Before the Enforcement Division of the Securities and Exchange Commission

In the Matter of CapWealth Advisors, LLC	SEC File No. A-03907-A

WELLS SUBMISSION OF CAPWEALTH ADVISORS, LLC

June 15, 2020

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I. INTRODUCTION AND SUMMARY

Despite the Staff's arguments, this enforcement matter is *not* about 12b-1 fees and can find no precedent in cases the SEC previously has brought relating to 12b-1 fees.

CapWealth Advisors, LLC ("CapWealth") is an advisor that focuses on investments *other* than mutual funds. For the period 2016 through 2018, 12b-1 fees accounted for only 2.6% of CapWealth's entire *revenue*, but that revenue did not increase CapWealth's *income* because CapWealth offset that revenue through discounts applied to the client's 1% advisory fee. In other words, CapWealth did not benefit financially from the *de minimis* 12b-1 fee revenue it received. Its clients suffered no financial detriment from any 12b-1 fees. 12b-1 fees were irrelevant to clients because clients paid no more than 1% in total fees regardless.

CapWealth's fee structure is simple and illustrates this point: during the relevant period, clients typically paid CapWealth an annual advisory fee equal to a 1% of the client's assets under management ("AUM"). This 1% advisory fee was the *maximum* amount that CapWealth received *directly or indirectly* from investors during the relevant period for the first $1,000,000 invested. For the small number of clients during the relevant time period who invested in mutual fund share classes that paid 12b-1 fees to CapWealth, their investment advisory fees were offset by the amount of 12b-1 fees CapWealth received. CapWealth had no incentive to recommend mutual fund share classes that paid 12b-1 fees because the net effect of such an investment was entirely inconsequential to CapWealth's bottom line. To our knowledge, ***the SEC has not settled a single case,[1] or***

[1] *See, e.g., In re William Vescio* at ¶ 1, Release No. 10789 (June 2, 2020) ("Vescio ***benefitted from*** the increased 12b-1 fees he received in connection with these investments."); *In re U.S. Bancorp Invs. Inc.* at ¶ 13, Release No. 88976 (June 1, 2020) ("The Clearing Firm's payment of 12b-1 fees and shareholder servicing fees gave USBI the ***financial incentive*** to favor NTF load-waived Class A shares and similar NTF share classes over other lower-cost share classes."); *In re Am. Portfolios Advisors Inc.* at ¶ 11, Release No. 5083 (Dec. 20, 2018) ("IARs had a conflict of interest as a result of the ***additional compensation*** they received for selecting share classes paying 12b-1 fees even when less expensive share classes of the same fund were available."); *In re Geneos Wealth Mgmt. Inc.* at ¶ 1, Release No. 83003 (Apr. 6, 2018) ("Geneos ***financially benefitted*** from investing advisory clients in mutual fund share classes with higher fees, which ***created a conflict of interest*** that Geneos failed to adequately disclose in its Forms ADV, Part 2A . . . or

brought a single action,[2] against an investment advisor for failing to disclose an alleged conflict of interest related to mutual fund share class selection where the advisor did not benefit financially from 12b-1 fees its clients incurred.

Yet, the Staff has made a preliminary determination to recommend an enforcement action against CapWealth for "fraud" under Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act") for (1) allegedly failing fully and fairly to disclose a non-existent conflict of interest created by CapWealth's "receipt" of 12b-1 fees clients paid when CapWealth recommended mutual fund share classes but from which CapWealth received no benefit and (2) allegedly failing to obtain best execution, or the "best price," for advisory clients in these mutual fund share class investments. The Staff also is considering recommending charges under Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder and Section 207 of the Advisers Act. The SEC lacks any legal or factual basis to bring these charges as illustrated *infra* and in the enclosed Expert Report by Professor Jonathan Macey of Yale Law School, a renowned securities law scholar.

First, during the relevant period, CapWealth appropriately disclosed its receipt of 12b-1 fees in written disclosures including its Form ADV. (CAP Ex. 6, pp. 8, 9) Of course, CapWealth's disclosures were not limited to its Form ADV, or even its written disclosure documents. CapWealth advisors conducted meetings with their clients, where they discussed in detail the differences in mutual fund share classes and the fees incurred. (Venable dep. 132, 140; Pagliara dep. 107-09; Murphy dep. 78) CapWealth was not required to disclose a conflict of interest that did not exist.

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otherwise."); *In re Credit Suisse Sec. (USA) LLC* at ¶ 1, Release No. 80373 (Apr. 2, 2017) ("Thus, 12b-1 fees decreased the value of advisory clients' investments in mutual funds and ***increased the compensation*** paid to Credit Suisse and its RMs.").

[2] *See, e.g.*, Complaint at ¶ 3, *S.E.C.* v. *Ambassador Advisors, LLC, Bernard I. Bostwick, Robert E. Kauffman, & Adrian E. Young*, Case No. 20-cv-02274 (E.D. Pa. May 13, 2020) (Defendants "received ***additional compensation*** in the form of 12b-1 fee revenue."); Amended Complaint at ¶ 4, *S.E.C.* v. *Cetera Advisors LLC and Cetera Advisor Networks LLC*, No. 19-cv-02461 (D. Colo. Oct. 11, 2019) ("As a result, Cetera Advisors and Cetera Advisor Networks had an incentive to invest and maintain client assets in these higher-cost share classes that paid them ***additional compensation***.").

The mere receipt of 12b-1 fees did not create a conflict of interest–the conflict arises where an advisor financially benefits to a client's detriment. This was not the case here.

Second, even if CapWealth failed somehow adequately to disclose its receipt of 12b-1 fees, such a disclosure would have been immaterial to investors because the frequency with which CapWealth purchased mutual funds, and the quantity of 12b-1 fees it received, was *de minimis*. CapWealth largely invests clients in individual stocks. (Pagliara dep. 63, 70) On occasion, CapWealth recommended mutual funds. During the period 2016 to 2018, 12b-1 fees accounted for just ***2.6%*** of CapWealth's *revenue* but accounted for ***0%*** of CapWealth's *income* because of the offset to advisory fees. *See* Appendix 1 hereto.

Third, CapWealth and its representatives did not act with *scienter.* There is simply no evidence to suggest CapWealth or its representatives intended to mislead or harm clients. To the contrary, CapWealth carefully and consistently credited the 12b-1 fees back to investors by offsetting such fees from its standard 1% advisory fee. (Venable dep. 132; Pagliara dep. 108; and Murphy dep. 116) Moreover, CapWealth voluntarily began converting clients to lower-cost share classes in 2015, ***three years*** before the SEC's Share Class Selection Disclosure Initiative (the "Initiative") was announced. (Venable dep. 82, 83; Pagliara dep. 81-83) Indeed, by June 2018, just four months after the Initiative, CapWealth had converted all its clients to a lower-cost share class. (Pagliara dep. 49-50)

Fourth, an enforcement action against CapWealth violates due process because the disclosures that the Staff now contends are required constitute substantial, unannounced change to CapWealth's disclosure obligations. This is nothing short of rulemaking by enforcement. The SEC should not seek to punish CapWealth retroactively for conduct occurring well before CapWealth, or the regulated community, was on notice of these purported obligations. And this would be the

very first enforcement case against an advisor who did not financially benefit from 12b-1 fees.

II. FACTUAL BACKGROUND

1. Timothy J. Pagliara Founded CapWealth in 2009 as a Registered Investment Advisor.

CapWealth is an investment advisory firm that Timothy J. Pagliara founded in 2009 in Franklin, Tennessee. (CAP Ex. 6 at 4) The firm currently provides investment advice to more than 600 families, many of whom Mr. Pagliara has served for decades. (Pagliara dep. 43) In many cases, CapWealth advises several generations of clients within each family. Under Mr. Pagliara's leadership, and with its client-focused, individualized approach to wealth management, the firm has grown steadily since its formation and now has more than $1.2 Billion in assets under management. (CW000544) Through its Provable Integrity® process, CapWealth regularly provides its clients with accurate, transparent, and thorough financial information concerning their accounts. CapWealth complies with a rigorous set of performance-reporting guidelines called Global Investment Performance Standards ("GIPS"), pursuant to which it provides a quarterly report to each client that, *inter alia*, discloses the total management fees for its services and the client's return net of fees. (Pagliara dep. 156)

The financial services industry has recognized CapWealth as one of the top financial advisory and wealth management firms in the state of Tennessee. In both 2018 and 2020, *Barron's* magazine named Mr. Pagliara as the No. 1 Financial Advisor in Tennessee and *Forbes'* selected Mr. Pagliara as No. 1 on its list of Best-In-State Wealth Advisors. (CW000569) Mr. Pagliara's selection was based upon in-person interviews, industry experience, his compliance record, revenue produced, and assets under management.

2. CapWealth Has Not Received 12b-1 Fees Since June 2018.

CapWealth does not currently receive, and since June 2018 has not received, 12b-1 fees. (Pagliara dep. 49-50) In June 2018, as part of its long-planned transition to a strictly Registered

Investment Advisor ("RIA") model, CapWealth closed its affiliated introducing broker-dealer, CapWealth Investment Services, LLC ("CWIS"), which theretofore had placed orders for purchases of mutual funds on behalf of its clients. (*Id.*) CapWealth's implementation of its new business model began in 2015, long before (and quite separate and apart from) the SCSD Initiative launched in February 2018. (Venable dep. 82-83; Pagliara dep. 81-83)

3. CapWealth Received Only 2.6% of Its Revenue But 0% of Its Income From 12b-1 Fees During the 2016 to 2018 Period.

As its website, www.capwealthgroup.com, highlights, CapWealth is a registered investment advisor that "[t]hrough a unique client-discovery session, paired with [its] proven research process, … provides investment advice and wealth management and planning services" for its clients. It does so primarily through the selection and purchase of individual securities for its clients. CapWealth uses mutual funds to accomplish its clients' objectives only in select cases where, for example, the value of a client's account is not sufficient to allow proper diversification through the purchase of individual securities, or where a client has established a 529 education savings plan. (Pagliara dep. 136)

Consequently, the 12b-1 fees CapWealth has received over the years have been very modest. In 2018, for example, CapWealth collected a total of $64,053 in 12b-1 fees against total revenues of more than $6,967,187. (*See* Appendix 1) In other words, in 2018, 12b-1 fees accounted for less than 1% of CapWealth's revenues. From 2015 through 2017, the other time periods in dispute, 12b-1 fees made up, on average, approximately 3% of CapWealth's revenue. (*Id.*) But critically, and as explained in further detail *infra*, CapWealth provided discounts off its standard 1% advisory fee to clients who paid such fees so that the net annual management fee each client paid CapWealth did not exceed 1% of the client's assets under management. Therefore, CapWealth did not derive any income whatsoever from 12b-1 fees and did not financially benefit in any way.

4. CapWealth Fully Disclosed Its Receipt of 12b-1 Fees to Its Clients.

As stated *supra*, CapWealth's approach to investment advice begins with a "unique client-discovery session." The testimony during the enforcement investigation demonstrates—without contradiction—that CapWealth's investment advisors meet in-person with all prospective clients. (Venable dep. 132; Pagliara dep. 108; and Murphy dep. 116) During these client-centered discovery sessions, CapWealth's representatives explained the existence and collection of 12b-1 fees. (*Id.*) CapWealth began this practice prior to the time non-12b-1 paying F2 share classes became available in the marketplace in 2009 and after such share classes became available. (*Id.*) In his video Wells submission, Mr. Pagliara also has provided statements of two clients who verified and corroborated such testimony. Significantly, neither client had ever read CapWealth's Form ADV. Rather, their knowledge and understanding of 12b-1 fees came entirely from the disclosure CapWealth made to them during the client-discovery sessions. CapWealth provided the best and most effective disclosure possible—it explained 12b-1 fees to its clients in face-to-face meetings.

5. CapWealth Did Not Receive "Avoidable 12b-1 Fees."

During the Wells call, the SEC Staff explained that it had reached a preliminary determination that CapWealth had violated Sections 206(1) and (2) of the Investment Advisers Act of 1940 because, *inter alia*, CapWealth received "avoidable 12b-1 fees." This "preliminary determination" disregards the evidence gathered during the enforcement division's investigation and ignores the development of mutual fund share classes over time.

Both before and during the relevant period, CapWealth charged its clients a standard annual management fee equal to 1% of the value of the client's investment portfolio. (Venable dep. 98) Prior to 2008, clients who owned mutual funds also necessarily paid—in one form or another—fees for the marketing, distribution and management of such mutual funds. F2 and F3 share classes did not then exist. Acting in the best interests of its clients, and ***five years*** before the SEC settled

its first enforcement action related to 12b-1 fee disclosures,[3] CapWealth provided clients whose investment portfolios included mutual funds a discount off its standard 1% management fee so that the total management fee the client paid CapWealth each year did not exceed 1%. (*See* Appendix 1; *see also* Venable dep. 132; Pagliara dep. 108; and Murphy dep. 116) Thus, CapWealth's receipt of 12b-1 fees did not increase the fees any client paid one iota. Rather, CapWealth's practice of purchasing F1 class shares of mutual funds for its clients greatly benefitted clients. Such purchases avoided a client's payment of an up-front or back-end "load" to purchase mutual funds and, during the relevant period, did not cost the client anything because the amount of the 12b-1 fee was entirely offset by a reduction in the client's annual management fee.

In 2008, when F2 share classes became available, CapWealth—after full disclosure to and discussion with its clients—continued to select F1 class shares that paid a 12b-1 fee and provide an offsetting discount to the 1% annual management fee. That CapWealth provided such a discount cannot be disputed. Every witness who has testified has confirmed that CapWealth discounted its advisory fee to offset its receipt of 12b-1 fees. CapWealth's CEO, Phoebe Venable testified:

> Q. When CapWealth chose, let's say, F1 share classes for example for its clients that had 12b-1 fees in a fund that also had lower cost share classes that didn't have 12b-1 fees, did that selection of the higher cost share class violate this policy?
>
> A. No.
>
> Q. Why is that?
>
> A. Not in our situation. ***Because we had made concessions on the fee for the client to take into consideration that we were receiving the 12b-1fee.***
>
> Q. You mean -- you mean concessions of the firm's advisory fee?
>
> A. Yes.
>
> Q. And so, was that communicated to clients as far as you recall?

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[3] *See In re Manarin Investment Counsel, Ltd., Manarin Securities Corp., and Roland R. Manarin*, Release No. 9462 (Oct. 2, 2013).

A. Always, yes.

(Venable dep. at 132) (emphasis added)

Timothy Pagliara, the founder and chairman of CapWealth testified:

Q. Walk us through what you would have said to a client who was in that type of a situation in 2016?

A. I would have said, you know, we are, you know, committed to providing you the lowest cost that we can, you know. We will -- for example with that client relationship that I talked about, if they opened a new trust account, I would have said, ***Look, we're going to put you in a share class where we'll get compensation at 25 basis points. We're not going to charge you an administrative fee. We're not going to charge you an advisory fee. We'll do this as an accommodation based upon the whole relationship that we have with you. We would adjust our discounting policy to the total relationship*** and what we would be paid. So, it was part of a broad that we had with every client where we were trying to price the relationship fairly and equitably based upon everything that they had with us.

(Pagliara dep. at 108)

Timothy Murphy, an investment advisor at CapWealth, testified:

Q. Tell me about situations when you would negotiate a lower management fee than what we see listed in the exhibit.

A. If a client -- sometimes they ask for -- for, you know, a discount of some sort. And if there were situations where there were 12b-1s, you often would discount that.

Q. ***How much of a discount would you offer in light of 12b-1 fees?***

A. ***Typically 25 -- 25 percent.***

(Murphy dep. at 116) (emphasis added)

In addition, two of CapWealth's clients, [redacted] and [redacted], have provided videotaped statements confirming that they received such discounts and that Mr. Pagliara explained these discounts and the payment of 12b-1 fees in excruciating detail.

CapWealth selected the F1 share class and discounted its advisory fee to compensate clients for its receipt of 12b-1 fees because, *inter alia*, doing so increased each client's net after-tax gain on his investment. (*See* Video Wells submission of Timothy J. Pagliara; *see also* Expert Report of

Jonathan R. Macey ¶ 42) Marketing and distribution fees, including 12b-1 fees, paid within a mutual fund are deductible as an ordinary and necessary business expense under 26 U.S.C. §162 and thus are paid with pre-tax dollars. (*Id.*) On the other hand, the deductibility of an advisory fee paid to an investment advisor was subject to a limitation of 2% of adjusted gross income and therefore not available to most of CapWealth's clients. (*Id.*) Even the limited deductibility of advisory fees was eliminated by the Tax Cuts and Jobs Act of 2017. (*Id.*) By selecting F1 class shares for its clients and discounting its advisory fee by a like amount, CapWealth conferred a valuable tax benefit on each of its clients. CapWealth's discounted advisory fees also benefitted its legacy clients because it allowed such clients to continue to purchase the same class of shares already in their portfolio without adding so much as a dime of cost to the client to purchase such shares.

That CapWealth made these credits is irrefutably demonstrated in the Excel spreadsheet attached as Appendix 1 hereto. The spreadsheet illustrates what CapWealth's representatives testified to during the enforcement investigation: that CapWealth discounted the standard 1% management fee for clients whose investment portfolios included mutual funds. The discounted advisory fee CapWealth provided completely offset the so-called "avoidable" 12b-1 fees for CapWealth's clients.[4]

Thus, the Staff's claim that CapWealth *received* "avoidable 12b-1 fees" is itself misleading. It is true that CapWealth's advisors received 12b-1 fees during the relevant period even though, in some case, F2 class shares that did not pay a 12b-1 fee were available. But it is incorrect for the Staff to contend that CapWealth's receipt of such fees increased the fees clients paid to CapWealth.

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[4] Appendix 1 also shows that CapWealth received 12b-1 fees in 2006, 2017 and 2018 totaling, respectively, $56,749, $54,527, and $13,533, from clients who did not receive a discount to the 1% advisory fee. Importantly, these clients purchased mutual funds prior to the advent of the F2 class of shares and thus a 12b-1 (or other) fee was not avoidable. But even as to these clients, CapWealth recommended the lowest cost share class available at the time.

As such, CapWealth's representatives had no incentive to recommend that clients purchase shares of a class that paid a 12b-1 fee because CapWealth—not the client—absorbed the cost associated with the purchase. The client received the best of both worlds: the client was able to purchase the same class of shares already in the client's portfolio while avoiding the marketing, distribution and management costs associated with the purchase.

In other words, the Staff's 12b-1 case is a total red herring— clients paid a 1% (or lower) advisory fee with or without 12b-1 fees. Because money is fungible, it defies logic to bring an enforcement action against CapWealth for charging 1% when some of that money comes from 12b-1 fees, when the Staff surely would not recommend charges against CapWealth if clients paid the full 1% and then CapWealth credited back 100% of the 12b-1 fees.

6. CapWealth's Transition Away from 12b-1 Fees Began in 2015, Long Before the SCSD Initiative.

CapWealth decided in 2014 to focus its business entirely upon providing investment advice. (Pagliara dep. 145-46) Its transition to an exclusively RIA platform began on December 15, 2014, when it signed a contract with Pershing Advisory Services ("Pershing") to act as the custodian and broker dealer for its advisory clients. As part of its transition, CapWealth intended to shut down its affiliated broker dealer, CWIS, and rely entirely upon Pershing to clear trades for its advisory clients. (Venable dep. 172) As Mr. Pagliara explained at length in his testimony, CapWealth's decision to shut down CWIS and focus exclusively upon providing investment advice to its clients had nothing to do with share classes, 12b-1 fees or the SCSD Initiative, which was not even announced until February 12, 2018. (Pagliara dep. 81-83) Rather, CapWealth's decision was driven by the need to move away from the instability at its then custodian and clearing broker dealer, Sterne Agee and Leach, Inc. ("SAL"). (*Id.*)

But because its business model going forward did not include an affiliation with its introducing broker dealer, CWIS, CapWealth would not be receiving any 12b-1 fees once the transition was completed. Simultaneous with the movement to a new custodian and the elimination of 12b-1 fees, CapWealth intended to increase its advisory fee in order to account for the elimination of such fees. (Venable dep. 172) As CapWealth's chief executive officer, Phoebe Venable, testified, CapWealth intended the increase in the advisory fee and the elimination of the 12b-1 fees to be "revenue neutral" to the firm's clients. (*Id.*) This, of course, is entirely consistent with the fact that CapWealth historically had discounted its advisory fee for clients whose investments included mutual funds. Because the 12b-1 fee portion of CapWealth's fee was being eliminated, so too was the discount.

On February 10, 2015, CapWealth initiated the movement of a first tranche of client assets, consisting of approximately $200,000,000 in assets, to Pershing. (Venable dep. 85) Once custody of these client assets had been moved to Pershing, CapWealth purchased F2 class shares for clients whose investment needs included the purchase of mutual funds. (*Id.* 183) As stated *supra*, the goal was to accomplish a "revenue neutral" transition from a management fee that included a discounted advisory fee and a 12b-1 fee to a management fee that eliminated the discount and the 12b-1 fee. (*Id.* 172) For clients for whom SAL still functioned as custodian and with whom CWIS still functioned as the introducing broker dealer, CapWealth continued to provide a discounted advisory fee and to purchase F1 class shares. Once all clients had been moved to Pershing, all 12b-1 fees and all associated discounts were to be eliminated. (*Id.* 173)

For reasons not relevant here, but explained in detail in Ms. Venable's testimony, the move to Pershing did not go well. (*Id.* 83) Many of the promises Pershing made to CapWealth concerning its products and services were left unfulfilled. (*Id.*) Consequently, CapWealth did not proceed with

moving the second and third tranches of client assets to Pershing. Instead, on September 18, 2017, CapWealth selected Charles Schwab ("Schwab") as its sole custodian. CapWealth then engaged industry consultants to assist it in navigating the process of closing down CWIS to facilitate its move to an RIA-only platform. In early 2018, CapWealth sent the necessary transfer forms to its clients so that all clients, those at Pershing and those who remained at SAL (which had since been acquired by INTL FC Stone), could move their assets to Schwab.

On January 1, 2018, CapWealth—consistent with the business plan it had adopted at the beginning of the transition—increased its advisory fee to account for the elimination of the 12b-1 revenue. (*See* Venable dep. 90; and CW001725) By this time, American Funds had launched its F3 class of mutual fund shares that not only, like the F2 share class, eliminated 12b-1 fees but lowered costs to clients still further by eliminating other expenses. (*Id.*) In its negotiations with Schwab, CapWealth insisted that as Schwab received custody of the assets of CapWealth's advisory clients, Schwab convert all shares of mutual funds held in such accounts to class F3 shares. (Pagliara dep. 110-11) Schwab complied with CapWealth's direction making CapWealth's clients *among the first in the nation* to have converted to the F3 class of shares, the class that provided the lowest cost available to CapWealth's clients.

Rather than recognize that CapWealth always had placed the financial interests of its clients ahead of its own, the Staff now criticizes CapWealth for not having converted clients invested in F1 class shares sooner. This criticism is ill-founded for three reasons:

First, the criticism ignores the undisputed fact that CapWealth had discounted the advisory fee of clients invested in F1 class shares to absorb the cost of the 12b-1 fees. At no time did any CapWealth client bear the financial burden of any 12b-1 fee. CapWealth bore 100% of the burden of such fees through the discount it provided to its advisory fee.

Second, the Staff's criticism ignores the fact that clients necessarily incur costs to convert from one share class to another. To convert a client from an F1 share class to an F2 share class only to be later converted to an F3 share class would have harmed many clients. (Venable dep. 90; 258) The Staff appears either oblivious to or unconcerned with this economic reality.

Third, even if CapWealth's clients bore the expense of a 12b-1 fee (which was not the case), and even if it made economic sense to convert clients to F2 shares while at INTL FC Stone only to convert them again to F3 shares at Schwab (which was also not the case), the fact remains that converting all lots of all purchases of mutual fund shares of all CapWealth's clients who owned such shares, many of which had been owned for decades, cannot happen overnight. The Staff's criticism evidences no understanding of or appreciation for the difficulty and careful work required to convert the mutual fund shares CapWealth's clients owned. (Pagliara dep. 86; 148) CapWealth always acted diligently and in the best interest of its clients in converting mutual fund shares to the F3 share class, the most advantageous class available in the marketplace.

7. CapWealth Is a GIPS Compliant Firm.

CapWealth is certified as a GIPS compliant firm. (Pagliara dep. 156) Participation in GIPS is voluntary but distinguishes those firms who chose to participate as firms truly committed to reporting excellence both as to the performance of a client's investment and as to the fees an investment advisory firm charges for its services. CapWealth, for example, provides its clients quarterly reports that—on the very first page—not only disclose the performance of a client's investments net of all fees but also disclose *the total fees* the client paid to CapWealth for the preceding quarter. (*See* Video Wells Submission of Timothy J. Pagliara) Nothing is hidden from clients.

Thus, although during the Wells call the Staff claimed that CapWealth failed fairly and fully to disclose its receipt of 12b-1 fees to its clients, the opposite is true. CapWealth disclosed such fees to every mutual fund client in the client-discovery session. CapWealth disclosed such fees in

its Form ADV Part 2A. CapWealth disclosed such fees in the Investment Management Agreement ("IMA") each client signed. Each IMA (CAP Ex. 5) discloses that CapWealth's representatives may receive income from mutual funds and directs each client to the prospectus of each fund for further details. And, in addition to these disclosures, CapWealth voluntarily provided to each of its clients every quarter a GIPS-compliant report that simply and on the first page (a) shows each client the performance of his investment net of all fees and (b) shows the client total fees paid to CapWealth for the preceding quarter. CapWealth's disclosures not only comply with existing securities laws but go beyond the requirements of the law and satisfies the rigorous GIPS standards.

8. CapWealth Relied Upon Industry Consultants and Upon Guidance from OCIE Throughout the Relevant Period.

The evidence uncovered in the enforcement investigation establishes that CapWealth relied upon guidance from both the Office of Compliance Inspections and Examinations ("OCIE") and industry consultants in crafting the 12b-1 fee disclosures contained in its Form ADV Part 2A and in the IMAs it provided to its clients. (Pagliara dep. 75-78; 97-99) These facts vitiate any claim of *scienter* necessary for an alleged violation of Section 206(1) of the Investment Advisers Act of 1940.

CapWealth and its affiliated broker dealer, CWIS, were formed in January 2009. On May 2, 2011, OCIE conducted its first on-site inspection and examination of all aspects of CapWealth, including its business practices and disclosures. The inspection included CapWealth's Form ADV Part 2A and its form IMA. Mr. Pagliara testified that the inspection included a review of the firm's disclosures concerning 12b-1 fees (Pagliara dep. at 75-77). Mr. Pagliara modified the firm's disclosure documents in the manner OCIE recommended (*Id.* at 78). From 2011 through 2018, the last year that CapWealth's registered advisors received 12b-1 fees, the disclosures that CapWealth included in its Form ADV Part 2A and IMA regarding 12b-1 fees remained unchanged. Otherwise

stated, the disclosures the Staff now claims violate Section 206 are the very same disclosures that OCIE reviewed and approved in its 2011 inspection and examination and which CapWealth thereafter used with confidence for the next seven years.

In addition, as Ms. Venable testified, during the relevant period (2015-2018), CapWealth retained and relied upon the regulatory advice of two separate industry consultants, Asgard Regulatory Group, LLC and 1st BridgeHouse Securities, LLC (Venable dep. at 123). These consultants reviewed CapWealth's practices and its Form ADV Part 2A to ensure, *inter alia*, that CapWealth's disclosures met every regulatory requirement. 1st BridgeHouse even filed CapWealth's disclosure documents with the SEC on behalf of CapWealth (Venable dep. at 231-32).

Thus, the record shows that even if CapWealth's disclosures were deficient in some respect, which is not the case, the notion that CapWealth intentionally failed to disclose any matter that the law required be disclosed is insupportable. CapWealth always acted in reliance upon the guidance OCIE provided in its 2011 examination and upon the guidance two separate industry consultants, Asgard and 1st BridgeHouse, provided.

III. CAPWEALTH DID NOT VIOLATE SECTION 206(1) OR 206(2) OF THE INVESTMENT ADVISERS ACT OF 1940.

In its May 13, 2020, Wells notice, the Staff states that it has reached a preliminary determination that CapWealth violated Sections 206(1), 206(2), 206(4) and 207 [15 U.S.C. §§ 80b-6(1), 80b-6(2), 80b-6(4), and 80b-7] of the Investment Advisers Act of 1940, and Rule 206(4)-7 [17 C.F.R. § 275.206(4)-7], thereunder. As relayed to CapWealth during the Wells call, and as the companion Wells notices the Staff simultaneously issued to CapWealth's advisors state, "[t]he facts that [the Staff] believe[s] support charges against [CapWealth] include, among others: (1) failing to fully and fairly disclose to advisory clients of CapWealth Advisors, LLC your mutual fund share class selection practices and the conflicts of interest created by the 12b-1 fees incurred by advisory

clients' accounts; and (2) failing to obtain best execution for advisory clients in their mutual fund share class investments." These statements, however, are not statements of fact but rather are conclusions that the record demonstrates to be contrary to the facts. As set forth below, and as confirmed in the Expert Report Professor Jonathan Macey has submitted, CapWealth did fully and fairly disclose to its clients all material facts concerning 12b-1 fees and CapWealth did obtain "best execution" in connection with the purchase of mutual funds on behalf of its clients. Furthermore, an enforcement action against CapWealth based on these allegations violates due process.

A. CapWealth Fully and Adequately Informed Its Clients of Its Receipt of 12b-1 Fees and Conflicts of Interest.

The Staff's claim that CapWealth failed adequately to disclose facts concerning 12b-1 fees is deficient in two material respects. First, the Staff has failed to consider the "totality of the circumstances" concerning disclosure. Second, the Staff has failed to understand and evaluate the facts subject to disclosure.

1. The Staff Has Failed To Consider the Totality of CapWealth's Disclosures.

The Staff's criticism of CapWealth's disclosure of its receipt of 12b-1 fees is myopically focused upon CapWealth's written disclosures in its Form ADV Part 2A and in its form IMA. But as Professor Macey explains in his Report, "[t]he SEC has long taken a practical, sensible, holistic approach to disclosure." (Macey Report p. 4). Professor Macey explains that "[a]ny decision to insist that disclosure is only proper and appropriate if it is contained in Form ADV Part 2A is inconsistent with long-standing SEC disclosure policies that provide significant benefits to investors." (*Id.*) According to Professor Macey, "appropriate disclosures of 12b-1 fees were made [here] in a variety of ways, including by prospectus, confirmation and actual in-person conversations with clients." (*Id.*) The record fully supports Professor Macey's opinions. First, the record unequivocally establishes that CapWealth made adequate disclosure of its receipt of 12b-1 fees to its

clients in-person during its initial client discovery sessions. Timothy Pagliara, a registered investment advisor with and principal owner of CapWealth, testified that he explained to clients any receipt of 12b-1 fees during initial, face-to-face meetings with clients and how such fees flowed to him in his role as a registered representative or as an owner of CapWealth. (*Id.* ¶ 23)[5] Likewise, CapWealth's CEO, Phoebe Venable has testified that she *always* discussed the nature of 12b-1 fees with clients investing in mutual funds that had such fees. (*Id.* ¶ 24). She did so during face-to-face meetings with her clients. (*Id.*) Her explanations included a discussion that the 12b-1 fees factored into negotiating a discount on advisory fees. (*Id.*) Ms. Venable also explained to her clients that many of the funds in which they were invested had lower cost share classes that did not have 12b-1 fees for which they were eligible. (*Id.*) When a specific mutual fund share class was selected Ms. Venable also informed her clients of whether they were eligible for lower cost share classes of the same fund. (*Id.*) Such disclosures, of course, are the very same ones that the SEC claims should have been made, but in the Form ADV, rather than in actual conversation. (*Id.* ¶ 25) As the SEC recently stated, in assessing whether its clients have received a full and fair disclosure, CapWealth is entitled to rely on oral disclosures and the multiple written disclosure documents described *infra*:

> "***We do not interpret an adviser's fiduciary duty to require that full and fair disclosure or informed consent be achieved in a written advisory contract or otherwise in writing***. For example, an adviser could provide a client full and fair disclosure of all material facts relating to the advisory relationship as well as full and fair disclosure of all conflicts of interest which might incline the adviser, consciously or unconsciously, to render advice that was not disinterested, through ***a combination of Form ADV and other disclosure*** and the client could implicitly consent by entering into or continuing the investment advisory relationship with the adviser."[6]

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[5] Mr. Pagliara's testimony in this regard is fully corroborated by the videotaped statements of two representative clients, [redacted] and [redacted], submitted in Mr. Pagliara's contemporaneously provided videotaped Wells submission.

[6] *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Release No. IA-5248, at 27 n.68 (June 5, 2019), https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

According to Professor Macey, "the disclosures made here were of the highest quality because they were delivered orally, in an interactive format." (*Id.* ¶ 27) Professor Macey explains in his report that "there are qualitative differences in disclosures, both in terms of the format of such disclosures and in terms of the substance of such disclosures. Specifically, disclosures written with significant jargon or tucked away in a footnote likely will not have the same force and effect as disclosures that are written in plain English and featured prominently in disclosure forms ***or are carefully explained in-person to a client***. (*Id.* ¶ 26)(emphasis added)

"The oral communication of 12b-1 fees by investment advisers that was done by CapWealth was a *superior* mode of disclosure to the alternative, written disclosure that the SEC advocates in its recent SCSD enforcement initiative." (*Id.* ¶ 32)(emphasis in original) "By orally communicating the fee information, the advisers made sure that the relevant information actually was conveyed and was not lost inside of some unread document. Moreover, advisers making oral disclosures of 12b-1 fees had the opportunity to make sure that clients fully understood the fees that were being disclosed because such oral disclosure was, by its very nature, interactive, allowing the opportunity for questions and answers, and increasing the odds that such disclosures would be fully internalized by clients." (*Id.*)[7] In Professor Macey's opinion, "…it would be misguided to pursue enforcement policies that discourage or diminish the value and importance of in-person disclosures such as those that occurred here." (*Id.* ¶ 28)[8]

2. CapWealth Disclosed in Writing Its Receipt of 12b-1 Fees.

These fulsome disclosures of 12b-1 fees during in-person meetings with clients were in

[7] 17 CFR 240.15l-1 (Regulation Best Interest), effective September 10, 2019, explicitly allows such disclosures.
[8] Professor Macey explains that this is so because "It is well established that investors typically do not read the disclosure documents such as Annual Reports, proxy statements, mutual fund prospectuses, or mutual fund shareholder reports, with which they are supplied by brokers, investment advisers and others. Moreover, it also is widely understood that the primary and dominant source of information for individual investors are communications from their investment adviser or broker." (*Id.* ¶ 30)

addition to the written disclosures CapWealth provided in its Form ADV Part 2A and in its form IMA. CapWealth's Part 2A expressly and accurately disclosed CapWealth's receipt of 12b-1 fees. *See*, e.g., Form ADV Part 2A filed February 2, 2016, pp.8, 9. ("Most of the investment professionals of CapWealth are also registered with CWIS…Therefore, the principals of CapWealth may receive compensation as a result of acting in one or both capacities, ***including the receipt of 12b-1 distribution payments from certain funds***.")(emphasis added) CapWealth's form IMA likewise disclosed that its advisors may receive 12b-1 fees and referred clients to the prospectus of each subject mutual fund for further information. ("Client understands that Account assets invested in shares of mutual funds or other investment companies ("funds") will be included in calculating the value of the Account for purposes of computing Adviser's fees ***and the same assets will also be subject to additional advisory and other fees and expenses, as set forth in the prospectuses of those funds, paid by the funds but ultimately borne by the investor.***") *See* Cap Ex. 5, p. 2.

3. CapWealth's Receipt of 12b-1 Fees Did Not Present a Conflict of Interest and Was Not Material to Client Investment Decisions Because CapWealth Discounted the Advisory Fee for Clients Who Paid 12b-1 fees.

In addition to its singular focus on the Form ADV as a basis for its alleged violation of Section 206, the staff also has complained that CapWealth failed adequately to disclose to clients that a recommendation of a class of shares that paid a 12b-1 fee presented a conflict of interest for its advisors. In making such a claim, the Staff has disregarded the overwhelming evidence that CapWealth eliminated the alleged conflict of interest because—through a discounted advisory fee to clients who invested in class of shares that paid a 12b-1 fees—CapWealth removed the incentive, and therefore eliminated the conflict of interest, about which the staff complains. Professor Macey's economic analysis of this issue is instructive.

In his report, Professor Macey explains that because any 12b-1 fees CapWealth customers

paid were offset by reductions in the standard advisory fees CapWealth charged "the net effect on a customer of incurring 12b-1 fees, when accompanied by an offsetting deduction in the standard advisory fee, was zero." (Macey Report ¶ 16). "The particular 12b-1 fees CapWealth clients paid were immaterial because an ordinarily prudent, rational investor would not consider such fees to be important or even relevant to his or her investment decision." (*Id.* at ¶17) "The conflicts of interest that ordinarily exist when 12b-1 fees are collected by advisers were avoided altogether because CapWealth's investment advisers, unlike other investment advisers whose disclosures have been targeted in this enforcement initiative, had no financial incentive to select a higher cost share class that paid a 12b-1 fee, since those very fees were returned to the customer in the form of a reduction in the advisory fees charged to the customers paying the 12b-1 fees." (*Id.* at ¶18)

That CapWealth provided such a discount that eliminated any conflict that otherwise might have existed is indisputable. CapWealth advised a total of 817 clients during the relevant period whose accounts included mutual funds. *See* Appendix 1 hereto. The discounted advisory fee CapWealth provided completely offset the 12b-1 fees for these clients.[9] (*Id.*) Even when the 12b-1 fees CapWealth are considered, the fees CapWealth charged mutual fund customers remained below CapWealth's standard 1% advisory fee during the relevant period. The incentive, and therefore the conflict, about which the Staff complains did not exist.

B. CapWealth Did Not Act with Scienter.

Although none of the claims the Staff has determined to pursue are well grounded in fact, the Staff's determination that CapWealth violated Section 206(1)—a provision that requires proof of scienter—is a particularly unsupported claim. During the Wells call, the Staff stated that their

[9] As noted supra in footnote 4, CapWealth received 12b-1 fees in 2006, 2017 and 2018 totaling, respectively, $56,749, $54,527, and $13,533, from clients who did not receive a discount to the 1% advisory fee. These clients purchased mutual funds prior to the advent of the F2 class of shares and thus a 12b-1 (or other) fee was not avoidable.

basis for the fraud charge came from the emails introduced at testimony "because it was widely known that small set of clients were moved to Pershing in lower cost share class, while others were not" and that the emails showed there was a "constant focus at firm about 12b-1 fees and moving clients over to Charles Schwab." The Staff also stated that the allegedly offending conduct "continued for four years and that goes to scienter." These arguments fall flat.

1. The Emails to Which the Staff Refers Do Not Show That CapWealth Knowingly Engaged in Wrongful Conduct.

During the Wells call, the Staff adverted to several e-mails (CAP Exs. 7-15) CapWealth provided in response to the Staff's enforcement subpoena as purported evidence of scienter. These e-mails, however, simply confirm the testimony of the witnesses (Venable, Pagliara and Murphy), all of whom testified (a) that CapWealth selected F1 class shares when SAL had custody of client assets, (b) that the firm selected F2 class shares when custody was moved to Pershing in anticipation of the closing of CWIS, and (c) that ultimately all clients were converted to the F3 class of shares when custody was moved to Schwab and CWIS was closed. *See*, e.g., Venable dep. 157, 172, 180-82 and 220-21 (explaining and providing context for e-mails) The Staff argues, apparently, that such e-mails demonstrate that CapWealth knew all along that F2 class shares were more beneficial to clients than F1 class shares, and therefore that it knowingly and in violation of its fiduciary duty to its clients failed to select the F1 class of shares for such clients from the beginning. This analysis is flawed at multiple levels.

First, as Ms. Venable explained in her testimony, CapWealth began to convert clients to F2 class shares as part of the switch to Pershing because CapWealth, as part of that transition, was closing its affiliated broker-dealer, CWIS. Because CapWealth was closing CWIS, CapWealth could no longer use the 12b-1 fees paid in connection with F1 shares to offset the 1% advisory fee charged to clients and provide to clients the tax benefit discussed *supra*. The conversion of clients

from F1 class shares to F2 class shares, thus, is not an admission that CapWealth intentionally breached its fiduciary duty to clients in the first instance by recommending the purchase of F1 shares. To the contrary, CapWealth began to convert clients to F2 shares because the benefits clients obtained from having purchased the F1 shares was going away.

Second, to the extent that the Staff claims that CapWealth's failure to more quickly move to convert from F1 class shares to F2 class shares all clients whose assets had moved to Pershing, and likewise failed to move more quickly to convert from F1 class shares to F2 class shares those clients who remained at INTL FC Stone, shows *scienter*, the Staff's position is without merit for the same reason. So long as CWIS remained a duly licensed broker-dealer, CapWealth's advisory clients were better off remaining in F1 shares because (a) the 12b-1 fees associated with that class of shares were offset by a discounted advisory fee and (b) such fees were paid on a pre-tax basis, given that the taxable gain clients received from such shares was net of such fees. CapWealth's alleged "failure" to move clients to F2 shares more quickly actually inured to the clients' financial benefit. Such alleged failure does not remotely show intentional wrongdoing.

Finally, as Mr. Murphy testified, although on many occasions prior to the transition to Schwab F2 shares were shown by prospectus to be available for purchase, such shares were not in fact available to CapWealth's clients through SAL. (Murphy dep. 98) Thus, the mere fact that CapWealth converted a client from the F1 class of shares to the F2 class does not indicate that CapWealth's initial purchase of the F1 shares was a wrongful act, much less a knowingly wrongful act.

Accordingly, the emails upon which the Staff purports to rely to show scienter prove no such thing.

2. The Record Testimony Shows the Absence of Scienter.

The testimony in this case is uniformly contrary to the staff's preliminary determination that

Cap-Wealth intended to deceive its clients regarding 12b-1 fees. Every witness who has provided evidence on the issue has squarely contradicted the Staff's claim. Mr. Pagliara has testified that he fully disclosed the existence, nature and effect of 12b-1 fees to his clients. (Pagliara dep. 107-09) Ms. Venable testified that she *always* disclosed CapWealth's receipt of 12b-1 fees to clients and explained how CapWealth would offset those fees through a discount to its 1% advisory fee. (Venable dep. 116, 132, and 140) Mr. Murphy testified that he also explained to his clients the existence of 12b-1 fees, CapWealth's receipt of such fees, and the discount provided in connection with such fees. (Murphy dep. 78-79; 82; and 116) He further testified that he always selected the class of mutual fund shares best suited to his client's investment objectives. (Murphy dep. 42-43, and 84-85) Two representative clients of CapWealth, Richard Warren and Melody Sullivan, have provided videotaped statements confirming that CapWealth explained the existence and operation of 12b-1 fees in face-to-face, in-person meetings. These witnesses also testified to the existence of the discount to CapWealth's advisory fee that the firm used to offset the receipt of 12b-1 fees.

3. CapWealth Retained and Relied on Outside Consultants

In addition to this, CapWealth explicitly disclosed the receipt of 12b-1 fees in its Form ADV Part 2A and, in its form IMA, also disclosed that its advisors may be compensated through mutual funds, referring its client to the prospectuses of the mutual funds for further information. The written disclosures CapWealth provided in Part 2A and in its form IMA during the relevant period were the same disclosures that OCIE reviewed and approved during its May 2, 2011, on-site inspection and examination. Two separate industry consultants, Asgard and 1st BridgeHouse, reviewed and approved these same disclosures. (Venable dep. 121-23; and 231-32) CapWealth relied upon both the OCIE examination and the advice of its industry consultants in believing the written disclosures met every legal and regulatory requirement. (*Id.*)

The testimony and statements of all five witnesses who have provided evidence in this case, and CapWealth's explicit reliance upon OCIE's guidance and the guidance of CapWealth's specially retained industry consultants uniformly militate against any notion that CapWealth deceived anyone, much less did so with *scienter*.

In the face of this body of evidence, the Staff has come forward with no competent evidence—none—to support its claim that CapWealth intentionally deceived its clients.

IV. AN ENFORCEMENT ACTION AGAINST CAPWEALTH UNDER SECTION 206(1) OR (2) FOR ITS ALLEGED FAILURES RAISES FAIR NOTICE AND DUE PROCESS CONCERNS.

Bringing an enforcement action against CapWealth violates due process and basic principles of fair notice because it targets conduct that has conformed to all applicable rules and that no law, statute, rule, court decision or binding precedent declared unlawful. "Due process requires that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited."[10] "Although the Commission's construction of its own regulations is entitled to substantial deference," courts will not "defer to the Commission's interpretation of its rules if doing so would penalize an individual who has not received fair notice of a regulatory violation."[11] An agency has provided fair notice only where "a regulated party acting in good faith would be able to identify, with ascertainable certainty, the standards with which the agency expects parties to conform."[12] Fair notice is absent here.

The Staff contends CapWealth was required, under Section 206, to state specifically that

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[10] *Upton* v. *S.E.C.*, 75 F.3d 92, 98 (2d Cir. 1996) (citation and internal quotations omitted). *See also F.C.C.* v. *Fox Television Stations, Inc.*, 567 U.S. 239, 253 (2012) ("[A] fundamental principle in our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required."); Executive Order No. 13,892, 84 Fed. Reg. 55,239 (Oct. 15, 2019) ("Regulated parties must know in advance the rules by which the Federal Government will judge their actions.").

[11] *Upton*, 75 F.3d at 98.

[12] *Gen. Elec. Co.* v. *U.S. E.P.A.*, 53 F.3d 1324, 1329 (D.C. Cir. 1995), as corrected (June 19, 1995) (internal quotations and citations omitted).

CapWealth placed clients in more expensive share classes where less expensive share classes existed for the same fund. Section 206 does not require such disclosure. Section 206 has been interpreted to require disclosure of conflicts between the adviser and client.[13] As discussed above, CapWealth's disclosures were sufficient under the *applicable rules* of Section 206: its ADV disclosures conformed to the Commission's Form ADV Part 2A instructions,[14] and it ensured that clients were adequately informed about fees and conflicts of interest through a combination of other written and oral disclosures, which is expressly permissible under Regulation Best Interest.[15] Instead, the Staff proposes to hold CapWealth to a new legal standard of disclosure based on general anti-fraud rules as elaborated in settled enforcement cases, the Initiative, and other informal guidance. These actions are not law. Even more unjust, the Staff is considering retroactively punishing CapWealth for failing to make this disclosure from 2015, ***three years before*** CapWealth could have conceivably understood that such a disclosure was required under the Initiative. That is not how the rule of law works and that is not how the SEC should operate.

A. Settled Enforcement Actions Are Not Binding and Did Not Put Capwealth on Notice of The Purported Disclosure Obligation.

Settled enforcement actions did not put CapWealth, or other firms in the industry, on notice of the mutual fund share class selection disclosures that firms are purportedly obligated to make because those settled actions have no precedential value.[16] Commissioner Hester Peirce appropriately cautioned against relying on settlement orders to establish legal precedent, warning that the

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[13] *See S.E.C.* v. *Tambone*, 550 F.3d 106, 146 (1st Cir. 2008), reh'g en banc granted, opinion withdrawn, 573 F.3d 54 (1st Cir. 2009), and opinion reinstated in part on reh'g, 597 F.3d 436 (1st Cir. 2010) ("Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund and its investors, and includes an obligation to provide 'full and fair disclosure of all material facts' to investors and independent trustees of the fund.")
[14] *See* Section III.A.2, *supra*.
[15] *See* Section III.A.1, *supra*.
[16] *United States* v. *E.I. du Pont de Nemours & Co.*, 366 U.S. 316, 330 n.12 (1961) ("[T]he circumstances surrounding such negotiated agreements [consent decrees] are so different that they cannot be persuasively cited in a litigation context.").

"practice of attempting to stretch the law is a particular concern when it occurs in settled enforcement actions" because "often, given the time and costs of enforcement investigations, it is easier for a private party just to settle than to litigate a matter."[17] As such, "*a settlement negotiated by someone desperate to end an investigation that is disrupting or destroying her life should not form the basis on which the law applicable to others is based.*"[18]

The disclosure deficiencies stated in the settlement orders are fact-specific and unique, based on each firm's individual facts, circumstances, conflicts of interest and various practices. Those firms may not have believed that they had a disclosure deficiency but nevertheless chose to settle for reasons that never will be known to those outside of those firms. Firms should not be expected to be clairvoyants, reading the tea leaves of settlement orders to determine, in good faith, what, if any, specific disclosures they were required to make.[19] In the absence of a regulation or interpretive guidance pronouncing a specific disclosure requirement to the industry, a firm reviewing these settlement orders may determine that—based on its own facts, circumstances, conflicts of interest, universe of disclosures and various practices—it is not required to make the exact same disclosure.

To make an already unclear disclosure regime worse, the SEC is not even consistent in its approach to the precedential value of settlements, and the extent to which firms can rely on past settlement orders in determining whether their disclosures were sufficient. In the recent case of *SEC* v. *Cetera*, the SEC filed a district court action against an investment adviser for violations of

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[17] *See* Commissioner Hester Peirce, The Why Behind the No: Remarks at the 50th Annual Rocky Mountain Securities Conference, (May 11, 2018), https://www.sec.gov/news/speech/peirce-why-behind-no-051118#_ftnref34.

[18] *Id.*

[19] *See also* Executive Order 13924, 85 Fed. Reg. 31,353 (In the context of the coronavirus pandemic, stating that "[t]he heads of all agencies shall . . . decline enforcement against persons and entities that have attempted in ***reasonable good faith*** to comply with applicable statutory and regulatory standards, including those persons and entities acting in conformity with a pre-enforcement ruling.").

Section 206, among others, for exactly the same allegedly "inadequate"[20] mutual fund share class disclosures at issue here. Defendant Cetera argued in its motion to dismiss that its disclosures were sufficient in light of revised disclosures that the SEC had blessed in the settled order, *In re Everhart Financial Group, Inc.*[21] Remarkably, and echoing the sentiments of Commissioner Peirce, in its Opposition, the SEC argued that "Cetera's reliance on this settled order [was] misplaced" because:

> "A settled order is the document by which the SEC simultaneously brings certain claims and settles those claims with the parties named in the order (called the 'Respondents'). As the order notes, the Respondents submitted offers of settlement and the SEC accepted those offers. The order is resolving a dispute between the SEC and the Respondents and *is limited to the facts of that particular dispute*. Moreover, the order states that '[t]he findings herein are made pursuant to [the Everhart] Respondents' Offers of Settlement and are *not binding on any other person or entity in this or any other proceeding.*'"[22]

In denying Cetera's motion, the court agreed, stating "it is my experience that many factors go into approving a settlement that are not present in a fully litigated case; therefore, *an order approving a settlement has less precedential value*" and that "a tacit approval in an administrative proceeding that is focused on a settlement of a case is *not substantial authority*."[23] And yet, as discussed below, the SEC cites to these nonbinding settled orders as the *sole legal authority* for these purported Form ADV disclosure "requirements." The SEC cannot have it both ways: if a firm's reliance on settled orders is "misplaced" during litigation, so too is the Staff's reliance on them to bring enforcement actions.

B. Informal SEC Guidance Did Not Provide Reasonable Notice Because There Was Substantial Uncertainty in the SEC's Interpretation of Investment Adviser's Mutual Fund Share Class Disclosure Obligations.

Informal guidance issued by the Staff did not provide reasonable notice to CapWealth, or other regulated entities, regarding the specific ADV disclosure requirements regarding mutual fund

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[20] Opp. Br. at 2, *SEC* v. *Cetera Advisors LLC*, No. 19-CV-02461-MEH (D. Colo. Feb. 4, 2020), EFC No. 40.
[21] 113 SEC Docket 1190, 2016 WL 159329 (Admin. Order Jan. 14, 2016).
[22] Opp. Br. at 27-28, *SEC* v. *Cetera Advisors LLC*, *supra* n. 20 (internal citations omitted).
[23] *SEC* v. *Cetera Advisors LLC*, No. 19-CV-02461-MEH, 2020 WL 1905046, at *5 (D. Colo. Apr. 17, 2020).

share class selection. On July 13, 2016, the Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert announcing the "Share Class Examination Initiative" as one of its 2016 examination priorities (the "OCIE Risk Alert"). Although the OCIE Risk Alert stated that OCIE "[e]xaminers . . . likely [would] review an adviser's practices surrounding its selection of mutual fund[s] . . . 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," it lacked the specificity to put any firm on notice of what conduct would be proscribed or what specific disclosures would be required."[24] This is hardly the clarity one would expect from a disclosure agency.

The Division of Enforcement announced the Share Class Selection Disclosure Initiative on February, 12, 2018, which purported to impose on firms highly proscribed 12b-1 conflict of interest disclosure "requirements."[25] For the first time, the Staff announced that for these disclosures to be "sufficient," firms' Forms ADV, *in isolation*, must "explicitly" disclose "the conflicts of interest associated with (1) making investment decisions in light of the receipt of the 12b-1 fees, and (2) selecting the more expensive 12b-1 fee paying share class when a lower-cost share class was available for the same fund."[26] In the absence of any applicable, binding legal authority to support this purported "requirement," the Initiative relied *solely* on settled enforcement actions that the Staff has acknowledged are nonbinding, as discussed above.[27]

Two months later, in April 2018, the Commission published a proposed interpretation of

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[24] National Exam Program Risk Alert, OCIE's 2016 Share Class Initiative at 1 (July 13, 2016), https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf.
[25] *See* https://www.sec.gov/enforce/announcement/scsd-initiative#_ftn3.
[26] *See* https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation#_ftnref15.
[27] There are six such orders: four from the second half of 2017, one from June 2015 and one from October 2013.

the standard of conduct for investment advisers that attempted to back-door some purported guidance. The Commission stated that "[i]n light of the *comprehensive nature* of our proposed set of rulemakings, we believe it would be appropriate and beneficial to address in one release and *reaffirm*—and in some cases *clarify*—certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act."[28] The proposed interpretation referred briefly to disclosures about more expensive mutual fund share classes, but there was no existing guidance to reaffirm or clarify:

> "We believe that an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance. *For example, if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other available options when the adviser is receiving compensation that creates a potential conflict and that may reduce the client's return*, the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, *provide full and fair disclosure of the conflict and its impact on the client* and obtain informed client consent to the conflict."[29]

Despite the Division of Enforcement's sweeping Initiative to identify "potential[ly] widespread violations" with respect to mutual fund share class disclosures, the Commission's final interpretation released in June 2019 tellingly *omitted* this reference to share class disclosures.[30]

Having failed to promulgate rules requiring these mutual fund share class disclosures, on October 18, 2019, the Division of Investment Management again tried to re-write history by issuing

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[28] Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation at 5, Release No. IA-4889 (April 18, 2018), https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

[29] *Id.* at 12.

[30] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019), https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

"Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation" (the "FAQs").[31] The FAQs purportedly reiterated that these "disclosure obligations" are required under the existing Instructions to the Form ADV, and that they "create[d] no new or additional obligations."[32]

To the contrary, these purportedly required mutual fund share class disclosures were not (and still are not) required under the Instructions to the Form ADV. To the extent advisers "accept[] compensation . . . from the sale of mutual funds," the Instructions to the Form ADV only require advisers to "[d]escribe *generally* how you address conflicts that arise, including your procedures for disclosing the conflicts to clients," and that "if you *primarily*[33] recommend mutual funds, disclose whether you *will* recommend 'no-load' funds."[34] CapWealth met its obligations under existing law,[35] and this action amounts to rulemaking by enforcement.

C. Because the SEC Failed To Provide Notice, CapWealth Cannot be Sanctioned Under the SEC's Substantial Additions to the Regulatory Framework.

The settled orders, Initiative and the FAQs make substantive legal additions to the regulatory framework but they do not provide adequate notice as a matter of law, so CapWealth cannot be sanctioned for alleged disclosure failures. "The Commission may not sanction [a defendant] pursuant to a substantial change in its enforcement policy that was not reasonably communicated to the public."[36]

Indeed, the sheer number of enforcement actions the SEC has settled and complaints the SEC has filed following the Initiative related to firms' alleged mutual fund share class disclosure

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[31] *See* https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation#_ftnref15.
[32] *Id.*
[33] As discussed in Section I, *supra*, only a small percentage of CapWealth's AUM were invested in mutual funds.
[34] PART 2: Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements, General Instructions for Part 2 of Form ADV, https://www.sec.gov/about/forms/formadv-part2.pdf.
[35] *See* Sections III.A.1-2, *supra*.
[36] *Upton*, 75 F.3d at 98.

failures demonstrates that the Initiative constituted a substantial change to the SEC's enforcement policy that was not communicated to the public. Despite claiming that the "legal and regulatory requirements in this area are clear,"[37] since February 2012, the SEC has settled over 110 enforcement cases and filed four complaints against investment advisers for alleged deficient mutual fund share class disclosures. Courts "will not lightly presume an entire industry negligent."[38] To paraphrase the Supreme Court: Although it "may be 'possible'" that an "entire industry" was "in violation of the [Investment Advisers Act] for a long time without the [Commission] noticing," the "more plausible hypothesis is that the [Commission] did not," until recently, "think the industry's practice was unlawful."[39]

Moreover, this new disclosure regime was not reasonably communicated to the public. The Initiative simply cited nonbinding settlement orders as the basis for the disclosure obligation. Despite having the opportunity to do so, and in an era where mutual fund share class disclosures were evidently top of mind, the SEC has declined to adopt a regulation requiring the disclosures the Staff now claims is required under Section 206.[40] As such, advisers had every reason to expect that disclosures satisfying the obligations specified in Form ADV would be in full compliance.[41]

Courts have struck down similar misplaced actions by the SEC in the past, and courts will do so again here. In *Upton*, the court held that "because there was substantial uncertainty in the

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[37] Press Release, SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors (Feb.12, 2018), https://www.sec.gov/news/press-release/2018-15.
[38] *In re City of New York*, 522 F.3d 279, 285 (2d Cir. 2008) (emphasis added).
[39] *Christopher* v. *SmithKline Beecham Corp.*, 567 U.S. 142, 158 (2012) (*quoting Dong Yi* v. *Sterling Collision Ctrs., Inc.*, 480 F.3d 505, 510–11 (7th Cir. 2007)).
[40] *See* Petition For Rulemaking To End The Commission's Backdoor Regulation Of 12b-1 Fees at 37-38 (Apr. 29, 2020), https://www.sec.gov/rules/petitions/2020/petn4-761.pdf ("[T]he Commission has repeatedly promulgated rules that address mutual fund fee disclosure requirements and related conflicts of interest. But it has never adopted, or even proposed, a rule requiring the specific share class disclosures that the Commission—through the Initiative and the FAQs—has said were always really required. Such detailed disclosures have never been the law.").
[41] So too did CapWealth's outside compliance consultants. *See* Section II.8, *supra* and Macey Report at ¶ 39 ("The purpose of retaining such consultants was to ensure that the firm's disclosures met all applicable regulatory disclosure requirements.").

Commission's interpretation of Rule 15c3–3(e)," the defendant "was not on reasonable notice that FiCS's conduct might violate the Rule."[42] Notably, the court found that "the Commission was aware that brokerage firms were evading the substance of Rule 15c3–3(e) . . . as early as 1986, two years before the events in this case took place . . . [but] took no steps to advise the public that it believed the practice was questionable" for three years.[43] Similarly here, the SEC was well aware of firms' purported disclosure deficiencies since at least 2013.[44] Yet, the SEC has issued no regulations clarifying firms' disclosure obligations. If the Commission decides to impose new requirements such as those set forth in the Initiative, it must do so through notice-and-comment rulemaking, not through enforcement.[45]

D. The Staff Cannot Punish CapWealth Retroactively.

Even to the extent the Initiative provided CapWealth with fair notice of a new disclosure regime in February 2018, the Staff may not use its newly articulated requirement to alter the legal consequences of CapWealth's conduct dating back to 2015. Courts will not defer to an agency's interpretation where its "interpretation of ambiguous regulations [ ] impose ***potentially massive liability*** on [defendants] for conduct that occurred ***well before that interpretation was***

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[42] *Upton.*, 75 F.3d at 98.

[43] *Id.*

[44] *See* Press Release, SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors, *supra* n. 37 ("The Commission has ***long been focused*** on the conflicts of interest associated with mutual fund share class selection."); Announcement, Share Class Selection Disclosure Initiative (Feb. 12, 2018), https://www.sec.gov/enforce/announcement/scsd-initiative#_ftnref1. ("There is significant concern that many investment advisers have not been complying with their obligation under the Advisers Act to fully disclose all material conflicts of interest related to their mutual fund share class selection practices, and that investor harm involving this lack of disclosure may be ***widespread***.").

[45] *See* Commissioner Hester Peirce, Reasonableness Pants: Remarks at Rutgers Law School, Camden, NJ (May 8, 2019) (emphasis added) (the SEC has a duty "to be clear with registrants about [its] interpretation of the fiduciary duty. If [the SEC] see[s] a wide-scale departure from the fiduciary duty as [it] interpret[s] it occurring over numerous years, [the SEC] owe[s] it to the firms [it] regulate[s] and—more importantly—the investors whom [the SEC is] charged with protecting ***to be very clear that there is a problem***."), https://www.sec.gov/news/speech/speech-peirce-050819; *See* Petition For Rulemaking To End The Commission's Backdoor Regulation Of 12b-1 Fees at 10, *supra* n. 40 ("This 'Share Class Selection Disclosure Initiative' [has] not gone through notice-and-comment rulemaking, had not been reviewed by Congress, and had not been discussed with the Office of Management and Budget's Office of Information and Regulatory Affairs. Nevertheless, the Initiative targeted 'widespread' industry practice—and tried to change it virtually overnight.").

announced."[46] Such deference in these circumstances "would seriously undermine the principle that agencies should provide regulated parties fair warning of the conduct a regulation prohibits or requires" and "result in precisely the kind of 'unfair surprise' against which our cases have long warned."[47] As of May 15, 2015, the date from which the Staff plans to seek disgorgement, the SEC had settled ***one*** enforcement action related to 12b-1 fee mutual fund share class disclosures.[48] Even assuming that nonbinding settled enforcement actions put firms on notice of new disclosure obligations—which they do not—one settled order certainly would not have put CapWealth on notice as early as May 2015.

V. THERE IS NO LEGAL OR FACTUAL BASIS UNDER SECTION 206 TO ALLEGE CAPWEALTH FAILED TO OBTAIN BEST EXECUTION BY INVESTING CLIENTS IN "HIGHER-COST" SHARES CLASSES.

A. Imposing a Duty of Best Execution in the Context of Mutual Fund Share Class Selection Would Constitute an Unannounced, Substantial Change in the Law.

The Staff also has alleged that CapWealth violated its duty of best execution under Section 206 by investing clients in "higher fee" mutual fund share classes. This theory of liability vastly expands the duty of best execution. The SEC was required but failed to provide notice of this novel interpretation. There are at least *four* reasons why CapWealth lacked any notice that it had violated its duty to seek best execution by investing clients in a higher fee mutual fund share class.

First, absolutely no court has held that Section 206 imposes a duty to seek to obtain best execution in this context of mutual fund share class selection. Not even the Series 65 Uniform Investment Adviser Law Exam or the Series 7 General Securities Representative Exam refers to

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[46] *Christopher*, 567 U.S. 142, 155–56 (2012).
[47] *Id.* at 156 (internal citations and quotations omitted). The President has instructed that an agency's understanding of "unfair surprise" "should be informed" by the Supreme Court's decision in *Christopher* v. *SmithKline Beecham Corp.*, 567 U.S. 142 (2012). *See also Kisor* v. *Wilkie*, 139 S. Ct. 2400, 2417–18, 204 L. Ed. 2d 841 (2019) ("A court may not defer to a new interpretation … that creates 'unfair surprise' to regulated parties.").
[48] *See In re Manarin Investment Counsel, Ltd., Manarin Securities Corp., and Roland R. Manarin*, Release No. 9462 (Oct. 2, 2013).

mutual funds in the context of the duty of best execution. Except in the context of these share class selection enforcement actions, the SEC's interpretation of the duty of best execution has focused on the quantitative and qualitative factors that bear on an adviser's *selection of broker-dealers* to execute securities transactions.[49] In addition to price, "[o]ther terms . . . are also relevant to best execution" including "trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market."[50] These non-price factors are inapplicable to selecting mutual fund share classes. Mutual funds are purchased and sold at Net Asset Value ("NAV") following the close of business daily. Execution price is not available until the fund reconciles daily activity on purchase and sales to reflect gain and loss of transactions executed during trading hours on the day the order is entered. The price of execution at NAV is the *same* for every share class within the fund. The expenses attached to the share class vary on the day *following* execution to include other expenses including the assessment of 12b-1 fees.[51]

Second, the authorities that the SEC cites in settled orders—which, as discussed *supra*, themselves are nonbinding—as the legal basis for this alleged violation actually *support* the view that the duty of best execution applies to an adviser's selection of broker-dealers. Outside of the cases settled pursuant to the Initiative,[52] the SEC has settled ***28*** cases related to 12b-1 fees and mutual fund share class selection. In ***23*** of these cases, the SEC has alleged the adviser failed to seek best execution by selecting a "higher fee" share class when a "lower fee" share class was

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[49] *See e.g.*, Compliance Issues Related to Best Execution by Investment Advisers (July 11, 2018), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf .

[50] *Newton* v. *Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 271 (3d Cir. 1998).

[51] *See* Macey Report at ¶ 37 ("[The duty of best execution for mutual fund trades requires simply that those buying or redeeming mutual fund shares receive the NAV next calculated after the mutual fund receives their order. Costs not related to trade execution, such as soft dollar arrangements and 12b-1 fees present distinct issues entirely separate and apart from best execution.").

[52] The Initiative stated that for self-reporting firms, the Staff would not recommend charges related to failure to seek best execution even "where the facts would support these charges." *See* Announcement, Share Class Selection Disclosure Initiative at n.3, *supra*.

available, stating generally that "Section 206 of the Advisers Act imposes on investment advisers a fiduciary duty to act for the benefit of their clients. That duty includes, among other things, an obligation to seek best execution for client transactions—i.e., 'to seek the most favorable terms reasonably available under the circumstances.'" The SEC cites to three authorities that purport to impose this duty to mutual fund share class selection:

- In ***12*** cases, the SEC cites to a 1986 release interpreting the safe harbor for soft dollar arrangements in Section 28(e) of the Securities Exchange Act of 1934.[53] The release discusses at length, "factors considered in *selecting broker-dealers* and in determining the reasonableness of commissions charged."[54]
- In ***11*** cases, the SEC cites to *In re Fidelity Management Research Company*, Release No. 2713 (March 5, 2008), a settlement order regarding alleged violations of best execution by Fidelity traders who "allowed their receipt of travel, entertainment and gifts from brokers and their family or romantic relationships with brokers to influence their *selection of brokers* to handle Fidelity's securities transactions."[55]

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[53] *See In re Manarin Investment Counsel, Ltd., Manarin Securities Corp., and Roland R. Manarin* at ¶ 10, Release No. 9462 (Oct. 2, 2013); *In re Everhart Fin. Gr. Inc., Richard Scott Everhart, & Matthew James Romeo* at ¶ 16, Release No. 76897 (Jan. 14, 2016); *In re Credit Suisse Sec. (USA) LLC* at ¶ 21, Release No. 80373 (Apr. 2, 2017); *In re Suntrust Investment Services Inc.* at ¶ 19, Release No. 81611 (Sept. 14, 2017); *In re Cadaret, Grant & Co., Inc.* at ¶ 21, Release No. 81274 (Aug. 1, 2017); *In re PNC Invs. LLC* at ¶ 20, Release No. 83004 (Apr. 6, 2018); *In re First Western Advisors* at ¶ 11, Release No. 83934 (Aug. 24. 2018); *In re Harbour Invs. Inc.* at ¶ 13, Release No. 84115 (Sept. 13, 2018); *Capital Analysts, LLC* at ¶ 18, Release No. 5009 (Sep. 14, 2018); *In re American Portfolios Advisors, Inc.* at ¶ 12, Release No. 5083 (Dec. 20, 2018); *In re Thoroughbred Fin. Servs. LLC* at ¶ 17, Release No. 84918 (Dec. 21, 2018); *In re PPS Advisors, Inc.* at ¶ 14, Release No. 5084 (Dec. 20, 2018).

[54] *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters* at 9, Release No. 23170 (Apr. 23, 1986), 51 Fed. Reg. 16004, 16011 (Apr. 30, 1986).

[55] *In re Everhart Fin. Grp. Inc., Richard Scott Everhart, & Matthew James Romeo* at ¶ 16, Release No. 76897 (Jan. 14, 2016); *In re Cadaret, Grant & Co., Inc.* at ¶ 21, Release No. 81274 (Aug. 1, 2017); *In re Geneos Wealth Mgmt. Inc.* at ¶ 18, Release No. 83003 (Apr. 6, 2018); *In re Sec. Am. Advisor, Inc.* at ¶ 12, Release No. 4876 (Apr. 6, 2018); *In re Sigma Planning Corp.* at ¶ 21, Release No. 87029 (Sept, 19, 2019); *In Re BMO Harris Fin. Advisors Inc. & BMO Asset Mgmt. Corp.* at ¶ 21, Release No. 87145 (Sept. 27, 2019); *In re Founders Fin. Sec. LLC* at ¶ 12, Release No. 87177 (Sept. 30, 2019); *In re Mid Atlantic Fin. Mgmt. Inc.* at ¶ 12, Release No. 5387 (Sept. 30, 2019); *In re BPU Inv. Mgmt. Inc.* at ¶ 11, Release No. 88202 (Feb. 13, 2020); *In re U.S. Bancorp Invs. Inc.* at ¶ 13, Release No. 88976 (June 1, 2020); *In re William Vescio* at ¶ 22, Release No. 10789 (June 2, 2020).

- In ***eight*** cases, in an exercise in circular logic, the SEC cites to *its own past settled orders* as the basis for imposing a duty of best execution when selecting mutual fund share classes.[56] As discussed above, these are non-binding, fact-specific, and do not serve to put firms on notice of conduct that is required or proscribed.

Third, SEC informal guidance did not put firms on notice of a duty to seek best execution in this context. The 2016 OCIE Risk Alert announced that OCIE's examinations would "likely focus on . . . topics applicable to the adviser's share class recommendation practices" including "best execution,"[57] and that "examiners would "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 . . . investments to clients." This informal guidance did not impose any new obligations on advisers. Tellingly, *after* the SEC announced the Initiative, OCIE released a risk alert entitled "Compliance Issues Related to Best Execution by Investment Advisers."[58] The alert does not mention *any* duty of best execution in the context of share class selection. Rather, consistent with prior interpretations, focuses on an adviser's "responsibility to *select broker-dealers* and execute client trade."

Fourth, the SEC's theory of liability, that selecting a higher-cost mutual fund share class

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[56] *In re Everhart Fin. Grp. Inc., Richard Scott Everhart, And Matthew James Romeo* at ¶ 16, Release No. 76897 (Jan. 14, 2016); *In re Credit Suisse Sec. (USA) LLC* at ¶ 21, Release No. 80373 (Apr. 2, 2017); *In re Suntrust Inv. Servs. Inc.* at ¶ 19, Release No. 81611 (Sept. 14, 2017); *In re Cadaret, Grant & Co.* at ¶ 21, Release No. 81274 (Aug. 1, 2017); *In re PNC Investments LLC* at ¶ 20, Release No. 83004 (Apr. 6, 2018); *In re Harbour Inv. Inc.* at ¶ 13, Release No. 84115 (Sept. 13, 2018); *Capital Analysts LLC* at ¶ 18, Release No. 5009 (Sep. 14, 2018); *In re Founders Fin. Secs. LLC* at ¶ 12, Release No. 87177 (Sept. 30, 2019). In two settlement orders, the SEC cites no authority for the alleged best execution violations. *See In re Pekin Singer Strauss Asset Mgmt. Inc., Ronald L. Strauss, William A. Pekin, & Joshua D. Strauss* at ¶ 42, Release No. 4126 (June 23, 2015); *In re Packerland Brokerage Servs. Inc., & Atlas Capital Mgmt. Corp* at ¶ 1, Release No. 82383 (Dec. 21, 2017).

[57] National Exam Program Risk Alert, OCIE's 2016 Share Class Initiative at 1-2, *supra* n. 24.

[58] Compliance Issues Related to Best Execution by Investment Advisers (July 11, 2018), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf .

violates an adviser's duty of best execution is entirely inconsistent with the holistic approach required by Regulation Best Interest, where the SEC acknowledged that although cost would generally be one of many important factors an adviser should consider when making an investment recommendation, "the fiduciary duty *does not necessarily require an adviser to recommend the lowest cost investment product or strategy.*"[59]

Given that the SEC's purported interpretation of Section 206 to impose upon advisers a duty to seek best execution in mutual fund share class selection represents "a substantial change in its enforcement policy that was not reasonably communicated to the public,"[60] such a charge against CapWealth violates due process.

B. CapWealth Sought the Most Favorable Terms Reasonable Available.

Even to the extent that a duty of best execution applies in this context, CapWealth *did* seek to obtain for its clients the most favorable terms reasonably available under the circumstances. As discussed above, and as Professor Jonathan Macey concluded, "if a mutual fund had more than one share class and some classes featured 12b-1 fees, but and other classes were not, [CapWealth] advisers used the class with the lower fees as long as such a class was available" which is "precisely what an investment adviser's fiduciary duties require."[61]

VI. CAPWEALTH DID NOT VIOLATE SECTION 206(4) OF THE INVESTMENT ADVISERS ACT OR RULE 206(4)-7.

In its Wells notice, the staff claims to have determined preliminarily that CapWealth violated Section 206(4) of the Investment Advisers Act and Rule 206(4)-7 thereunder. Rule 206(4)-7 requires an investment adviser to "adopt and implement written policies and procedures reasonably designed to prevent violation … of the Advisers Act and the rules the Commission has adopted

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[59] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, at 17 (June 5, 2019), https://www.sec.gov/rules/interp/2019/ia-5248.pdf.
[60] *Upton.*, 75 F.3d at 98.
[61] Macey Report at ¶ 34, 36.

under the Act." According to the Staff, CapWealth violated Rule 206(4)-7 in that it failed to adopt and implement written policies and procedures that (a) disclosed its conflicts of interests in the selection of mutual fund share classes that paid 12b-1 fees and (b) obtained "best execution" for clients in the selection of mutual fund share classes. The facts belie the Staff's claims.

First, as detailed in Professor Macey's report, CapWealth had no conflict of interest in the selection of mutual fund share classes because CapWealth, through the discounted advisory fee provided to clients, removed any incentive any investment advisor had to recommend a share class based upon CapWealth's receipt of any 12b-1 fees. Because CapWealth removed the conflict of interest by reducing its advisory fee to offset the collection of any 12b-1 fees, there was no conflict of interest for it to disclose.

Second, as the Macey report also establishes, CapWealth did obtain "best execution" for its clients in the selection of mutual fund share classes, to the extent that that term has meaning as applied to the purchase of mutual funds. According to Professor Macey, "To the extent that the duty of best execution applies in this context, it requires brokers and investment advisers to provide their customers the most favorable terms commercially available for their trades. Here the record indicates that CapWealth customers who paid 12b-1 fees received best execution of their trades, even if the definition of best execution is expanded to include the post-execution fees for expenses imposed by a mutual fund." (Macey Report ¶ 8) "[B]y lowering its standard (one (1) percent) advisory fee to offset entirely any 12b-1 fees paid by customers the conflicts of interest have been eliminated and best execution has been achieved." (*Id.* ¶ 13)

Further, with the assistance of its industry consultants, CapWealth has adopted a comprehensive 85-page Policies and Procedures Manual. Section 2.1 of CapWealth's Policies and Proce-

dures Manual provides, "Under SEC Rule 206(4)-7, it is unlawful for an investment adviser registered with the SEC to provide investment advice unless the adviser has adopted and implemented written policies and procedures reasonably designed to prevent violation of the Advisers Act by the advisor or any of its supervised person." Consistent with this regulatory mandate, Section 3.2 of CapWealth's Manual requires that "[e]ach new CapWealth client must be provided full disclosure with respect to the Advisor's services, fees to be charged, conflicts of interest, disciplinary problems of certain personnel, and certain other information that the regulators deem as important to a client prior to engaging the services of the Advisor." Section 3.5 of CapWealth's Manual requires that advisors "[e]nsure mutual fund purchases and holdings are the most advantageous share class available at the time."

As detailed *supra*, when CapWealth selected Schwab as the custodian for its clients' accounts, CapWealth insisted that all F1class and F2 class mutual fund shares in client accounts be converted to F3, the most advantageous class of shares for CapWealth's clients. This conversion followed a transition that began on February 10, 2015, when CapWealth began to convert the class of shares held in its clients' account to F2 shares as part of its closing down its affiliated broker-dealer, CWIS. The record shows that, consistent with Rule 206(4)-7, CapWealth has both adopted and implemented policies that adequately disclose its fees and that provide best execution for its clients' trades.

VII. CAPWEALTH DID NOT VIOLATE SECTION 207 OF THE INVESTMENT ADVISERS ACT.

The Staff's final claim in its Wells notice states CapWealth violated Section 207 of the Investment Advisers Act. Section 207 of the Advisers Act makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission … or willfully to omit to state in any such application or report any material fact

which is required to be stated therein."

For the reasons detailed *supra* at Section III.B.3, the statements CapWealth made in its Form ADV Part 2A—the same statements OCIE reviewed and approved in 2011 and the same statements CapWealth's industry consultants separately reviewed for compliance with Section 207 and all other applicable securities laws, rules and regulations, are true. CapWealth disclosed its receipt of 12b-1 fees on pages 8 and 9 of its Form ADV Part 2A. Although the Staff claims the disclosure is inadequate because it does not describe its receipt of 12b-1 fees as a conflict of interest, CapWealth eliminated the alleged conflict of interest with the discount it provided to mutual fund clients to its standard 1% advisory fee. Professor Macey's a report confirms the adequacy of CapWealth's disclosures. CapWealth did not violate Section 207 in any respect.

VIII. CONCLUSION

The facts, law and policy discussed *supra* show that CapWealth always placed the interests of its clients ahead of its own in connection with the selection of share classes of mutual funds for its clients. Even in the uncommon case where CapWealth recommended the purchase of mutual fund shares to achieve a client's financial objectives, CapWealth did not benefit from the selection of share classes that paid 12b-1 fees. Rather, CapWealth discounted its 1% advisory fee so that it—not the client—bore the burden of such fees. As proven above, clients benefitted from this practice because of the tax deductibility of the 12b-1 fees as an ordinary and necessary business expense.[62] For the foregoing reasons, a closing letter terminating the enforcement investigation is appropriate.

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[62] Otherwise stated, the facts demonstrate that CapWealth has always complied with the Commission's core principle that "an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is otherwise identical…" But in evaluating the cost of a security to a client, the Commission necessarily must consider (a) any discount the adviser provides in connection with the purchase and (b) the tax treatment of the costs associated with the investment. Here, the Staff has failed properly to consider these critical facts.

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Appendix 1

	2016	2017	2018
Total 12b1 Fees	$ 202,178	$ 207,887	$ 64,053
Total 12b1 Fees tax adjusted	$ 122,116	$ 125,564	$ 38,688
CapWealth Total Revenue	$ 5,248,342	$ 6,022,391	$ 6,967,187
12b1 Fees % of Revenue	3.9%	3.5%	
Accounts that paid a 12b1 fee	733	732	684
Average Account 12b1 Fee	$ 275.82	$ 288.35	$ 93.37
Highest Total Fee Rate (12b1 Tax Adj + Advisory)	1.14%	1.15%	
Accounts that paid ZERO advisory fees	17%	12%	11%
Accounts with Advisory fee rate discounts			
Accounts with Minimum Fee Waived	125	281	212
Total 12b1 Fees in Accounts with Minimum Fee Waived	$ 13,760.33	$ 22,788	$ 5,677
Accounts with Advisory Fee Rate Discounts	338	258	283
Total 12b1 Fees in Accounts with Advisory Fee Rate Discounts	$ 131,669.30	$ 130,572	$ 44,843
Accounts with No Advisory Fee Rate Discounts	270	194	190
Total 12b1 Fees in Accounts with No Advisory Fee Rate Discount	$ 56,749	$ 54,527	13,533
% of accounts with discounts	69.3%	73.6%	72.4%
% of 12b1 Fees in discounted accounts	71.9%	73.8%	78.9%
Total 12b1 Fees, No Discounts as % of CapWealth Revenue	1.08%	0.91%	

Appendix 2

Before the Enforcement Division of the Securities and Exchange Commission

In the Matter of CapWealth Advisors, LLC	SEC File No. A-03907-A

EXPERT REPORT OF JONATHAN R. MACEY

June 13, 2020

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A. Support for my Opinion One that any alleged failure to disclose was not material. The record indicates, and for purposes of this Report I have assumed, that CapWealth's investment advisors generally selected the share class for its clients that offered the best overall terms of execution available. CapWealth's management practices as they related to fees deprived investment advisors of any incentive to guide clients towards high fee share classes because CapWealth discounted its standard advisory fee (or provided other discounts) to off-set any 12b1 fee imposed by a fund that was imposed, such as in cases where only a share class that paid a 12b-1 fee was available to a particular investor. This fact differentiates CapWealth from other advisors who may have faced these sorts of conflicts because such other advisers had a financial incentive to select a higher cost share class that paid a 12b-1 fee. This substantive difference makes disclosure immaterial in this context. 8

B. Support for Opinion Two that the SEC has long taken a practical, holistic approach to disclosure. Here the appropriate disclosures were made in a variety of ways (prospectus, confirmation and in in-person conversations with clients). Any decision to insist that disclosure is only proper and appropriate if it is contained in Form ADV Part 2A is inconsistent with long-standing SEC disclosure policies that provide significant benefits to investors. 9

C. Support for Opinion Three that the duty of best execution requires that customers receive the most favorable terms commercially available for their trades. Here the record indicates that CapWealth customers who paid 12b-1 fees received best execution of their trades. 13

D. Support for Opinion Four that the Record shows that CapWealth's corporate governance and culture was directed at instilling a culture of compliance in the firm. This indicates that a lack of scienter or intention to engage in wrongdoing 15

V. Conclusion 15

I. Introduction

A. Qualifications

1. I am the Sam Harris Professor of Corporate Law, Corporate Finance, and Securities Law at Yale Law School, and a Professor at the Yale School of Management. I am also a member of the Provost's Standing Advisory & Appointments Committee for the Yale School of Management, and Chair of the Yale University Advisory Committee on Investor Responsibility. I serve on the Executive Committee of the Yale Law School Center for the Study of Corporate Law. I am also a member of the European Corporate Governance Institute. I serve on the Members Consultative Group for the American Law Institute's Restatement of the Law/Corporate Governance Project. I teach courses on Business Organizations, Corporate Governance, Corporate Finance, and Banking and Financial Institutions Regulations. Additionally, I have authored more than 100 articles and more than half a dozen books on topics including corporate governance, the regulation of the financial services industry, and the economic role of reputation in corporate finance and investment banking.[1]

2. Prior to joining the Yale faculty in 2004, I taught at Cornell University as the J. DuPratt White Professor of Law from 1991 to 2004. I was also a tenured law professor at the University of Chicago from 1990 to 1991 and Cornell University from 1987 to 1990. I have been a visiting professor at several universities including Harvard, the Stockholm School of

[1] These publications include, in addition to articles focused on the law and economics of best execution and on conflicts of interest cited herein, "Macey on Corporation Laws" (two volume treatise) (originally published in 1998, updated annually, Wolters Kluwer Law & Business, 2019); "Cases and Materials on Corporations Including Partnerships and Limited Liability Companies" (Thomson*West, thirteenth edition, 2017) (with Robert Hamilton and Douglas Moll); "The Law of Banking and Financial Institutions" (Aspen Law & Business, sixth edition, 2017) (with Richard Cornell and Geoffrey P. Miller); "The Death of Corporate Reputation: How Integrity Has Been Destroyed on Wall Street," (The Financial Times Press, 2013); "Corporate Governance: Promises Kept, Promises Broken" (Princeton University Press, 2008); "Classics in Corporate Law and Economics," Jonathan Macey, editor (Edward Elgar Publishing, 2008); "Iconic Cases in Corporate Law," Jonathan Macey, editor (Thomson*West, 2008); and "The Value of Reputation in Corporate Finance and Investment Banking (and the Related Roles of Regulation and Market Efficiency)," 22 Journal of Applied Corporate Finance, 18-29 (2010).

Economics, the University of Tokyo, and the University of Virginia. Outside of academics, I serve as a member of the Economic Advisory Board of the Financial Industry Regulatory Authority (FINRA).

3. I have more than 30 years of experience in the research and study of corporate governance, financial institutions, and securities regulation, including disclosure policy, conflicts of interest and the duty of best execution from the perspective of economic and public policy. My expertise also includes knowledge of the policies underlying the regulation of mutual funds. In the course of my research, I have also extensively reviewed corporate filings, including SEC filings by mutual funds and public companies, and corporate governance documents. My complete curriculum vitae, which includes a list of my publications, is attached as **Appendix A** to this Report.

4. I am being compensated at my current standard rate of $1,250 per hour for my time and reimbursed for my out-of-pocket expenses in connection with my review of the record, preparation of this Report, and provision of testimony. My compensation is not dependent on the content of my Report or testimony or the outcome of this investigation or any subsequent litigation. My prior testimony over the past four years is provided in **Appendix B**.

B. Scope of Engagement

5. I have been retained by Leader, Bulso & Nolan, PLC, and Cahill, Gordon Reindel LLP counsel for the CapWealth Advisors LLC parties,[2] ("CapWealth Advisors") to analyze the imposition and disclosure of certain 12b-1 fees paid by CapWealth clients from a public policy and economic perspective. Specifically, I analyze the materiality of any alleged non-disclosure

[2] The CapWealth Advisors LLC parties include CapWealth Advisors, LLC, Timothy J. Pagliara, and Timothy R. Murphy.

of such fees from the perspective of ordinary and customary investment advisor behavior. I also analyze the appropriateness and quality of the disclosures that were made. Finally, I analyze the trades involving 12b-1 fees from the point of view of investment advisers' duty of best execution of customers' orders, to the extent that such a duty applies in this context.[3]

C. Information Considered

6. In forming my opinions, I have drawn upon my education, experience, and knowledge acquired through decades of teaching, research and writing in the economics and public policy of disclosure, best execution of trading orders, corporate governance, economics, law and economics, finance, and other areas of expertise.

7. I reserve the right to modify or supplement the opinions expressed in this Report, including in response to the review of new evidence, in response to opinions or arguments by any expert that the Commission may retain, and in response to any ruling by a Court or administrative judge.

II. Summary of Opinions

8. Below are summaries of the four (4) opinions that I have formulated in this matter. I hold these opinions to a high degree of certainty. I discuss and provide support for these opinions in the sections that follow.

- Any alleged failure to disclose was not material. The record indicates, and for purposes of this Report I have assumed, that CapWealth's investment advisors generally selected the mutual fund share class for its clients that offered the best overall terms of execution available. CapWealth's management and governance practices as they related to fees deprived investment advisors of any incentive to guide clients towards higher fee share classes because CapWealth discounted its standard advisory fee (or provided other

[3] See Part IV. C., *infra* for a discussion of the interaction of Rule 22c-1's forward pricing obligation with the duty of best execution.

discounts) to off-set any 12b-1 fee imposed by a fund, such as in cases where only a share class that paid a 12b-1 fee was available to a particular investor, or when paying a 12b-1 fees and deducting the fee from the standard advisory fee was best for the client for the tax reasons discussed below.[4] This fact differentiates CapWealth from other advisors who may have faced conflicts because they had a financial incentive to select a higher cost share class that paid a 12b-1 fee. This substantive difference makes disclosure immaterial.

- The SEC has long taken a practical, sensible, holistic approach to disclosure. Here appropriate disclosures of 12b-1 fees were made in a variety of ways, including by prospectus, confirmation and actual in-person conversations with clients. Any decision to insist that disclosure is only proper and appropriate if it is contained in Form ADV Part 2A is inconsistent with long-standing SEC disclosure policies that provide significant benefits to investors.

- To the extent that the duty of best execution applies in this context, it requires brokers and investment advisers to provide their customers the most favorable terms commercially available for their trades. Here the record indicates that CapWealth customers who paid 12b-1 fees received best execution of their trades, even if the definition of best execution is expanded to include the post-execution fees for expenses imposed by a mutual fund.

- The Record shows that CapWealth's corporate governance was directed at instilling a culture of compliance in the firm. This culture of compliance, which included hiring expert advisors to guide the 12b-1 disclosure process, indicates that a lack of scienter or intention to engage in wrongdoing

III. Background Facts and Context

9. Recently, the Securities and Exchange Commission ("Commission") has filed numerous actions in cases in which an investment adviser failed to make certain disclosures relating to its selection of mutual fund share classes that paid the adviser (as a dually registered broker-dealer) or its related entities or individuals a fee pursuant to Rule 12b-1 of the Investment

[4] See *infra* footnote 42. The term "12b-1 fee" is used to describe the fees charged to customers for the costs of marketing, distributing and account servicing. This fee includes the fees paid to compensate brokers who sell fund shares. FINRA rules dictate that 12b-1 fees cannot exceed 1.00%. 12b-1 payments are mainly used "to compensate sales professionals for advice and assistance given to buyers of fund shares." John D. Rea & Brian K. Reid, *Trends in the Ownership Cost of Equity Mutual Funds,* INV. CO. INST. PERSPECTIVE, Nov. 1998, at 1. Such payments have been justified on the ground that they are assessed "not only to encourage growth, but also to stimulate improved shareholder service." Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472, 490 n.37 (S.D.N.Y. 1988).

Company Act of 1940 ("12b-1" fee) when a lower-cost share class for the same fund was available to clients.[5]

10. The levying of 12b-1 fees began in the 1980s when the SEC formally recognized that mutual funds could pass distribution costs directly to shareholders.[6] While such fees are controversial in some circles,[7] properly used, they provide a valuable mechanism for incentivizing brokers and investment advisers to educate unsophisticated clients about the benefits of mutual funds and diversified equity investing. Such fees provide an avenue by which certain clients appropriately can add equity investments to asset portfolios that might otherwise consist entirely of bank accounts of various kinds. Put simply, the fees associated with mutual funds are socially desirable and efficient when properly used because they allow the financial system to achieve the ultimate goal of mutual funds, which is to "allow those with relatively little wealth, education or information to invest in securities."[8]

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[5] February 12, 2018, United States Securities and Exchange Commission, Announcement, "Share Class Selective Disclosure Initiative," https://www.sec.gov/enforce/announcement/scsd-initiative (hereinafter SCSDI); See also, SEC Press Release, 2018-15, "SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors," https://www.sec.gov/news/press-release/2018-15

[6] 17 C.F.R. § 270.12b-1 (1999). Shortly after the adoption of Rule 12b-1 thousands of mutual funds adopted rule 12b-l plans. Joel H. Goldberg & Gregory N. Bressler, Revisiting Rule 12b-1 Under the Investment Company Act, 31 SEC. & COMMODITIES REG. REV. 147 (1998). Rule 12b-1 fees provide a means by which pricing and distribution could be reordered through the imposition of conditional deferred sales loads. Terry R. Glenn et al., *Distribution in Mid-Decade: Coping with Success and Other Problems, in* INVESTMENT COMPANIES 1986, at 84 (PLI Corp. Law Practice Course, Handbook Series No. B4-6746m 1986).

[7] John C. Bogle, Mutual Fund Industry Practices and their Effect on Individual Investors, Statement before the U.S. House of Representatives, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services (Mar. 12, 2003).

[8] John Coates and Glenn Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy, at 46 http://www.law harvard.edu/programs/olin_center/papers/pdf/Coates_592.pdf . In addition to competing on price, mutual funds also compete on the basis of equity mutual funds compete on non-price factors such as service quality and scope, reputation of fund managers, breadth of fund complex, and, most importantly, performance returns to shareholders. U.S. General Accounting Office, Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition, GAO/GGD-00-126 (Washington, D.C.: June 7, 2000).

11. On February 12, 2018, the Commission announced its Share Class Selective Disclosure Initiative (SCSD Initiative).[9] In the SCSD Initiative, the Division of Enforcement announced that it would recommend that the Commission accept favorable settlement terms for investment advisers that self-report to the Division possible securities law violations relating to their failure to make necessary disclosures concerning mutual fund share class selection.[10]

12. The SCSD Initiative targets Investment advisers "that did not explicitly disclose in applicable Forms ADV (i.e., brochure(s) and brochure supplements) the conflict of interest associated with the 12b-1 fees the firm, its affiliates, or its supervised persons received for investing advisory clients in a fund's 12b-1 fee paying share class when a lower-cost share class was available for the same fund."[11] In announcing its SCSD Initiative, the Division of Enforcement recommended that investment advisors who had not disclosed the relevant information related to 12b-1 fees "should consider self-reporting to the Division," because in doing so they would be able to "take advantage of the SCSD Initiative, pursuant to which the staff might recommend that the Commission accept favorable settlement terms for self-reporting investment advisers."[12]

13. It appears clear that there are two public policy concerns at the heart of the Commission's efforts related to mutual fund class selection and disclosures. These concerns relate to the obligations to disclose conflicts of interest, and the obligation to seek best execution of customer orders that stem from the fiduciary duties of care and loyalty that investment advisers

[9] United States Securities & Exchange Commission, Share Class Selection Disclosure Initiative, https://www.sec.gov/enforce/announcement/scsd-initiative.
[10] *Id.*
[11] *Id.*
[12] *Id*

owe to their clients.[13] As such it seems clear that investment advisers, such as those at CapWealth, that have eliminated conflicts of interest by rendering such conflicts of interest immaterial by lowering its standard (one (1) percent) advisory fee to offset entirely any 12b-1 fees paid by customers the conflicts of interest have been eliminated and best execution has been achieved.

14. From a governance perspective, the most fundamental insight is that when dealing with conflicts of interest, fiduciaries' first goal should always be to work to avoid such conflicts in the first place whenever possible. It is only if conflicts of interest cannot be avoided that they have to be ameliorated or mitigated through disclosure or other means.[14]

15. In the case of CapWealth, the conflicts of interest posed by the sale of mutual funds with multiple classes were avoided altogether because CapWealth's investment advisers, unlike all of the other investment advisers whose disclosures have been targeted in this enforcement initiative, had no financial incentive to select a higher cost share class that paid a 12b-1 fee, since those very fees were returned to the customer in the form of a reduction in the standard (one percent) advisory fee charged to the customers paying the 12b-1 fees.

[13] Jaqueline M. Hummel, "Why the SEC is Obsessed with Mutual Fund Share Class Selection and Disclosure (and why you should be too)," April 30, 2019, https://www hardincompliance.com/wp-content/uploads/2018/05/share-class-selection-process-4-30-2018.pdf (accessed June 2, 2020).

[14] Thomas L. Carson, Conflicts of Interest, 13 J. BUS. ETHICS 387, 387 (in ordinary cases it is wrong, all things considered, to allow- an avoidable conflict of interest to occur). See also id, at 392 ("no moral disapprobation ought to attach to agents in unavoidable conflicts of interest."); Jonathan R. Macey and Geoffrey Miller, An Economic Analysis of Conflict of Interest Regulation, 82 IOWA L. REV. 966 (1997); John Boatright, "Conflict of Interest: An Agency Analysis," *in Ethics and Agency Theory,* Norman Bowie and R. Edward Freeman, eds. (Oxford, 1992), pp. 187-203.

IV. Support of Opinions

A. Support for my Opinion One that any alleged failure to disclose was not material. The record indicates, and for purposes of this Report I have assumed, that CapWealth's investment advisors generally selected the share class for its clients that offered the best overall terms of execution available. CapWealth's management practices as they related to fees deprived investment advisors of any incentive to guide clients towards high fee share classes because CapWealth discounted its standard advisory fee (or provided other discounts) to off-set any 12b1 fee imposed by a fund, such as in cases where only a share class that paid a 12b-1 fee was available to a particular investor or where paying a 12b-1 fee and offsetting that fee by a reduction in the investment advisory fee was the most efficient cost structure for the client. This fact differentiates CapWealth from other advisors who may have faced these sorts of conflicts because such other advisers had a financial incentive to select a higher cost share class that paid a 12b-1 fee. This substantive difference makes disclosure immaterial in this context.

16. Any 12b-1 fees paid by CapWealth customers were offset by reductions in the standard advisory fees charged by CapWealth.[15] As such, the net effect on a customer of incurring 12b-1 fees, when accompanied by an offsetting deduction in the standard advisory fee, was zero.

17. Thus, due to this offsetting of fees, the particular 12b-1 fees paid by CapWealth clients were immaterial because an ordinarily prudent, rational investor would not consider such fees to be important or even relevant to his or her investment decision.

18. In the case of CapWealth, the conflicts of interest that ordinarily exist when 12b-1 fees are collected by advisers were avoided altogether because CapWealth's investment advisers, unlike other investment advisers whose disclosures have been targeted in this enforcement initiative, had no financial incentive to select a higher cost share class that paid a

[15] Phoebe Venable, Deposition Before the U.S. Securities & Exchange Commission, April 30, 2020, at 118, 132, (when a fund with 12b-1 fees was selected, "we had made concessions on the fee for the client to take into consideration that we were receiving the 12b-1 fee."). *See also Id*. at page 141 (same).

12b-1 fee, since those very fees were returned to the customer in the form of a reduction in the advisory fees charged to the customers paying the 12b-1 fees.

19. Ms. Phoebe Venable confirmed that when clients were placed in a share class that paid a 12b-1 fee, CapWealth's 1% advisory fee was correspondingly reduced. As established in her deposition, her receipt of 12b-1 fees "was fully disclosed to the clients. The clients knew that it was in our --that it was part of our business model, that it helped us provide small investors and small accounts with a very cost effective way to access our services and we disclosed it."

20. Thus, CapWealth, in order to offset the 12b-1 fees, would provide clients paying such fees with an economic benefit in the form of a corresponding reduction in other fees that they were paying. Such fees would, as Ms. Venable testified "get deducted out of the account as opposed to paid to us from the mutual fund."[16]

B. Support for Opinion Two that the SEC has long taken a practical, holistic approach to disclosure. Here the appropriate disclosures were made in a variety of ways (prospectus, confirmation and in in-person conversations with clients). Any decision to insist that disclosure is only proper and appropriate if it is contained in Form ADV Part 2A is inconsistent with long-standing SEC disclosure policies that provide significant benefits to investors.

21. Mutual funds typically disclose their corporate governance structures and business models and pricing strategies in various filings, including pre-purchase sales materials (brochures), prospectuses, registration statements, annual reports, proxy statements and post-sale confirmations.

22. The two fundamental elements of the SEC disclosure framework are: (1) all material information must be disclosed; (2) when a particular disclosure is made, sufficient

[16] *Id*. at 117-118; 140-141

additional disclosures must be made, if necessary, in order to make such particular disclosures not misleading.

23. Here the record indicates that the 12b-1 fees were disclosed. For example, as Timothy Pagliara, a registered representative and the principal owner of CapWealth, testified at his deposition before the Securities and Exchange Commission, he would explain to clients any receipt of 12b-1 fees verbally and how such fees flowed to him in his role as a registered representative or as an owner of CapWealth.[17]

24. Similarly, Phoebe Venable testified that she discussed with her clients who were investing in a mutual fund that had 12b-1 fees, the nature of those fees verbally. These explanations included a discussion that the 12b-1 fees factored into negotiating a discount on advisory fees. Ms. Venable also explained to her clients that many of the funds in which they were invested had lower cost share classes that did not have 12b-1 fees for which they were eligible.[18] When a specific mutual fund share class was selected Ms. Venable also informed her clients of whether they were eligible for lower cost share classes of the same fund.[19]

25. These disclosures, of course, are the very same ones that the SEC claims should have been made, but in the Form ADV, rather than in actual conversation.

26. Importantly, there are qualitative differences in disclosures, both in terms of the format of such disclosures and in terms of the substance of such disclosures. Specifically, disclosures written with significant jargon or tucked away in a footnote likely will not have the

[17] Timothy Pagliara, Deposition Before the U.S. Securities & Exchange Commission, May 1, 2020, at 107.
[18] Venable Deposition, *supra*, at 139-141.
[19] *Id*.

same force and effect as a disclosures that are written in plain English and featured prominently in disclosure forms, or are carefully explained in-person to a client.

27. Here, in my opinion, the disclosures made here were of the highest quality because they were delivered orally, in an interactive format.

28. From a public policy point of view, it would be misguided to pursue enforcement policies that discourage or diminish the value and importance of in-person disclosures such as those that occurred here.

29. It is well-settled that disclosures can be accomplished in a variety of ways. It does not make sense from a public policy point of view to discourage or diminish one method of disclosure such as oral disclosures, particularly where the alternative disclosure approach likely provides retail clients with more and better information as well as with the opportunity for asking questions and for other interaction.

30. It is well established that investors typically do not read the disclosure documents such as Annual Reports, proxy statements, mutual fund prospectuses, or mutual fund shareholder reports, with which they are supplied by brokers, investment advisers and others.[20] Moreover, it also is widely understood that the primary and dominant source of information for individual investors are communications from their investment adviser or broker.[21] Following investment advisers and brokers as sources of information were the internet, friends and family, magazines, newspapers, with prospectuses ranking barely above television, and only five percent of respondents reporting prospectuses as their main source of information about investments.[22]

[20] Abt SRBI, Mandatory Disclosure Documents Telephone Survey, https://www.sec.gov/pdf/disclosuredocs.pdf
[21] *Id*. at page 4, Figure 3.
[22] *Id*.

31. Specifically with regard to mutual fund prospectuses, an empirical research study using survey methodology specifically directed at mutual fund prospectuses, reported that nearly most investors who received mutual fund prospectuses either "rarely (28%)," "very rarely" (14%), or "never" (12%) read them.[23]

32. In other words, the oral communication of 12b-1 fees by investment advisers that was done by CapWealth was a *superior* mode of disclosure to the alternative, written disclosure that the SEC advocates in its recent SCSD enforcement initiative. By orally communicating the fee information, the advisers made sure that the relevant information actually was conveyed and was not lost inside of some unread document. Moreover, advisers making oral disclosures of 12b-1 fees had the opportunity to make sure that clients fully understood the fees that were being disclosed because such oral disclosure was, by its very nature, interactive, allowing the opportunity for questions and answers, and increasing the odds that such disclosures would be fully internalized by clients.

33. Other cases brought by the SEC presented a different set of facts than the fact pattern presented here. Specifically, in other cases, the SEC brought enforcement actions against respondents who "failed to disclose in their Forms ADV ***or otherwise*** its conflicts of interest related to (a) their receipt of 12b-1 fees, and/or (b) their selection of mutual fund share classes that pay such fees."[24] Here, in stark contrast, the issue is not the complete lack of disclosure, or

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[23] *Id*. at p. 56

[24] In the Matter of Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Investment Advisers Act of 1940, Release No. 5199 / March 11, 2019, Administrative Proceeding File No. 3-19102, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) And 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, at 2 (*emphasis supplied*). *See also*, In the Matter of Merrill, Lynch, Pierce, Fenner & Smith, Incorporated, Investment Advisers Act of 1940 Release No. 5479 / April 17, 2020, Administrative Proceeding File No. 3-19753, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) And 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order,

even inadequate disclosure, but rather the fact that the disclosures were made orally, and in writings other than in Form ADV, which, apparently, now is the SEC's preferred vehicle for making this particular disclosure. Clearly, a firm such as CapWealth that has been disclosing its 12b-1 fees, albeit in a non-preferred format, should not be subject to the same sanctions as Merrill Lynch or Wells Fargo that were making either inadequate disclosures or no disclosures whatsoever.

C. Support for Opinion Three that the duty of best execution requires that customers receive the most favorable terms commercially available for their trades. Here the record indicates that CapWealth customers who paid 12b-1 fees received best execution of their trades.

34. The duty of best execution that applies to brokers and investment advisers requires that customers receive the most favorable terms commercially available for their trades.[25] Here the testimony was clear and unequivocal that if a mutual fund had more than one share class and some classes featured 12b-1 fees, but and other classes were not, the investment advisers used the class with the lower fees as long as such a class was available.[26]

35. Moreover, as discussed above, when 12b-1 fees were charged, the investment adviser's standard compensation of one percent or less was reduced to offset such fees.

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at 3 ("At times during the Relevant Period, Respondent did not disclose adequately to its clients either in its Forms ADV or otherwise its conflicts of interest related to (a) its receipt of 12b-1 fees, and/or (b) its selection of mutual fund share classes that pay such fees.").

[25] Jonathan Macey and Maureen O'Hara, The Law & Economics of Best Execution, J. FINANCIAL INTERMEDIATION 6, 188-223, (1997). The legal duty of best execution is widely recognized under securities laws and exchange rules. For example, in establishing NASDAQ, Congress declared its purpose to be assuring ''the practicability of brokers executing investors' orders in the best markets' Courts have noted that "(t)he relationship between a broker/dealer and its customer gives rise to 'certain fiduciary obligations," and that one of these "obligations is a duty to execute the customer's order at the best available price." In re Merrill Lynch, 911 F. Supp. 754, 760 (1995) (cited in In re E.F. Hutton & Co., Securities Exchange Act Release No. 25887, (1988 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 84303, 89326 at 89326 (July 6, 1988); Restatement (Second) of Agency ¶ 1 (1957)). Merrill Lynch at *760 (citing Payment for Order Flow, Exchange Act Release No. 34902 (1994 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 85444, 85849 at 85854 n. 28. Order Execution Obligations, Exchange Act Release No. 34-37619A, 60 Fed. Reg. 48290, 48322.

[26] Deposition of Timothy Murphy before the Securities & Exchange Commission, May 19, 2020, at 83-84.

36. The practices followed by CapWealth in purchasing mutual funds on behalf of clients are precisely what an investment adviser's fiduciary duties require and are consistent with best industry practices.

37. I note that under the forward pricing rule (22c-1),[27] trades in U.S.-based, open-end mutual funds are required to be priced at the next net asset value per share (NAV) calculated after an order is placed. The vast majority of mutual funds calculate their NAVs once per day, usually sometime after 4 p.m. Eastern time. This means that all orders that are placed before 4 p.m. must be priced at the current-day NAV as calculated after the market closes.[28] As such, taking account of rule 22c-1, the duty of best execution for mutual fund trades requires simply that those buying or redeeming mutual fund shares receive the NAV next calculated after the mutual fund receives their order.[29] Costs not related to trade execution, such as soft dollar arrangements and 12b-1 fees present distinct issues entirely separate and apart from best execution.

38. However, as the analysis here shows, to the extent that the concept of best execution is expanded by the SEC in its enforcement actions to include the imposition of post-execution mutual fund fees, such as 12b-1 fees, all fiduciary duties, including the expanded duty of best execution were met.

[27] The forward pricing rule is Investment Company Act Rule 22c-1, 17 CFR 270.22c-1(a), pursuant to which underwriters, and dealers must sell and redeem fund mutual fund shares at the price determined by the net asset value ("NAV") for the funds's shares that is next computed after receipt of an order to buy or redeem such shares. The rule also requires that funds calculate their NAV at least once a day, which is typically after the major markets close at 4:00pm eastern time.
[28] Eric Zitzewitz, How Widespread Was Late Trading in Mutual Funds? 96 AMER. ECON. REV. 284 (2006).
[29] See also Deposition of Timothy Pagliara, *supra*, at 123-125 (making this point).

D. Support for Opinion Four that the Record shows that CapWealth's corporate governance and culture was directed at instilling a culture of compliance in the firm. This indicates that a lack of scienter or intention to engage in wrongdoing.

39. CapWealth used independent consultants to craft the disclosures in its Form ADV Part 2A, and in other disclosure documents. The purpose of retaining such consultants was to ensure that the firm's disclosures met all applicable regulatory disclosure requirements. In particular, as Ms. Venable attested in her deposition the firm hired two outside consultants to help with disclosure issues: "We've had two (consultants). For a number of years it was BrightHouse and the principal there was Howard Landers. And then subsequent to that is Asgard and the principal there is Jon Hurd."[30]

V. Conclusion

40. CapWealth's investment advisors generally selected the share class for its clients that offered the best overall terms of execution available. CapWealth's management practices, as they related to fees, deprived investment advisors of any incentive to guide clients towards high fee share classes because CapWealth discounted its standard advisory fee (or provided other discounts) to off-set any 12b-1 fee imposed by a fund, such as in cases where only a share class that paid a 12b-1 fee was available to a particular investor or in cases in which paying a 12b-1 fee and then offsetting that fee by a reduction in the investment advisory fee was the most efficient cost structure for the client. This fact completely differentiates CapWealth from other advisors who may have faced conflicts because they had a financial incentive to select a higher cost share class that paid a 12b-1 fee. This important substantive difference makes disclosure immaterial.

[30] Deposition of Phoebe Venable, *supra,* at 122.

41. The SEC has long taken a practical, holistic approach to disclosure. In particular, fulsome disclosure is encouraged, so long as information necessary in order to make fulsome disclosure not misleading also is made. And corrective disclosure is encouraged, as are disclosures in formats appropriate for investors. Here the appropriate disclosures were made in a variety of ways (prospectus, confirmation and in-person). Any decision to insist that disclosure is only proper and appropriate if it is contained in Form ADV Part 2A represents a conflict with long-standing SEC disclosure policies that provide significant benefits to investors. The fees were disclosed in the mutual fund prospectuses and in the confirmations sent to customers purchasing. It would be bad public policy to diminish the other disclosures.

42. Further with respect to overall execution quality and customer experience, CapWealth's method for executing trades in funds with 12b-1 fees was in the best interests of its clients when viewed from a tax planning perspective. Having a client first pay the 12b-1 fees associated with a fund and then having the amount of the advisory fee returned to the client through a reduction in the annual advisory fees by an offsetting amount preserved the deductibility of such fees. This is because the advisory fees are not fully deductible, while the 12b-1 fees are treated as a necessary and ordinary business expense and are deductible from the net gains of the fund.[31]

43. The duty of best execution that applies to brokers and investment advisers provide their customers the most favorable terms commercially available for their trades. Here the record indicates that CapWealth customers who paid 12b-1 fees received best execution of their trades.

[31] Section 11045 of the Tax Cuts and Jobs Act of 2017 eliminated the deductibility of all miscellaneous expenses, including investment advisory fees, subject to the 2 percent limitation for the years 2018 through 2026. But the 12b-1 distribution and service fees a mutual fund pays to investment advisors continue to be deductible under 26 U.S.C. §162.

I attest to holding the opinions discussed in the above Report to a high degree of certainty.

Respectfully submitted,

Jonathan Macey
June 13, 2020

Appendix A

Curriculum Vitae

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Education: J.D. Yale Law School; Article and Book Review Editor, Yale Law Journal, 1982; A.B., cum laude (economics), Harvard College, 1977.

Current Positions:

- Sam Harris Professor of Corporate Law, Finance, and Securities Regulation, Yale University
- Professor, Yale School of Management
- Chair, Yale University Advisory Committee on Investor Responsibility (ACIR)
- Chair, Yale Faculty Committee on Athletics
- Executive Committee, Yale Law School Center for the Study of Corporate Law
- Provost's Standing Advisory and Appointment Committee (SAAC) for the Yale School of Management
- Economics Advisory Board, Financial Industry Regulatory Authority, (FINRA)
- Member, European Corporate Governance Institute (ECGI)

Subjects: Business Organizations (Corporations and Other Business Associations); Corporate Finance; Corporate Governance; Banking and Financial Institutions Regulation; the Economics of Regulation

Other: Ph.D. (Law) *honoris causa* Stockholm School of Economics, 1996

D.P. Jacobs prize for the most significant paper in volume 6 of the Journal of Financial Intermediation for "The Law & Economics of Best Execution" (co-authored with Maureen O'Hara) (1997)

Paul M. Bator Award for Excellence in Teaching, Scholarship and Public Service awarded by the University of Chicago Law School Chapter of the Federalist Society, 1995

Bipartisan Policy Center (BPC) Financial Regulatory Reform Initiative's Working Group on Capital Markets

Fellow, Columbia Law School and Columbia Business School, Program in the Law & Economics of Capital Markets

Founding Member, CCH/Aspen Wolters Kluwer Law & Business, Banking and Securities Editorial Board

Books:

"Cases and Materials on Corporations Including Partnerships and Limited Liability Companies" (Thomson*West, Thirteenth Edition 2017) (with Robert Hamilton and Douglas Moll)

"The Law of Banking and Financial Institutions" (Aspen Law &Business, sixth edition, 2017) (with Richard Cornell and Geoffrey P. Miller)

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Remarks at Colloquium on the ALI Corporate Governance Project, 71 Cornell Law Review. (assorted pages) (1986)

"A Conduct Oriented Approach to the Glass-Steagall Act," 91 Yale Law Journal 102 (1981) (published as a student)

Recent Testimony

"Measuring the Systemic Importance of U.S. Bank Holding Companies," Senate Banking Committee Hearing, July 23, 2015

Current Activities:

Member, American Law Institute;

Members Consultative Group for American Law Institute's Restatement of the Law/Corporate Goverance Project;

Editorial Board, Journal of Accounting, Finance and Law;

Academic Advisory Board Committee, the Banking Law Anthology;

Academic Advisory Board, The Social Philosophy and Policy Center;

Board of Editors, Journal of Banking and Finance;

Board of Editors, Journal of Banking Law;

Board of Editors, Journal of Financial Crime;

Board of Editors, Corporate Practice Commentator;

Guest Contributor, Harvard Corporate Governance Blog

Employment History:

Sam Harris Professor of Corporate Law, Securities Law and Corporate Finance, Yale University, 2004 – present;

Visiting Professor, Bocconi University, Milan, Italy, fall 2012;

Visiting Professor of Law, Yale University, 2003-2004;

J. DuPratt White Professor of Law, Cornell Law School, 1991-2004;

Visiting Professor of Law, Harvard Law School, 1998-1999;

Visiting Professor, Faculty of Law, Stockholm School of Economics, fall, 1993;

Research Fellow, International Centre for Economic Research, Turin Italy, winter, 1993, spring, 1994;

Professor of Law (with tenure), University of Chicago, 1990-1991;

Professor of Law, (with tenure), Cornell University, 1987-1990;

Visiting Professor of Law, The University of Chicago, fall quarter, 1989-1990;

Visiting Professor, University of Tokyo Faculty of Law, summer, 1989;

Visiting Associate Professor of Law, University of Virginia, 1986-1987;

Assistant to Associate Professor of Law, Emory University, 1983-1986;

Law Clerk to the Honorable Henry J. Friendly, United States Court of Appeals, Second Circuit, 1982-1983 term of court;

Consultant, Municipal Finance Department, Lloyd Bush & Associates, New York, NY (consultant representing municipalities and investment banks before credit rating agencies (1978-1979));

Municipal Bond Trader, Bankers Trust Company, New York, NY (1977-1978);

Member, Board of Directors, Telxon Corporation, 1998-1999 (appointed as dissident director in settlement of proxy contest dispute); Member, Board of Directors, WCI Communities, Inc., 2007-2009; Member, Board of Directors, Shred-It Connecticut, 2007-2010; Alternative Director nominee for Illumina, Inc., 2012, Hess Corporation; 2015; Director nominee Rexene Corporation, 1999, Circon Corporation, 1998, Arvin Meritor, Inc. 2004, Wynn Resorts, Ltd. 2012, Family Dollar Stores, 2014 (among others).

Current consulting rate: $1,250.00 per hour.

Appendix B

Jonathan Macey -- Prior Expert Testimony as of May 13, 2020

Year	Case Name	Court	Testimony Given
2015	New York v. Maurice Greenberg	Supreme Court of the State of New York, County of New York	Deposition Testimony
2015	State of Connecticut v. The McGraw Hill Companies, and Standard & Poor's	Superior Court, Judicial District of Hartford, Hartford, CT	Deposition Testimony
2015	George L. Miller, Chapter 7 Trustee, v. Kirkland & Ellis	United States Bankruptcy Court, District of Delaware	Deposition Testimony
2015	In the Matter of Office of the Comptroller of the Currency v. James E. Plack	U.S. Department of the Treasury, Office of the Comptroller of the Currency	Deposition Testimony
2015	Paolo Moreno v. SFX Entertainment, Inc.	United States District Court for the Central District of California, Western Division	Deposition Testimony
2015	Future Select v. Tremont Group Holdings	Superior Court for the State of Washington for King County	Deposition Testimony
2015	Panattoni Development Company, Inc. v. Scout Funds 1-A, LP and 1-C, LP	Supreme Court of the State of New York, County of New York	Deposition Testimony
2016	Crystal Good, et al. v. American Water Works Company, Inc., et. al	United States District Court for the Southern District of West Virginia	Expert Report
2016	CaremarkPCS Health, L.L.C. v. Walgreen Co.	American Arbitration Association, Phoenix, AZ	AAA Arbitration Hearing Testimony
2017	SLSJ, LLC v. Kleban	United States District Court for the District of Connecticut	Expert Report
2017	Robinson Mechanical Contractors, Inc. v. PTC Group Holdings Corp.	United States District Court for the Eastern District of Missouri, Southeastern Division	Deposition Testimony
2017	Vikas Goel v. American Digital University, Inc.	Supreme Court of the State of New York, County of Westchester	Expert Report
2018	In the Matter Of NewSat Limited (In Liquidation	Federal Court of Australia District Registry: Victoria Division: General	Joint Expert Witness Statement

2018	United States of America v. AT&T Inc., DirecTV Group Holdings, LLC, and Time Warner, Inc.	United States District Court for the District of Columbia	Deposition Testimony
2018	Blueblade Capital Opportunities LLC, v. SciQuest, Inc.	Court of Chancery of the State of Delaware	Deposition Testimony
2019	Deere & Company v. Hitachi Construction and Machinery Co., Ltd. v. Hitachi Construction and Machinery Co., Ltd	International Chamber of Commerce International Court of Arbitration, Paris, FR	Expert Report
2019	Maurice Greenberg v. Eliot L. Spitzer	Supreme Court of the State of New York, County of Putnam	Deposition Testimony
2019	In Re: National Prescription Opiate Litigation	U.S. District Court for the Northern District of Ohio	Deposition Testimony
2019/ 2020	Party City Corporation v. Cayan LLC	American Arbitration Association	Deposition Testimony/ AAA Arbitration Hearing Testimony
2020	In re; ASHINC Corporation, et. al, debtors, Catherine Youngman Litigation Trustee v. Black Diamond Opportunity Fund II, LP	United States Bankruptcy Court for the District of Delaware	Deposition Testimony
2020	A.O.A. *et al*. v. Doe Run Resources Corporation, *et. al*.	United States District Court for the Eastern District of Missouri, Eastern Division	Deposition Testimony
2020	Wai Chun Shek v. Luckin Coffee Inc.,	United States District Court for the Southern District of New York	Expert Report

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