Why the SEC is Obsessed with Mutual Fund Share Class Selection and Disclosure (and why you should be too)

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On April 6, 2018, the SEC released three settlement orders with investment advisers because they “failed to disclose conflicts of interest and violated their duty to seek best execution by investing advisory clients in higher-cost mutual fund shares when lower-cost shares of the same funds were available.” The firms had to reimburse investors to the tune of $12 million, as well as pay penalties ranging from $250,000 to $900,000. With the deadline for advisers to voluntarily comply with SEC’s “Share Class Selection Disclosure Initiative” coming up June 12, 2018, the Commission is sending a message to show what could happen to those who fail to take advantage of its offer. (See our Blog Post for more on the Share Class Selection Disclosure Initiative.)

The SEC is concerned primarily with two basic fiduciary issues: failure to adequately disclose a conflict of interest, and failure to seek best execution. The purpose of this article is to analyze these issues and provide guidance to investment advisers to avoid these failures.

Conflicts of Interest

As a fiduciary, an adviser is expected to provide investment advice that is in the client’s best interest. This includes an obligation to avoid or mitigate conflicts of interest. But for those conflicts that cannot be avoided, an investment adviser is required to provide full and fair disclosure about the conflict and let the client decide whether to do business on those terms. A primary focus of the settlement orders discussed above and the Share Class Selection Disclosure Initiative is the failure of advisers to provide full and fair disclosure in situations regarding fees paid by the mutual funds to dual registrants (firms registered as both investment advisers and broker-dealers) and affiliated broker-dealers of advisers.

The SEC feels advisers should explicitly disclose to their clients that the recommendation to purchase mutual funds share classes with 12b-1 fees can result in the receipt of payments by the adviser, the adviser’s investment advisory representatives (IARs), or an affiliated broker-dealer. The fact that an adviser’s affiliated entity receives payments from the mutual fund company (in the form of 12b-1 distribution and marketing fees) as a direct result of the client’s investment in that fund is a conflict of
interest that should be disclosed to clients in the adviser’s Form ADV. This is especially applicable if the adviser has a choice of multiple and potentially lower cost share classes for its clients.

The Department of Labor (DOL) has taken a stricter position\(^1\), prohibiting an advisory firm that serves as a fiduciary investment adviser to ERISA plans\(^2\) from receiving any fees in addition to its advisory fee, such as 12b-1 fees and revenue sharing payments. This is a violation of the prohibited transactions rules of section 406(b) of ERISA. Therefore many investment advisers to ERISA plans offset or credit any 12b-1 fees that they receive to the ERISA plan.

**The 12b-1 Conflict**

12b-1 fees are fees that a mutual fund pays directly from fund assets for marketing, distribution expenses, and shareholder servicing. This includes fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares. FINRA rules dictate that 12b-1 fees cannot exceed 1.00%. The bottom line on these fees is that because they come directly out of fund assets, they reduce investor returns.

The 12b-1 distribution fees are meant to compensate brokers for selling mutual fund shares. Therefore, these fees can only be paid to broker-dealers and their registered representatives for sales activities. Registered investment advisory firms that are dually registered, i.e., registered as both investment advisers and broker-dealers, can receive 12b-1 fees as part of the brokerage function. Additionally, many IARs of such firms are registered both as IARs and as registered representatives. As a result, an individual who is an IAR and a registered representative of a broker-dealer, can receive an advisory fee in his/her IAR role, and a portion of a 12b-1 fee in his/her registered representative role. Similarly, there are investment advisory firms that have a broker-dealer affiliate, and IARs of that RIA who are registered representatives of the affiliate broker-dealer. If an investment adviser places client assets in a mutual fund share class with 12b-1 fees using its affiliate as the introducing broker, that broker can then receive the accompanying 12b-1 fees.

In addition to the 12b-1 fees that have the SEC so hot and bothered, there are other types of compensation that an investment adviser can receive that could cause a conflict of interest. These fees include revenue sharing arrangements, marketing support payments (as discussed in the PNC Investment case below), and others. At the end of the day, the SEC is looking for situations where the adviser receives some kind of payment or remuneration for selecting specific investments, and fails to disclose these payments to clients.

**We should have seen this coming....**

SEC findings in the cases against PNC Investments, LLC, Securities America Advisors Inc., and Geneos Wealth Management should not come as a surprise. Back in 2003, there was a mutual fund scandal involving some major mutual fund companies and other financial institutions engaging in inappropriate market timing, late trading of fund shares, and the misuse of material, nonpublic information about fund portfolios. Ultimately, this led to the SEC adopting new rules requiring advisers and funds to adopt

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2 ERISA Section 3(21) definition includes a fiduciary who provides investment advice for a fee.
compliance controls administered by a chief compliance officer, Rule 206(4)-7 of the Advisers Act and Rule 38a-1 under the Investment Company Act.

In the wake of the original scandal, the SEC began targeting misconduct in the relationships between brokerage firms and mutual fund companies. There were a number of high-profile cases involving Edward D. Jones & Co., L.P., Massachusetts Financial Services Company, and Morgan Stanley DW, Inc., where the SEC nailed these firms for failure to disclose revenue sharing and distribution payments made by mutual fund companies to brokerage firms in exchange for promoting fund shares.

More recently, in 2011, the SEC’s Asset Management Unit (“AMU”) started its “mutual fund fee initiative” which is focused on excessive fees that mutual fund advisers charge retail investors. Based on the cases brought over the past couple of years, the AMU is focused on situations where the adviser or its affiliated broker-dealer has a vested interest in placing client assets into certain mutual fund shares because of additional payments it stands to receive from mutual fund companies.

The SEC’s Office of Compliance Inspections and Examinations (“OCIE”) jumped on the band wagon as well. In a Risk Alert issued on July 13, 2016, OCIE announced its Share Class Initiative. As part of the examination process, OCIE put advisers on notice that it would be conducting focused, risk-based examinations of high risk areas, including:

- Fiduciary Duty and Best Execution;
- Disclosures of conflicts of interest and receipt of compensation from mutual fund companies; and
- Adoption and implementation of an adviser’s practices for selection of mutual fund shares classes.

*The War on “May” Begins....*

Consequently, we start seeing cases like The Robare Group, Ltd., et al., where the SEC found that if an adviser discloses that it “may” receive revenue sharing payment, but actually does receive revenue sharing payments, that disclosure is not sufficient. (Check out our blog post on the Robare case.) Similarly, in 2016, there was a case called Royal Alliance, where the SEC alleged that three subsidiaries of AIG placed client assets into mutual funds that paid 12b-1 fees, instead of a lower fee alternative, mostly reserved for institutional investors. All three were dual-registrants, and received 12b-1 fees paid by the funds in which their advisory clients were invested. Again, the SEC targeted the language in the Form ADV, where the firms stated that they “may” receive 12b-1 fees from mutual fund investments, which the Commission found to be insufficient disclosure. The SEC also found that the firms failed to disclose the specific conflict of interest that existed in selecting mutual fund share classes with 12b-1 fees, since the firms had a financial incentive to place advisory clients in higher-fee share classes over lower-fee share classes of the same mutual fund.

There are many other cases, some of which are included in the footnote to the SEC’s Announcement of the Share Class Selection Disclosure Initiative. They all boil down to the same two issues: failure to adequately disclose a conflict of interest, and failure to seek best execution.

*The Breaking Point*
Apparently the SEC determined that investment advisers just aren’t getting the message, and came out with the Share Class Selection Disclosure Initiative on February 12, 2018. The SEC then followed up in April with three cases against investment advisers to make the point in ALL CAPS and BOLD, with this headline: “SEC Orders Three Investment Advisers to Pay $12 million to Harmed Clients.”

How to Disclose Conflicts

There are some lessons to be learned from these cases. According to the SEC, there is an inherent conflict of interest if an adviser or its affiliates receive additional fees beyond an investment management fee as a result of an adviser investing client assets in a specific investment product. This conflict requires explicit disclosure. An adviser cannot rely on clients to connect the dots.

An adviser that receives 12b-1 fees (whether directly, as a dually registered broker-dealer, or indirectly through an affiliated broker-dealer) as a result of using mutual fund share classes with 12b-1 fees for its clients should specifically state on its Form ADV Part 2A that:

1. The firm [or its affiliate(s)] receives [insert type of payments, such as 12b-1 fees, revenue sharing payments, marketing support payments, etc.] from [insert relevant source of payment];
2. These payments present a conflict of interest between the firm and its clients’ best interests. Simply put, the firm has a financial incentive to invest client assets in mutual funds where the firm or its affiliate(s) receive [insert relevant reference, i.e., revenue sharing payments, 12b-1 fees, marketing support payments, etc.]; and
3. The firm and its IARs select mutual fund share classes that charge 12b-1 fees, even in situations where clients may be eligible for lower cost share classes of the same fund.

Honestly, I cannot see many advisers willing to make that last disclosure. Not only would it turn off clients, but it also appears to conflict with an adviser’s duty of best execution (discussed later).

This disclosure could be included in Item 4, Advisory Business; Item 5, Fees and Compensation; Item 11, Code of Ethics Participation or Interest in Client Transactions and Personal Trading; or Item 14, Client Referrals and Other Compensation. Of course, don’t forget to highlight these changes as material in Item 2 of the Form ADV Part 2A. In the Geneos case, the SEC cited the firm for failing to discuss its new disclosure stating that the firm and its IARs would select share classes that assess 12b-1 fees most of the time even if a less expensive share class was available to the client. The SEC considers this a material change that should have been highlighted for clients.

One of the firms swept up in OCIE’s Share Class Initiative was Cadaret, Grant & Co., which now includes the following disclosure in its Form ADV Part 2A under Fees and Compensation:

Cadaret, Grant and its IARs have a financial incentive to recommend or select share classes that have higher expense ratios because such share classes generally result in higher compensation. Cadaret, Grant has taken steps to minimize this conflict of interest, including by providing its IARs with training and guidance on this issue, as well as by conducting periodic reviews of client holdings in mutual fund investments to ensure the appropriateness of mutual fund share class selections and whether alternative mutual fund share class selections are available that might be more appropriate given the client’s particularized investment objectives and any other appropriate considerations relevant to
mutual fund share class selection. Regardless of such considerations, Cadaret, Grant clients should not assume that they will be invested in the share class with the lowest possible expense ratio.

Cadaret, Grant also discloses that any 12b-1 fees paid to the firm attributable to client assets will be credited to the client’s account.

Although it is not stated in the settlement order, my guess is that the actions described in this disclosure were a direct result of Cardaret’s negotiations with the SEC. None of the settlement orders dealing with this issue have strictly forbidden investment advisers from accepting 12b-1 fees, either directly (for firms that are dually registered) or through an affiliated broker-dealer. However, at least some of the firms subject to SEC administrative actions now disclose that they no longer accept 12b-1 fees, or credit such fees to the client’s account. My prediction is that other firms will be following suit.

**Best Execution**

The second issue raised by the SEC is the duty of an investment adviser to seek best execution for its clients. There is no statutory definition, but best execution *is usually defined* as the duty to seek to obtain the most favorable terms for a customer transaction reasonably available under the circumstances. This does not mean that an adviser is required to seek the lowest possible commission, but instead can consider a number of different factors including the price, the size of the order, the value of any research provided, commission rates, and the broker’s execution capability and responsiveness.

In a mutual fund transaction, the price for open-end mutual fund shares is not set by the market, but determined by the fund at the end of each business day based on the fund’s net asset value. The trades are executed by the mutual fund itself, and the transactions can be entered by a broker, an adviser, or directly through the fund. Unlike equity transactions, mutual fund trades are not subject to market fluctuations throughout the day, so brokers cannot add value by working the trade. Other typical “best execution” factors, such as the value of research provided, commission rates, and the broker’s execution capability and responsiveness, do not apply in an open-end mutual fund transaction.

Best execution ultimately for mutual fund trades boils down to making sure that the investor gets the least expensive share class, and this is borne out by the research: low-cost funds produce higher returns than high-cost funds. It’s pretty simple to understand why. The more expenses a fund incurs, the greater the drag on its performance.

But mutual funds don’t sell themselves, and fund companies developed different share classes with different fee structures to compensate brokers and advisers for their sales efforts. The key distinctions among share classes are the sales charges and ongoing fees and expenses of the fund. For example, funds that use brokers to sell shares to retail investors impose a fee on investors, known as the “sales

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3 This practice is noted in Form ADV Part 2A of Royal Alliance Associates, Inc. dated March 30, 2018; Form Part 2A for Geneos Wealth Management, Inc., also includes disclosure stating that 12b-1 fees will be credited to the client’s advisory account.

4 The fund calculates its net asset value per share (NAV), by determining the current market value of the fund’s underlying securities, subtracting the liabilities, and dividing by the total number of shares. Mutual fund shares are sold at their NAV per share, plus any applicable sales charge.
load”, which is paid to the broker, similar to a commission. Some share classes also include 12b-1 fees, which (as discussed earlier) are used by fund companies to pay brokers and other financial institutions for distribution expenses and shareholder servicing fees. There is an entire alphabet soup of additional share classes, but the SEC has been primarily focused on the selection of Class A shares over Institutional Class or I-Shares, so I will focus on the distinctions between these classes.

According to FINRA’s Investor Alert on Understanding Mutual Fund Share Classes, Class A shares typically charge a front-end sales load based on the amount of assets being invested. The load is charged upfront, reducing the initial investment. However, Class A shares generally have lower 12b-1 fees and annual expenses than other retail share classes. Sometimes “load waived” Class A Shares (or “Advisor Shares”) are available. The lower overall cost is the main reason for selecting Class A shares. (For more information on the different share classes, check out the SEC’s Guide for Investors on Mutual Funds and ETFs.)

Mutual fund companies also offer institutional share classes (“Class I Shares”) that do not charge 12b-1 fees and have lower overall expenses as compared to retail share classes. Initially, these shares were only available to institutional investors that made a significant investment in a fund. In recent years, mutual fund companies have made Class I shares available to non-institutional investors, such as retail investors in wrap fee programs. As the SEC points out in the Suntrust case, as mutual funds made Class I shares more widely available, they also began allowing clients holding Class A shares to convert those shares to Class I shares at the request of investment advisers. These “share class conversions” are generally made through a tax-free exchange, meaning that no gains or losses are recognized for the investor. There is usually a fee charged by the custodian for the exchange, sometimes called a “ticket charge”, which is paid by the investor.

Given the lower fees and expenses and absence of sales loads, it would seem like a no-brainer to require investment advisers to use Class I shares in client accounts where possible. But the analysis is not that simple. Class I shares are not always available to investment advisers, and the investor may not be able to meet the minimum investment threshold. Some custodians or brokers also impose a ticket charge for the exchange. If the client’s position is relatively small, the savings on the lower internal mutual fund expenses may not be enough to compensate for that charge at least initially. Additionally, some clients may need to trade the shares frequently, and would prefer to pay higher internal fund expenses instead of upfront ticket charges. Other considerations include whether the firm has trading discretion over the client’s account. If not, the adviser will need client permission to make the change. There are also limitations imposed by mutual fund companies on the number and timing of conversions. Based on a firm’s client base, there may be other factors to be considered.

Importance of Process

The message from the SEC is that all advisers should develop a process for selecting the appropriate mutual fund share classes. This process should focus on what is best for the client, without regard to compensation to the adviser or its affiliates, and should include the following:

- Established criteria for selecting of share classes, taking into consideration the client’s time horizon and preferences;

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5 There are also “no-load” mutual funds, which do not charge sales loads, but may have 12b-1 fees.
• Periodic reviews of client holdings in mutual fund investments to ensure the appropriateness of mutual fund share class selections;
• Communication and training of IARs and staff on the application of these criteria and review process;
• Documentation of the process; and
• Period testing to ensure the process is being followed.

For example, this process could include:
• Adviser’s investment committee to determine the share classes of a particular mutual fund that are approved for use, and establish the criteria to enable IARs to select the appropriate share class;
• The criteria are documented in a policy and procedure, and incorporated in the firm’s compliance manual.
• The policy and procedures are communicated to the IARs and relevant staff;
• Training is provided on how to select and document the choice of mutual fund share classes for each client;
• IARs are assigned the responsibility could then be responsible for the initial selection of the appropriate mutual fund share class for their clients, and documenting the reason for the selection either in the client file, the client relationship management system, or another record retention system.
• IARs and/or other staff are responsible for performing a periodic review of all client mutual fund holdings to ensure that the procedures are being followed. This review should take into account whether a client’s situation has changed, and/or whether new share class options are available, with the goal of evaluating whether the client now qualifies for, or has access to, a lower-cost share class.
• Results of the review are reported to management. There should be consequences for failure to follow the procedures.
• The compliance officer also periodically reviews client mutual fund holdings to test whether the IARs are complying with the procedures, and reports the results to management.

As with many other policies and procedures, it’s best to automate to the extent possible. Moreover, the process should be well-defined and easy to follow. There should be periodic reports that help determine and document whether the process is being followed. Issues should be followed up and resolved. Perhaps most importantly, there should be accountability and consequences for failure to follow the procedure. The SEC has honed in on this issue, and firms failing to take action are undoubtedly going to suffer.