

Regulation Best Interest Meets Opaque Practices

It's Time to Dive Past Surface-Level Conflicts

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Executive Summary

In recent years, investors have increasingly purchased mutual funds through new share classes that jettison two traditional sources of potential conflicts of interest: explicit fees for distribution and front-end loads that are shared back with brokers. While these changes are mostly positive for investors, these new share classes expose investors to new conflicts. These modern conflicts mostly involve revenue sharing—the practice of a fund sharing money back with broker/dealers under a variety of opaque arrangements. Furthermore, modern conflicts are much harder for regulators and the public to evaluate than traditional conflicts of interest.

The SEC has not historically focused on revenue-sharing arrangements (although there have been recent crackdowns on failures to disclose them) but rather on the once-typical practice of paying for distribution out of the expense ratio. Even though revenue sharing has not been heavily scrutinized, it has the potential to create a variety of distortions in the advice investors receive from brokers. Further, because of the lack of focus, the disclosures on revenue sharing are very limited and are presented in an open-end format that stifles efforts to summarize and quantify the wide variety of potential conflicts of interest they create.

Examining the limited disclosures on these conflicts, we find that not all revenue-sharing payments create conflicts, and we built a taxonomy of revenue-sharing payments from the least to most likely to create conflicts of interest: educational expenses; platform fees; data fees; select lists; and payments based on sales, assets, or accounts. Critically, the degree to which any revenue-sharing arrangement creates a conflict depends on the magnitude of the payments and the degree to which the payments are directly tied to sales.

Despite historically low levels of scrutiny, recent regulatory developments may force changes in revenue sharing as brokers work to mitigate conflicts of interest in order to comply with Regulation Best Interest. Brokers now have an obligation to mitigate and disclose the kinds of conflicts that revenue sharing can create, and we expect certain kinds of arrangements to get increasing scrutiny as the regulation goes into force.

We recommend that market participants and policymakers use our taxonomy when evaluating revenue-sharing arrangements for the level of conflict they create. We also recommend that the SEC collect data on revenue sharing in a structured, standardized format to facilitate further research in this area.

Key Takeaways

Popular new share classes mean that investors and regulators are exposed to new sources of conflict.

- ▶ An evolution in share classes has continued despite a shifting regulatory backdrop.
- ▶ Conflicts embedded in popular share classes are often opaque and harder to evaluate than other conflicts of interest.

Although these payments can create a variety of conflicts and distort investment recommendations, the SEC has not historically regulated revenue sharing.

- ▶ The SEC has focused on the established practice of paying for distribution out of the expense ratio.
- ▶ Although the SEC has not historically regulated revenue sharing, it has recently begun to crack down on failures to disclose it.

Not all revenue-sharing payments create conflicts, but limited data impedes assessing which payments do and to what degree.

- ▶ Load sharing creates conflicts of interest when brokers have incentives to recommend one fund over another.
- ▶ The degree to which revenue sharing creates conflicts of interest depends on the magnitude of the payments and the degree to which they are tied to sales.

Regulation Best Interest may force changes in revenue-sharing practices as brokers mitigate conflicts of interest.

- ▶ Brokers traditionally followed a suitability standard, which did not impose much scrutiny of revenue sharing.
- ▶ Regulation Best Interest strengthened the standard of conduct for brokers and is likely to affect revenue-sharing practices.

Background

Asset managers introduced the first mutual fund in the United States in 1924,¹ and these fund structures have been regulated since Congress passed the Investment Company Act and Investment Advisers Act of 1940.² The principal market participants in the mutual fund ecosystem are fund sponsors, brokers, investment advisors, and custodians/recordkeepers.

- ▶ Fund sponsors are those who create the mutual funds, that is, devise the investment strategy and manage the fund portfolios. Fund sponsors are also often referred to as asset managers, though asset managers can manage portfolios that consist of asset classes other than funds.
- ▶ Usually, investment advisors manage client assets either through direct investment into funds or other assets or by sponsoring a fund. A firm must be registered with the SEC as an investment advisor.
- ▶ Brokerage platforms distribute funds from a number of sponsors. Clients can often purchase funds directly from a fund sponsor. To access a wider variety of funds, however, ordinary investors often purchase funds on brokerage platforms, which charge either a fee or commission for executing purchase and sell orders submitted by an investor.
- ▶ Custodian/recordkeepers are financial institutions that hold customers' securities for safekeeping in order to minimize the risk of their theft or loss. Brokers often provide these services as often the broker is the custodian for client funds and assets and maintains the records relating to fund ownership. Custodians hold securities and other assets in electronic or physical form. Consequently, funds may pay fees for these services, which are generally categorized as subtransfer agent (or subaccounting) services. We will refer to fees paid for these services as subaccounting fees.
- ▶ Investment advisors are fiduciaries under the Advisers Act, and their fiduciary duty has been clarified through case law and SEC guidance. In general, investment advisors are responsible for working with clients to create portfolios appropriate for their needs. An advisor to an individual or an institution must determine what set of asset classes, including funds, is appropriate for a particular client.

Their duty is broad and requires that investment advisors act with this duty in every step of the advisor-client relationship. It requires that investment advisors apply a level of duty determined by the scope of the client relationship, a duty of care to the client, and a duty of loyalty to the client.³

1. The creation of the Massachusetts Investors' Trust in 1924 heralded the arrival of the modern mutual fund in the United States. Doane, C.R. & Hills, E.J. 1962. Investment Trusts and Funds From the Investors Point of View," *American Institute for Economic Research*, (March), P. 35. <https://www.aier.org/sites/default/files/Files/Documents/Research/3233/EEB196203.pdf>.
2. Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq., <https://legcounsel.house.gov/Comps/Investment%20Company%20Act%20of%201940.pdf>; Investment Adviser Act, 15 U.S.C. § 80b-1 et seq., <https://legcounsel.house.gov/Comps/Investment%20Advisers%20Act%20of%201940.pdf>.
3. Commission Interpretation Regarding the Standard of Conduct for Investment Advisers, 17 CFR Part 276, *Securities and Exchange Commission*, (June 2019), P. 1. <https://www.sec.gov/rules/interp/2019/ia-5248.pdf>.

While funds themselves are affiliated with an investment advisor, for example, an entity registered with the SEC, the duties of the advisor to a fund are different from those to a particular individual. A fund has a particular investment strategy that has been marketed and sold, and it is the duty of the investment advisor to carry out this strategy.⁴

Investment advisors who service clients directly are often paid through an assets-under-management-based arrangement, typically based on a percentage of the AUM.⁵ Typically, an advisor to a fund would be paid a management fee, which comes out of the fund expenses.⁶

As a matter of industry practice, fund sponsors pay brokers in a variety of ways for offering a fund on their platforms and featuring it in ways that will be discussed further in this paper. We call these forms of payment for distribution inducements, which can take several forms.

- ▶ Distribution fees paid under rule 12b-1 are charged to investors as part of the cost of owning the fund and are paid explicitly for distribution. Finra, the self-regulatory organization for broker/dealers in the U.S., limits 12b-1 fees to .75% for marketing and distribution and an additional .25% for shareholder services.⁷

The fund advisor may also make payments to the broker out of its own profits, which are payments that fall in the broad category of revenue sharing, rather than from the fund itself. These payments do not get explicitly charged as part of the fund's expenses and are disclosed in prospectuses and Form ADV filings in only a narrative form. Funds do not disclose precise terms, obscuring key information about the magnitude or frequency of these payments from fund sponsors to brokerage platforms. Yet, as we will demonstrate, revenue-sharing arrangements cover a wide variety of potential services, and these payments create conflicts as some forms of them can induce brokers to promote the funds of a particular fund sponsor for reasons other than client needs.

- ▶ Brokers can also earn a load, or commission, associated with the sale of a fund. These loads may be charged when a client purchases a fund or when a client sells a fund, often if not held for a sufficient period. The load may be partially paid back to the fund sponsor, serving as another form of revenue sharing.

In some cases, the different payments made for distribution create a conflict of interest. Where a conflict is created, it is sometimes disclosed clearly, as in the case of 12b-1 fees, where clients can

4. "Section 206 imposes a fiduciary duty on investment advisors to act at all times in the best interest of the fund and its investors." S.E.C. v. *Tambone*, 550 F.3d 106, P. 35 (1st Cir. 2008) <https://www.law.du.edu/documents/corporate-governance/disclosure/tambone/SEC-v-Tambone-550-F-3d-106.pdf>.

5. "When it comes to financial advisor cost, most firms charge fees based on a percentage of assets under management (AUM) for ongoing portfolio management. According to a 2017 AdvisoryHQ study, the average financial advisor cost is 1.02% of AUM for a \$1 million account." Stanek, B. 2019. "How Much Does a Financial Advisor Cost?," *SmartAsset* (August). <https://smartasset.com/financial-advisor/financial-advisor-cost>.

6. "Management fees are fees that are paid out of fund assets to the fund's investment adviser (or its affiliates) for managing the fund's investment portfolio, and administrative fees payable to the investment adviser that are not included in the 'Other Expenses' category." Investor Bulletin Mutual Fund Fees and Expenses, *SEC Office of Investor Education and Advocacy*, P. 6 https://www.sec.gov/files/ib_mutualfundfees.pdf.

7. FINRA Rule 2341(d)(3), *FINRA*, (2017) https://www.finra.org/rules-guidance/rulebooks/finra-rules/2341?rbid=2403&element_id=3648.

see what is paid, and in other cases the amount is not disclosed. We will examine in greater detail the potential conflicts that are created from the variety of payments in the fund ecosystem.

Popular New Share Classes Mean That Investors and Regulators Are Exposed to New Sources of Conflict

Fundamentally, share classes of a fund can differ in only a few ways, with these distinctions generally dictating the type of investor and the distribution channel through which they are reached. There has long been an alphabet-soup aspect to the share-class landscape. Some share-class structures have more-consistent nomenclature across the industry, such as the fact that A share classes include a front-end load while B shares include a back-end load. In many cases, however, firms have independently developed their naming systems, making it difficult for investors to make apples-to-apples comparisons of share classes for funds from different providers.

Other examples illustrate differences in nomenclature. For instance, M shares for a couple of firms include both a 12b-1 distribution fee and a front load. For another firm, however, these share-class features are available only to their wealth-management clients and therefore are more similar to a traditional institutional share class. A slightly more complex example is with the range of share classes specific to retirement accounts. These share classes are normally designated by R followed by a number between 1 and 6. Traditionally, the number dictated the size of retirement plan to which the share class would be available, with a smaller number designating smaller plans. Not all firms offer all six share classes, with some offering only two or three within this range. Comparisons, therefore, are challenging as the sizing is not consistent across firms. In these cases, and others where the industry has divergent naming, identifying comparable share classes across funds from different firms requires considering more than just the name.

In 2018, Morningstar launched a data point that groups share classes based on their service-fee arrangement.⁸ When we bucket share classes by the way an investor pays for the services associated with the operation and distribution of a fund, we can see where potential conflicts of interest can arise. In unbundled share classes, the expense ratio encompasses only the investment management and fund operating expenses. The fund and its advisor do not pay third parties who sell their funds to the public, meaning investors pay any intermediary they purchase through directly in the form of either a fee or commission. (Sometimes, these arrangements are called clean shares.)

When investing in bundled share classes, by contrast, investors pay a load or a 12b-1 distribution fee. Both fees are paid to the mutual fund; however, the fund advisor in turn pays this to the intermediary used by the investor. The investor is indirectly paying the intermediary for services in this arrangement.

8. Szapiro, A. "The Future of Clean Shares." *Morningstar Magazine*, June/July 2018, PP. 19-20, <https://www.morningstar.com/blog/2018/07/09/clean-shares.html>.

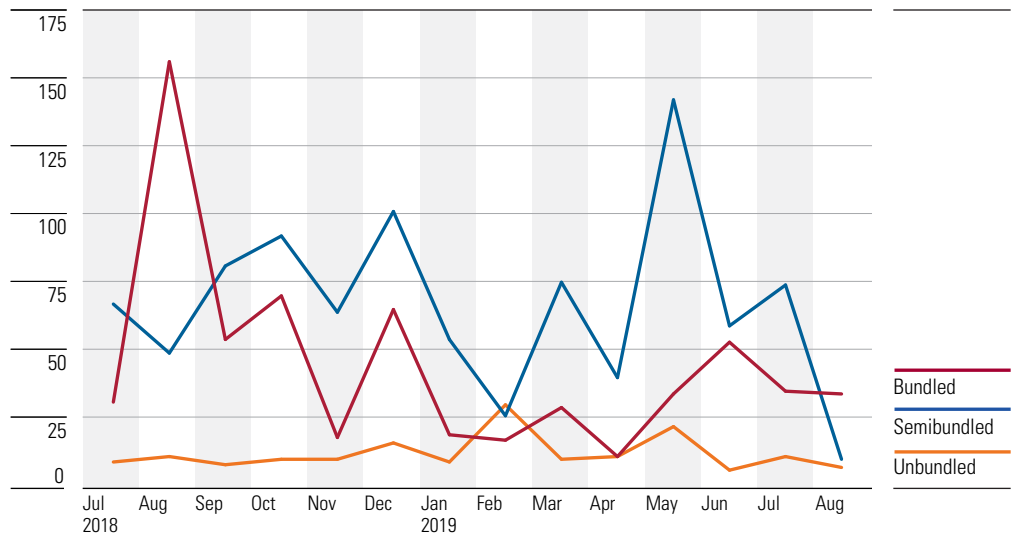
In the middle are semibundled share classes, which do not feature traditional distribution fees or load sharing but pay revenue sharing or subaccounting fees. Distribution fees and load sharing clearly remunerate an intermediary for services selling the fund and do so through fees an investor pays to the fund. Subaccounting fees are also collected through the fund expenses as part of the ongoing expense ratio. The fund pays this portion to intermediaries for recordkeeping services. Revenue-sharing payments are made by a fund advisor to third parties from their legitimate profits for a variety of services, including distribution. We will explore the various types of revenue-sharing arrangements further in the section on revenue sharing below.

An Evolution in Share Classes Has Continued Despite a Shifting Regulatory Backdrop

The different service-fee arrangements traditionally support different distribution models and, similarly, data on the most popular service-fee arrangements provide valuable insights into brokers' needs and asset managers' distribution strategies. In 2016, sparked by the Department of Labor's package of regulations, often called the "Fiduciary Rule," fund complexes began evaluating whether a new structure of share class would be needed in the market to assist distributors in their compliance. Specifically, because of the need to cope with the new prohibitions on varying payments from asset managers to brokers for similar products, the rule created an urgent market need for an unbundled share class distributed through intermediaries, such as broker/dealers and advisors. Historically, unbundled share classes were often reserved for institutional investors or large retirement plans, limiting their number in the marketplace. While the regulation that began the interest in unbundled share classes was ultimately vacated, the industry has continued to move toward unbundled and semibundled share classes.

One way to assess where the industry is headed is to examine trends in the launches of new share classes. Exhibit 1 shows that, over the last year, semibundled share classes have eclipsed bundled share classes in their rate of coming to market, with more launched every month (except one) since July 2018. There has also been a consistent, if smaller, stream of unbundled launches. The preference to launch semibundled over unbundled share classes is unsurprising given the ambiguity of the regulatory landscape during this time frame. Launching share classes is an expensive endeavor, generally leading fund advisors to prioritize the share classes most likely to be adopted by the marketplace. For distributors, semibundled classes are less disruptive to their business model, which historically centered on bundled share classes. With less regulatory impetus for adoption, unbundled share classes have become less widespread than would have been anticipated when the fiduciary rule was originally promulgated.

Exhibit 1 Share Class Launches by Service-Fee Arrangement



Source: Morningstar. Data as of 9/1/19.

Share class closures in the same time frame tell the same story, in reverse, as these share classes began to fall into disfavor. More bundled share classes closed in the 14 months starting July 2018 through September 2019 than semibundled and unbundled combined. It could be thought that this was due to a larger number of bundled share classes in the market at the start of the period. However, in July 2018, there were fewer bundled than semibundled and unbundled share classes in the market. The proportion of bundled share classes that closed during this time is therefore also higher than that of semibundled and unbundled classes combined, as demonstrated in Exhibit 2.

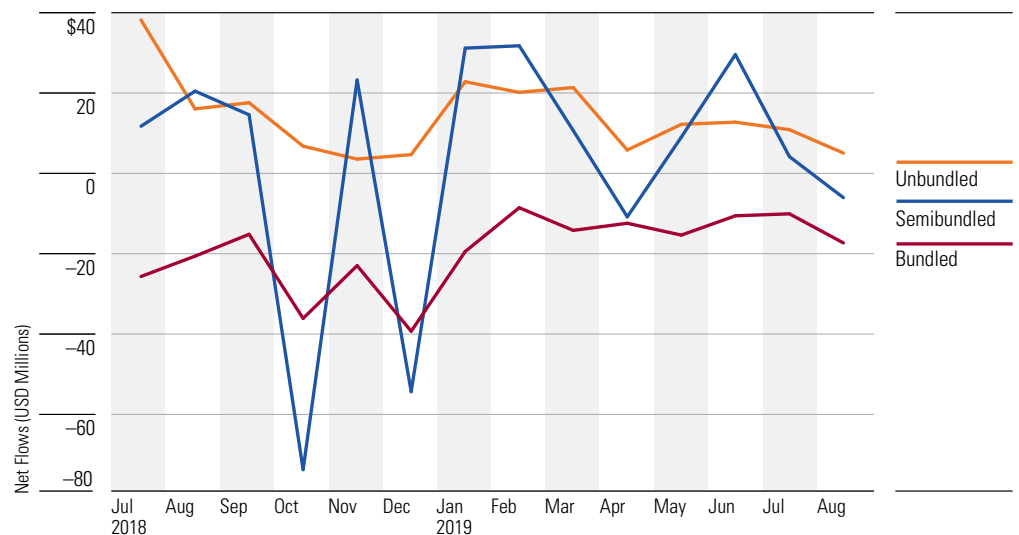
Exhibit 2 Share Class Closures by Service-Fee Arrangement

Service-Fee Arrangement	Share Classes		% of Share Classes	
	Active on 7/1/2018	Active on 7/1/2018, Closed by 8/31/2019	Active on 7/1/2018, Closed by 8/31/2019	
Bundled	14,891	1,248	8.38	
Semibundled	13,134	835	6.36	
Unbundled	2,194	134	6.11	
Semibundled + Unbundled	15,328	969	6.32	

Furthermore, flows to these share classes demonstrate an even greater market preference by brokers and ultimately their customers, the investing public, for fewer bundled share classes. In this case, unbundled received almost 5 times as much new money as semibundled share classes since July 2018, as they gathered inflows in every month in the period from July 2018 to August 2019. While flows to semibundled share classes fluctuated much more drastically, they still received net positive

flows during this period. This trend is in stark contrast to the consistent flows out of bundled share classes. In fact, during this period, the total outflows from bundled share classes is almost matched by the total inflows to both unbundled and semibundled share classes. Across all three metrics considered, an increased investor preference for semibundled and unbundled share classes is exhibited.

Exhibit 3 Estimated Net Flows by Service-Fee Arrangement



Source: Morningstar. Data as of 9/1/19.

Estimated net flows are a more relevant measure than total net assets, in this case because of the legacy of bundled share classes. Many investors with money in bundled share classes are not paying for bundled services on an ongoing basis, as the bundling is due to load sharing. If there is no 12b-1 fee in the expense ratio, then the investor paid for the bundling at the time of sale. On an ongoing basis, an investor would pay the same expenses as a semibundled or unbundled share class, minimizing any incentive for investors to move these assets.

Conflicts Embedded in Popular Share Classes Are Often Opaque and Harder to Evaluate Than Other Conflicts of Interest

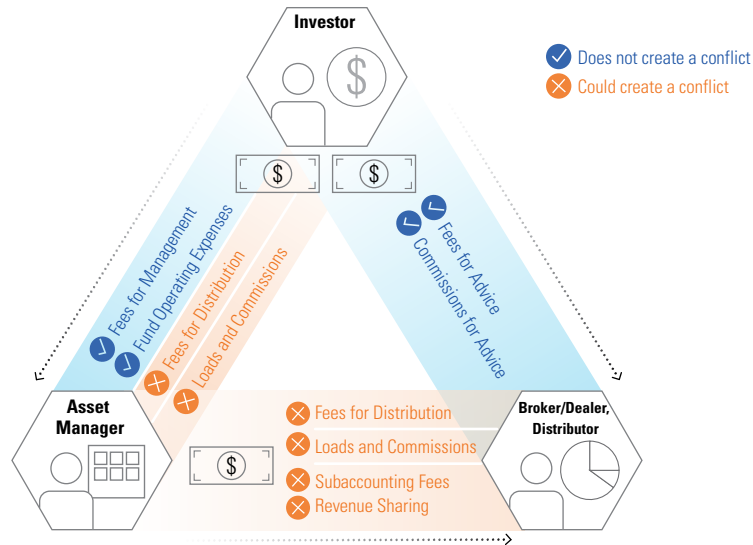
Given the move away from bundled share classes, investors and regulators need to better understand how these payments may create conflicted investment recommendations from brokers when revenue sharing and subaccounting fees act as inducements. Substantial literature evaluates the effects of both 12b-1 fees and load sharing on the advice investors receive, and this literature served as part of the economic basis for the Fiduciary Rule mentioned above and the SEC's recent regulatory agenda around conflicts of interest. Revenue sharing is an area of less historical focus and presents several unique challenges in evaluating its impact on investor outcomes.

Dual-registered advisors can interact with investors as either a brokerage or a registered investment advisor, or RIA. Recently, Boyson (2019) considered the case of dual-registered advisors and demonstrated how the conflicts of interest they face affect their advice to both their brokerage and fiduciary (RIA) clients.⁹ Depending on the relationship, the advisor is held to different standards in terms of how they weigh what is best for the client against any possible benefits to themselves. Boyson's research focuses on the unexpected consequences of a 2007 lawsuit that moved many brokerage accounts to be under the RIA side of these dual registrants. This shift subjected clients to AUM-based fees that they did not previously face. While this shift placed the account under a fiduciary relationship, the dual-registered advisors seemed to continue to be influenced by the revenue-sharing payments, consistently placing clients in underperforming funds that paid revenue sharing. While the RIA client may be placed in an institutional share class that is lower in cost, the same fund would be offered to brokerage clients through a different share class. Thus, the RIA clients were not better off in terms of performance than the brokerage clients. Boyson highlights how investor outcomes can be negatively impacted by revenue sharing and not exclusively in a brokerage setting.

Although These Payments Can Create a Variety of Conflicts and Distort Investment Recommendations, the SEC Has Not Historically Regulated Revenue Sharing

The SEC has historically regulated conflicts in the mutual fund industry in very limited ways, focusing on specific types of payments. Specifically, the SEC has primarily focused on conflicts arising through payments reflected in the mutual fund expense ratio. The expense ratio consists of all expenses paid from the fund and therefore disclosed to investors in the prospectus and taken out of fund returns. The expense ratio typically consists of the "money for the managers, analysts, traders, transfer agents, compliance officers, customer service reps, lawyers, directors, technology providers, research resources, and printers, plus additional profits for the fund company, brokerage, and possibly the broker or financial planner."¹⁰ Out of these expenses, the SEC has been primarily focused on distribution or 12b-1 fees, as these are specifically paid by funds to distribution platforms for distribution. Exhibit 4 illustrates common expenses investors pay for mutual funds and advice and payments that may create a conflict of interest.

9. Boyson, N. 2019. "The Worst of Both Worlds? Dual-Registered Investment Advisers." Northeastern U. D'Amore-McKim School of Business Research Paper No.3360537 (May 2019) <https://ssrn.com/abstract=3360537>.
10. Kinnel, R. 2014 "Mutual Fund Expense Ratio Trends,." *Morningstar*, June 2014, P. 3.

Exhibit 4 Disbursement of Common Expenses Investors Pay for Mutual Funds and Advice

Source: Morningstar.

The SEC Has Focused on the Once-Typical Practice of Paying for Distribution out of the Expense Ratio

Although funds can pay for distribution out of the expense ratio, they are supposed to disclose this expense. Other forms of payments from the expense ratio to brokers cannot cover distribution. While this payment creates a conflict of interest, current regulations permit these payments as long as they are disclosed.

As clarified in the SEC IM Guidance Update: Mutual Fund Distribution and Sub-Accounting Fees¹¹ ("The Guidance"), a fund must have a board-approved process for any payments made to intermediaries for distribution.¹² The board must receive sufficient information to evaluate whether such payments are appropriate. Where funds have been sanctioned by the SEC, it is because they have paid for administrative, accounting, or transfer agent services collectively known as subaccounting payments but these payments have actually been designed to facilitate distribution rather than pay for services.¹³ If a payment is for distribution, it must be part of a fund's distribution plan, or 12b-1 plan.¹⁴ Thus, if other expenses contained in the expense ratio are being utilized for distribution and not properly disclosed as distribution fees to investors in the Rule 12b-1 plan, the SEC deems those expenses to have been fraudulently paid.

11. IM Guidance Update: Mutual Fund Distribution and Sub-Accounting Fees, *Securities and Exchange Commission* (January 2016) (IM Guidance Update) <https://www.sec.gov/investment/im-guidance-2016-01.pdf>.

12. IM Guidance Update, P. 3.

13. IM Guidance Update, P. 1.

14. 17 CFR 270.12b-1, *Securities and Exchange Commission*, (April 2012) (Rule 12b-1) <https://www.govinfo.gov/content/pkg/CFR-2012-title17-vol3/pdf/CFR-2012-title17-vol3-sec270-12b-1.pdf>.

The Guidance suggests a board process must be established to make determinations on when subaccounting fees are being used to pay for distribution.¹⁵ “Rule 12b-1W makes clear that directors bear a substantial responsibility in determining whether payments made by a fund are for distribution.”¹⁶ Some characteristics utilized in examining the validity of subaccounting fees include lack of a 12b-1 plan, tiered payment structures, lack of specificity or bundling of services, distribution benefits taken into account when proposing or changing subaccounting fees, large disparities in subaccounting fees paid to intermediaries, and sales data.¹⁷ The SEC has cracked down on funds in a few critical cases where subaccounting fees were not properly being utilized for their disclosed purposes. For instance, the most notorious cases have fined firms in excess of \$50 million for violating Rule 12b-1.¹⁸ Subaccounting fee violations are perhaps the area where funds are most wary of SEC enforcement regarding conflicts of interest in distribution. Mostly, however, this issue is one of disclosure, as properly disclosed subaccounting fees are generally not problematic.

Although the SEC Has Not Historically Regulated Revenue Sharing, It Has Recently Begun to Crack Down on Failures to Disclose It

Revenue sharing typically flows from a fund’s advisor to a third party that sells the fund. In contrast to payments from the expense ratio for distribution, the SEC has not focused on revenue-sharing payments from the fund sponsor to the broker—perhaps because these do not factor into the fund expense ratio. However, precisely because these payments are not disclosed in the expense ratio, they are more opaque and more likely to create a conflict of interest for broker/dealers and advisors selling mutual funds. These revenue-sharing arrangements must come from the “legitimate profits” of the advisor, but in practice, these profits are derived from the management fees in the expense ratio, among other management fees the advisor charges to its clients, such as AUM fees to separate account clients. Further, fund advisors often distribute revenue-sharing payments in return for brokers distributing funds in particular ways or in certain volumes. While revenue sharing is not paid for directly by investors, it may be paid indirectly since a fund could lower its management fee if its advisor did not engage in revenue sharing and accepted a lower fee.

Recently, the SEC has begun to crack down on revenue-sharing arrangements that were not disclosed and created a conflict of interest. In February 2018, the SEC created the Share Class Selection Disclosure Initiative (SCSD Initiative), an enforcement program to crack down on ongoing harm caused by investment advisors in the sale of mutual fund shares.¹⁹ The SEC found that advisors were placing their clients in higher-cost mutual fund share classes that charged 12b-1 fees without disclosing to their clients that there was a lower-cost option in the same fund.²⁰ The program encourages advisory firms to self-report undisclosed conflicts of interest, compensate investors, and

15. IM Guidance Update, P. 3.

16. IM Guidance Update; Rule 12b-1.

17. IM Guidance Update, PP. 7-9.

18. Fields, B.J. 2015. “Matter of First Eagle Investment Management.” *Securities and Exchange Commission* (September 2015) <https://www.sec.gov/divisions/enforce/claims/first-eagle.htm>; Katz, J.G. 2005. “Matter of Smith Barney Fund Management LLC.” *Securities and Exchange Commission*, (May 2005) <https://www.sec.gov/litigation/admin/34-51761.pdf>.

19. SEC Share Class Initiative Returning More Than \$125 Million to Investors, *Securities and Exchange Commission*, (March 2019), (SCSD Initiative) <https://www.sec.gov/news/press-release/2019-28>.

20. SCSD Initiative.

review and correct fee disclosures.²¹ Specifically, this program includes investment advisors that did not disclose the conflicts of interest in applicable Forms ADV (brochure[s] and brochure supplements).²² Under this program, advisors who come forward are required to return money to investors but are able to avoid fines. Last March, this initiative procured a settlement in which 79 investment firms agreed to return \$125 million to their clients, a substantial majority going to retail investors.²³

More recently, the SEC charged Commonwealth Equity Services LLC in August 2019 with failure to disclose material conflicts of interest in its Form ADV related to revenue-sharing arrangements, which benefited Commonwealth but harmed its clients.²⁴ The SEC's complaint alleged that Commonwealth had failed to inform its clients the following: "(i) there were mutual fund share class investments that were less expensive to clients than some of the mutual fund share class investments that resulted in revenue-sharing payments to Commonwealth, (ii) there were mutual fund investments that did not result in any revenue-sharing payments to Commonwealth, and (iii) there were revenue-sharing payments to Commonwealth under the broker's 'transaction fee' program."²⁵ The SEC stated that Commonwealth had breached its fiduciary duty to disclose material conflicts of interest, thereby violating antifraud provisions of Section 206 of the Investment Advisers Act of 1940. The SEC reprimanded Commonwealth for not having policies and procedures to prevent such violations of Rule 206(4)-7.²⁶

Not All Revenue-Sharing Payments Create Conflicts, but Limited Data Impedes Assessing Which Payments Do and to What Degree

Conflicts can arise when a broker/dealer is incentivized to recommend one product over another, regardless of the client's situation, because it will increase their profits. This creates a situation where they must decide between prioritizing their interests and their client's, which may not always align to the same recommendation. As discussed, the compensation brokers receive from asset managers or distributors on behalf of the funds can come from three places: (1) the expenses an investor pays the investment advisor of a fund in the expense ratio; (2) loads, called load sharing; and (3) the legitimate profits of the fund advisor, called revenue sharing. We have already discussed the SEC's stance on payments made from the expense ratio. Now, we will discuss load sharing and revenue sharing.

Load Sharing Creates Conflicts of Interest When Brokers Have Incentives to Recommend One Fund Over Another

Load sharing is the practice of dividing the load, or fee, an investor pays to access a fund between

21. SCSD Initiative.

22. SEC Share Class Selection Disclosure Initiative, *Securities and Exchange Commission*, (May 2018) (SCSD Initiative Announcement) <https://www.sec.gov/enforce/announcement/scsd-initiative>.

23. SCSD Initiative.

24. SEC Charges Investment Adviser for Failing to Disclose Conflicts Arising from Receiving Revenue Sharing on Client Investments, *Securities and Exchange Commission*, (August 2019) (SEC v. Commonwealth), <https://www.sec.gov/litigation/litreleases/2019/lr24550.htm>.

25. SEC v. Commonwealth.

26. SEC v. Commonwealth.

the broker that sold the fund and the investment advisor. In this way, while the investor's money goes directly to the investment advisor, a portion is then routed indirectly to the broker. Similar to revenue sharing, if the compensation brokers receive is different for the distinct funds they could recommend, there is a conflict of interest. Since the industry offers a wide range of investments spanning no-load funds to those with 5% or more in loads, the environment is such that load sharing creates a conflict of interest.

While the details of revenue-sharing arrangements are largely opaque, the impact of load sharing is measurable because it has historically been well-disclosed. Extending methodology developed by Susan Christoffersen, Richard Evans, and David Musto, we've demonstrated that funds with higher-than-expected loads to brokers historically received greater inflows.²⁷ This correlation reflects the incentive brokers have to recommend these funds, independent of the investor's interest. Our research also shows that, since 2010, this correlation has weakened. One factor that likely influenced this result is the regulatory environment that increased focus on broker practices—and particularly on load sharing—leading into the DOL Fiduciary Rule proposal. Loads play a smaller part in broker incentives because of the greater inflows to no-load funds, focus on broker recommendations, and greater attraction to low-cost index funds, which typically do not have loads. Thus, a combination of awareness and a culture of accountability has decreased the popularity of loads.

The Degree to Which Revenue Sharing Creates Conflicts of Interest Depends on the Magnitude of the Payments and the Degree to Which They Are Tied to Sales

Many, but not all, of the inducements brokers receive in connection with mutual funds²⁸ create conflicts of interest for the broker when recommending products to a client. In general, we have limited insight into how these payments are structured. As previously discussed, these inducements have not been a focus of prior regulation, with the result that disclosures of the arrangements are relegated to the depths of fund documents, such as prospectuses and Statements of Additional Information. The specificity of the disclosures can vary greatly, but the following anonymized examples allow us to evaluate the structure of some revenue-sharing payments that exist today and the extent to which they represent a conflict of interest. Exhibit 5 shows the spectrum of potential conflicts that different revenue-sharing arrangements can create.

27. Sethi, J. Spiegel, J. & Szapiro, A. 2019. "Conflicts of Interest in Mutual Fund Sales," *The Journal of Retirement* (Winter 2019) <https://doi.org/10.3905/jor.2019.1.044>.

28. While we will often use the general term "fund," these conflicts are not exclusive to mutual funds. In particular, exchange-traded funds are sometimes thought to be free of these conflicts; however, many ETFs also participate in revenue-sharing arrangements.

Exhibit 5 Common Types of Revenue-Sharing Arrangements and the Conflicts They Can Present

Source: Morningstar.

We can group revenue-sharing arrangements into three categories: those that create a direct conflict; those that may or may not create a conflict depending on whether they are coupled with access, recommendations, and the like; and those that do not create a conflict. Revenue-sharing arrangements that create obvious conflicts of interest that can distort a broker's recommendations include those in which payment is based on sales, assets, accounts, or some combination of the three. For example, the disclosure in Exhibit 6 is taken from a Statement of Additional Information in which the distributor of the funds is an affiliate of the investment advisor and all of the funds are members of the fund complex. The second paragraph describes generally how the payments are calculated—they can be based on sales or net assets. The frequency of these payments is not disclosed, but it can be inferred that the calculation is based on what transpired since the previous payment. For example, if the payments occur once a quarter, each payment would consider all the sales since the last quarter or the average total assets over that period. This description allows for three cases: (1) the amount is determined by the volume of sales by the intermediary; (2) the amount is determined by the value of assets associated with that intermediary; and (3) the amount is the sum of the payments determined in (1) and (2). While this gives an investor insight into the events that may result in a broker/dealer receiving revenue-sharing compensation, sales, and ongoing assets, it does not include the rate that is assessed against these values (for example, 0.15% of sales). Further, preferential access to conferences and other marketing type events for intermediaries is also indicated.

Exhibit 6 Sample Mutual Fund Disclosure of Payments Based on Sales, Assets, or Accounts

"The Distributor makes revenue sharing payments as incentives to certain firms to promote and sell shares of the Funds. The Distributor hopes to benefit from revenue sharing by increasing the Funds' net assets, which, as well as benefiting the Funds, would result in additional management and other fees for the Advisor and its affiliates. In consideration for revenue sharing, a firm may feature certain funds in its sales system or give the Distributor additional access to members of its sales force or management. In addition, a firm may agree to participate in the marketing efforts of the Distributor by allowing it to participate in conferences, seminars or other programs attended by the intermediary's sales force. Although an intermediary may seek revenue sharing payments to offset costs incurred by the firm in servicing its clients that have invested in the Funds, the intermediary may earn a profit on these payments. Revenue sharing payments may provide a firm with an incentive to favor the Funds.

"The revenue sharing payments the Distributor makes may be calculated on sales of shares of the Fund ("Sales-Based Payments"). Such payments also may be calculated on the average daily net assets of the applicable funds attributable to that particular financial intermediary or on another subset of assets of funds in the fund complex's (asset-Based Payments). Sales-Based Payments primarily create incentives to make new sales of shares of the funds and Asset-Based Payments primarily create incentives to retain previously sold shares of the funds in investor accounts. The Distributor may pay a firm either or both Sales-Based Payments and Asset-Based Payments."

The structure of this payment creates a conflict of interest as the broker/dealer may not receive a similar payment from other advisors associated with other funds. Therefore, when broker/dealers are comparing mutual funds, they would have an incentive for recommending ones from this complex over others—thereby misaligning the interests of brokers with those of the investors they are servicing.

While it is clear this type of payment creates a conflict, the materiality of this conflict can be difficult to assess. There is only a material conflict of interest if the incentive is strong enough to influence the broker/dealer. In the example from Exhibit 6, the factors that drive the payment are clearly laid out, but neither an investor nor the SEC can determine the magnitude of the payments.²⁹

Similarly, in another example, the revenue-sharing payment is described as based on an unknown combination of "gross sales, current assets, . . . number of accounts . . . , or other factors." The document also allows that the payment amount and determination method may be inconsistent between recipients. All of the possible bases of the revenue sharing detailed in this disclosure create a conflict of interest for broker/dealers distributing the fund, and the relative size of this conflict is impossible to ascertain from this disclosure.

Payments for placement on "recommended" or "preferred" lists of funds available on a platform and the associated due-diligence costs are likely to create a conflict. As the list is often called a "preferred" or "recommended" list, it implies some level of recommendation on the quality of the investment. To that end, the broker/dealers may ask the investment advisors to pay for the due-diligence work needed to vet their funds prior to placing it on a list. In practice, these revenue-sharing arrangements are more commonly referred to by the product placement aspect as in Exhibit 7.

29. Elsewhere in the document it specifies for a list of Finra member firms that they may receive "revenue-sharing payments at an annual rate of up to 0.25% of the value of the Fund shares sold or serviced by the firm." This encompasses all revenue-sharing payments made to the firms, not just the "Sales and Asset-Based Payments." However, it also discloses that arrangements exist with firms not included in the list and does not specify if those arrangements are subject to the same annual cap.

Exhibit 7 Sample Mutual Fund Disclosure of Select Lists

“The Additional Payments are intended to compensate Intermediaries for, among other things: marketing shares of the Funds, which may consist of payments relating to funds included on preferred or recommended fund lists or in certain sales programs from time to time sponsored by the Intermediaries; “due diligence” examination and/or review of the Funds from time to time; access to the Intermediaries’ registered representatives or salespersons, including at conferences and other meetings; assistance in training and education of personnel; “finders” or “referral fees” for directing investors to the Funds; marketing support fees for providing assistance in promoting the sale of Fund shares (which may include promotions in communications with the Intermediaries’ customers, registered representatives and salespersons); provision of analytical or other data to the Investment Adviser or its affiliates relating to the sales of shares of the Fund; and/or other specified services intended to assist in the distribution and marketing of the Funds, including provision of consultative services to the Investment Adviser or its affiliates relating to marketing of the Fund and/or sale of shares of the Fund.”

These payments create a conflict of interest both through the recommendation by the broker and the special access granted to the broker. The investment advisor anticipates greater fund volume from providing this access and in turn receiving preferential treatment by the broker. The fees the broker generates from the preferred list incentivize products to be placed on “preferred” lists for reasons not aligned with the interests of investors. By contrast, if the fees are charged for vetting the funds and the brokers reject some funds in practice for not meeting the standards of their “preferred” lists, then these fees might not create a conflict.

An incentive for brokers can be more directly calibrated to their efforts using data. When revenue sharing is paid for data, an increasingly common practice, as described in Exhibit 8, investment advisors can pay for access to detailed data on the sales of their products from broker/dealers. This can allow for more-specific compensation to broker/dealers for their sales.

Exhibit 8 Sample Mutual Fund Disclosure of Data Fees

“Distributors may also make payments, outside of the formulas described above for, among other things, data (including fees to obtain lists of financial advisors to better tailor training and education opportunities), account-related services, and operational improvements. In 2018...Distributors paid the following firms for such information and services amounts that did not exceed the following amounts...”

If the data is utilized to promote “education” as indicated in the disclosure, it may not create a conflict. If, however, it is used to reward certain brokers for their efforts, then it creates a sales-contest type of situation.

Another type of payment that can go either way in creating a conflict is platform fees. Most investment advisors pay for their funds to be distributed through third-party platforms in the form of setup and maintenance fees. These payments constitute revenue sharing as described in Exhibit 9. These payments—presumably charged by an intermediary to all fund advisors—constitute payment for a service or payment for access to the platform. Assuming that they are charged and paid based on the service being provided, for example, the number of funds to be onboarded onto the platform or some other objective factor, they should not create a conflict of interest, although they could exclude funds that refuse to pay the fee. Exhibit 9 illustrates an example of such a payment.

Exhibit 9 Sample Mutual Fund Disclosure of Platform Fees

“The Adviser, from its own resources, may make payments to financial service agents as compensation for access to platforms or programs that facilitate the sale or distribution of mutual fund shares, and for related services provided in connection with such platforms and programs.”

If all of the fund providers pay a similar type of revenue-sharing payment to access the platform, then no conflict is created. The use of the word “programs” indicates that some differentiation in access may exist. For instance, brokers may have preferred products to recommend to clients, and access to such a preferred program may require higher revenue-sharing payments than general access, thereby creating a conflict of interest as discussed previously.

Finally, some common industry practices fit the definition of revenue-sharing payments but do not create a conflict of interest. Examples include payments related to educational support and to attending conferences hosted by broker/dealers. While payments for these activities go from an investment advisor to a broker/dealer, the payments do not depend on the broker/dealer’s distribution of the funds. In disclosing revenue-sharing payments, some firms will consider these types of expenses separately from other revenue-sharing arrangements. Exhibit 10 is an example of how education, training, and entertainment fees are explicitly excluded from the advisor’s definition of revenue sharing.

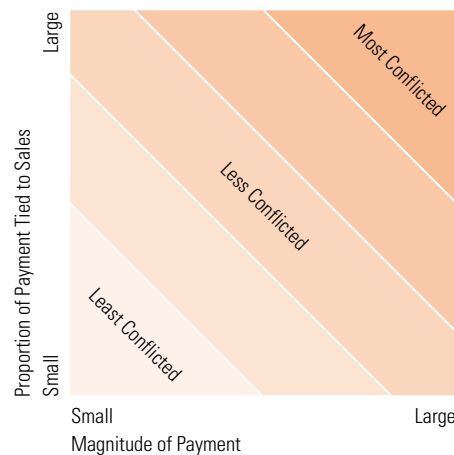
Exhibit 10 Sample Mutual Fund Disclosure of Educational Expenses

“[T]he Distributor has agreed to make revenue sharing payments (not including payments for entertainment, and training and education activities for the Dealers, their investment professionals and/or their clients or potential clients) with respect to the Funds were as follows...”

Not all disclosures are as clear, though, and it can sometimes be difficult to isolate the types of payments that do not create conflicts. For a different fund, not shown, expenses associated with educational programming are described in conjunction with “sales contests and/or product promotions,” creating ambiguity as to the purpose of the revenue-sharing payments and, therefore, if a conflict exists or not. While sales contests would clearly create a conflict (and are now prohibited under Regulation Best Interest), education would not and would presumably be equitably provided across intermediaries.

The range of revenue-sharing arrangements is extensive and fills a continuum from those that clearly create conflicts of interest to those that do not. The challenge in assessing where in the continuum a given arrangement falls is twofold: Both the structure (the degree to which it is tied to sales) and the magnitude of the payment must be considered. Further, this assessment is complicated by having access to often-vague disclosures of the arrangements in fund documents. Exhibit 11 illustrates how these two factors interact to create various degrees of conflicts of interest.

Exhibit 11 Structure and Magnitude of Revenue-Sharing Payments Determine the Level of Conflict of Interest



Source: Morningstar.

Regulation Best Interest May Force Changes in Revenue-Sharing Practices as Brokers Mitigate Conflicts of Interest

Aside from the recent SEC actions already discussed, prior to Regulation Best Interest, the SEC rarely addressed conflicts of interest created through revenue-sharing payments.³⁰ The SEC's views regarding revenue-sharing payments to date have been that they are permitted as long as brokers are fulfilling their obligations for suitability. It is worthwhile to explicate and differentiate the duty for brokers before and after Regulation Best Interest here.

Brokers Traditionally Followed the Suitability Standard, Which Did Not Impose Much Scrutiny of Revenue Sharing

For brokers, there are three suitability obligations, including reasonable-basis suitability, customer-specific suitability, and quantitative suitability.³¹ Reasonable-basis suitability “requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors.”³² Customer-specific suitability “requires that the broker have a reasonable basis to believe that the recommendation is suitable for that customer,” based on investment profile.³³ Quantitative suitability requires that the broker in control of a customer's account has a reasonable basis to believe that the recommendations are not excessive and unsuitable for the customer.³⁴

The duty of brokers may extend to only one transaction or set of transactions for which the broker is engaged.³⁵ Brokers do not have an ongoing duty to monitor the accounts of their clients unless they are specifically engaged to do so. Prior to Regulation Best Interest, brokers were not expected to put their clients' interests ahead of their own. Consequently, as long as a recommendation was suitable, it did not have to be in the client's best interest. A broker could have had access to investments that were better suited to the client's needs and not recommended them because of a conflict of interest, for example, financial incentives tied to one product over another—and that would not interfere with their fiduciary duty.

30. Regulation Best Interest: The Broker-Dealer Standard of Conduct, *Securities and Exchange Commission*, (June 2019), P. 21 (Regulation Best Interest) <https://www.sec.gov/rules/final/2019/34-86031.pdf>.

31. FINRA Rule 2111 (Suitability), FINRA, (May 2014) (FINRA Suitability) http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

32. FINRA Suitability, P. 1.

33. FINRA Suitability, P. 1.

34. FINRA Suitability, P. 2.

35. FINRA Rule 2111 (Suitability) FAQ, *FINRA*, (2014) <https://www.finra.org/industry/faq-finra-rule-2111-suitability-faq>.

Regulation Best Interest Strengthened the Standard of Conduct for Brokers

Regulation Best Interest, which the SEC finalized in June of this year, altered the landscape for standards of conduct. Brokers now have to act in their clients' best interest, a higher standard than the previous suitability requirement. They must also eliminate or disclose and mitigate material conflicts of interest. Brokers are explicitly required to consider cost as a factor under Regulation Best Interest, while such a requirement was not as explicit under the Suitability Rule.

Regulation Best Interest's standard, however, is still not as rigorous as the fiduciary standard under ERISA, which is what would have applied to brokers if the DOL Rule had remained in effect. ERISA requires fiduciaries to act: solely in the interest of plan participants; for the purpose of providing plan benefits; with the care, skill, prudence, and diligence that a prudent person in similar circumstances would use; by diversifying the plan's investments to minimize the risk; and in accordance with the plan's documents.³⁶ A fiduciary has a central duty to act prudently.³⁷

When evaluating the investor's risk tolerance under the prudent standard, the fiduciary duty requires expertise in a variety of areas. "Lacking that expertise, a fiduciary will want to hire someone with that professional knowledge to carry out those functions."³⁸ Thus, the prudence standard requires financial expertise and calls for acting in the interest of the investor, a stronger standard than that applied to brokers even under Regulation Best Interest.

Regulation Best Interest Is Likely to Affect Revenue-Sharing Practices

As we have shown in the previous section, revenue sharing may, but need not, create a conflict of interest for brokers recommending one fund over another. For illustration, we will consider the application of Regulation Best Interest to the arrangements we discuss above, grouped into three categories.

First, consider the sales contests, bonuses, and payments tied to the volume of sales or total assets in a fund. In all of these cases, brokers are incentivized to recommend a fund for reasons apart from it being in a particular client's best interest. The SEC has explicitly prohibited sales quotas and bonuses tied to product sales. We believe that any incentives for individual broker agents to meet certain volume or assets goals for funds are similar explicit conflicts. These conflicts would, as required by Regulation Best Interest, have to be eliminated altogether or disclosed and mitigated. It is difficult to imagine how intermediaries could mitigate such inducements. Any direct targets for particular fund sales should be considered as clearly prohibited under Regulation Best Interest as sales contests and quotas.

36. FAQs about Retirement Plans and ERISA, *United States Department of Labor*, P. 2, (ERISA Compliance FAQs)

<https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/faqs/retirement-plans-and-erisa-compliance.pdf>.

37. ERISA Sec. 404(a)(1)(B) provides that "[A] fiduciary shall discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." ERISA Sec. 404(a)(1)(B),

<https://www.govinfo.gov/content/pkg/CFR-2019-title29-vol9/xml/CFR-2019-title29-vol9-part2550.xml>.

38. ERISA Compliance FAQs, P. 2.

At the other end of the spectrum are payments for services, particularly ones that brokers charge to all fund sponsors operating on their platforms. Such fees could be called platform fees or access fees, and act similarly to the distribution fees paid as part of a fund's expense ratio. Education, training, and conference expenditures to teach brokers about products could also be seen as not creating a conflict as long as they are provided without consideration for whether brokers are selling those particular funds in certain quantities. If education and conferences are viewed as perks and are seen as rewards for achieving certain fund sales targets, then they create a conflict for brokers to recommend fund products with these perks. If education and training is provided simply to inform brokers, then brokers may be more likely to recommend funds with which they are more familiar through such training. The training is not per se creating a conflict. In order to comply with Regulation Best Interest, fund companies will likely be able to continue to offer education and training. However, disclosures by brokers and possibly even in fund prospectuses should be enhanced to indicate whether or not the training is independent of any sales targets. If it is, then disclosure and mitigation obligations are likely satisfied. If it is a type of perk, then the question arises as to how brokers might mitigate this conflict. Ironically, one form of mitigation would be that brokers receive education and training from multiple fund complexes, and fund complexes could end up in a "race to the top" in providing these services as perks to win the favor of brokers. If the fact that brokers attend multiple trainings is disclosed and that they are not limited to those of a particular fund provider or attendance is not based on their sales, then mitigation of the conflict may be satisfied with such practices.

The third category of payments are those paid for including funds within "recommended" or "preferred" lists or as part of robo platforms. These inclusions are clearly intended to drive more flows to these funds. If, however, funds are more likely to be recommended to clients based on these fees separate and apart from whether they are appropriate for the client's needs, then these payments clearly create a conflict. Intermediaries have several options in addressing these conflicts. One option is that they could forgo the fees altogether. The second is to include disclosures around the conflict and mitigate with additional actions. For instance, they could document why these funds are also in the best interest of the clients for whom they are being recommended for reasons apart from the fees generated for the broker. If such documentation is robust, it may be sufficient to satisfy Regulation Best Interest examiners from the SEC. The gray area we see in the rule is its emphasis on cost. The SEC is expressly requiring that a broker/dealer understand and consider the potential costs associated with its recommendation and have a reasonable basis to believe that the recommendation does not place the financial or other interest of the broker/dealer ahead of the interest of the retail customer.³⁹ If a fund is appropriate for a client and a broker receives revenue sharing for including it in a recommended list, is it in the best interest of the client if a just as good but cheaper fund is not included because the cheaper fund does not offer revenue sharing to qualify it for the "recommended" list"? Regulation Best Interest is not absolutely clear on this question, and

39. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 17 CFR Part 240, *Securities and Exchange Commission*, P. 33,326 (July 2019) (Regulation Best Interest) <https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf>.

we believe that such questions will be answered through future examination and enforcement. We believe that intermediaries should be thinking about compliance policies and how to decide which funds to place on “recommended” lists with these risks in mind.

Conclusion and Recommendations

Regulation Best Interest will both challenge and alter the industry in its fund-distribution practices. It will also provide the commission and the public with tremendous amounts of data through the client relationship summary and broker disclosures. While we believe that these disclosures could be more standardized for ease of analysis, they serve as a starting point to provide investors with comparisons of conflicts across the industry.

We encourage the commission to gather more data on inducements to allow for empirical analysis of their effects. The narrative disclosures in Form ADV are difficult to systematically compare across funds. Broker disclosures will also be in different forms and in different locations. We also encourage the standardization of such disclosures with specificity as to magnitude, circumstances warranting payment, and the exact split between the intermediary and the fund complex to inform investors and allow third parties to assess the effects of such payments on recommendations and investor performance. ■■■

Disclosures

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