CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

ANONYMOUS CASE HISTORIES
NUMBER 30450

This is a summary of a Settlement Agreement entered into at the October 2017 hearings of the Disciplinary and Ethics Commission ("the Commission") of Certified Financial Planner Board of Standards, Inc. ("CFP Board"). The conduct at issue in this case occurred after January 1, 2009. The Rules in effect at that time under the *Rules of Conduct* were Rules 1.1 through 6.5.

I. Issues Presented

Whether a CFP® professional ("Respondent") violated CFP Board's *Standards of Professional Conduct* when he failed to: (a) seek best execution for clients when investing them in share classes that charged 12b-1 fees despite the availability of corresponding share classes without the fees; (b) disclose in his firm's Forms ADV and advisory agreements the conflicts of interest that existed regarding his recommendations to clients of mutual funds that contained 12b-1 fees; and (c) perform required annual compliance reviews.

II. Findings of Fact

Respondent has worked for ABC in various capacities since 1999. ABC is a registered investment adviser that was founded by John Doe in 1995. Mr. Doe, ABC's President and majority owner, is Respondent's partner and co-respondent in the Cease and Desist Order. Mr. Doe is a control person and owns between 50-75% of ABC. He was also ABC's Chief Compliance Office ("CCO") from 1995 until 2014.

ABC is dually registered as a Registered Investment Advisor with the SEC and as an agent of a broker-dealer. The firm is compensated based on a percentage of assets under management and commissions earned on the sale of investment products. ABC's Form ADV indicates that it provides financial planning and portfolio management services for individuals. Respondent is a minority owner of ABC. He is a control person of ABC and owns between 10-25% of the firm. From 2014 to 2016, Respondent also served as CCO of ABC. Beginning in 2010, prior to his appointment as CCO, Respondent oversaw and signed annual updates to ABC's Form ADV and Form ADV Part 2A and was responsible for distributing them to ABC's clients.

Both Respondent and Mr. Doe were investment advisor representatives of ABC and registered representatives of ABC's affiliated broker-dealer ("Broker").

In 2013, the SEC conducted a compliance audit of ABC and discovered certain deficiencies regarding Respondent, Mr. Doe and the firm concerning disclosures and procedural matters.

ABC was required to perform annual compliance reviews. During the periods 2008 through 2011, 2013 and 2014, ABC failed to perform the required annual compliance reviews. Although Broker performed periodic inspections of ABC, these inspections were limited to ABC's contractual obligations with Broker and focused on employees who were registered representatives of the broker-dealer. Broker's inspections did not cover ABC's overall advisory business and was, therefore, inadequate under the Adviser's Act compliance rule. Rule 206(4)-7(b) requires registered investment advisers to "[r]eview, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation."

Historically, ABC principally invested its clients in a single family of mutual funds, referred to as the "Mutual Fund Complex." The Mutual Fund Complex offered two classes of shares which are similar but contain one notable difference, one class charges 12b-1 fees and the other does not. Classes of shares that contain 12b-1 fees are known as "Investor shares." This class of shares is sold to the general public as opposed to "Institutional shares" which are generally available only to certain high-net worth investors and individuals that invest through registered investment advisors. The 12b-1 fees are meant to cover fund distribution and shareholder service expenses pursuant to the Investment Company Act of 1940. Institutional shares have no immediate or deferred sales charges and do not have 12b-1 fees. Thus, purchasers of Institutional shares pay lower fees and keep more of their investment returns than purchasers of Investor shares of the same fund.

Despite the higher fees of the Investor shares, Respondent and some ABC advisors nearly always invested non-retirement individual advisory accounts in this class of shares. These fees were paid to ABC's principal owners and their receipt of the 12b-1 fees created a conflict of interest that was not adequately disclosed to ABC's clients. Respondent and other ABC advisors had a duty to seek best execution for their clients. By favoring the Investor shares over the Institutional shares for non-retirement accounts, Respondent and the other ABC advisors failed in their duty to seek best execution for their clients. To account for its receipt of 12b-1 fees, ABC reduced the advisory fee charged to clients who purchased such shares by an amount equal to the 12b-1 fees.

Breach of Fiduciary Duty

According to Section 206 of the Adviser's Act, investment advisors have a fiduciary duty to act for the benefit of their clients, including the duty to seek best execution for client transactions. Although ABC's non-retirement advisory clients were eligible to purchase Institutional shares from the Mutual Fund Complex, Respondent nearly always recommended a mutual fund share class that charged a 12b-1 fee. According to the Regulator:

> "By not choosing mutual fund share classes with a view to minimizing transactional and ongoing costs, and by failing to disclose that best execution would not be sought for mutual funds with multiple share classes available, Doe and Respondent failed to seek best execution on behalf of their individual advisory clients."

To account for its receipt of 12b-1 fees, ABC reduced the advisory fee charged to clients who purchased such shares by an amount equal to the 12b-1 fees.

Failure to Disclose Conflict of Interest

From 2010 through January 2014, ABC had two versions of an investment advisory agreement that its advisory clients were required to sign. Both versions of the advisory agreement disclosed the clients' advisory fee. The 2010 to mid-2013 version, however, did not disclose 12b-1 fees and the conflicts of interest that were created by ABC's advisors' receipt of 12b-1 fees from certain mutual funds that were purchased by them for their non-retirement client accounts. The 2010 and 2013 advisory agreements also failed to disclose Respondent's practice of nearly always investing non-retirement advisory clients in share classes that generate 12b-1 fees ultimately paid to Respondent. Such agreements did, however, reflect a reduced advisory fee charged to clients to account for the receipt of 12b-1 fees.

In 2013, ABC revised and updated its client agreement to inform clients that: (a) the firm and its advisors receive 12b-1 fees from certain mutual funds purchased by clients; and (b) the firm will conduct due diligence regarding its fiduciary duties to clients before recommending any mutual fund that pays 12b-1 fees. Nonetheless, ABC failed to perform any due diligence when selecting a mutual fund share class because the firm nearly always selected shares that charged 12b-1 fees. ABC's due diligence was limited to picking a mutual fund rather than a particular share class of that fund. However, ABC accounted for the 12b-1 fees by reducing the advisory fee it charged to clients.

ABC failed to provide new clients with its Form ADV Part 2A Brochure and did not provide existing clients with annual updates to the Brochure, including a summary statement of material changes. Instead, ABC sent a notice to clients informing them that a new Brochure was available and offered to send it to them.

Items 5.E and 14.A of the Brochure required advisors to disclose: (a) fees they receive from the sale of mutual funds and compensation paid by third-parties for providing investment advisory services to clients; and (b) the resulting conflicts and how the advisors address them. ABC's March 2011 Brochure informed clients that ABC and its advisors may receive 12b-1 distribution fees from mutual funds in connection with a client's investments and that the payments were in addition to ABC's advisory fees. There was no discussion, however, about any conflicts of interest or Respondent's practice of investing certain clients in share classes that charged 12b-1 fees despite the availability of corresponding share classes without the fees.

In March 2012, ABC updated its Brochure and included the same language about 12b-1 fees as the March 2011 version, but this Brochure was never filed on the Investment Adviser Registry Depository ("IARD") system. Although it was never filed with IARD, ABC relied on this brochure from March 2012 until November 2013.

In June 2013, ABC filed another Brochure (signed by Respondent) which did not mention 12b-1 fees at all and omitted language regarding 12b-1 payments that had been in prior versions.

In November 2013, ABC again updated its Brochure and made no disclosures about 12b-1 fees generally or the 12b-1 fees paid to ABC's advisors or the related conflict of interest created by the payments. Moreover, ABC still failed to disclose Respondent's and Mr. Doe's practice of investing in share classes that charge 12b-1 fees when there were corresponding share classes available that did not charge 12b-1 fees.

In March 2014, ABC updated its Brochure in response to an SEC examination and, for the first time since 2009, disclosed its conflict of interest due to its registered representatives receiving 12b-1 fees. The Brochure stated that its representatives may recommend load or no-load mutual funds which charge clients 12b-1 fees and that they receive a portion of these 12b-1 fees. Additionally, clients were told that these payments could represent an incentive for ABC or the representative to recommend mutual funds with 12b-1 fees or higher 12b-1 fees over mutual funds with no 12b-1 fees or lower 12b-1 fees, resulting in a conflict of interest.

Securities Law Violations

Ultimately, the SEC initiated an enforcement action against Respondent, Mr. Doe, and ABC. In January 2016, Respondent, Mr. Doe and ABC agreed to a Cease and Desist Order ("Order") to resolve the SEC enforcement action. Without admitting or denying the findings, Respondent consented to the entry of the Order.

Pursuant to the settlement, Respondent's, Mr. Doe's and ABC's conduct violated the following sections of the Adviser's Act and the rules promulgated thereunder:

a. Section 206(2) of the Advisers Act, which makes it unlawful for an advisor to use means or instrumentality of interstate commerce to engage in any transaction, practice, or course of business that operates as a fraud or deceit upon any client or prospective client. Scienter (intent or knowledge of wrongdoing) is not a requirement for establishing a Section 206(2) violation, a finding of negligence is sufficient;

b. Section 207 of the Advisers Act, which makes it unlawful for a person to willfully omit to state material facts in registration applications and reports filed with the SEC;

c. Section 206(4) of the Advisers Act, which makes it unlawful for any investment advisor to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative;

d. Rule 206(4)-7 under the Advisers Act, which requires a registered investment advisor to annually review the adequacy of written policies and procedures, reasonably designed to prevent violations of the Adviser's Act and its rules;

e. Section 204 of the Advisers Act, which requires investment advisers to make and disseminate reports the SEC deems to be in the public interest or for the protection of investors;

f. Rule 204-3(a) requires registered investment advisers to deliver a Brochure and one or more brochure supplements containing information required by the Form ADV Part 2 to each client or prospective client;

g. Rule 204-3(b)(1) requires advisors to deliver its current Brochure to new clients before or at the time the adviser enters into an advisory relationship with the client; and

h. Rule 204-3(b)(2) requires that if there are material changes to the Brochure, the advisor must deliver either a current Brochure or a summary of those changes and an offer to provide clients a copy of the Brochure.

Pursuant to the settlement, ABC agreed to a number of undertakings, including appointing an independent compliance consultant and adopting and implementing all of the consultant's recommendations.

The Cease and Desist Order:

a. Censured Respondent, ABC and Mr. Doe;

b. Ordered Respondent to cease and desist from committing or causing any violations and any future violations of Sections 204, 206(2), and 207 of the Advisers Act and Rules 204-3(a) and 204-3(b)(1) and (2) thereunder;

c. Ordered ABC, Respondent and Mr. Doe to, jointly and severally, disgorge a total of $201,985.66 plus prejudgment interest of $23,422.66 within 14 days of the entry of the Order;

d. Ordered Respondent to pay a $20,000 civil penalty within 14 days of the entry of the Order;

e. Ordered Mr. Doe to pay a $40,000 civil penalty within 14 days of the entry of the Order; and

f. Ordered ABC to pay an $80,000 civil penalty.

g. All monies paid pursuant to the Order were paid and no money was deemed to be owed to ABC's clients.

In ABC General Counsel's response to CFP Board's Notice of Investigation, he said that Respondent and Mr. Doe acknowledge that they made mistakes and accepted responsibility for them. The General Counsel said, that it was important to note that no client funds or investment returns were impacted. Additionally, General Counsel said that there was no assertion by the SEC that Respondent and Mr. Doe sought to deceive their clients or acted dishonestly.

General Counsel contends that Respondent and Mr. Doe recommended the Mutual Fund Complex because they believed it best served their clients' interests. General Counsel also contends that, ABC's clients were not overcharged. He said that, for many years, the Mutual Fund Complex did not offer a class of shares that did not pay 12b-1 fees and ABC's advisory fees were reduced to offset the 12(b)-1 fees.

General Counsel said that receipt of 12b-1 fees is permitted if properly disclosed as a potential conflict of interest and that Respondent and Mr. Doe properly made such disclosure for many years until 2010 when the disclosure law changed to require that Form ADV Part 2 be presented in narrative form. General Counsel contends that the compliance consultant retained to prepare ABC's new-form Brochure inadvertently omitted the required disclosure. Respondent and Mr. Doe admit that they failed to notice the omission and annual compliance audits by Broker also failed to detect the issue.

General Counsel asserts that Respondent and Mr. Doe vigorously addressed the issues identified by the SEC in its Order and seized the opportunity to significantly improve their practice. ABC terminated its relationship with Broker and registered with Company A, which has a robust compliance program. As a result, Respondent and Mr. Doe readily agreed to a heightened supervision program. ABC changed custodians and transferred all advisory assets to Custodian, which does not remit 12b-1 fees to advisors. They hired an experienced compliance professional to serve as interim CCO and an attorney with 24 years' experience in securities compliance to work with the CCO. ABC also retained Compliance Consulting to complete year-end compliance audits in 2016 and 2017 as required by the Order. General Counsel also asserts that all ABC's agreements and compliance procedures have been reviewed and revised in accordance with the Order and they will be closely monitored going forward.

Article 13.1 of the *Disciplinary Rules* provides that a letter or other writing from a governmental or industry self-regulatory authority to the effect that a Respondent has been the subject of an order of professional discipline by such authority shall conclusively establish the existence of such professional discipline for purposes of disciplinary proceedings and shall be conclusive proof of the basis for such discipline by the Respondent. As defined in Article 13.4 of the *Disciplinary Rules*, professional discipline "shall include the suspension, bar or revocation as disciplinary measure by any governmental agency, industry self-regulatory organization or professional association."

III. Grounds for Discipline

First Ground for Discipline

Pursuant to Article 3(a) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 1.4 of the *Rules of Conduct*, which provides that a certificant shall at all times place the interest of the client ahead of his or her own. When the certificant provides financial planning or material elements of financial planning, the certificant owes to the client the duty of care of a fiduciary as defined by CFP Board. CFP Board defines "fiduciary" as "one who acts in utmost good faith, in a manner he or she reasonably believes to be in the best interest of the client."

Respondent, a certificant, failed to act with the duty of care of a fiduciary by failing to: (a) seek best execution for clients when investing them in share classes that charged 12b-1 fees despite the availability of corresponding share classes without the fees; and (b) disclose in his firm's Forms ADV and advisory agreements the conflicts of interest that existed regarding his recommendations to clients of mutual funds that contained 12b-1 fees. Thus, Respondent violated Rule 1.4 of the *Rules of Conduct*.

Second Ground for Discipline

Pursuant to Article 3(a) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 2.2B of the *Rules of Conduct*, which provides that a certificant shall disclose to a prospective client or client the following information: a general summary of likely conflicts of interest between the client and the certificant, the certificant's employer or any affiliates or third parties, including, but not limited to, information about any familial, contractual or agency relationship of the certificant or the certificant's employer that has a potential to materially affect the relationship.

Respondent, a certificant, failed to disclose in his firm's Forms ADV and advisory agreements the conflicts of interest that existed regarding his recommendations to clients of mutual funds that contained 12b-1 fees. Thus, Respondent violated Rule 2.2B of the *Rules of Conduct*.

Third Ground for Discipline

Pursuant to Article 3(a) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 4.3 of the *Rules of Conduct*, which provides that a certificant shall comply with applicable regulatory requirements governing professional services provided to the client.

Respondent, a certificant, failed to: (a) seek best execution for clients when investing them in share classes that charged 12b-1 fees despite the availability of corresponding share classes without the fees; (b) disclose in his firm's Forms ADV and advisory agreements the conflicts of interest that existed regarding his recommendations to clients of mutual funds that contained 12b-1 fees; and (c) perform required annual compliance reviews. The Order is conclusive proof that Respondent violated Sections 204, 206(2), and 207 of the Advisers Act and Rules 204-3(a) and 204-3(b)(1) and (2) thereunder, which are applicable regulatory requirements governing professional services provided to the client. Thus, Respondent violated Rule 4.3 of the *Rules of Conduct*.

Fourth Ground for Discipline

Pursuant to Article 3(a) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 4.4 of the *Rules of Conduct*, which provides that a certificant shall exercise reasonable and prudent professional judgment in providing professional services to clients.

Respondent, a certificant, failed to exercise reasonable and prudent professional judgment in providing professional services to clients by failing to: (a) seek best execution for clients when investing them in share classes that charged 12b-1 fees despite the availability of corresponding share classes without the fees; and (b) disclose in his firm's Forms ADV and advisory agreements the conflicts of interest that existed regarding his recommendations to clients of mutual funds that contained 12b-1 fees. Thus, Respondent violated Rule 4.4 of the *Rules of Conduct*.

Fifth Ground for Discipline

Pursuant to Article 3(d) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts that are the proper basis for professional discipline. The acts set forth in the Order are the proper basis for professional discipline, and the Order constitutes professional discipline. Therefore, the Order is conclusive proof that there are grounds to discipline Respondent for acts that are a proper basis for professional discipline.

IV. Discipline Imposed

The Commission and Respondent entered into a Settlement Agreement in which Respondent consented to the Findings of Fact and Grounds for Discipline. Pursuant to the terms of the Settlement Agreement, the Commission imposed a Public Letter of Admonition on Respondent. The issuance of the Public Letter of Admonition was published in a press release, or in such other form of publicity as selected by the Disciplinary and Ethics Commission. The fact of a Public Letter of Admonition includes the publication of the facts and grounds for discipline underlying the discipline along with the identification of the CFP® professional.

The Commission determined that the applicable Sanction Guidelines recommended: (a) a suspension for at least one year and one day for Conduct 4: Breach of Fiduciary Duty; (b) a Public Letter of Admonition for Conduct 7: Conflict of Interest; (c) a Public Letter of Admonition for Conduct 14(b): Failure to Disclose (Failure to Provide in Writing, Discuss, or Disclose Required Information to Client; (d) a Public Letter of Admonition for Conduct 20(d): Misrepresentation to Clients and Prospective Clients; and (e) a Public Letter of Admonition for Conduct 30: Securities Law Violation.

The DEC focused its analysis on Conduct 4: Breach of Fiduciary Duty because it deviated from the other applicable Sanction Guidelines. While Respondent breached his fiduciary duty, the Commission gave significant weight to two Policy Notes in the Sanction Guidelines:

1. Was the breach of fiduciary duty intentional or inadvertent? As stated in the Offer, Respondent violated his fiduciary duty by failing to: 1) seek best execution for clients when investing in share classes that charged 12b-1 fees despite the availability of corresponding share classes without the fees: and 2) disclose in his firm's Form ADV and advisory agreements the conflicts of interest that existed regarding his recommendations to clients of mutual funds that contained 12b-1 fees. Based on these two alleged violations, the Commission did not find the breach of fiduciary duty to be intentional based primarily on two factors. Most significantly, Respondent's firm discounted the advisory fees for those clients who paid a 12b-1 fee in an amount that was equal to the amount Respondent's firm was collecting in 12b-l fees. Thus, there was no real financial effect for the clients when Respondent collected a 12b-1 fee. Further, Respondent did not directly gain financially from the 12b-1 fees. The Order stated that Respondent violated his duty to seek best execution by "not choosing mutual fund share classes with a view to minimizing transactional and ongoing costs ... " The Order fails to make mention of the fact that the client did not suffer any financial effect due to the discounted advisory fees. Thus, the Commission determined the issue of best execution was not an intentional violation. Second, Respondent's disclosures in his Form ADV and the Advisory Agreement indicate that his firm was sloppy, rather than intentionally failing to disclose the 12b-1 fees and the conflicts associated with the fees. This sloppiness is demonstrated by the constantly changing disclosures in his firm's Form ADV regarding 12b-l fees. A 2011 version of the Form ADV Part 2 Brochure contained a disclosure that Respondent's firm may receive 12b-1 fees, but did not disclose that there was a conflict associated with the receipt of such fees. In March 2012, Respondent's firm updated its brochure with the same language, but failed to file this version with the SEC. In 2013, Respondent's firm updated its brochure again, but the brochure did not contain any reference to 12b-1 fees. In 2014, Respondent's firm updated its brochure and disclosed that it could receive 12b-1 fees and that there was a conflict associated with the receipt of such fees. If Respondent and his firm sought to intentionally avoid disclosure, they would have never made any disclosure.

2. What was the relative harm to the client? The Commission determined that because Respondent's firm offered a reduction in the advisory fee that was in the exam amount of 12b-1 fee collected, that there was little, if any, client harm.

Based on this analysis, the Commission significantly discounted the Breach of Fiduciary in its analysis of whether the Offer was appropriate. The Commission consulted *Anonymous Case Histories* ("ACH") 30034 and 30434. Each ACH involved a breach of fiduciary duty involving fees charged to clients and resulted in a Public Letter of Admonition. Thus, the relevant Sanction Guidelines and ACHs indicated that the appropriate sanction was a Public Letter of Admonition.

The Commission then considered whether any aggravating or mitigating factors would affect the appropriate sanction. The Commission did not identify any aggravating factors. In mitigation, the Commission determined that based on the record before the Commission, Respondent's conduct did not cause client harm because Respondent's firm reduced the advisory fee charged to clients who purchased such shares by an amount equal to the 12b-1 fees. Given that the Commission already took this issue into account when evaluating whether to give significant weight to Sanction Guideline, the Commission determined this mitigating factor did not mitigate a Public Letter of Admonition.