



By the Office of Compliance Inspections and Examinations¹

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OCIE's 2016 Share Class Initiative

In this Alert:

Topic: Share Class Examination Initiative

Key Takeaways: OCIE staff intends to focus on certain registered advisers and their associated persons that may be receiving undisclosed compensation or other financial incentives. Such examinations will likely focus on the following topics applicable to the adviser's share class recommendation practices: fiduciary duty and best execution; disclosure; and compliance policies and procedures.

I. Introduction

The Office of Compliance Inspections and Examinations' ("OCIE") 2016 Examination Priorities include examining matters of importance to retail investors.² OCIE's retail investor protection focus includes examining advisory activities under various initiatives for, among other things, conflicts of interest, recommendations made to clients, fees charged, and disclosure practices.³ Consistent with these priorities, OCIE is undertaking an initiative to address the risk that registered advisers may be making certain conflicted investment recommendations to their clients. Specifically, OCIE is seeking to identify conflicts of interest tied to advisers' compensation or financial incentives for recommending mutual fund and 529 Plan share classes that have substantial loads or distribution fees ("Share Class Initiative"). Examples of conflicts of interest related to share class recommendations include situations where the adviser is also a broker-dealer or affiliated with a broker-dealer that receives fees from sales of certain share classes, and situations where the adviser recommends that clients purchase more expensive share classes of funds for which an affiliate of the adviser receives more fees. OCIE is issuing this Risk Alert to provide additional information concerning the Share Class Initiative.

II. Background

The Commission has stated that an investment adviser has failed to uphold its fiduciary duty when it causes a client to purchase a more expensive share class of a fund when a less expensive class of that fund is available.⁴ As a fiduciary, an adviser has an obligation to act in its client's best interest and to disclose material conflicts of interest such as the receipt of compensation for selecting or recommending mutual fund share classes. Additionally, the Commission has highlighted the need for advisers making mutual fund share class selections to adopt and implement

¹ The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations, in coordination with other Securities and Exchange Commission ("SEC" or "Commission") staff, including staff of the Division of Investment Management ("IM"). The Commission has expressed no view on its contents. This document was prepared by the SEC staff and is not legal advice.

² See [OCIE, Examination Priorities for 2016 \(January 11, 2016\) \("OCIE 2016 Priorities"\)](#).

³ OCIE 2016 Priorities.

⁴ See Investment Advisers Act of 1940 ("Advisers Act") Release No. 3686, [Manarin Investment Counsel, Ltd.](#) (October 2, 2013). FINRA also has taken action for failures by broker-dealers to apply eligible sales charge waivers to mutual fund transactions made by charitable institutions and retirement plans. See FINRA News Release [FINRA Fines Merrill Lynch \\$8 Million; over \\$89 Million Repaid to Retirement Accounts and Charities Overcharged for Mutual Funds](#) (June 16, 2014); [FINRA Orders Wells Fargo, Raymond James, and LPL Financial to Pay More Than \\$30 Million in Restitution to Retirement Accounts and Charities Overcharged for Mutual Funds](#) (July 6, 2015); and [FINRA Orders an Additional Five Firms to Pay \\$18 Million in Restitution to Charities and Retirement Accounts Overcharged for Mutual Funds](#) (October 27, 2015). FINRA further addresses this issue in its [2016 Regulatory and Examination Priorities Letter](#), which reiterates the concern FINRA expressed in its 2015 letter about failures to provide appropriate sales charge waivers and discounts.

written policies and procedures that are reasonably designed to prevent violations of the Advisers Act including those that govern their selection process.⁵

III. Examinations

The staff will focus on the adviser's practices related to share class recommendations and compliance oversight of the process. The staff will conduct focused, risk-based examinations of high-risk areas, including:

- **Fiduciary Duty and Best Execution.** An investment adviser has a fiduciary duty under Section 206 of the Advisers Act that obligates it to act in the client's best interest, and to seek best execution for client transactions (*i.e.*, "to seek the most favorable terms reasonably available under the circumstances").⁶ Examiners will likely review advisers' investment practices to determine whether they are acting in their clients' best interest and seeking best execution when recommending or selecting mutual fund and 529 Plan investments to clients. Examiners will review advisers' books and records to identify share classes held and purchased in clients' accounts and any compensation received by the adviser or any of its associated persons related to such investments.
- **Disclosures.** As a fiduciary, an investment adviser has a duty to make full and fair disclosure of all material facts, including all material conflicts of interest that could affect the advisory relationship.⁷ Registered investment advisers must provide narrative disclosure in their ADV Part 2 brochure to their clients and prospective clients regarding whether the adviser or its supervised persons accepts compensation for the sale of securities or other investment products, including asset-based sales charges or service fees from the sale of mutual funds.⁸ Registered investment advisers must also explain the conflict of interest such compensation creates and how the adviser addresses the conflict, including the adviser's procedures for disclosing the conflict to its clients.⁹ An adviser must update its brochure at least annually (and more frequently, if required by the instructions to Form ADV) and notify clients of any material changes.¹⁰ Examiners will likely review an adviser's practices surrounding its selection of mutual fund and 529 Plan investments in its clients' accounts with a focus on assessing the accuracy, adequacy, and effectiveness of the adviser's disclosures regarding compensation for the sale of shares and the conflicts of interest created.
- **Compliance Program.** Advisers must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.¹¹ Examiners will likely review the adviser's practices surrounding its selection of mutual fund and 529 Plan share class investments in clients' accounts and assess the adequacy and effectiveness of the adviser's corresponding written policies and procedures.

While these are the primary focus areas for the Share Class Initiative, examiners may select additional topics based on other risks identified during the course of the examination.

⁵ See Advisers Act Release No. 4351, [In re Royal Alliance Associates, Inc., SagePoint Financial, Inc. and FSC Securities Corporation et al](#) (March 14, 2016).

⁶ See Advisers Act Release No. 2713, [In re Fidelity Management Research Company and FMR Co., Inc.](#) (March 5, 2008). See also, Advisers Act Release No. 3057, [In the Matter of James C. Dawson, A.](#) (July 23, 2010) (adviser barred from associating with any other adviser after the Commission found that he had engaged in "cherry-picking," allocating a disproportionate percentage of profitable trades to his own account, rather than those of his clients).

⁷ See [SEC v. Capital Gains Research Bureau, Inc.](#), 375 U.S. 180 (1963). See also, [General Instructions to Part 2A of Form ADV.](#)

⁸ See Part 2A of Form ADV, Item 5.E.

⁹ *Id.*

¹⁰ See Section 204 of the Advisers Act and Rules 204-1(a) and 204-3, thereunder. See also Form ADV, Part 2A, Instruction 4; Advisers Act Release No. 4314, [In re Everhart Financial Group, Inc. et al.](#) (January 14, 2016).

¹¹ Rule 206(4)-7 under the Advisers Act.

IV. Conclusion

In sharing the primary focus areas for the Share Class Initiative, OCIE encourages advisers to reflect upon their own practices, policies, and procedures in these areas and to make improvements in their advisory compliance programs where necessary.

This Risk Alert is intended to highlight for firms risks and issues that the staff has identified. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
