UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

AMBASSADOR ADVISORS, LLC, BERNARD I. BOSTWICK, ROBERT E. KAUFFMAN, and ADRIAN E. YOUNG,

Defendants.

Case No.: 5:20-cv-02274-JMG

***AMICUS CURIAE* BRIEF OF FINANCIAL SERVICES INSTITUTE, INC. IN OPPOSITION TO PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT**

CORPORATE DISCLOSURE STATEMENT

Amicus Curiae certifies that it has no parent corporations and no publicly held company owns 10% or more of its stock.

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STATEMENT OF INTEREST OF AMICUS CURIAE

The membership of the Financial Services Institute ("FSI") is the trade association for the independent financial services firm industry.[1] It represents independent financial services companies (most of which are dually registered as both investment advisers and broker-dealers), and more than 33,000 independent financial advisor members who serve more than 20 million American households.[2] Founded in 2004, FSI has a clear mission: to ensure that all individuals have access to competent and affordable financial advice, products, and services delivered by a growing network of independent financial advisors and independent financial services firms. Each FSI investment adviser member firm is required by the Investment Advisers Act of 1940 ("Advisers Act") to register as an investment adviser with the Securities Exchange Commission ("SEC") or, alternatively, required by state securities laws to register as an investment adviser with a state securities regulator.[3]

FSI appreciates the opportunity to express its concerns about this action, which has potentially far-reaching consequences for FSI members and for the industry at large. If the SEC is successful in this action, a new standard of general applicability would become effective without going through the formal rulemaking process – which will result in widespread ramifications to

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[1] No party or counsel for a party authored this brief in whole or in part, and no person other than *Amicus*, its members, or its counsel has made any monetary contributions intended to fund this brief's preparation or submission. Defendants are not members of FSI. The principals of Defendant Ambassador Advisors are registered representatives with American Portfolios – a FSI member firm. Neither Ambassador Advisors nor its principals are currently FSI members.

[2] FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide contribute $35.7 billion to the United States' national GDP. This activity, in turn, supports 408,000 jobs, including direct employees, those employed in the supply chain, and those supported in the broader economy, *see* Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2020), available at https://media.financialservices.org/wp-content/uploads/2021/03/The-Economic-Impact-of-FSI-Members-2021.pdf (last accessed July 19, 2021).

[3] *See* Section 202 et al. of the Investment Adviser Act of 1940 [15 U.S.C. § 80b-3]. As a practical matter, virtually all of the FSI member firms are registered as investment advisers with the SEC.

the financial services industry. The expanded duties of disclosure would substantially increase the operational and compliance costs of investment advisers, perhaps prohibitively so, and such costs would ultimately fall on the investing public. Even more so, the stage would be set for the regulated financial services industry to be subject to new requirements and changing standards for which adequate notice and an opportunity for comment is not provided at the whim of agency personnel.

INTRODUCTION

In this enforcement case, the SEC seeks to impose a new standard that the agency itself had failed to discern in existing law, was never mentioned in any rule, and, which, presumably, the entire investment adviser industry had been violating for decades. That is not how the rule of law is supposed to work – a change in the regulatory framework must go through the proper rulemaking process. There is a phrase for this practice: "rulemaking by enforcement" – which many prominent securities law commentators, including current SEC Commissioner Hester R. Peirce, have identified as problematic.[4] The novel standards that are at issue in this enforcement case and which were first announced in an SEC "initiative" should have been issued through notice-and-comment rulemaking, should have been subject to economic analysis, and should have gone through the Regulatory Flexibility Act procedures. In no event should the SEC have

[4] *See, e.g*., Barry P. Barbash & Jai Massari, The Investment Advisers Act of 1940: Regulation By Accretion, 39 Rutgers L.J. 627, 653 (2008) (former Director of the Division of Investment Management explaining that the SEC uses "enforcement actions as a means of establishing rules of conduct for investment advisers" because "[e]nforcement-action rulemaking can . . . be undertaken quickly and almost certainly is a faster form of proceeding that traditional rulemaking, which contemplates the Commission's publishing a rule proposal, receiving and responding to public comment, and adopting a final rule"); Harvey L. Pitt & Karen L. Shapiro, Securities Regulation by Enforcement, 7 Yale J. on Reg. 149, 270 (1990) (former Chairman describing how the Commission has "bootstrapp[ed]" settled enforcement actions "into a substantive rule of law" as a means of "bypass[ing] the notice and hearing requirements of the Administrative Procedure Act").

attempted to apply its pronouncements retroactively, violating bedrock constitutional and administrative law principles of due process and fair notice.

FSI has brought its concerns to the attention of the SEC. On April 29, 2020, FSI filed a Petition for Rulemaking with the SEC on this very issue, detailing the regulatory history and the legal infirmities with the SEC's backdoor regulation of 12b-1 fees through a retroactive application of the February 2018 Share Class Selection Disclosure Initiative ("SCSD Initiative")[5] and subsequent October 2019 Frequently Asked Questions ("FAQs")[6]. As the Petition explained, the SEC's actions violated the Administrative Procedure Act ("APA") and bedrock principles of fair notice and due process. The SEC has not been responsive to FSI's concerns regarding the widespread negative impact arising out of its attempts to regulate by enforcement.

FSI is now submitting this brief to further amplify its concern that the SEC's regulation by enforcement is severely problematic. Accordingly, for the reasons set forth in further detail below, the SEC's misguided attempt to base its request for summary judgment against Ambassador Advisors, LLC and its principals Bernard I. Bostwick, Robert E. Kauffman and Adrian E. Young (together "Ambassador") on new disclosure standards that have developed through non-precedential enforcement actions and non-binding staff guidance should be denied.

OVERVIEW OF THE ARGUMENTS

The SEC's motion for summary judgment (Doc. 48) asserts a standard of liability against Ambassador that is plainly a new standard of general applicability that did not go through the

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[5] 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 (last accessed July 22, 2020)

[6] SEC, Division of Investment Management, "Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation," (Oct. 18, 2019), *available at*: https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation (last accessed July 22, 2020).

proper formal rulemaking process. Fundamentally, the standard that the SEC seeks to impose goes beyond the foundations of adequate disclosure which the SEC cites to, rather it seeks to retroactively impose a specific disclosure requirement to state explicitly, in very particular language, that "a lower-cost share class was available." This was not required prior to the announcement of the SCSD Initiative in February 2018.

The new standard of general applicability that the SEC is seeking to impose through this litigation meets the definition of a "rule" under the APA and therefore must go through the required administrative procedures before it can be applied to Ambassador or similarly situated investment advisers. The actions that the SEC and the SEC Staff have taken in connection with this new standard as well as other enforcement matters evince a pattern of shifting regulator expectations that creates a great deal of uncertainty for advisers attempting to comply with regulatory obligations in good faith. When these shifting expectations apply retroactively, leaving advisers exposed to SEC enforcement actions based on hindsight, the SEC and the SEC Staff violate bedrock principles of fair notice and due process to which investment advisers are entitled.

ARGUMENT

I. The new standard the SEC is seeking to impose is a "rule" under the Administrative Procedure Act and cannot be imposed without going through the proper rulemaking process.

The standard of new general applicability that the SEC is seeking to establish through the SCSD Initiative, related guidance, and this litigation does not follow the proper rulemaking procedure under the APA. Rules issued in compliance with the APA (including public notice and

comment requirements) and that fall within the scope of authority delegated to the SEC by Congress, have the force and effect of law.[7]

The SEC's failure to comply with the APA through its retroactive enforcement of its new disclosure standard created by the SCSD Initiative deprives Ambassador (and other similarly situated advisers) of its legal right and ability to participate in the rulemaking process. Therefore, the SEC's retroactive attempt to penalize Ambassador and other similarly situated investment advisers for failing to specifically state that "a lower-cost share class was available" even where appropriate and sufficient disclosures were provided under existing disclosure rules should not stand and the SEC's Motion for Summary Judgment should be denied.

a) The new proposed standard of general applicability meets the definition of a "rule" under the Administrative Procedure Act.

Through its SCSD Initiative, the resulting settled orders and this litigation, the SEC is seeking to impose new specific enhanced disclosure requirements. In a press release issued in February 2018, the SEC announced the SCSD Initiative. Many advisers, including many FSI members, reluctantly agreed to participate in the SCSD Initiative, despite believing they provided appropriate and sufficient disclosure. The resulting settled orders were largely identical, and stated that the advisers had violated Section 206(a) of the Investment Advisers Act 1940,[8] failing to distinguish between firms who made a good faith effort to comply with disclosing 12b-1 fee arrangements and those who made no effort at all.

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[7] Rules that carry the force and effect of law are known as legislative rules. *See*, e.g., *Appalachian Power Co. v. EPA*, 208 F.3d 1015, 1020, (D.C. Cir. 2000) ("Only 'legislative rules' have the force and effect of law… A 'legislative rule' is one the agency has duly promulgated in compliance with the procedures laid down in the statute or in the Administrative Procedure Act."); *Nat'l Mining Ass'n v. McCarthy*, 758 F.3d 243, 250 (D.C. Cir. 2014) ("Legislative rules have the 'force and effect of law' and may be promulgated only after public notice and comment.") (citation omitted).

[8] 15 U.S.C. § 80b-6.

Any firm that had already been contacted by the SEC on this topic was denied the opportunity to participate in the SCSD Initiative. In addition, "For advisers that would have been eligible for the terms of [the SCSD Initiative] but did not participate, the [SEC's Division of Enforcement] expects . . . to recommend **additional** charges . . . and the **imposition of penalties**. . . . A [case] against an eligible adviser that fails to self-report under the . . . Initiative may include **greater penalties than those imposed in past cases** . . . ."[9]

The standard that the SEC seeks to impose on Ambassador (and has imposed on similarly situated advisers through the SCSD Initiative) should be subject to the formal rulemaking process. While it is accepted that the APA exempts "interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice" from its notice and comment procedures, all other rules must go the formal rulemaking process.[10] A "rule," for purposes of the APA, is defined expansively to include any "agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency."[11] If a rule creates rights, assigns duties, or imposes obligations, the basic tenor of which is not already outlined in the law itself,[12] or if it affects "individual rights and obligations,"[13] then it is substantive and must go through notice,

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[9] SCSD Initiative pt. III.E (emphasis added).

[10] *See* 5 U.S.C. § 553(b).

[11] *See* 5 U.S.C. §551(4).

[12] *See Warder v. Shalala*, 149 F.3d 73, 80 (1st Cir.1998) (quoting La Casa Del Convaleciente v. Sullivan, 965 F.2d 1175, 1178 (1st Cir.1992)).

[13] *See Chrysler Corp. v. Brown,* 441 U.S. 281, 301–302 (1979)*; see also Williams v. Hanover Hous. Auth.,* 871 F. Supp. 527, 532 n. 4 (D. Mass. 1994) (substantive rule "must affect or modify law, policy or individual rights and obligations").

comment and publication before it can be enforced.[14] Due process requires that "laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited."[15]

The SEC is seeking to impose a new standard, which is not an obligation already outlined in a law or regulation, as a mandatory rule.[16] The new standard is not interpretative, it imposes new disclosure obligations that are of general and particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing industry practice requirements. Indeed, the sheer number of advisers whose disclosures allegedly fell short of the SEC's standards, and the resulting large dollar fines they were subject to, is itself strong evidence that the SEC's newly minted interpretation seeks to substantively change the law. The SEC has found that nearly 100 advisers violated its share class disclosure standards. Courts "will not lightly presume an entire industry negligent."[17] And while it "may be 'possible'" that an "entire industry" was "in violation of the [Investment Advisers Act] for a long time without the [SEC] noticing," the "more plausible hypothesis is that the [SEC] did not," until recently, "think the industry's

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[14] *See* 5 U.S.C. § 553. *See e.g. Mendoza v. Perez*, 754 F.3d 1002, 1025 (D.C. Cir. 2014) where the court held that two training and Employment Guidance Letters that were promulgated without notice-and-comment rulemaking, "were subject to the notice and comment requirements [of the APA] because they possess[ed] all the hallmarks of a legislative rule," by "chang[ing] the regulatory scheme.".

[15] *See Upton v. SEC*, 75 F.3d, 92, 93 (2d Cir. 1996) citing *Grayned v. City of Rockford*, 408 U.S. 104, 108, 92 S.Ct. 2294, 2298–99, 33 L.Ed.2d 222 (1972).

[16] *See Kelly v. Keystone Shipping Co.,* 281 F. Supp. 2d 313 (D. Mass. 2003).

[17] *See In re City of New York*, 522 F.3d 279, 285 (2d Cir. 2008).

practice was unlawful."[18] Therefore, the new standard created by the SCSD Initiative meets the definition of a rule subject to rulemaking under the APA.[19]

b) The proposed standard must be subject to notice-and-comment under the Administrative Procedure Act.

The APA establishes the process of public notice for proposed rulemakings and provides the opportunity for public comment and input before a rule is made final and published in the Federal Register.[20] Notice of rulemaking under the APA is important. It allows the rule to be tested by exposing it to public comment to assure fairness and mature consideration of rules of general application.[21] The SEC did not follow this process when imposing the standards created by the SCSD Initiative. Instead, the SEC seeks to impose these standards through settlements that have no force of law. As the name itself suggests, the SCSD "Initiative" is a novel concept designed to impose new and original requirements on investment advisers.

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[18] *See 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)); *see also Util. Air Regulaty. Grp. v. EPA,* 573 U.S. 302, 324 (2014) ("When an agency claims to discover in a long-extant statute an unheralded power to regulate a significant portion of the American economy, we typically greet its announcement with a measure of skepticism." (citation and quotation marks omitted)); *Chamber of Commerce v. Dep't of Labor,* 885 F.3d 360, 380 (5th Cir. 2018) ("[T]hat it took DOL forty years to 'discover' its novel interpretation further highlights the Rule's unreasonableness.").

[19] The APA covers the activities of the SEC, *see Commercial Capital Corp. v. SEC*, 360 F.2d 856, 857–58 (7th Cir. 1966). Under federal regulations implemented by the SEC through the Advisers Act, investment advisers are required to comply with SEC rules that are promulgated through a formal rulemaking process under the APA. The APA established the process of public notice for proposed rulemakings, providing the opportunity for public input and comment before a final rule is published in the Federal Register, and a 30-day period before such a rule becomes effective; see 5 U.S.C. § 553(d): "The required publication or service of a substantive rule shall be made not less than 30 days before its effective date".

[20] Section 553 of the APA provides that an agency is required to: (i) give notice of a proposed rule; and (ii) give interested persons an opportunity to comment, before releasing its final rule.

[21] *See N. L. R. B. v. Wyman-Gordon Co.,* 394 U.S. 759, 764 (1969).

The SEC should not be allowed to avoid notice and comment simply by mislabeling their substantive pronouncements as enforcement actions under existing statute or "initiatives." On the contrary, the Court should look to the contents and impact of this litigation, together with the SCSD Initiative, to determine that notice-and-comment demands should apply.[22]

Appropriate notice also informs interested parties that their substantive rights may be affected in forthcoming public proceedings[23] and facilitates clear requirements. As recognized by SEC Commissioner Peirce, the SEC has a duty to notify its regulated entities of any new obligations. Commissioner Peirce addressed this precise issue in dissenting to an October 2020 SEC settlement in stating that "[a]n enforcement action is an inappropriate way for a regulator to communicate its interpretation of the laws."**[24]**

It would not be fair for the SEC to force advisers to find and review enforcement actions on the SEC's website to determine new obligations and revise their disclosures accordingly, or for those new obligations to apply retroactively. Imposition of new disclosure requirements on investment advisers by use of the SCSD Initiative and resulting settled orders would not afford the public and the industry an opportunity to comment on the fairness of the application of the new requirements or even consider its implications and put in place effective mechanisms to ensure compliance. In the words of Commissioner Peirce:

> …the SEC also has a duty. Our duty is to be clear with registrants about our interpretation of the fiduciary duty. If we see a wide-scale departure from the fiduciary duty as we interpret it occurring over

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[22] *See Azar v. Allina Health Servs.*, 139 S. Ct. 1804, 1808, 1811 (2019) ("Agencies have never been able to avoid notice and comment simply by mislabelling their substantive pronouncements. On the contrary, courts have long looked to the contents of the agency's action, not the agency's self-serving label, when deciding whether statutory notice-and-comment demands apply.")

[23] *See Visiting Nurse Ass'n of N. Shore, Inc. v. Bullen,* 93 F.3d 997, 1010 (1st Cir. 1996).

[24] Hester M. Peirce, Commissioner, U.S. Securities and Exchange Commission, "Statement of Commissioner Hester M. Peirce – Great Plains Trust Company" (Oct. 2, 2020), available at https://www.sec.gov/news/public-statement/peirce-dissent-great-plains-2020-10-01 (last accessed July 19, 2021).

> numerous years, we owe it to the firms we regulate and—more importantly—the investors whom we are charged with protecting to be very clear that there is a problem. A regulator wearing its reasonableness pants tells the firms it regulates what their regulatory obligations are. When I say tell them, I do not mean bring a few enforcement actions and expect firms to find these actions on our website and revise their disclosures in light of what they can glean from those actions. I do not mean issue an OCIE risk alert, though such alerts are very helpful in giving a window into the problems our staff is seeing in the field. What I mean is that when we see a widespread problem that is affecting investors, we—the Commission—should issue our own guidance or promulgate a rule and put an end to the problem before it hurts investors further. Doing this is better for investors than waiting many years to bring a large enforcement initiative. It is also respectful of the due process of the firms we regulate by giving them notice of what the SEC expects from them.[25]

The SEC's objective is to protect investors by setting out clear formal guidance for its regulated entities, particularly where a widespread problem affecting investors has been identified. Requiring firms to sort through settled orders and enforcement actions with unique fact patterns to work out what the SEC expects is unreasonable and unsatisfactory. Indeed the policy of the former Presidential Administration – which was in effect when the SEC commenced this action – also confirms "Regulated parties must know in advance the rules by which the Federal Government will judge their actions."[26] Notice also gives affected parties an opportunity to develop evidence in the record to support their objections to a rule, thus enhancing the "quality of any judicial review."[27]

The new standard of general applicability that the SEC is seeking to impose is a substantial departure from the usual scope of disclosure requirements and seeks to inaugurate a material

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[25] Hester M. Peirce, Commissioner, U.S. Securities and Exchange Commission, "Reasonableness Pants" (Rutgers Law School, Camden, New Jersey, May 8, 2019), available at https://www.sec.gov/news/speech/speech-peirce-050819 (last accessed July 22, 2020).

[26] Exec. Order No. 13,892, 84 Fed. Reg. 55239-55243 (Oct. 9, 2019).

[27] *See Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin.*, 626 F.3d 84, 95 (D.C. Cir. 2010) (citation omitted).

change in policy in respect of the disclosure requirements for advisers. Imposing the new standard on advisers will have a substantial impact on the investment adviser industry and cannot be exempt from the notice and comment requirements.

II. The new standard is also subject to Economic Analysis as required by Section 202(c) of the Investment Advisers Act of 1940.

Section 202(c) of the Advisers Act[28] requires the SEC to consider and determine whether an action is necessary or appropriate in the public interest, for the protection of investors, and for the promotion of efficiency, competition, and capital formation when it engages in rulemaking. This effectively calls for an economic analysis.

There is no evidence that the SEC has considered the implications of the new standard of general applicability on the industry. If the SEC is successful in this action and the new obligations become effective as a regulation without a rule, there will be widespread ramifications on the investment adviser industry.

Of significant consideration is the fact that the SEC is giving the new standard retrospective effect. This has huge implications on the investment adviser industry and is grossly unjust. Following the rulemaking procedure and providing clear guidance will allow firms the time to make the necessary changes. Retrospective adoption of a “rule," via this litigation deprives the firms of the opportunity to provision for the economic impact. Such a process could have many different elements, such as: the re-negotiation and amendment of agreements with service providers (such as clearing firms and mutual fund complexes), financial advisors and investment advisory clients; the re-structuring of the economics of advisory programs to allow for the elimination of the conflict if an investment adviser decides to pursue that; and the revision of Form

[28] 15 U.S.C. § 80b-2.

ADV Brochures and other necessary documentation and disclosures to reflect any new pricing models or conflict disclosures.

Such deprivation would not be limited to just the particular standard the SEC seeks to impose through the SCSD Initiative. Rather, with a precedent of the SEC being permitted to impose new standards through enforcement, if (or, perhaps, when) the SEC decides to pursue a similar tactic with respect to other conflicted compensation arrangements investment advisers often face (such as revenue sharing arrangements), the investment advisory industry will again be caught flat-footed and unable to plan ahead to deal with the wide-spread economic impact of SEC pronouncements.

Allowing the SEC to expand the duties of federally registered investment advisers through the SCSD Initiative, settled orders and enforcement actions (rather than the customary notice-and-comment rule making process required by the APA) would set a dangerous procedural precedent nationally and have dramatic economic consequences.[29] FSI is concerned that the SEC is envisioning being able to announce future new requirements without the benefit of rulemaking based on the SEC's staff's changing policy whims, which would be grossly unjust on the industry as a whole. The SEC admittedly collected more than $135 million from 96 investment advisers

[29] By way of comparison, in the adopting release for the SEC's new enhanced standard of conduct for broker-dealers (i.e., Regulation Best Interest), the SEC estimates a significant initial aggregate cost of at least $1,508.88 million and an ongoing aggregate annual cost of at least $499.59 million on broker-dealers in respect of complying with enhanced disclosure obligations. *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, SEC (June 5, 2009) available at https://www.sec.gov/rules/final/2019/34-86031.pdf (last accessed July 22, 2020). While it is accepted that the extent of the enhancements in this present case are more limited in scope, the exercise required to be undertaken is similar in many respects. Significant investment will be required from investment advisers to update disclosures, renegotiate clearing agreements, update marketing materials, and implement other necessary changes ensure compliance with the new standard.

during its SCSD Initiative.[30] If the SEC continues to penalize investment advisers for failing to meet the new standards, the rest of the industry could be exposed to a burdensome remediation project that will threaten the ability of many investment advisers to continue conducting business.[31] As well as looking back retrospectively, investment advisers would also have to insure against future risks or the enforcement of regulations without notice and time to prepare for compliance, further increasing the operational costs for investment advisers. Such costs would ultimately fall on the investing public. Indeed, this very idea was advanced in an August 24, 2020 letter from Senator Charles Grassley to SEC Chairman Jay Clayton addressing the very same issues raised in this brief. In questioning why the SEC was pursing enforcement actions based on "retroactively applied guidance as opposed to a written rule of regulation", Senator Grassley stressed that "a climate of uncertainty on what is required of independent financial services firms could ultimately lead to increased cost and decreased choice for consumers."(*See* Exhibit 1.)

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[30] U.S. Securities and Exchange Commission Press Release: SEC Share Class Initiative Returning More Than $125 Million to Investors available at https://www.sec.gov/news/press-release/2019-28 (last accessed July 22, 2020); and U.S. Securities and Exchange Commission Press Release: SEC Orders an Additional 16 Self-Reporting Advisory Firms to Pay Nearly $10 Million to Investors available at https://www.sec.gov/news/press-release/2019-200 (last accessed July 22, 2020).

[31] The SEC has already settled a number of cases relating to the conflicts arising out of revenue sharing arrangements. For example, *See, e.g.*, *In the Matter of Voya Financial Advisors, Inc. SEC Release No. IA-4661* (Mar. 8, 2017), available at: https://www.sec.gov/litigation/admin/2017/34-80177.pdf (last accessed July 22, 2020); and *In the Matter of KMS Financial Services, Inc.*, SEC Rel. No. IA-4730 (July 19, 2017), available at: https://www.sec.gov/litigation/admin/2017/34-81169.pdf (last accessed July 22, 2020) And now, the SEC appears to be moving to treat the standards the SEC believes it established through those settled cases to sue other investment adviser, just as the SEC is doing in the instant Case with respect to Ambassador. *See SEC v. Commonwealth Equity Services, LLC*, Case No. 1:19-cv-11655 (D. Mass., Complaint filed Aug. 1, 2019), available at: https://www.sec.gov/litigation/complaints/2019/comp24550.pdf (last accessed July 22, 2020); *SEC v. Bolton Securities Corporation d/b/a Bolton Global Asset Management,* Civil Action No. 4:19-cv-40143 (D. Mass., filed November 4, 2019); and *SEC v. Ambassador Advisors, LLC, Bernard I. Bostwick, Robert E. Kauffman, and Adrian E. Young,* No. 5:20-cv-02274 (E.D. Pa. filed May 13, 2020) available at: https://www.sec.gov/litigation/complaints/2020/comp24817.pdf (last accessed July 22, 2020).

III. **The new standard is subject to the analytical and procedural requirements of the Regulatory Flexibility Act.**

Where an agency is required to publish general notice of proposed rulemaking under the APA, the agency is also required to make available for public comment an initial regulatory flexibility analysis.[32] Such analysis shall describe the impact of the proposed rule on small entities and must be published in the Federal Register at the time of the publication of general notice of proposed rulemaking for the rule. In addition, the agency shall transmit a copy of the initial regulatory flexibility analysis to the Chief Counsel for Advocacy of the Small Business Administration.[33] By failing to follow the notice and comment procedure required under the APA, the SEC has also avoided preparing a final regulatory flexibility analysis under the Regulatory Flexibility Act (the "RFA").

The SEC has failed to follow the requirements of the RFA. No statement has been published and small businesses (including some FSI members) have not had the opportunity to consider the impact of changes to its business. As set out above, it would not be fair to expect investment advisers to thumb through non-binding settled orders and find enforcement actions on the SEC's website and revise their disclosures accordingly. Investment advisers must have clear guidance of applicable standards, prior to any enforcement action taking place.

IV. **Retroactive application of the Commission's new standard violates fundamental principles of due process and fair notice.**

Even if the SEC could enforce the SCSD Initiative through this litigation—and it cannot—another barrier would still remain standing against the imposition of liability: fundamental principles of fair notice embodied in the United States Constitution. The Due Process Clause

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[32] *See* 5 U.S.C. § 604.
[33] *See* 5 U.S.C. § 603 (a).

forbids the federal government from retroactively imposing liability without giving "fair notice of [the] conduct that is forbidden."[34] This "bedrock due process principle" precludes "'an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule.'"[35] The SEC's enforcement action here violates these basic constitutional requirements by threatening liability based on a standard that no one, at the time of their actions, knew, or even could have known, was supposedly unlawful. The SEC's failure to cite a single statute, rule, or litigated case that even mentions the additional disclosures that it now says are (and always have been) required demonstrate that it was entirely impossible for Ambassador or similarly situated investment advisers to have "identif[ied]" at the time of the challenged conduct, let alone with the requisite "ascertainable certainty," "the standards with which the" SEC now seemingly "expects parties to conform."[36] Accordingly, investment advisers have not been afforded notice, or the opportunity to comment on the enhanced standard, or the time to put in place systems and controls to ensure compliance with the new standard. Failure to provide such notice and opportunities violates constitutional due process.

V. Application of the new standard in this case would set a dangerous precedent

As demonstrated above, the new standard of general applicability falls squarely under the definition of a "rule" pursuant to the APA and should therefore be subject to the formal rule-making process under the APA, economic analysis under the Advisers Act, and the analytical and procedural requirements under the RFA. The standard should therefore not apply until such time as the SEC has met these procedural requirements, in accordance with the rule of law.

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[34] See *FCC v. Fox Television Stations, Inc.*, 567 U.S. 239, 253 (2012).

[35] See *PHH Corp. v. CFPB*, 839 F.3d 1, 44, 49 (D.C. Cir. 2016) (Kavanaugh, J.), *reinstated on reh'g en banc*, 881 F.3d 75 (D.C. Cir. 2018) (quoting *Satellite Broadcasting Co. v. FCC*, 824 F.3d 1, 3–4 (D.C. Cir. 1987)).

[36] See *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1329 (D.C. Cir. 1995).

The SEC's success in this action would set a dangerous precedent as to the way in which rules governing the securities industry may be enacted, enabling agencies to bypass the customary notice-and-comment process and threatening the existing federal scheme of securities regulation. Moreover, it would alarmingly affirm that the SEC can use the threat of enforcement action to make rules. The SEC's success in holding Ambassador liable for failing to meet the new standards would radically expand the duties imposed on federally registered investment advisers. These new duties, in turn, would significantly increase the costs of operating as a federally registered investment adviser that would be passed on to investors.

The burdens and costs that the new standard of general applicability, if adopted, would impose on FSI's members and their clients and the larger financial services industry are real, not hypothetical. The imposition of the new disclosure requirements threaten the ability of investment advisers to continue conducting business. At a minimum, FSI's member firms and other advisers would be required to raise their fees to pay for the administrative infrastructure that would be necessary to conduct a retrospective review and comply with the new disclosure requirements. Investment advisers would also have to dedicate resources (and, thus, raise the costs for investors) to continuously follow settled orders, enforcement actions and lawsuits for clues as to what SEC expectations are with respect to all kinds of other conflicted compensation arrangements and adjusting disclosures and practices as the SEC refines or changes its theories relating to the material facts that need to be disclosed regarding such conflicts. Consequently, a victory by the SEC in this proceeding would have a substantial impact on FSI's investment adviser members and their clients.

Because of the federal interests involved in this case and the procedural and substantive harm the SEC's success would inflict on the securities industry, the Court should prevent any

adjudicative ruling accepting the position the SEC is taking with regard to the general applicability of any new standard that has not gone through the formal rulemaking process.

This kind of regulation by enforcement harms independent financial services firms and American investors. Specifically, independent financial firms and advisors have a reasonable expectation the SEC will disclose the rules of the road before engaging in enforcement. Regulation by enforcement creates uncertainty because it does not give notice to firms of how they should operate their businesses, leads to inconsistencies in interpretation and enforcement, and increases cost for investors.

CONCLUSION

For the foregoing reasons, the Court should deny the SEC's Motion for Summary Judgment.

Dated: July 19, 2021

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the foregoing brief has been filed with the Clerk of the Court using the CM/ECF system, which will send notification of such filing to all attorneys of record, on this July 19, 2021.

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