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Crown Capital ordered to pay $1.6m to settle SEC disclosure case

By **Cynthia Fernandez**, Reporter at Financial Planning (Article)[1]

A midsize wealth manager's SEC settlement displays the fragmented industry awaiting the Biden administration's next move on fiduciary rules.

Broker-dealer Crown Capital Securities agreed to pay a $1.6 million in disgorgement, interest and a fine after the SEC alleged the company did not disclose its conflicts of interests related to mutual fund share classes, cash sweep arrangements, and no-transaction fee revenues, according to a recent SEC filing.

Amy Doberman, an attorney and partner at WilmerHale, says that SEC enforcement actions relating to mutual fund share class selection has "changed the nature of the business."

"We have an industry practice — using 12b-1 share classes — that had been going on for 15 years and all of a sudden there's a slew of enforcement activity. Understandably, firms were unprepared for that. The avalanche of enforcement actions has caused changes in business practices — fairly dramatically," she says. "The loss of that revenue has been frustrating, understandably, for the industry and they have been seeking to compensate for that in other ways — revenue sharing, additional client fees, etc."

Knut Rostad, co-founder and president of the Institute for the Fiduciary Standard, says he views the initiative as very positive.

"The SEC is exposing an egregious practice of broker dealer dual registrants," Rostad says. "This action highlights a practice which should not be, in any way shape or form, permitted."

"The industry rebuttal is pathetic. The industry says that they were surprised by this enforcement action, and this is laughable," adds Rostad.

The language calling it a fiduciary breach is a noteworthy step under the new administration, he says.

"In some of the cases prior to the Biden administration, they stopped short and called it a lack of disclosure," Rostad says. "The point is not that you can't have 12b-1 fees. The point is that you have to disclose them, and you've got to disclose them in a way that your customer understands what that means."

Crown, established in 1999, is registered with the SEC as both an investment advisor and broker-dealer, according to its customer relationship summary. Crown's brokerage services include retirement planning, buying and selling securities, estate planning and college financial planning. Its advisory services include portfolio management, financial planning, and advisor referral services.

Crown did not respond to media inquiries.

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Allegations

Crown invested clients in mutual fund share classes and cash sweep arrangements that "resulted in Crown receiving revenue sharing," according to court documents.

"In spite of these financial arrangements, Crown provided no disclosure or inadequate disclosure of the multiple conflicts of interest arising from the firm's receipt of this compensation. Crown, although eligible to do so, did not self-report to the Commission," court documents say. "At all relevant times, Crown also failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder in connection with its mutual fund share class selection practices, cash sweep revenue sharing, and NTF revenue sharing."

Court documents allege that Crown advised clients to purchase mutual fund share classes that charged 12b-1 fees and received fees "that they would not have collected had Crown's advisor clients been invested in an available lower-cost share of those funds."

A 12b-1 fee is a yearly marketing or distribution fee on a mutual fund that is considered an operational expense and is usually between 0.25 and 0.75% of a fund's net assets, according to Investopedia.

From October 2019 through January 2020, Crown converted its clients from existing investments in mutual fund share classes that charged 12b-1 fees to share classes that did not charge those fees, according to court documents.

Court documents also allege that when Crown's advisory clients invested in mutual funds in no transaction fee (NTF) programs, clearing brokers shared a percentage of the revenue received from those mutual funds with Crown. Crown did not disclose it was receiving NTF revenue from client investments in advisory accounts since at least 2014.

"The NTF revenue were expenses of the mutual funds, and thus, advisory clients invested in those funds indirectly paid the NTF revenue," per court documents.

The SEC states that Crown Capital did not "fully and fairly" disclose its conflicts of interest since at least 2014 and violated Sections 206(2) and 206(4) of the Advisers Act.

Section 206(2) of the Advisers Act of 1940 prohibits investment advisors from engaging in business that operates as "fraud or deceit upon any client," and imposes a fiduciary duty on advisors, including an "affirmative duty of utmost good faith and full disclosure of all material facts," according to the SEC.

It's not the first time Crown Capital has run into issues with regulators. According to its FINRA detailed report, in 2019 the firm was censured and ordered to pay $395,000 in restitution and a monetary fine of $75,000 after it failed to establish and maintain a supervisory system for reviewing and monitoring mutual fund switches.

The firm had four other disclosures listed on the detailed report, going back to 2013.

The SEC launched its Share Class Selection Disclosure initiative in 2018 to prevent investment advisors

from failing to make required disclosures related to its selection of mutual fund share classes that paid the advisor as a dually registered broker-dealer, according to the SEC. The SEC Commission's Division of Enforcement recommended that investment advisors that self report possible violations accept favorable settlement terms. The deadline for the program was in June 2018.

For advisors who would have been eligible but did not disclose mutual fund share class selections, the SEC expects additional charges and the imposition of penalties when appropriate, according to the SEC.

“Eligible advisers are cautioned that staff… plan to continue to make mutual fund share class selection practices a priority, and plan to proactively seek to identify investment advisers that may have failed to make the necessary disclosures,” the SEC wrote at the time.

Though Rostad would not comment on the $1.6 million price tag, he says what’s most important is that firms like Crown Capital have been censured.

“The background is important,” he says. “The SEC first came forward and urged firms to self-report these practices. Crown Capital decided not to do so.”

Restitution

According to the court documents, within 30 days of the order, Crown has to review and correct relevant disclosures concerning mutual fund share class selection and 12b-1 fees, sweep account revenue sharing, and NTF revenue sharing. Crown must also evaluate whether existing clients should be moved to lower-cost mutual fund share class, alternative cash sweep products, or mutual funds that do not result in Crown receiving NTF revenue.

Crown must also review and update its policies and procedures so that “they are reasonably designed to prevent violations of the Advisers Act in connection with disclosures regarding mutual fund share class selection, sweep account revenue sharing, and NTF revenue sharing,” per the court document.

Crown must also alert affected investors, both current and former clients that were financially harmed by these alleged practices.

Doberman says the SEC may in the future take the same approach to share class selection and related conflict disclosure in the broker dealer channel, now that Regulation Best Interest is in place, to put client interests first when they make recommendations.

“You're going to see all of those same concepts and issues now applied to the broker dealer world,” she says.

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