'Clean Share' Funds Not Without Conflicts Of Interest, Morningstar Says

December 1, 2017 • Tracey Longo

As broker-dealers move to standardize the commissions they pay to meet the Department of Labor’s fiduciary rule, more mutual funds and B-Ds are creating and offering investors “clean share” mutual funds.

But while there are many benefits to cleaning up the alphabet soup of mutual fund shares and standardizing fees offered to investors, clean shares have their own conflicts, Morningstar analyst Aaron Szapiro told an audience at the Consumer Federation of America’s 30th Annual Financial Services Conference in Washington D.C.

Clean share conflicts include any obscure fees, including platform fees, revenue-sharing arrangements or sub-transfer agent (TA) fees, which can cost investors 5 to 15 basis points, Szapiro told Financial Advisor Magazine. “It’s the variable payments that concern us more than anything,” he added.

“We’ve told the Labor Department to proceed cautiously in using clean shares as a new exempted class for the fiduciary rule, and we have told the SEC that the definition in Section 22(d) may not protect investors from other potential conflicts,” Szapiro said.

The growing reliance on clean shares, designed to standardize commissions and fees to avoid conflicts of interest for investors and minimize liability for the industry, appears to be increasing in large part because of an SEC opinion letter released earlier this year and growing conjecture that the DOL will add a clean share exemption to the fiduciary rule.

The DOL did not immediately respond to a request for comment on the possibility of a clean share exemption. But both LPL Financial and Capital Research and Management Group are developing clean share classes to minimize conflicts of interest and confusion for investors and liability for themselves and brokers and advisors who sell their products, executives who spoke at the CFA conference said.

Industry and regulators generally agree that clean shares are defined as mutual fund shares that have no front-end loads or 12b-1 fees, which are used to pay for a mutual fund's distribution costs, In addition, investors are expected to pay fees outside the fund for any advice—that is, the broker or advisor charges it directly to a client. But, there is disagreement about whether clean shares should include sub-transfer agency fees, or sub-TA fees, and other kinds of revenue sharing.

"A big part of the definition depends on what we expect clean shares to do and how much protection we think they give investors from conflicted advice on their own," Szapiro said.

"As we've told the regulators, there is promise and peril in embracing clean shares," Szapiro added.

"If regulators assume that clean shares with sub-TA fees and other kinds of revenue sharing are the same as the cleanest shares without them, they will be endorsing products that can have embedded conflicts of interest. These kinds of third-party payments obscure business relationships that can push a firm to sell one mutual fund over another. These back-door payments will elevate the conflicts of interest from the advisor level to the firm level, and add opacity to the way mutual funds are bought and sold."

Those types of hidden back-door payments are what the DOL fiduciary rule governing advisors and brokers who work with retirement investors were designed to eliminate.
There may be good reasons to use arrangements with revenue sharing or sub-TA fees, Szapiro said. For instance, some have argued that sub-TA fees can reduce the costs for accounting.

"We know that someone has to pay for the services the transfer agency provides. However, we believe that a clean-share structure that adds these payments from the mutual fund to a distributor—as opposed to a third party that has no relationship to the sellers of the fund—requires additional scrutiny to ensure investors are getting best-interest advice. Regulators should not assume that such arrangements eliminate conflicts of interest," Szapiro explained in an analysis titled: "Why Clean Shares Matter: What we've told federal regulators about 'clean' mutual fund shares."

Szapiro said the industry's move to minimize conflicts of interest by developing clean shares shows great promise, but that it is still early in the game.

Clean shares have the potential to benefit investors by removing perverse incentives for financial advisors that sell the funds to enrich themselves rather than their clients, he added.

“By forcing mutual funds to compete on merit as advisors recommend lower-cost, higher-returning funds rather than funds that are most lucrative for the advisor, clean shares could dramatically improve investors' experiences and their outcomes. With clean shares, investors will know exactly what they are getting for the fees to help them evaluate whether they are getting a fair value from their financial advisor. Over the last three decades, we have never seen as big a change in industry practice,” he said.

Still, it’s clear that regulators need to proceed with caution and scrutiny, the analyst said.

“Opaque fees and conflicts of interest can hurt investors’ progress toward their goals,” Szapiro concluded.

Morningstar's guidelines on clean share classes, which they’ve shared with regulators, state that advisors should charge investors directly for advice and that truly “clean” shares should only include fees that go directly from investor to asset manager (without any additional payments that flow from the asset management back to the advisor or distributor).

“Conflicted 'back-door' payments exist whenever money flows from the asset manager to the advisor/distributor, especially if the relationship between the advisor and asset manager is obscured,” Morningstar’s guidelines state.