, and whether that practice

differs depending on the class of client, advice, or transaction (e.g., with regard to clients whose accounts are subject to the Employee Retirement Income Security Act of 1974 or clients with individual retirement accounts).

Similar to an investment adviser's receipt of 12b-1 fees, the receipt of revenue-sharing payments creates incentives for investment advisers that, in turn, give rise to conflicts of interest. In addition to the principles and disclosure requirements discussed above, as relevant, what particular Form ADV disclosure requirements relate to an adviser's receipt of revenue-sharing payments?

Under Item 14.A of Part 2A of Form ADV, if someone who is not a client provides an economic benefit to an adviser for providing investment advice or other advisory services to its clients, the adviser must generally describe the arrangement, explain the conflicts of interest, and describe how it addresses the conflicts of interest.[23] For example, an adviser that receives payments from a custodian based on the value of client assets maintained at that custodian would have to provide disclosure in response to this item.[24]

What are some examples of material facts that an investment adviser should disclose about its practices related to revenue-sharing arrangements, if applicable?

Following are some examples of material facts that, in the staff's view, an adviser should disclose about its practices and conflicts, if applicable. These disclosures should be concise and in plain English. This is not a comprehensive list, and an adviser may need to disclose different or additional facts depending on its circumstances and how its practices change over time. These examples are in addition to the examples provided above with respect to disclosure, generally, about practices related to recommending share classes and the related conflicts, as applicable.

- The existence of any incentives provided to the adviser or shared between the adviser and others (e.g., clearing brokers, custodians, funds' investment advisers or service providers). For example:
  - Any agreements to receive payments from a clearing broker for recommending that clients invest in no-transaction-fee mutual fund share classes offered on the clearing broker's platform, as well as any agreements to receive payments from the clearing broker for recommending that the adviser's clients invest in 12b-1-fee-paying share classes; and
  - Any agreements to receive payments and/or expense offsets from a custodian for recommending that the adviser's clients maintain assets at the custodian.
- As with the receipt of 12b-1 fees, an adviser disclosing that it "may" have a conflict as the result of receiving revenue-sharing

payments is not adequate when the conflict actually exists.

If an investment adviser materially amends or supplements its disclosures concerning share class recommendations or revenue sharing arrangements in an annual update, is it required to highlight the new disclosure in its Form ADV's summary of material changes?

Yes. Form ADV requires, in Item 2 of Part 2A, that, if an adviser is amending its brochure for its annual update and the brochure contains material changes from its last annual update, the adviser must identify and discuss those changes. The adviser may include this disclosure on the cover page of the brochure, on the page immediately following the cover page, or as a separate document accompanying the brochure.

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[1] See note 9, below, explaining that compensation may take a variety of forms.

[2] The share classes of a mutual fund all represent an interest in the same investment holdings, but each class has different fees and expenses. Often, one or more share classes will include 12b-1 fees – ongoing fees paid out of mutual fund assets – to pay for fund distribution and shareholder services, while others will pay for distribution differently or provide for fewer shareholder services. In this way, the availability of different mutual fund share classes can allow an investor, or the investor's investment adviser, to select a fee and expense structure that best fits the investor's particular investment goals. At the same time, an investment adviser that receives, directly or indirectly, 12b-1 fees or revenue sharing in connection with investments that it recommends to clients has a financial incentive to recommend that a client invest in share classes that pay 12b-1 fees or that will generate revenue sharing. The resulting conflict of interest is especially pronounced when multiple share classes of the same fund are available to the client and provide different compensation to the adviser because the share classes differ only in their (direct or indirect) costs to the client and their benefits to the adviser.

[3] *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248 (June 5, 2019) ("Fiduciary Interpretation"), at 8 and 12 and discussion that follows page 12.

[4] Rule 206(4)-7 under the Investment Advisers Act.

[5] *See, e.g., Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) (adopting Rule 206(4)-7).

[6] We use "recommendation" here to include both an adviser's recommendation of an investment to a non-discretionary account and its selection of an investment on behalf of a discretionary account.

[7] *See SEC v. Capital Gains Research Bureau,* 375 U.S. 180, 194 (1963) ("Capital Gains") and Fiduciary Interpretation.

[8] *Capital Gains,* at 191-92; *see also* Fiduciary Interpretation.

[9] We use "compensation" here to also include the reduction or avoidance of expenses that an investment adviser incurs or otherwise would incur.

[10] When we refer to advisers receiving 12b-1 fees or other compensation "directly or indirectly," we are including (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.

When we refer to "available" share classes, we are including all share classes 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.

[11] In addition to the Part 2A brochure requirements we discuss here, beginning in the summer of 2020, advisers will be required to deliver a relationship summary (Form ADV, Part 3) to retail investors that will briefly summarize the adviser's services, fees and costs, and conflicts of interest, among other topics. *See Form CRS Relationship Summary; Amendments to Form ADV*, Investment Advisers Act Release No. 5247 (June 5, 2019).

[12] *See also* Fiduciary Interpretation at 24 ("In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent.") (citing, among other things, *In the Matter of Arleen W. Hughes,* Exchange Act Release No. 4048 (Feb. 18, 1948) (Commission Opinion)).

[13] *See* Fiduciary Interpretation at 25. The SEC has brought enforcement actions in such cases. *See, e.g., In the Matter of The Robare Group,* Investment Advisers Act Release No. 4566 (Nov. 7, 2016) (Commission Opinion) (finding, among other things, that an adviser's disclosure that it *may* receive a certain type of compensation was inadequate because it did not reveal that the adviser actually had an arrangement pursuant to which it received fees that created a conflict of interest); *aff'd in relevant part by Robare Group v. SEC*, 922 F.3d 468 (D.C. Cir. 2019) (denying petition challenging the SEC's finding that the Petitioners violated Section 206(2) of the Advisers Act). *See also SEC v. Westport Capital Markets,* slip op. (D. Conn. Sept. 30, 2019) (in granting summary judgment to the Commission on Section 206(2) claim, the court noted that the adviser's Form ADVs "warned clients that [the adviser and

its principal] *might* be deriving additional compensation from their trading activities on the clients' behalf . . . [but] did not advise the clients that they were *actually* doing so, much less how they were specifically doing so by [,among other things,] . . . garnering 12b-1 fees from mutual fund transactions") (emphasis in original).

[14] *See also* Fiduciary Interpretation at 25 ("For example, we would consider the use of 'may' inappropriate when the conflict exists with respect to some (but not all) types or classes of clients, advice, or transactions without additional disclosure specifying the types or classes of clients, advice, or transactions with respect to which the conflict exists.").

[15] For example, an adviser would need to disclose the conflict of interest that results when more than one share class of a mutual fund is available to a client and the adviser receives, directly or indirectly, compensation based on the share class it recommends.

[16] *See* Item 5.E of Part 2A of Form ADV. Advisers should also be aware that the recommendation of a higher-cost share class when a lower-cost class of the same fund is available to the client could violate an adviser's duty of care, including, depending on the facts and circumstances, its obligation to seek best execution. *See* Fiduciary Interpretation, Part II.B, including the Commission releases cited at footnotes 45-48 (discussing an adviser's duty of care, including its obligation to seek best execution). The SEC has also brought a number of enforcement cases regarding best execution in the context of recommendations of mutual fund investments. *See, e.g., In the Matter of American Portfolios Advisors*, Investment Advisers Act Release No. 5083 (Dec. 20, 2018) (settled order) and *In the Matter of Manarin Investment Counsel, Ltd.*, Advisers Act Release No. 3686 (Oct. 2, 2013) (settled order).

[17] *See Robare Group*. 922 F.3d at 478 (discussing adviser's and its principals' obligation to disclose revenue-sharing arrangements and stating, "regardless of what Form ADV requires, [the adviser and its principals] had a fiduciary duty to fully and fairly reveal conflicts of interest to their clients").

[18] For example, an adviser that has an ongoing relationship with a client would be monitoring the client's account and determining, periodically, whether to recommend changing investments or continuing to hold investments. This would be the case regardless of whether the adviser made the initial recommendation with respect to the investments in the account.

[19] General Instruction 2 for Part 2 of Form ADV. *See also* Fiduciary Interpretation at 25 ("Whether . . . disclosure is full and fair will depend upon, among other things, the nature of the client, the scope of the services, and the material fact or conflict.").

[20] *See supra* text at notes 9 and 10.

[21] *See also* Fiduciary Interpretation (an adviser must fully and fairly

disclose material facts relating to the advisory relationship). In addition, in *In the Matter of IFGNetworkSecurities*, Exchange Act Release No. 54127 (July 11, 2006) (Commission opinion), the Commission made clear that an investment's return is a material fact: "The rate of return of an investment is important to a reasonable investor. In the context of multiple-share-class mutual funds, in which the only bases for the differences in rate of return between classes are the cost structures of investments in the two classes, information about this cost structure would accordingly be important to a reasonable investor. . . ."

[22] *See* note 10, above, regarding the availability of share classes.

[23] Item 9.B of Part 2A, Appendix 1 also requires an adviser's wrap fee program brochure to respond to Item 14 of Part 2A.

[24] *See also* Item 5.E of Part 2A of Form ADV (if an adviser or a supervised person of the adviser receives compensation for the sale of securities, including asset-based sales charges or service fees from the sale of mutual funds, it must disclose this).

Modified: Oct. 18, 2019