



A PERSPECTIVE ON MUTUAL FUND SHARE CLASS DEVELOPMENTS

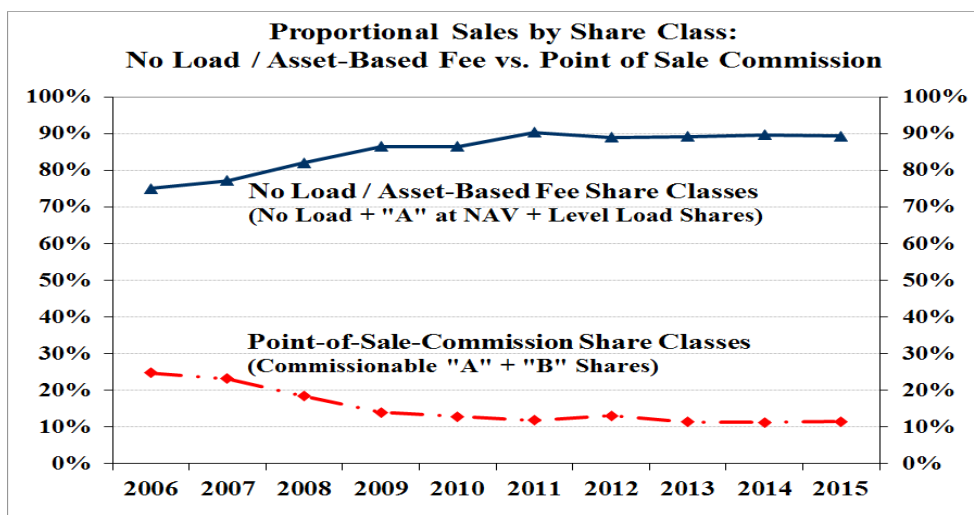
ABSTRACT

A new wave of mutual fund share classes are being considered – “T” shares and “Clean” shares – both addressing potential conflicts due to the DOL Fiduciary Rule, as well as responding to marketplace pressures and expectations by distributors. I welcome your questions and comments to this article – reach me at AviNachmany@gmail.com.

Avi Nachmany

A Rising Focus on Asset Allocation Culture Has Led to the Dominance of No-Load Share Class

- The steady expansion of ‘wrap’ programs and asset allocation ‘solutions’ has been pushing BDs and wealth management firms towards the use mutual funds’ least expensive share classes (as well as low-fee ETFs). Increasingly, the share classes being selected for new sales are ‘no load, no 12b-1 fee’ share classes. Advisors increasingly earn their ‘fees-for-service’ through charges to investors directly (in addition and independent of the costs of the underlying funds). Planning for and anticipating the DOL Fiduciary Rule accelerated this trend (which has been under way for many years, becoming more pronounced post 2008-2009)
- Overall, nearly all (80%-90%) mutual fund sales through financial advisors are within some form of ‘wrapped’ programs where investors are charged a fee-for-service. Inversely, likely less than 10% of mutual fund sales today are in platforms using point of sales (POS) commission.



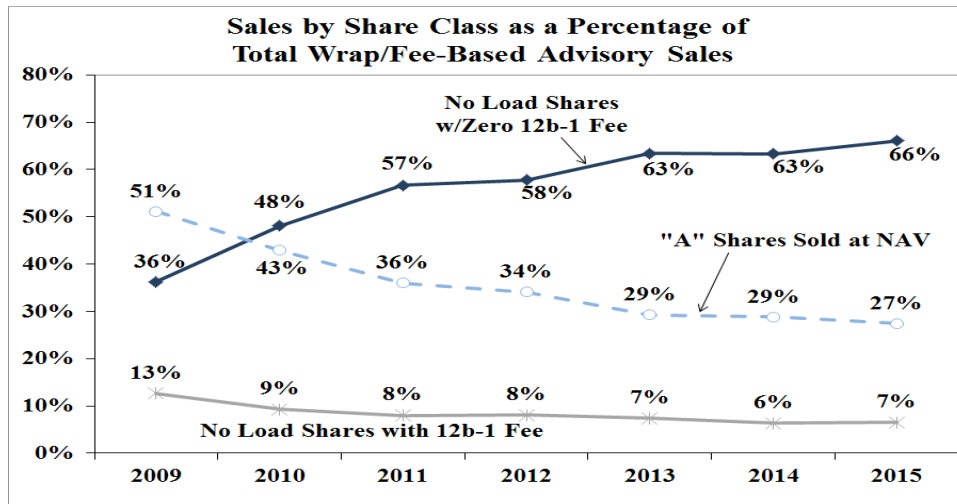
Source: Strategic Insight's Annual Sales Survey 2016

From No-Load, No Rule 12b-1 Fees to Even Lower Fee ‘Clean’ Classes: A Context

There are numerous structures for the ‘fee-for-service’ model used by financial advisors. Traditional FAs are managing their client assets within mutual fund wraps. Some FAs are still using level-load “C” share classes as substitution to wrap accounts (albeit “Cs” are under 10% of FA sales today and their share of sales is falling; yet “Cs” are valuable to many lower-balance investors, as level-load class tax-adjusted total costs are significantly lower than those incurred in ‘wrap’ accounts using the same funds). Naturally RIAs continue to help their HNW clients through asset allocation fee-for-service platforms administered by Schwab, Fidelity’s FundsNetwork, and others (RIAs now control one-quarter of all AUMs of mutual funds and ETFs).

Overall, over the past decade, advisors and BDs have dramatically shifted their revenue models, as they doubled their share of (more stable) revenues generated through on-going fees-for-service, and greatly reduced their dependency on (unpredictable) point-of-sales commissions. And, within

wraps/fee-based advisory programs, sales of no-load, no Rule 12b-1 fees have significantly increased to exceed two-thirds today.



Source: Strategic Insight's Annual Sales Survey 2016

Recognizing these trends, the SEC has signaled a growing interest in monitoring share class and wrap account suitability.

SEC's 2017 Agenda: Share Class Suitability and Related Issues

As disclosed by the SEC Office of Compliance Inspections and Examinations Priorities 2017: excerpts from OCIE's [Examinations Priorities 2017](#) emphasizing "PROTECTING RETAIL INVESTORS"

- Share Class Selection. ... conflicts of interest and other factors that may affect registrants' recommendations to invest, or remain invested, in particular share classes of mutual funds. For example, we will identify and assess conflicts that certain investment advisory personnel may have, such as those who also are registered representatives of a broker-dealer, which may influence recommendations in favor of share classes that have higher loads or distribution fees. We will also assess the formulation of investment recommendations and the management of client portfolios.
- Wrap Fee Programs. We will expand our focus on registered investment advisers and broker-dealers associated with wrap fee programs, which charge investors a single bundled fee for advisory and brokerage services. We will likely review whether investment advisers are acting in a manner consistent with their fiduciary duty and whether they are meeting their contractual obligations to clients. Areas of interest may include wrap account suitability, effectiveness of disclosures, conflicts of interest, and brokerage practices, including best execution and trading away...
- Electronic Investment Advice. Investors are increasingly able to obtain investment advice through automated or digital platforms. We will examine registered investment advisers and broker-dealers that offer such services, including "robo-advisers" that primarily interact with clients online and firms that utilize automation as a component of their services while also offering clients access to financial professionals. Examinations will likely focus on registrants' compliance programs, marketing, formulation of investment recommendations, data protection, and disclosures relating to conflicts of interest. We will also review firms' compliance practices for overseeing algorithms that generate recommendations.

Towards “Clean Shares:” New Low Fee Share Class (no 12b-1; No TA / Sub TA Fees)?

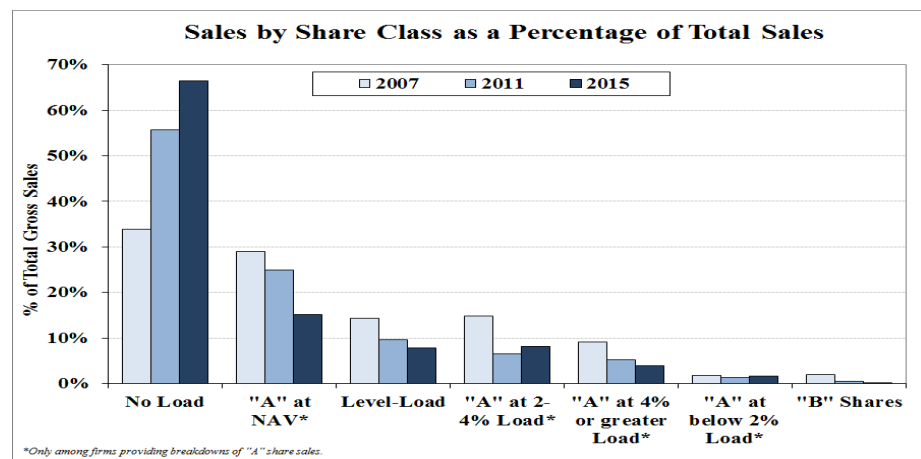
Share classes stripped of many embedded costs (distribution fees via Rule 12b-1 or TA / Sub TA fees) have become dominant with DC plans (typically such share classes are designed R6). In 2015, within DC Investment Only plans, an estimated 30% of sales were captured by such classes – just two years before, the share of such funds was a tiny 6%. Naturally the share of DCIO plan sales captured by R6 classes is even higher now.

Beyond retirement plans subject to ERISA rules and the anticipated (but now uncertain) DOL Fiduciary Rule, a likely new wave of R6-like share classes are being considered now. **Much of such discussion has centered on the new SEC No-Action Letter at the request of Capital Group (parent of American Funds).**

These new share classes are dubbed ‘Clean,’ (a UK terminology...) and can be used in both retirement accounts or non-retirement accounts. Using such share classes allow brokers to set their own commission (naturally the fund's prospectus would have to disclose that the broker may charge a commission on the sale of the shares. Other stated conditions: the broker is acting only on an “agency basis” for the sale of the shares; shares do not include any distribution-related payments to the broker). [There is some ambivalence about payment of revenue sharing in ‘Clean’ shares. It is understood that in its No-Action Letter the SEC did not specify whether sub-TA fees would be permissible, were a shop to create a version of clean shares that includes them – such should be permissible as they are not distribution-related payments.]

In planning for a future where ‘Clean’ share classes are popular (no Rule 12(b)1 fees and no TA / SubTA fees): who’ll pay for servicing costs of funds on a BD platform? Will such fees be absorbed by BDs, paid directly by investors, or paid by fund managers out of their falling profits? What will be the mechanism for such payment (no longer enjoying the mutualization of fees)? What the framework to permit the payment of such fees)?

“T” Share Classes: New Commission Share Classes for Commission Platform



Source: Strategic Insight's Annual Sales Survey 2016

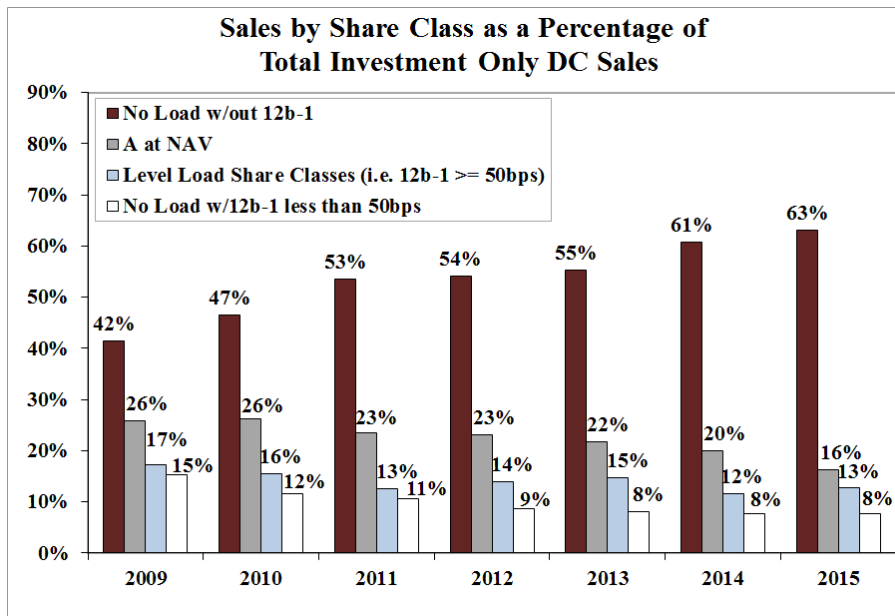
The use of traditional 'load' share classes has dramatically declined in recent years. And the DOL Fiduciary Rule has introduced new conflicts in the use of such share classes, triggering decision among some BDs to exit commission platforms for retirement accounts.

1. Documented in prior chart: "A" shares with 2-4% commissions have been the most commonly used in recent years, accounting for under 10% of sales in 2015 (in aggregate) and for a lower share last year and in 2017 (survey data for 2016 is not yet available). Actually for most fund firms, the share of any "As" sold with commissions are significantly lower than the above aggregate data suggest (as such aggregated data is distorted due to the experience of one large fund company).
2. Naturally, for wealthier investors the level of sales commissions for a new purchase are influenced by large balances already owned within same household (or BD), allowing customers the right of lower commissions. [Note: "Ts" do not allow such scale discounts, as each transaction POS commissions are set by the size of that purchase alone.]
3. Planning for the DOL Fiduciary Rule has led to a new generation of fund share classes to be used in commission-based platforms. Underway are adaptations to the rule – assumed to be implemented in April 2017 but likely delayed or altered now – around commission-based platforms in a post-DOL Fiduciary Rule environment.
4. Some BDs are exiting such commission platform for their ERISA assets – and likely over time in their taxable accounts; others are introducing modifications to the type of funds permitted in their commission-based platform.
5. Some BDs believe that their customers benefit (through lower lifetime total costs and other ways) if they maintain the availability of commission platform. This can be accomplished with the newly-introduced share classes which sidestep the DOL Fiduciary Rule conflicts (Existing share classes – historically used in commission platforms -- 'A's, 'B's, 'C's -- create conflicts for distributors adhering to the Rule).

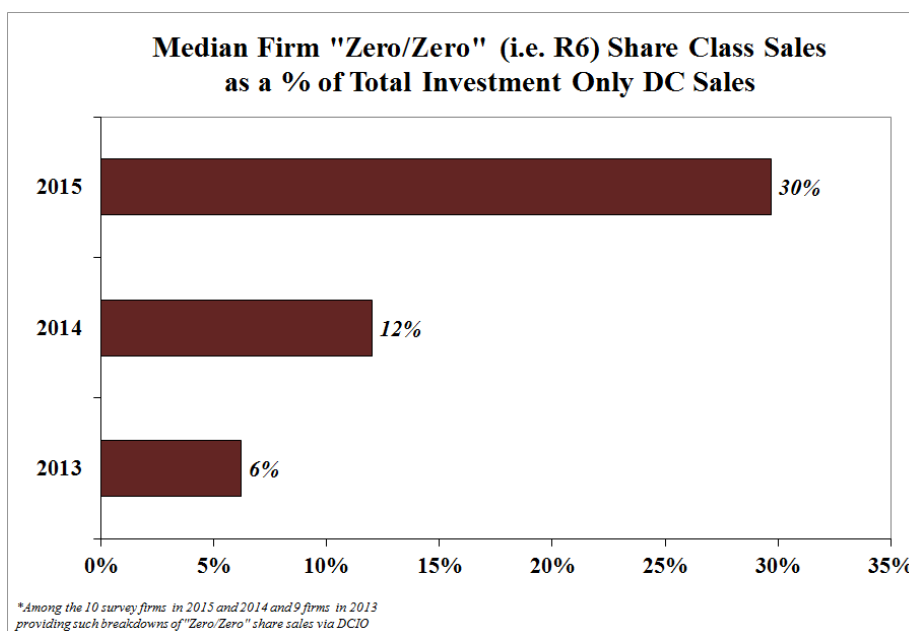
Enter "T" shares: a new share class. A typical structure [to simplify their acceptance and use, it is imperative that a 'standard' of 'Ts' is established]: POS charge of 2.5%; breakpoints up to \$1 million and 1% sales load for all transactions \$1 million and above); No shareholder AUM accumulation privileges (No ROA, No LOI); No CDSC; 0.25% Rule 12b-1 fee. Generally, "Ts" do not have a separate Shareholder Servicing Fees (an exception is JP Morgan's AM filings which include 0.25% Shareholder Services Fees which may be used for payment for sub-transfer agent or for shareholder and administrative service). (Existing transactional share classes used in DOL impacted retirement accounts – 'As,' 'Bs,' 'Cs' - may have to be closed and their AUMs exchanged into this new share class.)

A Harmonization of Share Classes Used in Retirement Accounts and in Taxable Accounts?

It is clear that no Rule 12b-1 fee share classes, and at times, share classes without TA/Sub-TA fee ('R6') have become a dominant structure within the majority of IODC new sales, as illustrated in the next two charts (2016 data is being collected and available in the coming months but the trend is irrefutable).



Source: Strategic Insight's Annual Sales Survey 2016



Source: Strategic Insight's Annual Sales Survey 2016

To reflect and plan for: How far, and how quickly, would distributors' preferences for lowest fee share classes is harmonized across retirement tax-deferred accounts and taxable accounts? Would compliance and reporting considerations accelerate such harmonization? How would it affect smaller accounts and their customers? The future of Revenue / Cost Sharing: where will level of such fees reach equilibrium? Must such payments (in taxable non ERISA account) be identical across all funds and fund managers? [If identical payments are required, payment may rise for Tier I legacy fund managers who have benefitted from long-established lower Revenue Share arrangements, and may decline for smaller firms?]

In conclusion

It has been my observation that it is better to be a fast follower than an early innovator of new share classes, allowing such patient firm to fine-tune their offering if needed.

Furthermore, the uncertainty around the DOL Fiduciary Rule suggests that some fund management companies delay filings and launching new share class until the 'dust settles' in the coming months.

Yet, some distributors have already set in motion programs around the selection and use of share classes which may require the introductions of new suites of such classes independent of the future of the DOL Rule. Overall, marketplace trends suggest that the mutual fund industry is evolving to a future where a majority of fund new sales and assets under management use share classes which cover only core management, administration, and legally required fees, side-by-side with low fee ETFs, all wrapped with an asset allocation programs in which additional fees-for service, fees for platform participation, and other administrative fees are charged separately to the investor.

The path in that direction is set, and fund management firms and their fund trustee should continue to plan for such a future.

Avi Nachmany
New York City, February 2017

AviNachmany@gmail.com
www.AviNachmany.com
