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Resource Constraints Cripple Shops' Chances at SEC Amnesty

By Jill Gregorie May 16, 2018

Shops and their distributors are scrambling to meet the SEC's June 12 deadline to volunteer information about instances in which they overcharged investors in exchange for amnesty from the regulator's enforcement unit.

But the challenges involved in sourcing and analyzing historical data about share class blunders are preventing many from even determining whether they flubbed fund sales in the first place, consultants say.

"It's a very time-consuming and data-intensive exercise that's made even more difficult when you have to pause everything else that may be going on," says Michael Abbriano, senior principal consultant, ACA Compliance Group.

The Securities and Exchange Commission launched its Share Class Selection Disclosure Initiative in mid-February, which offers "favorable settlement terms" to advisors who admit that they charged clients 12b-1 fees or other ongoing sales charges when those clients could have purchased a share class without it.

Since then, PNC Investments, Securities America Advisors and Geneos Wealth Management have settled sales overcharge allegations for a combined total of $28.3 million in disgorgement and interest.

Looking for past violations is a "very difficult and complicated" endeavor, and may not be possible within the four-month window provided by the SEC, says Burton Keller, executive vice president of strategic development at **Delta Data**.

For one thing, advisors need to identify which share classes were available to retail clients going back to January 1, 2014, the start of the period under regulatory scrutiny, he says.

"Share classes come and go, but you have to go back to the starting point and see what purchases were made, and whether at that time, you did or did not offer a different share class without a 12b-1 fee," Keller says.

Distributors that sold funds where cheaper shares required a certain minimum investment may need to spend “thousands and thousands of hours” doing forensics, which could entail wading through old prospectuses and possibly even calling fund sponsors on the phone, he says.

“The data is not readily available, and since it’s historical, you have to match up whether a certain date had the waiver then, or whether the waiver came later,” he says.

Once a potential violation is detected, distributors must go through “very, very complicated” calculations to determine how much they owe clients, Keller says.

Those calculations require tracking every purchase and redemption of the share class from 2014 to the end of the remediation period, he says.

“Essentially, you have to go back and create a trade blotter,” he says. Necessary data points include how many shares a client owned day by day, compared with the fund’s net asset value on each of those days, he says.

Reinvested dividends add another wrinkle to the process, Keller notes.

Following their disclosure to the SEC, firms have only 10 days to complete a questionnaire that asks for the amount of excess 12b-1 fees collected, and how much it intends to pay back to clients.

Under certain circumstances, the SEC may provide advisors more time to submit their questionnaire, according to a set of FAQs the agency released on May 1. Advisors must request an extension at least two days before their questionnaire is due to qualify.

Complicating matters is that advisors may also need to collect transaction data from custodians, as it may not be immediately clear whether the client actually paid a 12b-1 fee, says John Ivan, a managing director at Capital Forensics and former CCO at Raymond James.

“There are certain arrangements which would affect that, and of course none of those were drafted back in 2014 with this questionnaire in mind,” Ivan says.

Advisors are figuring a lot of this out on their own, since each firm has handled sales practices in its own manner, Ivan says.

Advisors also need to consider whether they converted higher-cost share classes, such as A shares, to lower-cost share classes, such as institutional shares, as they became available over time, ACA’s Abbriano notes.

Suitability questions also persist, since firms may be able to argue that a certain higher-fee share class actually proved to be a better fit for a commission-paying client who traded only infrequently, Abbriano says.

“Share classes were made available for specific purposes, so it’s not as clear as finding the cheapest share class and concluding that you’re eligible,” says Matt Calabro, director of institutional wealth services at Ascendant Compliance Management.

Exacerbating this problem is the fact that “prospectuses have historically been vague or complicated as far as who’s eligible for what share class, especially the further back you go in time,” Calabro says.

In recent months, fund providers have been adding language to their prospectuses that explicitly lays out the terms and conditions under which certain share classes can be obtained on a distributor-by-distributor basis. Such transparency will help to eliminate confusion going forward, Calabro says.

“Fund sponsors have been asked by their distributors over the past several years to bring more clarity to how those policies are written in the prospectus,” Calabro says. Terms can vary widely by fund provider and even product, and broker-dealers are left to update their systems to accommodate them.

Going forward, distributors may just grant an automatic rebate to anyone holding funds with 12b-1s, irrespective of whether a waiver is available, says Delta Data’s Keller.

“I think some will say, we’re probably overpaying, but it will save us time and money in the long run,” he says.

For now, however, firms are stuck going through the “painful” process of analyzing past investment recommendations, Abbriano says.

“You could spend years doing this analysis, and still not feel 100% confident that you got it right,” Abbriano says.