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. 4-761

REPLY COMMENT OF PETITIONER FINANCIAL SERVICES INSTITUTE IN SUPPORT OF PETITION FOR RULEMAKING

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INTRODUCTION

Investment advisers, like all Americans, have a right to be governed only by duly enacted statutes and the regulations lawfully promulgated pursuant to those statutes—and most importantly, to know what conduct is prohibited *before* the Securities and Exchange Commission pursues them for allegedly unlawful conduct. That is why the Financial Services Institute ("FSI") and a broad alliance of industry and public interest organizations petitioned the SEC to rethink the "different"—what the Commission euphemistically calls "innovative"—approach to enforcement employed in the "Share Class Selection Disclosure Initiative" and related "guidance" (the "Initiative," for short). Stephanie Avakian, Co-Director, Div. of Enforcement, Measuring the Impact of the SEC's Enforcement Program (Sept. 20, 2018), https://bit.ly/2XrdCsB; Jay Clayton, Chairman, Testimony on Oversight of the U.S. Securities and Exchange Commission (Dec. 11, 2018), https://bit.ly/2Pn55m4.

As the Petition explains, the Initiative declared that virtually every investment adviser had been violating federal law, presumably for decades, based on a disclosure regime that—until that point—no one, including the Commission, had ever heard of. *See* Petition for Rulemaking to End the Commission's Backdoor Regulation of 12b-1 Fees (Apr. 29, 2020) (the "Petition"). The Initiative coined a new standard of conduct, reversing decades of longstanding, widespread, and previously uncontroversial business practices—all outside the rulemaking process prescribed by Congress. And it imposed that newly-minted standard *retroactively*, punishing scores of firms—to the tune of $125 million—for conduct that no one at the time knew, or even could have known, was supposedly unlawful. *Id.* at 12. That is not how the rule of law is supposed to work, which is why the Petition urged the SEC to initiate a rulemaking to bring its enforcement activities into compliance with applicable law.

In the four months since then, the Commission has not yet responded to FSI's Petition. Instead, it has doubled down on its ever-expanding effort to regulate without rulemaking. The agency launched new enforcement actions, continuing to target firms that had run afoul of the Initiative's edicts. *See, e.g.*, *Signature Fin. Servs., Ltd.*, Advisers Act Release No. 5571, 2020 WL 5290845 (Sept. 3, 2020); *SCF Investment Advisors, Inc.*, Advisers Act Release No. 5560, 2020 WL 4720542 (Aug. 13, 2020); *NPB Fin. Grp., LLC*, Exchange Act Release No. 89,624, Advisers Act Release No. 5562, 2020 WL 4903776 (Aug. 20, 2020); *VALIC Fin. Advisors, Inc.*, Exchange Act Release No. 89,407, Advisers Act Release No. 5551, 2020 WL 4339269 (July 28, 2020); SEC Charges Investment Adviser and Principals for Breaching Fiduciary Duties, Litigation Release No. 24,817 (May 13, 2020), https://bit.ly/31nH6ZP. It defended similar actions previously filed. *See, e.g.*, Pl.'s Mot. to Strike Def.'s Second Affirmative Defense, *SEC v. Cetera Advisors LLC*, No. 1:19-cv-2461 (D. Colo. July 1, 2020), ECF No. 70 ("Mot. to Strike"). And it turned its flawed regulation-by-enforcement tactics on other widespread, historically uncontroversial practices, including advisers' use of bank or brokerage sweep accounts. *See, e.g.*, *SCF Investment Advisors*, 2020 WL 4720542, at *3–5; *see also* Pet. 3, 38;

infra pp. 17–19. All to impose policy preferences that the Commission could never enact—and has never enacted—through the proper channels. All the while, the Consumer Federation of America ("CFA") cheered the Commission's regulatory "vigor[ ]," not only opposing FSI's Petition but encouraging the agency to unlawfully retaliate against FSI's members (with "special scrutiny") for daring to question the Commission's approach at all. Letter from Barbara Roper, Director of Investor Protection, CFA, File No. 4-761, at 7 (June 15, 2020) ("CFA Comments").

FSI respectfully responds to these developments, which confirm the need for corrective rulemaking. For all their defenses of the SEC's conduct, the recent filings by the Commission and the CFA are astonishingly bereft of the one thing that matters: a single statute, regulation, or litigated case that has *ever* mentioned the detailed disclosures that the Initiative claims are, and always have been, required. Not one. This silence speaks volumes, and validates what FSI has said from the outset: the Commission has been wielding the Initiative to coerce compliance with a novel standard that—whatever its (in our view, questionable) merits, *see* Pet. 5–6—is simply not required by federal law.

For the reasons below and in FSI's Petition, it is time for the Commission to abandon its campaign of guerilla governance. More than time. The Commission should initiate a rulemaking to bring its regulation out of the shadows and to make clear—once and for all—that all Americans are bound only by duly enacted statutes and the regulations lawfully promulgated thereunder through the rulemaking process that the people's elected representatives have prescribed. Extralegal "guidance" is not the law—no matter how much an agency wishes it were.

DISCUSSION

I. The Commission Should Grant The Petition And Initiate A Rulemaking To End The Agency's Backdoor Regulation Of Rule 12b-1 Fees.

The Commission should grant FSI's Petition—now more than ever. The failure of both the Commission and the CFA to locate a single statute, regulation, or litigated case that has ever mentioned the Initiative's dictates is proof positive that the Initiative is a form of extralegal rulemaking—and a dangerous one at that. Recent developments have only underscored the case for corrective action. As the nation reels from the effects of the COVID-19 pandemic, the markets crave certainty—an essential component of any economic recovery that is undermined by the Commission's insistence on announcing, and retroactively enforcing, novel regulatory requirements outside the proper channels. A course correction is needed, and the Petition shows the way.

A. No Statute, Rule, Or Litigated Case Has Ever Required The Type Of Disclosure Mandated By The Initiative.

The fundamental flaw with the Commission's Initiative is that it announces a new standard of conduct outside the rulemaking process, and that it seeks to impose that standard retroactively, punishing firms for conduct that has already occurred.

1. As the Petition explains, the Commission is targeting Rule 12b-1 fees—the fees that mutual funds use to compensate financial advisers for ongoing sales and marketing assistance. Pet. 4. Different classes of mutual fund shares come with different cost structures, including different 12b-1 fees. This diversity offers investors (and the advisers acting on their behalf) different ways to pay a fund's expenses. Some share classes offer high "front-end" loads—a fee that pays a financial adviser's entire remuneration up front—with lower or even no annual 12b-1 fees. *Id.* at 5. Other share classes offer no load, with higher 12b-1 fees. *Id.* And others, still, offer everything in between. *Id.* Many 12b-1-fee-paying share classes, for example, were offered as part of a "no transaction fee" program, where investors avoided transaction costs altogether. *See, e.g.*, *VALIC Fin. Advisors*, 2020 WL 4339269, at *1. The total cost to an investor of holding a particular share class thus depends not only on the fees, but on other factors, including how the fees are structured, whether other costs are waived, and for how long the investor holds the security. Pet. 6.

That is why investment advisers have long had discretion, consistent with their fiduciary duty, to place their customers in the share classes that best serve each customer's specific needs. To be sure, the availability of 12b-1-fee-paying shares could create a conflict of interest for the adviser. But that potential conflict has long been known and addressed in the same manner as other potential conflicts: with disclosure. Accordingly, for decades, investment advisers have informed their clients in simple, straightforward terms that, because the adviser receives 12b-1 fees in connection with a client's investment, the adviser faces a conflict: to recommend mutual funds that pay a higher fee. Pet. 11. No statute, regulation, or litigated case had ever questioned these straightforward disclosures. *Id.* And they became the standard method of discussing 12b-1 fees, as the Commission has known for years. *See, e.g.*, 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, 4555 (Jan. 26, 2009) (specifically declining to address "alternative terms to describe . . . rule 12b-1 fees"); Letter from Seth Miller, Gen. Counsel & Chief Risk Officer, Cambridge Investment Research Advisors, Inc., File No. 4-761, at 3 (July 29, 2020) ("CIRA Comments") ("In 2016 . . . the examination staff specifically reviewed CIRA's ADV disclosure language related to share class selection and conflicts of interest.").

The Initiative changed all that—overnight. After failing to "reexamine" (2002), "refashion" (2004), or "replace" (2010) Rule 12b-1 fees through conventional channels, *see* Pet. 7 (citations omitted); *see also id.* at 7–9 (documenting Commission efforts), the Commission declared that virtually every recipient of these fees had actually been violating federal law for decades. Although investment advisers had long disclosed that they received 12b-1 fees and that receipt of those fees presented a potential conflict of interest, the Commission claimed that investment advisers were *also* required to state, in very particular terms, that less expensive share classes were available. *Id.* at 11–12. And because no one had ever given such a granular disclosure, every investment adviser—in realization of the Commission's failed, decade-long crusade to "clean[ ] out"

12b-1 fees, *id.* at 8 (quoting Chairman Cox)—had to refund them. Or so the Initiative claimed.

2. The Initiative's novel disclosure requirement, however, stretched the concept of "conflict disclosure" beyond all recognition. It did not merely "clarify or remind" investment advisers of their "preexisting duties." *Mendoza v. Perez*, 754 F.3d 1002, 1022 (D.C. Cir. 2014). Nor did it "'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)). Far from it. 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 the divergence were absent. Conflict disclosure thus requires identifying information about *a transaction*, not information about specific *alternative transactions* 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.

By requiring investment advisers to go further and discuss the terms of possible alternative investments, the Initiative "supplement[ed]" the existing regulatory regime, "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. That is a "rule." Pet. 25. And in our system of government, a rule such as the standards announced in the Initiative should have been issued through notice-and-comment rulemaking, should have been submitted to Congress for review, and should have been discussed with the

Office of Information and Regulatory Affairs. *See id.* 24–33. And in no event should the Commission have attempted to apply such a rule retroactively. *See id.* 33–38.

3. The Commission and the CFA, in recent filings, defend the Commission's actions, claiming that the standards announced in the Initiative really "existed well before 2012." Mot. to Strike 1; *see also* CFA Comments 2 ("the Commission has simply been engaged in enforcing well-established and long-recognized fiduciary obligations"). But, tellingly, neither the Commission nor the CFA cite a single source that says so.

a. Take the Commission. *See* Mot. to Strike 7–8. Its cited cases concern misleading recommendations, *see IFG Network Sec., Inc.*, Exchange Act Release No. 54,127, Advisers Act Release No. 2533, 2006 WL 1976001, at *10 (July 11, 2006), or principal transactions with a customer, *see German v. SEC*, 334 F.3d 1183, 1189 (10th Cir. 2003); *Arleen W. Hughes*, Exchange Act Release No. 4048, 1948 WL 29537, at *5 (Feb. 18, 1948); they do not addresses the situation at issue here, where an investment adviser accurately describes a transaction, but stops short of detailing other, alternative transactions. Indeed, the very fact that the Commission relies on such far afield authority confirms that the Initiative's "requirements" were never requirements at all.

The Commission's retreat to Section 206(2) of the Investment Advisers Act, 15 U.S.C. § 80b-6(2), the general anti-fraud provision, only confirms that advisers are expected to disclose the terms of *the proposed* transaction, not *alternative* terms that might be available in the absence of a conflict. As the Commission states, Section 206(2) has been interpreted to create a "fiduciary duty" between an investment adviser and its client. Mot. to Strike 6; *see SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191 (1963) ("The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship' . . . ." (citation omitted)). "The federal fiduciary standard," in turn, "focuses on the avoidance or disclosure of conflicts of interest between the investment adviser and the advisory client." *Belmont v. MB Inv. Partners, Inc.*, 708 F.3d 470, 503 (3d Cir. 2013). That means that an investment adviser "may benefit from a transaction to a client if, and only if, that benefit and all related details *of the transaction* are fully disclosed." *Id.* (emphasis added). There is no obligation to disclose the details of *other* possible transactions.

The Commission's own rules reflect this. Part 2 of Form ADV requires advisers to disclose compensation practices that "present[ ] a conflict of interest"—that is, practices that give the adviser "an incentive to recommend investment products based on the compensation received, rather than on a client's needs." Amendments to Form ADV, Advisers Act Release No. 3060, 2010 WL 2957506, at *80 (Aug. 12, 2010), *cited with approval in* Mot. to Strike 9. A properly informed client, the Commission explains, can "choose advisers based on affiliations and compensation methods" or "seek modifications to an investment advisory agreement to better protect the client against an investment adviser's potential conflict of interest." 2010 WL 2957506, at *2. There is no suggestion that disclosing a conflict entails disclosing possible alternative transactions.

All of this is presumably why the Commission has trotted out an alternative theory of liability: that use of conditional language in a firm's disclosures—the word "may"—is *also* inadequate. This, too, is off base. In *Cetera*, for example, the adviser disclosed that it "*may* invest in load and no-load mutual funds that *may* pay the firm . . . 12(b)-1 fees," and that, as a result, the adviser "'*may* have an incentive' to recommend more expensive funds." SEC's Opp'n to Mot. to Dismiss 22–23, *SEC v. Cetera Advisors LLC*, No. 1:19-cv-2461 (D. Colo. Feb. 4, 2020) (alteration in original). The Commission says that this type of disclosure is misleading because the firm "*did* invest" in 12b-1-fee-paying funds. *Id.*; *see also id.* at 26 (citing Amendments to Form ADV, 2010 WL 2957506, at *74). But it is *the Commission's* preferred disclosure—not the adviser's—that is inaccurate. Not all advisory customers invest in mutual funds, and not all mutual funds pay 12b-1 fees. So "may" is right: the adviser "may" invest his client in a mutual fund that "may" pay 12b-1 fees, which "may" give the adviser an incentive to invest in a more expensive fund. Or, depending on the investment decisions made by the client, the adviser may not.

There is nothing more to say, and the law does not require anything more. Again, the Advisers Act creates a "fiduciary" relationship between an adviser and his client—a relationship that requires the adviser to disclose certain "material facts." *Capital Gains*, 375 U.S. at 194. "There is no requirement," however, "that a material fact be expressed in certain words or in a certain form of language." *SEC v. Siebel Sys., Inc.*, 384 F. Supp. 2d 694, 705 (S.D.N.Y. 2005) (quoting *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 584

F.2d 1195, 1200 (2d Cir. 1978)). "Fair accuracy, not perfection, is the appropriate standard." *Id.* (quoting *Kennecott*, 584 F.2d at 1200). And here, the word "may" fairly tells an investor what he or she needs to know: Because the adviser "may" invest in a fund that "may" pay 12b-1 fees, the investor is alerted to the potential conflict and may act accordingly. No reasonable speaker of English would be thrown by the metaphysical distinction between "may" and "will," which is why the Commission itself often conflates the two—*and has done so in the very Initiative that is the subject of FSI's petition*. *Compare* Pet. Ex. 1 (the Initiative) at 6 (the Commission "*may* include greater penalties" (emphasis added)), *with* 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 (quoting Co-Director of Enforcement: "we promise that if we find [you] later we *will* punish [you] more severely" (emphasis added)). Where, as here, the Commission itself uses these two words interchangeably, it should not be "nit-picking" the usage of others. *Siebel Sys.*, 384 F. Supp. 2d at 705 (quoting *Kennecott*, 584 F.2d at 1200).

b. The SEC is not the only entity that can't find binding authority to support the broad disclosure requirements announced in the Initiative. The CFA fails as well. That group, to be sure, lets fly an onslaught of hyperbole: FSI's complaint that the Initiative has no basis in law is, in the CFA's view, "absurd," "entirely without factual basis," "disturbing" (three appearances), "a farce," "tortured" (two appearances), "baseless," and would "absolve advisers of any obligation to act in their client's best interest." *See* CFA Comments 1, 2, 4, 6. But for all its talk, the CFA fails to identify a single statute, regulation, or litigated case that would prove FSI wrong. The CFA does not even try. *See* CFA Comments *passim* (discussing no cases).

The CFA, instead, turns to a parade of horribles. It declares that "[i]f the Commission were to adopt" the "tortured logic" in FSI's "rulemaking petition, [the agency] would be unable to bring enforcement actions for violations of principles-based rules without first going through a separate notice-and-comment rulemaking process to define each example of non-compliance as an explicit violation of the standard." CFA Comments 1; *see also id.* at 6. That is just not true. FSI, in fact, favors principles-based regulation, as the CFA admits. *See id.* at 6; *see also, e.g.*, Letter from David. T. Bellaire, Exec. Vice President & General Counsel, FSI, File No. S7-07-18, at 6 (Aug. 7, 2018) ("We support the SEC's principles-based approach"). The problem with the Initiative is, therefore, not that it's principles-based, it is that it *departs*, without warning, from those principles. The principle underlying the Initiative is clear: an investment adviser owes a "fiduciary duty" to its clients. *Capital Gains*, 375 U.S. at 191. As shown above, however, that principle only requires disclosure of material facts concerning "*the transaction*," not *other* possible transactions. *Belmont*, 708 F.3d at 503 (emphasis added).

If the Commission wants to create a *new* principle—one that encompasses a broader disclosure regime—it is free to offer such a proposal. But it must use the rulemaking procedures that Congress has prescribed. *That* is the point of FSI's Petition—a point the Commission has previously embraced. The CFA, for example, is not the first group to "suggest[ ] . . . alternative terms to describe . . . rule 12b-1 fees." 74

Fed. Reg. at 4558. The issue has come up before. And in the last go-around, the Commission itself acknowledged that it would be "more appropriate to consider [such] changes," not in one-off decrees, as the CFA now supports, but "in the context of a full reconsideration of . . . rule 12b-1." *Id.* at 4555–56. The Commission had it right then: if the agency really wants to change the way the industry has described 12b-1 fees for decades, it should put out a proposal for comment and hear what the public has to say.

4. Indeed, as the Petition documents, the Commission has had multiple opportunities over the last two decades to require the type of share class-specific disclosure that the Initiative now demands. *See* Pet. 37. 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," Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26,591, 69 Fed. Reg. 54,728, 54,728 (Sept. 9, 2004). 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. And in 2010, the Commission proposed a "new regulatory framework" for 12b-1 fees, including a provision aimed at "improv[ing] disclosure designed to enhance investor understanding of [sales] charges." Mutual Fund Distribution Fees, 75 Fed. Reg. 47,064, 47,064–65 (Aug. 4, 2010).

But in each case, the Commission declined to "adopt[ ] any further changes to rule 12b-1." 69 Fed. Reg. at 54,731; *see also* 74 Fed. Reg. at 4555 (declining to adopt additional 12b-1 disclosures); Pet. 9 (explaining that the 2010 rulemaking was abandoned). Not one of those rulemakings, however, makes an appearance in the Commission's or the CFA's filings—and for obvious reason: they show that the standard the Commission is now trying to enforce through the Initiative is really just a rule by another name. This is quintessential rulemaking-by-enforcement, *see Appalachian Power Co. v. EPA*, 208 F.3d 1015, 1020 (D.C. Cir. 2000), and, as the Petition explains, it needs to stop, *see* Pet. 21–24; *see also* Petition for Rulemaking to Promulgate Regulations Prohibiting the Issuance, Reliance on, or Defense of Improper Agency Guidance, File No. 4-726 (July 30, 2018) (raising similar issues).

B. Recent Events Underscore The Need For Corrective Rulemaking.

The case for a corrective rulemaking is even stronger today than it was when FSI filed the Petition in April. Since then, the President of the United States has ordered a sweeping deregulatory effort to jumpstart the national economy in the wake of the ongoing COVID-19 pandemic. *See* Exec. Order No. 13,924, 85 Fed. Reg. 31,353 (May 22, 2020). And the Chairman of this Commission has vowed to help: "preserving the flows of credit and capital in our economy" is the Commission's "overriding" priority.

Jay Clayton, Chairman, 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://bit.ly/30wHRjN ("Deep and Essential Connections"). That will add both "speed and strength[ ] [to] our recovery." *Id.*

In these circumstances, continued enforcement—on a retroactive basis, no less—of a novel regulatory standard that has never been mentioned in any rule and that an entire industry has apparently been violating, without Commission comment, for decades, is the exact opposite of what the SEC should be doing. Yet, in recent months, the Commission's staff has only become *more* aggressive in pushing the Initiative and related actions, underscoring the need for corrective action—now.

1. Continued Enforcement Of The Initiative Is Inconsistent With The Administration's Pandemic Priorities And Policies.

This nation is "facing an unprecedented national challenge—a health and safety crisis that requires all Americans, for the sake of all Americans, to significantly change their daily behavior and, for many, to make difficult personal sacrifices." Clayton, Deep and Essential Connections. This crisis has wreaked havoc on the national economy, "disrupt[ing] the lives of [all] Americans." Exec. Order No. 13,927, 85 Fed. Reg. 35,165, 35,165 (June 9, 2020). In just two months, "more than 41 million Americans filed for unemployment," *id.*, and vast swaths of the citizenry has found itself subject to various state-implemented shelter-at-home orders. Business has paid a price.

The Administration, however, is fighting back. "It is the policy of the United States to combat the economic consequences of COVID-19 with the same vigor and resourcefulness with which the fight against COVID-19 itself has been waged." Exec. Order No. 13,924, 85 Fed. Reg. at 31,353. Accordingly, agencies across the federal government, including the Commission, have been ordered to address the "economic emergency by rescinding, modifying, waiving, or providing exemptions from regulations and other requirements that may inhibit economic recovery." *Id.* These agencies also must "give businesses . . . the confidence they need to reopen . . . by recognizing the efforts of businesses to comply with often-complex regulations in complicated and swiftly changing circumstances," and "by committing to fairness in administrative enforcement." *Id.* at 31,353–54. In short, this is not the time for an aggressive rewriting of federal law to reverse longstanding, widespread, and previously uncontroversial business practices—all outside the rulemaking process prescribed by Congress.

To the contrary, this is a time for regulatory certainty. *Cf.* Jay Clayton, Chairman, Testimony Before the Investor Protection, Entrepreneurship, and Capital Markets Subcommittee, U.S. House Committee on Financial Services (June 25, 2020), https://bit.ly/30yBwo5 (lamenting the "uncertainty in our capital markets"). As "extraordinary volumes and volatility" roil our markets, investors increasingly need professional advisers to guide them. Jay Clayton, Chairman, Capital Markets and Emergency Lending in the COVID-19 Era (June 25, 2020), https://bit.ly/2C6HumO. And as those advisers "transition most or all of their staff to remote work environments," FINRA Regulatory

Notice 20-16, at 1 (May 28, 2020), an entirely "different way[ ]" of operating, Clayton, Deep and Essential Connections, the firms have little room for added distraction.

And so, if there were ever a time for the Commission to make clear that regulated entities are bound only by actual law—the statutes and regulations that legitimately govern them—not the staff's *opinion* on what the law should be, this is it. After all, if the Commission did not think a redo of Rule 12b-1 was warranted in 2004, 2007, 2009, or 2010 through conventional means, *see* Pet. 8–9, then surely no redo is appropriate now, in the midst of a global pandemic, especially through the "innovative" tactics used to enforce the Initiative.

2. A Corrective Rulemaking Is Needed To Rein In The Staff's Increasingly Aggressive Enforcement Tactics.

The Commission should initiate a rulemaking to bring the Initiative and related enforcement endeavors into compliance with applicable law. The staff, for its part, has shown no indication that it will back off its improper "regulation by enforcement" on its own. If anything, the staff is doubling down. As the Petition explains, the staff has already turned its attention to other longstanding, widespread, and previously uncontroversial business practices, including revenue sharing, Pet. 39, and mark-ups of clearing firm charges, *see, e.g.*, Complaint ¶ 7, *SEC v. Cetera Advisors LLC*, No. 9-cv-2461 (D. Colo. Aug. 29, 2019), 2019 WL 4265066 (targeting certain mark-ups of charges by clearing brokers). And as part of that assault on other aspects of firms' pricing models, the staff has actually been 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." Pet. 39. "That is blatantly unfair and inappropriate." *Id.*

It is also counterproductive. Through this never-ending parade of enforcement actions, the Commission has been picking apart firms' pricing models one piece at a time. First it was 12b-1 fees. Then revenue sharing. Now sweep accounts, and who knows what will be next. With each novel addition to the regulatory arena, the Commission has sent firms back to the drawing board—to redo their Form ADVs, to restructure their pricing plans, and to rearrange their brokerage, clearing, and advisory relationships. This is costly and, more importantly, time consuming. If the Commission really believes that there are issues in the disclosure of mutual fund fees, then it should initiate a single rulemaking to resolve these issues. *Cf.* 74 Fed. Reg. at 4555 ("[S]ome commenters suggested that we consider alternative terms to describe sales loads or rule 12b-1 fees . . . . We have concluded that it is more appropriate to consider these changes in the context of a full reconsideration of sales charges and rule 12b-1 . . . ."). The sooner firms have clear instructions—established through the proper rulemaking channels—the sooner firms can comply. And the sooner they can put all their attention where it belongs: guiding their customers through these difficult times, not wondering what industry standard the Commission's enforcement staff will change—and retroactively apply—next.

With respect, the Commission should bring these serial enforcement actions to an end. There is no need to target *any* firms for violating a standard of conduct that has never appeared in any rule, let alone to re-shakedown firms that have already given in to the Commission's Initiative. But that is what the Commission seems intent on doing. FSI, for example, has learned that the Commission is now quibbling over the language that certain firms used to "notify affected investors . . . of the settlement terms" of the Initiative, even though those firms had asked the Commission to review the language—and it refused. There is no point to such gamesmanship; corrective action is needed.

If anything, the Commission should treat firms who cooperated with the Commission's Initiative with extra respect, not less. Just last term, the Supreme Court, in an 8-1 decision, ruled that disgorgement, as an "equitable" remedy, may only be used "to return a defendant's gains to wronged investors for their benefit." *Liu v. SEC*, 140 S. Ct. 1936, 1948 (2020). But many of the firms the Commission targeted in the Initiative had already credited investors their 12b-1 fees, creating the distinct impression that the Commission, in ordering additional "disgorgement," had crossed the line.

And even if the Commission's disgorgement orders were proper, the sheer magnitude of the funds disgorged is a strong indication that the Commission's enforcement program needs reform. The Commission is in the customer protection business. That is the goal. The fact that the disgorgement figures go up year after year, however, suggests either that the Commission is squeezing the innocent, or that it is failing to educate the industry on what is expected of it. Either way, something needs to change. And as the Petition explains, a return to enforcing written law and regulations—as opposed to the Commission's extra-legal guidance—would be a good place to start.

C. The Petition Offers The Commission A Sensible Path Forward; the Commission Should Take It.

The Petition lays out six specific rules that the Commission should adopt. *See* Pet. 40. These rules offer the Commission a straightforward way to bring its enforcement tactics into compliance with applicable law, and the Commission should immediately initiate a rulemaking to adopt the proposed rules.

At its core, the proposal asks the Commission to "make clear exactly what forms of compensation are or are not disclosable." Pet. 40. That should not be controversial. The industry "want[s] to comply with SEC rules" and already "dedicates significant efforts and resources to do[ing] so." CIRA Comments 1; *see also* Letter from Richard Bryant, CEO, Capital Investment Companies, File No. 4-761 (June 22, 2020); Letter from Summer Pretzer, Head of Supervision, Cetera Advisor Networks LLC, File No. 4-761 (July 9, 2020). The Commission should encourage and reward that cooperation by working with the industry and the public to make the law as clear as possible. That fosters compliance—and just as important, is fundamentally fair. All that FSI asks is that the Commission proceed through the rulemaking channels that Congress has prescribed, not through the backdoor of Initiative-style "guidance."

The remaining requests simply ask the Commission to return to the standards that actual statutes, regulations, and litigated cases provide. So this is not, as the CFA frames it, a push to "eliminate" pre-existing duties. CFA Comments 5. Quite the contrary. Take the target of the CFA's claim: best execution. *See id.* The Petition asks the Commission to "clarify that 'best execution' principles do not apply to actions under section 206 of the Investment Advisers Act." Pet. 40. *That is already the law.* No court has held that Section 206 of the Advisers Act imposes a duty to seek to obtain best execution in the context of selecting share classes. That is because, if such a duty did exist at all, it would arise from the fiduciary duty that advisers, as explained above, *supra* pp. 8–11, have already satisfied by disclosing potential conflicts arising from their receipt of 12b-1 fees. *See, e.g.*, *Hughes*, 1948 WL 29537, at *5 (linking best execution as a "corollary of the fiduciary's duty of loyalty").

The Commission should not object to clarifying what the law already says, especially where, as here, the Commission has started venturing beyond those limits—all outside the rulemaking procedures prescribed by Congress.

II. The Commission Should Reject The Consumer Federation of America's Unwise, Unlawful, And Unconstitutional Requests.

The CFA "urge[s] the Commission to draw two very different lessons from" FSI's Petition. CFA Comments 7. Neither is appropriate.

A. Subjecting FSI's Members To "Special Scrutiny" Is Blatantly Unconstitutional.

The CFA recommends, first, that the Commission subject FSI's members to "special scrutiny," because the "approach [FSI] advocated" in the Petition supposedly "misunderst[ood] [ ] what it means to be a fiduciary." CFA Comments 7. The Commission should do no such thing—in fact, the Commission should swiftly and unequivocally reject the CFA's proposal. It is wrong factually—FSI and its members know exactly what it means to be a fiduciary, and have long served their clients' best interests. Worse still, the proposal is blatantly unconstitutional.

The Commission may not flag a person for "special scrutiny" based on the policy positions for which he advocated. *Kinney v. State Bar of Cal.*, No. 14-cv-1591, 2014 WL 12689943, at *3 (C.D. Cal. May 6, 2014). That is retaliation. And it is illegal.

The law could not possibly be clearer: the "First Amendment prohibits government officials from subjecting an individual to retaliatory actions" based on his exercise of First Amendment rights. *Hartman v. Moore*, 547 U.S. 250, 256 (2006); *see, e.g.*, *Mt. Healthy City Bd. of Educ. v. Doyle*, 429 U.S. 274, 283–84 (1977) (adverse action cannot be taken when it is in response to the "exercise of constitutionally protected First Amendment freedoms"). Here, there is no question that "petition[ing] for the issuance . . . of a rule," 5 U.S.C. § 553(e), is a right protected by the First Amendment's Petition Clause. Nor is there any doubt that subjecting a person to "increased regulatory scrutiny" would be a form of retaliation. *Blankenship v. Manchin*, 471 F.3d 523, 529 (4th Cir. 2006). As a result, to subject a person to "special scrutiny" for an "approach [ ] advocated" in a petition for rulemaking, as the CFA demands, CFA Comments 7, would be to "violate[ ] the literal language of the Petition Clause which forbids 'abridging . . . the right of the people . . . to petition the government for a redress of grievances,'" *Gable v. Lewis*, 201

F.3d 769, 772 (6th Cir. 2000) (quoting U.S. Const. amend. I); *cf. Beedle v. Wilson*, 422 F.3d 1059, 1066 (10th Cir. 2005) ("[A] governmental lawsuit brought with the intent to retaliate against a citizen for the exercise of his First Amendment rights is itself a violation of the First Amendment.").

The Commission should not go down that road—and it should make clear that it never will.

B. The Commission Should Not Ban Rule 12b-1 Fees.

The CFA recommends, next, that the Commission should "limit or ban conflicts and business practices that are harmful to investors," presumably referring to Rule 12b-1 fees. CFA Comments 7. Again, the Commission should reject the CFA's misguided proposal.

To begin, the CFA is operating on a faulty premise. It assumes that the investment advisers "are not willing to provide clear disclosures with regard to their conflicts." *Id.* But nothing could be further from the truth. As detailed above, advisers have long informed their clients in simple, straightforward terms that, because the adviser receives 12b-1 fees in connection with a client's investment, the adviser faces a conflict: to recommend mutual funds that pay a higher fee. *Supra* p. 5; *see also* CIRA Comments 2 ("CIRA's Form ADV disclosed the firm's receipt of 12b-1 revenue, as well as the potential for related conflicts of interest."). FSI does not object to that disclosure, which is industry standard, nor even to a broader disclosure—all it asks is that the Commission "make clear exactly" what is expected of advisers. Pet. 40. There is thus no need to ban anything.

Beyond that, Rule 12b-1 fees play a "significan[t]" role in "the mutual fund market," as the Commission itself has recognized for years. Kathleen L. Casey, Comm'r, Statement at SEC Open Meeting: Mutual Fund Distribution Fees (July 21, 2010), https://bit.ly/30AmpL0. The Petition and other commenters have documented the abundant literature on the benefits of Rule 12b-1: by allowing funds to offer different classes of shares, with different cost structures, the rule expands investor choice. Pet. 5; Letter from Tasha Johns, File No. 4-761, at 1 (July 2, 2020) ("Johns Comments"); *supra* pp. 4–5. It helps funds to grow their asset base "to *reduce* costs to investors." Johns Comments 1 (July 2, 2020); *see* Pet. 4. And it provides a cost-efficient way for regular investors to pay for financial planning advice, encourages an ongoing relationship between advisers and their clients, unlocks freedom of movement between fund families, helps diversify the distribution channels for mutual funds, and generally fosters competition. Pet. at 5–6. Neither the CFA nor the Commission dispute these benefits, which is presumably why the Commission has never been able to garner the political will needed to repeal Rule 12b-1. *See id.* at 7–8. That is for the better; the Commission should not try to upend the $10 billion a year in economic activity that is Rule 12b-1 fees. 75 Fed. Reg. at 47,070. The CFA offers no reason, much less a persuasive reason, for the Commission to go down that misguided path.

III. The Commission Must Promptly Respond To FSI's Petition.

The Commission must now act on FSI's Petition. Under the APA, a federal agency is required to "conclude a matter" presented to it "within a reasonable time." 5 U.S.C. § 555(b). And while there is "'no *per se* rule as to how long is too long' to wait for agency action," the D.C. Circuit has made clear that a "reasonable time for agency action is typically counted in weeks or months." *In re Am. Rivers & Idaho Rivers United*, 372 F.3d 413, 419 (D.C. Cir. 2004) (citations omitted). So far, four months have passed since FSI filed its Petition. There is no good reason the Commission can't act on the Petition soon, especially considering that it involves an issue the Commission has been studying for years. The Commission should act now.[1]

Congress expects as much. Senator Jerry Moran has already raised, with respect to the Initiative, "concern[s] about what [he] believe[s] is occurring—an increase in the use of . . . regulation by enforcement." Tracey Longo, *SEC's Battle with Brokers Over 'Regulation By Enforcement' Flares at Senate Hearing*, Financial Advisor (Dec. 11, 2019),

[1] In a recent filing, the agency's lawyers have taken the citation-free position that the Commission is not "required to act on [FSI's] request." SEC's Resp. to Br. of *Amicus Curiae* Financial Services Institute, Inc. 7 n.7., *SEC v. Cetera Advisors LLC*, No. 1:19-cv-2461 (D. Colo. Sept. 11, 2020), ECF No. 92. But the Commission's rules provide that a petition "shall be transmitted . . . to the Commission for [ ] action," 17 C.F.R. § 201.192 (a), and by statute the Commission "shall proceed to conclude a matter presented to it" within "a reasonable time," 5 U.S.C. § 555(b). FSI is entitled to an answer and, if need be, the courts will enforce that right. *See, e.g.*, *Am. Rivers*, 372 F.3d at 420 (issuing writ of mandamus compelling agency to respond to petition).

https://bit.ly/3ik75bM. That was over eight months ago. In the meantime, Senator Grassley has raised his own concerns about the Initiative's apparent "retroactive[ ] applic[action] of guidance as opposed to a written rule or regulation." Letter from Senator Grassley to Jay Clayton, Chairman, SEC 1 (Aug. 24, 2020). "This has created uncertainty for independent financial services firms in Iowa and across the country," he explained, "and concern that there are inconsistencies in enforcement and interpretation of what constitutes a sufficient disclosure." *Id.* Accordingly, the Senator has asked the Commission whether it "intend[s] to issue formal rulemaking on the disclosure of 12b-1 fees, as requested by [FSI's] petition." *Id.* at 2. And "[i]f not, why not?" *Id.*

It is time for an answer. The agency does not—and could not reasonably—need more time. It announced, after all, that it would "be prepared to adjust the rule[12b-1] in light of experience" *in 1980—forty years ago*. Bearing of Distribution Expenses by Mutual Funds, Securities Act Release No. 6254, Investment Company Act Release No. 11,414, 45 Fed. Reg. 73,898, 73,901 (Nov. 7, 1980). And over the last few decades, the agency has stated again and again that examining Rule 12b-1 was a high priority. *See* Pet. 8 (documenting Commission efforts to examine the rule). In 2008, the rule was *still* on the "Commission's front burner," Christopher Cox, Chairman, Keynote Address to the Investment Company Institute 4th Annual Mutual Fund Leadership Dinner (Apr. 30, 2008), https://bit.ly/2EPFct4, where it remained nearly a decade later, *see* M. Waddell, 12b-1 Fees in Crosshairs at SEC—and DOL, ThinkAdvisor (Feb. 1, 2016), https://bit.ly/2ERbofG (reporting Chairman White's claim that "12b-1 fees were [still] in the [the Commission's] sightline"); *see* Pet. 9. In more recent years, the Commissioners have voted—*more than 100 times each*—to settle cases based on the Initiative's Rule 12b-1 demands, *see* Pet. 17, while the agency has thoroughly briefed "the very same issue" raised by "FSI's petition," Pl.'s Response to Mot. for Leave to File Brief of *Amicus Curiae* 3, *SEC v. Cetera Advisors LLC*, No. 1:19-cv-2461 (D. Colo. July 31, 2020), ECF No. 82.

In these circumstances, the Commission cannot reasonably claim to need more time. And no court would accept such a claim. If a five-month delay in responding to a petition for rulemaking is unreasonable, where a study of the issue had "been underway for nearly two years," *Pub. Citizen v. Heckler*, 602 F. Supp. 611, 613 (D.D.C. 1985), a similar delay cannot plausibly be justified on an issue that the Commission has been studying for *forty*. *See also Galvez v. Howerton*, 503 F. Supp. 35, 39 (D.D.C. 1980) ("the 6-month delay in the present case is unreasonable").

It is time for the Commission to bring the Initiative and related extralegal endeavors into compliance with applicable law.

CONCLUSION

For these reasons and the reasons stated in FSI's Petition, the Commission should initiate a rulemaking to promulgate the proposed rules and end the agency's unlawful "regulation by enforcement" with respect to 12b-1 fees once and for all.

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Respectfully submitted,

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