

Insights

SEC REINFORCES THE IMPORTANCE OF COST TRANSPARENCY

May 19, 2020

In advance of the June 30 effective compliance date for the Securities and Exchange Commission's (the "SEC") Regulation BI requirements, the SEC released an Order relating to transparency of fees, inaccurate communications, and conflicts about services and fees. Specifically, in an order dated May 12, 2020, the SEC imposed a \$5 million fine on a dual-registered broker-dealer / investment adviser (the "Firm") and found the Firm violated Sections 206(2) and (4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder. As is standard in SEC settlement Orders, the Firm neither admitted nor denied the SEC's findings, but merely consented to the entry of the Order.

The matter arose out of improperly disclosed costs associated with the Firm's retail wrap fee programs. According to the Order, from at least October 2012 until June 2017, the Firm distributed inaccurate marketing and client communications related to services rendered and costs incurred with these programs, and failed to adopt appropriate supervisory policies and procedures to prevent violations of the Advisers Act. Specifically, the SEC found that the Firm did not provide transparency into the overall fees clients were paying and, further, that the Firm provided incomplete and inaccurate information about potential overall asset-based wrap fees. Through marketing material and its financial advisors, the Firm advertised that the wrap programs offered "a 'transparent' fee structure that streamlines and simplifies client expenses." Clients were presented with information giving the impression that the Firm executed most trades, and while additional fees were possible, those costs were not incurred by the client.

However, as set forth in the Order, certain clients were subject to further transaction-based execution costs in addition to the wrap fee. These additional fees arose from the wrap managers "trading away," *i.e.*, the practice of using third-party broker-dealers for execution of trades, resulting in additional transaction-based charges. Transactional documents (trade confirms and account statements) sent to clients contained identical information, whether the trade was executed by the Firm or traded away—there was no indication of additional transaction fees. The Order stated that, "clients lacked complete and accurate information needed to assess the value of the services received in exchange for the wrap fee paid to [the Firm] and the costs associated with their accounts." Thus, while the Firm disclosed the *potential* for additional fees, this disclosure was insufficient because the costs were not visible to clients.

Additionally, the SEC found that certain transactions were executed through Firm affiliates. Because the client had already paid a wrap fee, any additional execution costs resulted in the Firm and affiliates getting paid twice for order execution. The SEC found that the Firm's policies and procedures were deficient because of the failure to identify and disclose these conflicts and trading practices.

The SEC explicitly gave credit to significant remedial steps taken by the Firm, including enhancing its policies and procedures, providing training to its field sales force, and providing additional information to customers in communications. Based on these findings and remedial measures adopted by the Firm, the SEC fined the Firm in the amount of \$5 million dollars.

This Order reinforces the messaging from the SEC over the last few years – *i.e.*, undisclosed or poorly disclosed costs will be a significant focus for the Enforcement Staff. We have seen this play out in a number of ways, including the Staff's 529 Plan Share Class initiative and the recent investigations of bank deposit sweep programs. Undoubtedly, the implementation of Regulation BI will provide the SEC further opportunities to review firm's cost disclosures and whether incurring those costs on top of advisory fees is truly in the client's "best interest."

Firms engaged in activities wherein costs are "bundled" or not otherwise set up to provide complete transparency, on a per item basis, should examine their various lines of business to identify hidden costs and to implement strategies to appropriately monitor and explicitly disclose such costs to clients.

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