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Mutual Fund Wrap Fee Programs: Despite the Fact that Everyone's Doing It, Many Things Could Possibly Go Wrong

by Jeffrey O. Himstreet

Over the past several years, the asset management industry has seen a proliferation in the development and offering of mutual fund wrap fee programs, whereby a client will elect to invest in a basket of mutual fund securities selected by an investment adviser, which charges a single fee for the advice and any transaction charges. Mutual fund wrap fee programs raise several regulatory and compliance issues for advisers with the selection of funds for inclusion in a wrap fee program and related conflicts of interest for the adviser sponsoring the program. These potential conflicts include the use of proprietary funds, and the use of non-proprietary funds where the adviser or its affiliate receive additional compensation, such as an affiliate receiving a 12b-1 fee, shareholder servicing fee, or other compensation.

The purposes of this article are to discuss: (a) investment advisory wrap fee programs generally; (b) an adviser's fiduciary obligation as it relates to selecting mutual funds for inclusion in a wrap fee program and monitoring other advisers; (c) a recent SEC enforcement action involving a mutual fund wrap fee program sponsored by an investment adviser and aided and abetted by an advisory affiliate where the sponsoring adviser failed to adhere to its selection methodology as disclosed to clients, the public, and as described in documents filed with the SEC that caused the adviser and its affiliate to favor poorly-performing proprietary funds over non-proprietary funds[1]; and (d) issues for investment advisory compliance personnel to consider should their firm act as a sponsor of a mutual fund wrap fee program.

A. Investment Advisory Wrap Fee Programs Generally

A wrap fee program is an investment advisory program that includes a bundle of services, including execution and investment advice (including the selection of other investment advisers) for a single fee.[2] Although the client elects to participate in the wrap fee program, the client gives discretionary authority to the adviser to change the underlying investments within the wrap fee program as the adviser deems appropriate, consistent with the adviser's overall investment strategy for that portfolio. The Securities and Exchange Commission has required investment advisers sponsoring wrap fee programs to offer or deliver a different, specialized brochure to wrap fee clients since 1994.[3]

In a traditional wrap fee program an investment adviser maintains contractual relationships with several unaffiliated investment advisers and offers access to the unaffiliated managers to clients that participate in the wrap fee program. The clients participating in the wrap fee program would invest funds indirectly (through the adviser) with the third-party manager, which in turn would manage the funds in a manner similar to a separately managed account. The investment adviser sponsoring the wrap fee program is responsible for constructing model portfolios consisting of multiple manager that participate in the program and replacing managers for various reasons as the adviser deems appropriate, including poor performance, changes in investment policy, portfolio manager turnover. This separate account wrap fee program is used commonly today with high net worth individuals.

The distinction between a traditional wrap fee program and a mutual fund wrap fee program is that, in the latter, the sponsoring adviser selects a basket of mutual funds rather than selecting other advisers to "mirror" separate account strategies used by the unaffiliated adviser. Mutual fund wrap fee programs are sometimes referred to as mutual fund asset allocation programs, which meet the wrap fee program definition,

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discussed above.[4] Mutual fund wrap fee programs generally are intended for the so-called "mass affluent," and typically have a lower investment minimum than a separate account wrap fee program.

Wrap fee programs have two layers of fees: the adviser sponsoring the wrap fee program charges an investment advisory fee (a portion of which may be shared with broker-dealer firms that solicit clients for participation in the wrap fee program), and the underlying investment manager charges a separate fee. In the case of a mutual fund wrap fee program the underlying funds charge a separate management fee in addition to typical fund expenses as disclosed in the funds' prospectuses.

Mutual fund wrap fee programs are offered and sold in several ways. The sponsoring adviser can invest its clients' assets directly in the program and/or use intermediaries such as broker-dealers, banks, or other investment advisers to solicit interest in the wrap fee program.

In a mutual fund wrap fee program the underlying fund manager typically does not "know" the underlying investor in the wrap fee program and the entity selling the wrap fee program (such as a broker-dealer or bank) typically maintains the client relationship.[5] The entity selling the wrap fee program is often times compensated for its distribution efforts through a 12b-1 or shareholder servicing fees which, as described below, creates a potential conflict for the adviser in selecting funds for the mutual fund wrap fee program should its affiliates be among those receiving the 12b-1 fee or other payment.

Mutual fund wrap fee programs are designed to meet a wide variety of investor needs. Some are designed to adhere to a particular risk strategy (e.g., aggressive growth, short-term income), sector (e.g., international), or class of securities (e.g., holding only passively managed ETFs or dividend-paying stocks). More recently, so-called time-based wrap fee programs have gained in popularity. Time-based portfolios are intended to shift the investment holdings to a more conservative tilt based on the investor's time horizon. The investment holdings in a time-based wrap fee program with a 20-year time horizon, for example, would shift away from more aggressive investments towards more conservative investments such as fixed income securities as the 20-year mark approaches.

Mutual fund wrap fee programs can provide several important benefits to investors. First, investment professionals typically represent that they are using research and analysis in selecting the underlying funds in the wrap fee program and monitoring the performance of the funds (or engaging a third party to perform these services). It is important to note that, although the manager can subcontract this function to a third party, the ultimate responsibility rests with the manager as a fiduciary, as discussed below. Second, a wrap fee program comprised of a basket of mutual funds provides investment and manager diversification within an investment strategy that for many investors would be inefficient to construct without professional management and the economies of scale available to a larger wrap fee sponsor. Third, wrap fee sponsors typically qualify for and use an institutional class of shares with lower expenses and fees not otherwise available to the investor. The wrap fee sponsor often times will also provide consolidated statement reporting and a single custodian, allowing the investor to more easily track holdings and performance. Finally, wrap fee programs commonly offer automatic rebalancing on a quarterly basis to mitigate "style drift" within the investment should one fund in the program outperform its benchmark while others underperform, causing the overall goal of the investment to shift away from its stated objective.

B. An Adviser's Obligations When Sponsoring Wrap Fee Programs

An adviser's obligation to its clients does not vary whether the adviser is sponsoring a wrap fee program, providing separately managed accounts to clients, advising a mutual fund, or providing fee-only financial planning: Section 206(2) of the Investment Advisers Act of 1940 (Advisers Act) prohibits the adviser from engaging in any "practice or course of business that operates as a fraud on clients." The Advisers Act moreover has long (and consistently) been interpreted as applying a fiduciary standard to the adviser-client relationship.[6]

As a fiduciary, an investment adviser has a duty to disclose to clients all material information which might cause an investment adviser to render advice that is not disinterested.[7] An adviser furthermore has a duty to disclose to clients "all material information which is intended 'to eliminate, or at least expose,' all potential or actual conflicts of interest 'which might incline an investment adviser consciously or unconsciously - to render advice which is not disinterested.'"[8] This fiduciary duty obligates advisers to act for the benefit of their clients,[9] and precludes the adviser from any undisclosed use of its clients' assets to benefit the adviser.[10]

An investment adviser sponsoring a mutual fund wrap fee program is exposed to several potential conflicts, some more obvious than others. If an adviser has discretionary authority to modify the investment lineup in the wrap fee program and has a choice between a proprietary fund and a non-proprietary fund that, as measured by fees, performance, investment style, and track record is identical to the proprietary fund, the adviser would have a conflict in recommending the proprietary fund because, in addition to receiving the wrap fee sponsor fee it (or an affiliate) would also be receiving the underlying advisory fee for managing the proprietary fund. Less apparent conflicts would for example be fees that the adviser's affiliates may receive for custodial, shareholder servicing, or transfer agency fees.

Many advisory affiliates and in some cases the adviser itself also receive various payments from mutual funds participating in the wrap fee program that, while perfectly legal, give rise to at least the appearance of a conflict of interest for the adviser. Affiliates of an adviser often times receive 12b-1 fees from at least some of the mutual funds included in the model portfolios of the sponsor's wrap fee program.[11] Rule 12b-1 permits the use of fund assets to pay for distribution-related expenses, which the broker-dealer or bank selling the wrap fee program can legitimately receive since the distribution of the wrap fee program aids the underlying fund.

Shareholder servicing fees pose similar issues. These fees are paid by fund companies to broker-dealers, investment advisers, and other intermediaries such as banks that maintain the relationship with the underlying shareholder, are available to answer many questions from the client, and often times assume functions such as mailing prospectuses and other shareholder information. The end client maintains its relationship with the entity that sold it the wrap fee program (typically a broker-dealer, another investment adviser, or an entity such as a trust company).

As with fiduciary matters under the Advisers Act generally, the accuracy and completeness of the adviser's disclosure, whether the disclosure is made to the SEC or to investors, is critical. If the adviser advertises, for example, the performance of the model portfolios in its mutual fund wrap fee program, the adviser is prohibited, under Advisers Act Rule 206(4)-1(a)(5), from publishing, circulating or distributing any advertisement that "contains any untrue statement of a material fact, or which is otherwise false or misleading."

The sponsor's Form ADV also must be accurate not only because the adviser's clients rely on the disclosure but also because the Advisers Act prohibits the adviser from making any untrue statement of a material fact in any "registration application or report filed with the Commission" or willfully to omit to state in any such application or report any material fact required to be stated therein. A person violates Section 207 by filing a false Form ADV, including any amended Forms ADV.[12] Form ADV Part II is "deemed filed" with the SEC although a physical filing is no longer required.

C. The Bank of America Enforcement Action

The SEC announced an enforcement action against two affiliates of Bank of America Corp. – Bank of America Investment Services, Inc. (BAIS), an investment adviser, and an advisory affiliate (Columbia Management Advisors, LLC, as successor in interest to Banc of America Capital Management, Inc. (BACM)) in May 2008 in connection with a mutual fund wrap fee program that it has offered since at least 2000.[13] The basis of the SEC's action can be summed up as follows: BAIS and its affiliate did not select funds in a manner consistent with the methodology disclosed to clients and the SEC, and the misleading disclosures constituted a breach of the Advisers Act and the adviser's fiduciary duty to its clients, and BACM aided and abetted in this fraud.

BAIS sponsored a mutual fund wrap fee program similar to the above description whereby clients could choose to maintain accounts and give BAIS the discretion to select the mutual funds that the client purchases. The clients are charged an asset-based fee for transaction and advisory services.

BAIS delegated to BACM the development of the research and evaluation functions for creating model portfolios for the wrap fee program clients with discretionary mutual fund accounts.[14] After conducting research and evaluation, BACM forwarded the recommendations to a committee within BAIS charged with approving the recommendations to add or drop a fund from the model portfolios.

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BAIS approved the research process developed by BACM, which was represented as providing unbiased recommendations.

BACM's processes, both for affiliated and unaffiliated funds, were that BACM would:
• Conduct a first screen of a vast universe of available investment managers based upon absolute performance and risk-adjusted performance;
• Conduct a second screen by evaluating certain business thresholds, including length of track record, which BACM required to be "generally five years";
• Conduct a third screen – a "more stringent quantitative analysis" – including assessing competitive returns, rolling performance, consistency of performance, and trailing returns over one, three, and five-year periods;
• Perform a qualitative analysis, focusing on subjective factors such as investment philosophy and investment process; then
• Make recommendations to BAIS based on the screening and evaluations performed; and
• Perform ongoing research of the managers recommended for inclusion or removal to BAIS.

The SEC found that, in practice, BACM sometimes omitted the first two screening steps, discounted the quantitative analysis, and emphasized subjective factors that favored proprietary funds (managed by BAIS under the name Nations Funds). Contrary to its stated research process, BACM did not consistently require a five-year track record or absolute performance thresholds for screening, evaluating, or recommending the proprietary, but instead focused primarily on subjective factors in evaluating those funds. BACM attempted to position the proprietary funds within the mutual fund wrap fee programs to compensate for "[BACM's] current weaknesses (i.e. performance)," given that "[f]rom a 5-year return perspective, [BACM] either doesn't have or has the worst 5-year absolute return within each respective asset class." As a result BACM elected to rely more on "more on qualitative issues and away from performance" to overcome performance weakness in the Nations Funds. BAIS approved this strategy, leading to the inclusion of two Nations Funds in the BAIS model portfolios.

The selection of affiliated funds (even if the advertised selection methodology was followed) gave rise to a conflict of interest because of the interests of BAIS and BACM in increasing the amounts of advisory fees paid to each firm and BAIS' fiduciary duty to its discretionary wrap fee clients in selecting the most appropriate mutual funds on their behalf, regardless of whether such funds were proprietary or unaffiliated. BACM's procedures were not uniformly followed in selecting mutual funds for the model portfolios. The SEC also found that BAIS omitted to disclose the scope of its conflict of interests, and the bias in the recommendation and selection process.

The SEC found that BAIS violated the Advisers Act's antifraud provisions by (i) misrepresenting that the model portfolios would be chosen according to the approved research process; and (ii) failing to disclose the conflict of interests in its selection of affiliated funds for inclusion in the model portfolios. As noted above, BIAS, as an adviser, owed a fiduciary duty to its discretionary mutual fund wrap fee clients to disclose all material facts, including all situations involving an actual or potential conflict of interests with a client. The SEC found that BAIS, contrary to its fiduciary obligations, placed its and BACM's interests ahead of its clients' interests.

As a result, BAIS violated the antifraud provisions of the Securities Act of 1933, and Sections 206(2), 206(4) (by using misleading advertisements), and 207 of the Advisers Act (by making a false filing with the SEC by misrepresenting the selection methodology in its Form ADV). BACM aided and abetted and caused violations of Sections 206(2) and 206(4) of the Advisers Act and Advisers Act Rule 206(4)-1(a)(5). The SEC order requires BAIS to disgorge $3.4 million to clients plus $1.3 million in interest, and to pay a $3 million penalty.

D. Some Best Practices for Compliance and Legal Professionals with Advisers that Sponsor Mutual Fund Wrap Fee Programs

The conflicts of interest for BAIS are somewhat similar to traditional conflicts of interest for firms that recommend proprietary products to clients. The distinction is that in a wrap fee program the conflicts can be more difficult to ascertain (and may appear diluted by the inclusion of non-proprietary funds in the program) and, for the compliance professional, more difficult to monitor. The following are some of what could be considered best practices for an adviser sponsoring a wrap fee program:
• ***Verify Selection Process:*** What is the adviser disclosing to clients and regulators that it selects mutual fund wrap fee managers in a particular manager? What is the adviser advertising as to selection methodology? Is the manager living up to its disclosure? Virtually all SEC enforcement actions against advisers are premised on disclosure that does not match actual controls and practices.
• ***Review Performance:*** What is the ratio of proprietary to non-proprietary funds offered in the wrap fee program? Are the proprietary funds, when measured against the universe of available funds for a particular strategy, worthy of inclusion? A majority of proprietary funds in a wrap fee program would likely be a red flag to examination and enforcement staff and, should such a ratio be justified the methodology for the ratio should be heavily documented, including committee minutes and ideally working papers documenting the selection process.
• ***Investigate Expenses:*** How do fees between proprietary and non-proprietary funds compare? Although

fees are one of many criteria to consider when an adviser selects funds for inclusion in a wrap fee program, the inclusion of proprietary funds with higher fees than similarly-performing non-proprietary funds creates at least the appearance of a conflict for the adviser selecting the proprietary fund for inclusion in the wrap fee program.

- ***Compare Returns:*** If an adviser uses a proprietary fund in lieu of a comparable non-proprietary fund, the compliance staff, as part of the annual review process, should consider back-testing the performance of the program as if the non-proprietary fund had been used. Would the returns to investors have improved? By how much? Are there other factors that would mitigate lower returns of a proprietary manager? (e.g., long-term proprietary manager track record, lower expenses, lower holdings turnover?)
- ***Calculate Revenues Received by the Adviser:*** What revenues does the adviser and its affiliates receive from funds that the sponsor selects? Are they reasonable? Can the adviser document the revenues and substantiate the reasons for them?
- ***Substantiate Other Affiliates' Revenues:*** Is there an affiliate (or other party with which the sponsor has a revenue sharing arrangement) benefiting from inclusion of a particular fund in the wrap fee program? How is this disclosed? Are the benefits (which partially includes fees) received by the affiliates comparable to what the wrap fee client would pay if the adviser used a third party?
- ***Involve Compliance:*** Compliance should be a member, or at least an invited guest of, the adviser's manager selection committee. The purpose of compliance with this committee is not to second guess whether Fund A is better than Fund B, or whether the adviser should terminate Fund C. These functions are appropriately left to the investment professionals hired or engaged to perform these functions. Rather, the purpose is to ensure that the advertised, disclosed, fund selection methodology is followed and documented appropriately. This is particularly important if the adviser is considering including newer or proprietary funds within a particular strategy that may have a limited or less portable performance history.

Conclusion

The offer and sale of proprietary funds has created a conflict of interest within the securities industry since its existence. Mutual fund managers, long before the enactment of the Investment Company Act of 1940, were accused of dumping less favorable securities out of more lucrative separate accounts and into mutual funds where the manager would receive lower advisory fees. In the 1980s and 1990s broker-dealer firms were accused of recommending proprietary funds over non-proprietary funds with better performance and lower fees to benefit their investment advisory affiliates (which shared revenue with the selling broker-dealer). The same conflict exists today in the realm of mutual fund wrap fee accounts. The goal of compliance is to determine the scope of this conflict and the extent to which proprietary funds can reasonably be included in a wrap fee program, the consideration of any attendendant benefits to the adviser or its affiliates from other compensation received from funds participating in the wrap fee program, and how these conflicts are disclosed to clients and to regulators.

1. *In Re: Banc of America Investment Services, Inc., and Columbia Management Advisors*, Investment Advisers Act of 1940, Rel. No. 2733 (May 1, 2008) (*In Re: BofA Order*).
2. Amendments to Form ADV, Investment Advisers Act Rel. No. 2711 (Mar. 3, 2008) (defining the term "wrap fee program" for purposes of Form ADV).
3. *See Disclosure by Investment Advisers Regarding Wrap Fee Programs,* Investment Advisers Act Rel. No. 1411 (Apr. 19, 1994) (adopting rules to require wrap fee sponsors to give wrap fee clients separate brochures).
4. Although mutual fund wrap fee programs meet the wrap fee programs definition, the SEC has elected not to require sponsors of mutual fund wrap fee programs to prepare and deliver schedule H to Form ADV. *See id*. ("The Commission believes that mutual fund set allocation programs, because they do not involve the provision of advisory and brokerage services for a single wrap fee generally do not raise the disclosure concerns addressed in the amendments, and has modified the definition of wrap fee programs to exclude mutual fund asset allocation programs."). *See* note 2, *supra.*
5. The mutual fund wrap fee program sponsor typically transmits purchases and redemptions in an omnibus manner to the underlying fund companies, giving each fund in the model portfolio instructions representing the aggregate inflows and outflows for the fund for each trading day on behalf of all wrap fee clients holding shares of that particular fund.
6. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963).
7. *See id*.
8. *1986 Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Rel. No. 23170 (April 23, 1986) (quoting *Capital Gains Research*, 375 U.S. at 191-92).
9. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979).
10. *Kingsley, Jennison McNulty & Morse Inc.*, Advisers Act Rel. No. 1396 (Dec. 23, 1993) (cited in *In Re: BofA Order*, *supra* note 1).
11. There exists regulatory uncertainty as to whether an investment adviser can receive a 12b-1 fee directly without also registering as a broker-dealer since arguably the receipt of a 12b-1 fee constitutes the receipt of transaction-based compensation for which broker-dealer registration would be required.
12. *In re: Stanley Peter Kerry*, Advisers Act Rel. No. 1550 (Jan. 25, 1996).
13. *In Re: BofA Order*, *supra* note 1.
14. While beyond the scope of this article, BACM also created a "Focus List" of recommended mutual funds from which the fund recommendations for the model portfolios was derived. *See id.* The SEC Action against BAIS also found that BAIS and BACM violated the Advisers Act and other federal securities laws in connection with the methodology used to create the Focus List.

The Changing Landscape of Disclosure: Proposed Changes to Form ADV Part 2

by Michelle L. Jacko

For those of us who have been in the compliance profession for more than eight years, we recall when the Securities and Exchange Commission ("SEC") first proposed Form ADV Part 2 in April 2000.[1] Back then, many advisers shared strong criticism for the proposal, which required significant additional disclosures related to disciplinary information, negotiation of brokerage commissions and audited balance sheets if the adviser was a qualified custodian or insurance company. While the 2008 proposed Part 2 has not materially changed from the former proposal, a few things are noticeably different. The SEC has changed the "check the box" format to a narrative "plain English" disclosure and will require all federal registrants to file Part 2 electronically.[2] In addition, the requirement for consistency of the current Form ADV Part II, Schedule F's Item disclosure order is removed, thus allowing advisers the ability to disclose whatever they want in whatever order they desire. This appears to be contrary to the Commission's typical desire to have disclosures appear in a particular order to allow investors to make an "apples to apples" comparison with other available products and services. Nonetheless, the amendments are designed to improve the disclosure process and give clients and prospective clients full and truthful disclosure in an understandable and clearly communicated format.[3]

If adopted, the new Part 2 will require advisers to provide additional disclosures related to their business practices, conflicts of interest, and backgrounds of their key advisory personnel. The form has been redesigned and will be divided into three sections. Part 2A, the "Firm Brochure" will contain 19 disclosure items, each covering a different topic. Appendix 1 to Part 2A, the "Wrap Fee Program Brochure" will apply to sponsors of wrap fee programs and is similar to today's Schedule H wrap-fee brochure. Finally, Part 2B, the "Brochure Supplement," will outline important information relating to the adviser's supervised persons who provide investment advice to clients. Each of these respective areas is described in detail below.

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I. Part 2A – The Firm Brochure

Amendments to Form ADV Part 2 mark significant changes to the form's format, disclosure content, delivery, updating and filing requirements. The new Part 2A will require detailed, narrative disclosure to allow investors the ability to better understand potential and actual conflicts of interest by requiring several new disclosure items not found on the current form.[4]

Not all of the old Part II will be lost, however. Disclosure of the adviser's code of ethics, personal conflicts, methods of analysis, and investment strategies will follow the existing requirements. However, all disclosures will contain a higher degree of specificity with respect to conflicts of interest.

A. Part 2A – Disclosure of Material Information

The proposed narrative disclosure in Part 2A is designed to provide information about advisers' business practices and conflicts of interest in order to permit clients to evaluate firms and decide whether to begin or continue using the firm's advisory services. The form does not mandate a particular order of disclosure topics and gives firms the flexibility to present the required information in the manner that they deem most suitable to their business. In addition to the mandated narrative presentation, Part 2A also contains additional disclosure requirements not found in the current version. Many of these additional items reflect the underlying purpose of the amendments to provide clear, meaningful disclosure to clients in a concise and direct brochure.

Material Changes: A notable addition to the disclosure topics is Item 2 of Part 2A, which will require advisers to provide a summary of any material changes to information in their brochure since the last annual update.[5] Such disclosures may be made on the cover page of the brochure or in a separate document accompanying the brochure. In what may seem somewhat repetitive, the summary will require advisers to identify information contained elsewhere in the brochure that has materially changed and consequently, of importance to clients. According to the SEC, the summary highlights should afford clients the ability to easily identify and reference the applicable information in the brochure.[6]

Material Disciplinary or Financial Information: Item 9 of proposed Part 2A will require advisers to include in their brochure any material facts about a legal or disciplinary event that could affect a client's evaluation of the advisory business or its management.[7] The proposed form will list specific types of events deemed presumptively material, such as a felony conviction or violation of an investment-related statute or regulation. As proposed, disclosure of this information will be required for ten years following the date of final order or judgment.[8] While this disclosure is not currently mandated by Form ADV Part II, it is required under Rule 206(4)-4 of the Advisers Act.[9] Once the proposed form is adopted, the SEC will likely rescind this Rule.

Similarly, Item 18 of the proposed form will require disclosure of certain financial information about the adviser's business, particularly about its financial condition including whether the adviser has filed a bankruptcy petition during the past ten years.[10]

Methods and Strategies: Proposed Item 8 of Part 2A would require advisers to describe their methods of analysis and investment strategies used in formulating investment advice or managing client assets.[11] The current Part II requires similar disclosures, but the narrative format of proposed Part 2A presents some significant practical considerations for advisers when disclosing this information. Advisers will have to balance providing enough information to effectively allow clients to evaluate the associated risks of their products and services while carefully constructing a disclosure that does not divulge "trade secrets" of the money management team.

Risk of Loss: Item 8 will additionally mandate an explanation of the risks involved in investing in securities and following the adviser's advice.[12] Unfortunately, little guidance was given in the proposal as to the expectations of the Commission on how advisers should define "risks" and what will constitute sufficient risk disclosure. The proposal, however, did provide that the amount of detailed risk disclosure will be dependent upon the type of advisory services offered by the firm. If an adviser offers a wide variety of services, it may be appropriate to simply state that investors should understand and be willing to accept the risk of loss that is associated with the investment. However, advisers that use more sophisticated methods or strategies that create unusual risks will be required to discuss the products' specific associated risks.[13] For example, some advisers that have multiple strategies may find it prudent to make "point of sale" disclosures unique to each client. However, doing so could result in additional administrative and resource expenses for the adviser regardless of size.

In addition, Item 6 of proposed Part 2A requires disclosure if the adviser charges performance fees and/or is involved in side by side management. For an adviser who offers hedge funds, this may particularly tricky given the non-solicitation rules governing private placement exemptions under the Securities Act of 1933 and the Investment Company Act of 1940.[14] In order to rely on this exemption, the issuer cannot engage in general solicitation or advertising.[15] However, under the new proposal, advisers will have to disclose their performance fees, types of clients, advisory services, and any conflicts involved in side by side management. While theoretically the Part 2A disclosures may not be intended to be a general solicitation, based upon its wording and public posting (vis-à-vis the SEC's website) these disclosures could create some practical complications for whether a registered hedge fund will violate the exemption. As proposed, Part 2A will require advisers who exclusively manage hedge funds to create a brochure that provides detailed information publicly, even though a significant number of the persons with access to the information may not be qualified to invest in hedge funds.[16] While the proposal is silent on this apparent contradiction, it is hopeful that the Commission will provide clarifying guidance in this important area.

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B. Part 2A – Disclosure of Conflicts

Several aspects of the proposed Part 2A relate to adequate disclosures of actual as well as potential conflicts of interest between the adviser, its advisory personnel and their clients. The proposed amendments call for clearer, more meaningful disclosure on how the adviser identifies and addresses these conflicts of interest. This description should enable clients to understand the relevant conflicts, their potential effect on the services provided and any advisory procedures that are in place to minimize potentially adverse effects.

Fees and Compensation: Proposed Items 5 and 6 require an explanation of the conflict presented when an adviser or a supervised person accepts compensation for the sale of securities or other investment products, including the receipt of performance fees.[17] As previously mentioned, advisers must explain the inherent conflicts that exist with the receipt of performance fees, and particularly notify clients of the potential incentive for advisory personnel to favor performance fee accounts.[18] A discussion of how advisers handle conflicts attributable to compensation based on sale of a security or investment product also is required.

Soft Dollar Practices: Under Item 12, advisers must describe their process for selecting brokers, and must describe any soft dollar benefits received.[19] The SEC continues to focus have a concentrated focus on soft dollar arrangements and the benefits received from such arrangements. Furthermore, Item 12 will require disclosure of whether the adviser's use soft dollars shall benefit all accounts proportionally and if not, the inherent conflicts this may create.[20] The degree of specificity required in the disclosure will be greater for mixed-use items and services that do not fully qualify for the safe harbor protections afforded by Section 28(e) of the Securities Exchange Act of 1934, such as those services that do not aid in the investment decision-making process or trade execution.[21]

Code of Ethics and Proxy Voting Processes: The SEC will codify this important disclosure into the new Form ADV Part 2 as Items 11 and 17, respectively. Importantly, while the disclosure requirements have not changed, each investment adviser will be required to discuss how it addresses conflicts as they arise and how to contact the firm for a summary of these policies.

C. Maintenance, Delivery and Filing Requirements of Form ADV Part 2A

Delivery and Updating Requirements: The proposal seeks to amend Rule 204-3 of the Investment Advisers Act of 1940, which sets forth the delivery and updating requirements for firm brochures.[22] If amended, advisers will have to deliver Part 2A to all prospects before or at the time of entering into an advisory contract and to all clients every year within 120 days of the adviser's fiscal year-end. While the amendments permit electronic delivery of the brochure, advisers will have to ensure compliance with the SEC's electronic delivery requirements. Electronic delivery is one solution to reduce the potentially significant costs associated with an annual delivery requirement. In addition, any interim updates of Part 2A, such as a disciplinary event or material change to information previously disclosed, will need to be delivered to the adviser's clients.[23]

Filing Requirements and Public Access to Part 2A: All SEC registered investment advisers will be required to file their new brochures electronically in a PDF format through the IARD system, which will make Part 2A available for public viewing.[24] The proposed amendments will require advisers to keep current the brochures filed with the SEC, with updates to Part 2A filed no less than annually or promptly if any information in the brochures becomes materially inaccurate.

II. Appendix 1 to Part 2A – Wrap-Fee Program Brochure

Another similar aspect of the current and proposed form is Appendix 1 to Part 2A, which will require advisers that sponsor wrap-fee programs to prepare a separate, specialized brochure for clients of their sponsored program.[25] The disclosure requirements for a wrap-fee program brochure will be substantially similar to what is currently required under the current Part II Schedule H, although the proposal contains some additional disclosure requirements if affiliated persons of the adviser serve as portfolio managers to the wrap-fee program and discuss such persons are selected and reviewed. Consistent with the firm brochure, the wrap-fee brochure requires discussion of all actual and potential conflicts of interest and how the adviser addresses each.

III. Part 2B – The Brochure Supplement

An additional aspect that represents a major shift from the current form is the new Part 2B - the "Brochure Supplement." The Supplement is designed to disclose information about the adviser's supervised persons who provide investment advice to its clients.[26] This heightened disclosure will allow investors to have additional information related to the individuals with whom they have direct contact, who formulate investment advice and/or have discretionary authority over the client's assets.[27] Detailed information about these employees will not be available in Part 2A.

Format: The brochure supplement, like the brochure itself, must be in narrative form and written in plain English. Part 2B will contain six items, each of which must be addressed for every supervised person that meets the requirements for a particular client. Required disclosures will include background information, disciplinary history, and qualifications of relevant supervised persons. Since this requirement has the potential of being extremely burdensome, the Form permits flexibility in the presentation of Part 2B. For example, if the brochure itself contains information as required by the supplement, Part 2B may not be required at all. [28] Similarly, the adviser may opt to use Part 2B to reference the relevant portions of Part 2A. The adviser's marketing, sales and compliance teams should begin discussions now as to what format Part 2B should take to minimize costs and increase efficiencies.

Disclosure Items: The supervised person's formal education and business background for the previous five years must be discussed and the adviser may, if desired, disclose the person's professional designations or attainments. The Brochure Supplement must also include disclosures of material disciplinary events that relate to a supervised person's integrity. Part 2B will continue to require firms to disclose the person's participation in other investment related business activities and discuss any conflicts that such activities may create. Similarly, the Brochure Supplement, if adopted, will require firms to describe situations in which a supervised person receives economic benefit (other than regular salary) for providing advisory services to a non-client.[29] This may require new disclosures related to sales awards or other incentive packages, which generally are kept confidential at the advisory firm level based on concerns of personnel bias during the investment decision making process. Finally, within Part 2B advisers will have to explain how they monitor advice provided by supervised persons and identify the individual(s) responsible for such supervision.

Delivery and Updating Requirements: Part 2B limits the types of clients to which the brochure supplement must be delivered. As proposed, advisers will not be required to provide brochure supplements to clients who do not receive a firm brochure under Part 2A or who only receive impersonal investment advice. Additionally, the brochure supplement need not be delivered to certain institutional and sophisticated clients who are in a better position to obtain the information than other investors. The amendments permit delivery to clients of Part 2B electronically and the supplement need not be updated annually as is required for Part 2A. Rather, an updated supplement must only be provided to disclose material changes to the disciplinary information contained therein.[30]

IV. Conclusion

If adopted in its current form, the effects of the new ADV Part 2 changes will be considerable and widespread. The new disclosure requirements will, as intended, benefit clients by providing them with clear and meaningful disclosure of material information in a comprehensible format; however, this will not come without potentially considerable costs to the more than ten thousand investment advisers registered with the SEC.[31]

A thorough understanding of the new disclosure requirements is imperative for every investment adviser subject to Form ADV Part 2. The NSCP has submitted a comment letter to the Commission sharing its support for various aspects of the proposal, recommending modifications to particular items and requesting further guidance on other points. To view the comment letter in its entirety, visit www.nscp.org/media/comment-05-16-08.pdf. The letter provides a wonderful outline of discussion points you may wish to consider with senior management prior to the adoption of new Form ADV Part 2. Rest assured, this time, it is coming.

1. *See Electronic Filing by Investment Advisers; Amendments to Form ADV*, Advisers Act Release No. 1862 (Apr. 5 2000) [65 Fed Reg. 20524 (Apr. 17, 2000)].
2. *See Amendments to Form ADV*, Advisers Act Release No. 2711 (Mar. 3, 2008) [73 Fed. Reg. 13958 March 14, 2008)] [hereinafter *Proposing Release*].
3. *Id.*
4. *Proposed Part 2*, General Instructions.
5. *Proposed Part 2*, Item 2 of Part 2A.
6. *Proposing Release* section IIA, 73 Fed. Reg. at 13960-61.
7. *Proposed Part 2*, Item 9 of Part 2A.
8. *Proposing Release* section IIA, 73 Fed. Reg. at 13963-65.
9. 17 C.F.R. § 275.206(4)-4.
10. *Proposing Release*, section IIA, 73 Fed. Reg. at 13968-69.
11. *Proposed Part 2*, Item 8 of Part 2A.
12. *Id.*
13. *Proposing Release* section IIA, 73 Fed. Reg. at 13963.
14. *See* Securities Act 1933 § 4(2); 17 C.F.R. §§ 230.501 – 230.506.
15. 17 C.F.R. § 230.502(c).
16. 17 C.F.R. § 230.506.
17. *Proposed Part 2*, Items 5 and 6 of Part 2A.
18. *Proposing Release* section IIA, 73 Fed. Reg. at 13962-63.
19. *Proposed Part 2*, Item 12 of Part 2A.
20. *Proposing Release* section IIA, 73 Fed. Reg. at 13966-67.
21. *See Proposed Part 2*, Item 12A of Part 2A.
22. *See* 17 C.F.R. 275.204-3.
23. *Proposing Release* section IIA, 73 Fed. Reg. at 13970.
24. *Id.* at 13975-76.
25. *Id.* at 13969.
26. *Id.* at 13971.
27. *Id.* at 13971; *Proposed Part 2*, Instructions for Part 2B.
28. *Proposing Release* section IIC, 73 Fed. Reg. at 13971-76.
29. *Proposed Part 2*, Items 2-5 of Part 2B.
30. *Proposing Release* section IIB, 73 Fed. Reg. at 13972-73.
31. Investment Adviser Association & National Regulatory Services, Evolution Revolution: A Profile of the Investment Advisory Profession, 2007, *available at* http://www.nrs-inc.com/icaa/EvRev2007.pdf.

Mutual Fund Share Classes Conflicting Messages, Competing Interests

by Stuart J. Speckman

The significant role of mutual funds in the world financial markets is undisputed. Per the Investment Company Institute (ICI), these funds now manage over $12 trillion in assets for 90 million investors.[1]
The importance of mutual funds is underscored by the fact that households are the largest group of investors. These investors have a dazzling array of funds from which to choose. Competition is intense for their assets. Nearly 700 firms compete in the U.S.[2]

Many retail investors rely on a financial advisor to identify promising opportunities. When that advice involves the selection not only of a fund, but also a share class, a conflict of interest may exist. An adviser may have a financial incentive to recommend one class over another. In fact, ***three*** NY Times articles,[3] a book,[4] and white paper[5] recently were published that concern various types of mutual fund conflicts-of-interest.

With respect to two of the NY Times articles, the overall claim is that conflicts encourage the sale of unsuitable share classes. The oft-maligned B- and C-shares are, for most investors, the best share class. However, conflicts of interest encourage the sale of less suitable A-shares. That specific claim is the focus of this paper.
The problem is most acute for load-paying equity fund investors with under $50,000 at one fund firm. To varying degrees, all load fund firms are affected. No load firms aren't really affected.

Conflicts-of-interest actually go fairly deep. They exist at the:

• Financial adviser level. Advisers often receive very different commission payments for each share class. The differences may encourage the sale of an unsuitable share class.
• B roker-dealer ("B-D") level. Like advisers, they receive very different revenue streams. It can appear that B-Ds encourage the sale of less-suitable shares in order to maximize revenue.
• Fund firm level. Profits are far higher for some shares than others. If the most profitable share differs for the firm and investor, prospectuses should disclose it in order to avoid appearances of impropriety.

For perspective, buying the wrong share causes losses that are at least five times larger than those due to late trading or market timing activities. Aggregate losses for those activities were large. For the issue at hand, they are far larger.

First, we will review how the situation got to this point. We start with the development of the share class structure. We then review past problems that related, in part, to conflicts of interest. Last, we will review the math of sample trades and evaluate the conflicts individually. We will look at the exact trade mentioned in the NY Times articles.

More Choices and More Complexity

Prior to 1980, investor choices were limited to "load" and "no load" mutual funds. Financial firms selling load funds, which featured a front-end sales charge, received of a portion of that charge as compensation. Investors understood that the amount of a sales charge depended on the amount invested and would be deducted at the time of sale.

Two developments had a major impact on compensation. In 1980, Rule 12b-1, permitted a fund to bear expenses in connection to the distribution of its shares.[6] Later, Rule 18f-3 was adopted in 1995.[7] Inadvertently, the rules increased the complexity of compensation arrangements. Funds could now offer shares with different pricing structures.

Today, investors clearly could benefit from a better understanding of their choices. In a book published earlier this year, Professor Louis Lowenstein of Columbia University pointed to Rule 18f-3, noting that "the level of complexity [inherent in the multiple class structure] defies almost any description."[8] In a recent New York Times article, Gretchen Morgenson observed that investors who buy load mutual funds must sort through a "dizzying list of share classes with a variety of fees." [9] Barbara Roper, Director of Investor Protection at the Consumer Federation of America, commented that "it is absolutely bewildering to try to figure this stuff out."[10]

Following are descriptions of the typical attributes of the most common retail share classes.[11]

• A-shares have a "front-end" sales charge (deducted at the time of purchase). It declines as the size of the investment increases and "breakpoints" are achieved. Typically, 5.75% is the maximum charge. These

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breakpoint discounts are specific to each fund. In general, A-shares are marketed as a long-term investment choice.

• B-shares have a "back-end" or contingent deferred sales charge (CDSC) of up to 5%. Often it declines to zero over six or less years. If shares are redeemed early, unless waived, a CDSC is assessed according to the methodology established by that fund. B-shares have higher ongoing expenses than A-shares but may convert to A-shares if held for six to eight years. [12] B-shares are marketed as a mid-term to long-term investment.

• C-shares have a 1% CDSC that expires after one year. Like B-shares, C-shares have higher expenses than A-shares. Unlike B-shares, C's do not convert to a lower cost share. So, C-shares are marketed as a short-to-mid-term choice.

Perspective on Investor Losses

A few years ago, high profile regulatory actions related to market timing and late-trading. While aggregate losses were large, per-investor losses were small. The evidence – albeit anecdotal – suggests that "harm" was roughly 0.10% per year. On a $40,000 trade, about $40 in account value was lost per year.

Other actions related to shelf-space arrangements. Fund firms paid, of its own assets, 0.10% to 0.25%/yr of assets held at a B-D in order to make a so-called "Preferred List." The B-D encouraged the sale of funds from that firm without properly disclosing the "pay-to-play" arrangement. The B-Ds' financial advisers were held-out as being impartial with respect to their mutual fund recommendations. Ostensibly, investors were receiving unbiased advice.

While conflicts of interest existed, quantifying a loss is hard. This author has seen no reliable estimate of direct, causative harm. Also, "biased" is not synonymous with "unsuitable." Math-wise, nothing precludes a biased recommendation from being beneficial to investors. If investors bought funds from firms that were not on a preferred list, returns would not necessarily have been higher.

If a conflict encourages the sale of an unsuitable fund or share class, that's a different story. It's the focus from here.

Problem for Investors Defined

Load fund investors often choose the wrong share class, which causes account values to be unnecessarily low. They select too many A-shares when B- or C-shares would be best for any holding period. The problem is systemic and includes trades from most major load fund families.

The best share is the one that generates the highest account value. It is not necessarily the least expensive share class. There are myriad examples of a share class being most expensive and best performing, odd as that seems. Simply, cost is no proxy for account value. For low cost to equal highest value, all else must be equal. For load funds, it's not equal. B-shares convert, but not A's. A-shares have a breakpoint schedule, but not B's.

Consider the Times' example of $40,000 in the $18 billion Lord Abbett Affiliated Fund – a fine fund from a fine firm. After 5 years at 8%/yr, account values for A-, B-, and C-shares are $53,230, $54,292, and $54,692.[13] The C- to A-share differential is $1,462, or roughly 3.65% of the initial $40,000 investment. That loss is about 0.70%/yr – ***seven times the estimated harm due to late trading.*** The B- to A-share differential is $1,062, or 2.65% of the initial investment. That loss is about 0.50%/yr – ***about five times the late trading harm.***

We will use this trade size throughout the paper since it was used by the NY Times. However, we are concerned with all trades below $50,000 at one fund firm, which covers most investors, per the ICI.[14]

Some studies suggest that the issue is of little consequence. One claims that sales of loaded A-shares are below 10% of all load trades[15] Thus, we should not care about share class choice. This conclusion may not be entirely correct.

True, 10% of all trades in a load fund may be in an A-share with a front-end sales charge. (The other 90% are in load-waived A's, B- and C-shares, and other shares.) However, 40% to 50% of ***dollars*** – not trades – have an associated front-end load; i.e., the A-share load is paid. Fund documents show the dollar volume of sales where A-share loads apply. It is clear that investors commonly pay a front-end load for A-shares.

Assume nine investors use load-waived A-shares in a 401(k). They make four $300 purchases a year. That's 36 load-waived trades and $10,800 (9*4*$300). Investor ten buys $10,000 in loaded A-shares. Overall, 90% of investors use load-waived shares (9/10) and 97% of trades are load-waived (36/37). However, 48% of dollars are loaded ($10,000/$20,800).

Conflicts at the Advisor Level

The multiple class structure provides financial advisers and broker-dealers with options for structuring compensation in connection with the sale of mutual funds. Therein lies the potential for a conflict of interest.

Investors should understand that financial incentives can motivate an advisor or B-D to recommend one share class over another. The release published in connection with Rule 18f-3 noted that investor understanding of sales and service charges had been a source of concern to the SEC.[16]

(Continued on page 12)

MUTUAL FUND SHARE CLASSES
(Continued from page 11)

The complexities attendant to the multiple class structure require financial advisers and B-Ds to exercise diligence in making share class recommendations. Interestingly, the regulatory scrutiny received by sales of B-shares in the early 2000s resulted in an industry bias in favor of A-shares.

New York Times columnist Gretchen Morgenson questioned this apparent bias. She wrote: "Class A shares are by far the most widely sold, perhaps because they are generally more lucrative for brokers when they make the sale. Class B shares often turn out to be a better deal for investors but are shunned by many brokers."[17] For trades totaling under $50,000 at one fund firm, she says advisers often earn higher commissions on A-shares than on B- or C-shares. The differential in pay may encourage them to sell a less suitable share class to investors.

She may be right. In general, for trades below $50,000, advisers are paid 4.75% to 5% of the sales load, plus a 0.25% asset-based trail commission. For B's, it's often 4% plus a trail starting in year two. C's pay 1% per year and, over the long-term, are most lucrative for advisers.

For the $40,000 Affiliated Fund trade, year one gross commissions ("GDC") are about $2,098 (i.e., ~5.25%) for A's vs. $1,600 (i.e., 4%) for B's. A's pay about $500, or 31%, more than B's. The differential is fairly constant over time. Is $500 an incentive for advisers to sell A-shares, merits aside? [18]

If A's are best in terms of account value, a conflict is of no import. For many funds, including the Affiliated Fund, A-shares ***never*** are best under $50,000. Still, sales of A's exceed those of B's and C's combined for this fund, and many others.[19] Even to $99,999, for most funds, and typical 4 to 6 year holding periods, B's or C's are best, not A's.

Ms. Morgenson referenced prospectuses from all three firms. Interestingly, Affiliated's prospectus did not fully detail pay until April 2008. Now, it does a good job at detailing how advisers are paid for selling various share classes. So does American Funds. In contrast, First Investors prospectuses offer no details on advisor pay.

One solution is to more clearly disclose advisor pay. Using the standard trade of $10,000 invested at 5%, prospectuses could estimate gross pay for 1-, 3-, 5-, and 10-year holding periods. Secondly, trade confirms could list commissions for all share classes of a certain fund. Now they are shown only for the share class sold.

Conflicts at the B-D Level

Problems are exacerbated when B-Ds set sales limits for B- and C-shares that are too restrictive. It can appear that they encourage advisers to sell a less-suitable share class because the B-D's revenue is higher.

Consider again the $40,000 Affiliated Fund trade. We saw that A-shares were best for the advisor in terms of pay. But what's good for an advisor is good for the B-D. Assuming a typical 45% advisor payout, year-one revenue to the B-D is $1,154 for A's, $880 for B's, and $220 for C's.[20] In year one, B-D revenue is 31% higher with A's than with B's. It is highest, over time, with C-shares. C-share sales, however, are relatively low.

For trades to $50,000 in this fund, B- or C-shares are best for investors for all horizons and returns. At most B-Ds, however, at least 80% of the time, the trade is done in an A-share.

Sales limits must be set fund-by-fund. The relationship between a fund's A-, B-, and C-share pricing profiles dictate the proper limit. As every fund firm prices funds differently, a one-size-fits-all policy on B- or C-shares is not optimal for investors. Consider two fund firms mentioned in the 4-6-08 NY Times article. For B-shares from First Investors, the proper limit should be $99,999. In contrast, B's from American Funds make sense, generally, to $24,999.

Incredibly, the proper B-share limit is $249,999 for over 500 funds.[21] Often the limit is set at $50,000 by a B-D. Those who invest over $50,000 often buy the wrong share as a result – i.e., A-shares.

Conflicts at the Fund Firm Level

For typical trades, not hypothetical ones held for ten years, fund firms often earn higher profits with A's than with B's or C's. Due to the economics of commission fronting, B's and C's are less profitable in the short-term, which is six or less years. In general, those shares are more profitable in long bull markets.

Most investors hold shares for four to six years.[22] In that period, for almost every equity fund trade below $100,000, C-shares are best; B's are second best. A-shares almost never are best.[23] Currently, prospectuses do not provide estimates of account values for various holding periods.

If fund firms and investors are best-served by the same share class, no conflict exists. Most small trades would go into B- or C-shares. They don't. Every fund publishes its share class sales figures each year, so we know that most dollars go to A-shares.

Look again at the Affiliated Fund. Assume CDSCs are waived, cost-of-capital is 11%, and inflation 3%. Our estimates of cumulative discounted revenue, after year 5, are $1,143 for A's, $628 for B's, and $626 for C's. Revenue derived from A-shares is 82% higher than from B-shares. If a 1% CDSC is collected, the B-share figure rises to $983.

This disparity in interests should be disclosed. A fund firm revenue example, akin an expense example, might work. Otherwise, investors may buy the share that is most profitable for a fund firm but not best for them.

Conclusion

Conflicts of interest must be disclosed if they are material to an investor's share class choice. For small trades, the share class that is sold most often (A-shares) pays the most commissions to financial advisers, revenue to B-Ds, and profits to fund firms.

Fortunately, the solution to the problem is easy: more complete and accurate disclosure at various levels.

At the advisor level, estimated cumulative pay should be disclosed for various holding periods, such as for one, three, five and ten years. That includes up-front pay plus 12b-1 payments. A prospectus should contain this information.

At the B-D level, sales limits should be set fund-by-fund. Setting across the board low limits on B- and C-shares belies the fact that, for many mutual funds, those shares are best for most investors. The required analytics are readily and affordably available.

At the fund firm level, a little extra prospectus disclosure will go a long way. For the typical small trade, investors should have some understanding of how much a fund firm earns on a trade.

1. 2008 Investment Company Fact Book – 48th Edition: A Review of Trends and Activity in the Investment Company Industry published by the Investment Company Institute and available at http://www.icifactbook.org.
2. Id.
3a. Unscrambling the Alphabet of Fund Fees. Gretchen Morgenson, New York Times January 20, 2008.
3b. It's Called 'Class A,' But is it Best for You? Gretchen Morgenson, New York Times April 6, 2008.
3c. Some Mutual Fund Numbers Look Great, but for Whom? Harry Hurt III, New York Times, April 20, 2008
4. The Investor's Dilemma: How Mutual Funds Are Betraying Your Trust and What to Do About It. Louis Lowenstein. Wiley, 2008
5. Some Inconvenient Truths. Tim Price, PFP Wealth Management, 4-25-08, newsletter at www.pfpg.co.uk
6. See *Bearing of Distribution Expenses* by Mutual Funds, Release No. IC-11414, October 28, 1980. Rule 12b-1 prohibits registered open-end investment companies from financing an activity that is primarily intended to result in the sale of its shares, except pursuant to a distribution plan that conforms to the rule's requirements.
7. See Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, Release No. IC-20915 March 2, 1995, 60 FR 11876 (Adopting Release).
8. Lowenstein. See note 5.
9. Morgenson, April 6, 2008. See note 3b.
10, Id.
11. The description of retail share classes reflects characteristics that this author believes to be common in the industry. Specific attributes of any share class will, of course, be specific to a particular fund. Some funds may offer additional shares that are available only to certain classes of investors. This paper does not consider them.
12. The point at which Class B shares "flip" to A-shares varies, depending on the fund under consideration, and is of critical importance to the share class suitability analysis.
13. Estimates by author using proprietary software, based on fund expenses found in the 2007 prospectus. The CDSC applied for year five is 1%, not 2%, as the holding period requirement was met.
14. 2007 ICI Fact Book. Characteristics of Mutual Fund Investors. Section six, page 58. Investment Company Institute. Median assets of mutual funds was $48,000. The average was substantially higher. If holdings of other types of packaged products were included, like ETFs and annuities, all figures would be higher.
15. Strategic Insight Finds Front-End Loads Going Out of Fashion Fast. Erin Kello, Mutual Fund Wire, May 29, 2008. Based on the research entitled "Fund Managers Focusing on Intermediary Sales: Trends in the Use of Share Class Pricing and Distribution Channels." Strategic Insight, 2008.
16. Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, Release No. IC-20915 March 2, 1995, 60 FR 11876 (Adopting Release).
17. Morgenson, April 6, 2008. See note 3b.
18. Estimates of the author using proprietary software. The fund's 2007 prospectus was used to derive figures.
19. See various filings with the Securities and Exchange Commission: www.sec.gov. Search for "Load Abbett Affiliated" under the Search For Company Filings link then the Mutual Fund Prospectuses link.
20. Estimates by author using proprietary software. Estimates based on a typical 45% advisor payout and the fund's 2007 expense figures.
21. Estimates by author after reviewing hundreds of funds from the top twenty fund firms in terms of assets. Results then were extrapolated to reflect the overall industry.
22. "Expectations Investing: Reading Stock Prices for Better Returns," 9/06, p 62. Michael J. Mauboussin, Chief Investment Strategist, Legg Mason Capital Management, CFA Conference Proceedings Quarterly. "The average holding period in the 1950s and 1960s was five to six years. Today, the average holding period is less than one year." See also "Investor Retention Rates at 20-Year High," April 5, 2005. Joe Morris, *Ignites.com*. "The survey by Dalbar finds that shareholders held on for an average of 4.2 years in 2004, compared to 3.3 years in 2003. It was the highest retention since Dalbar began tracking the activity in 1984."
23. Estimates by author using proprietary software and the FINRA Mutual Fund Expense Analyzer: http://apps.finra.org/investor_Information/ea/1/mfetf.aspx.

Salary Survey Last Call

NSCP has been conducting a Salary Survey since January and we have nearly 1000 participants to date. As of June 30th, the online survey will be closed and we will begin the work of compiling, analyzing, and documenting the results.

The final results will be presented at the NSCP 2008 National Meeting in Philadelphia, PA on October 20, 21 and 22.

If you have not participated and would like to be part of this very important survey, please visit

http://www.nscp.org/surveys.html

Registration Reform in Canada – National Instrument 31-103

by Mark Pratt

The Canadian Securities Administrators (the "CSA")[1] released a second draft of proposed National Instrument 31-103 ("NI 31-103" or the "Instrument") and its companion policy (the "Companion Policy")[2] for comment on February 29, 2008. The Instrument and the Companion Policy will bring about far reaching changes to the registration and ongoing operations of investment fund managers, dealers and advisers in Canada. Full implementation of NI 31-103 will require amendments to many of the provinces' securities acts[3], the amendment or repeal of certain provisions of the regulations made under those acts and the amendment or repeal of many other local and national rules, instruments and policies. Notwithstanding that there is much work still to do, it seems likely that the Instrument will come into force sometime in 2009 without any significant substantive changes from the current draft.

This article will provide a brief overview of NI 31-103, with a particular emphasis on certain elements of the Instrument and the Companion Policy that have not yet received much discussion and on what the changes mean for firms' compliance regimes and compliance staff.

Business Trigger

Currently, advisers in Canada are required to be registered if they engage in or hold themselves out as engaging in "the business of advising others" as to the investing in or buying or selling of securities and NI 31-103 will make no changes in this respect.

However, currently, the dealer registration requirement may be triggered by engaging in a single trade, unless an exemption is available elsewhere in provincial securities legislation. The Instrument has been drafted in contemplation that dealer registration will only be required if a person or company is "in the business of trading" securities. This change to a "business trigger" for dealer registration will not be made in the Instrument itself, but, rather, will be effected through amendments to the provincial securities acts. The CSA expects this change to result in the need for fewer statutory registration exemptions and fewer applications for exemptive relief from the dealer registration requirement.

Categories of Registration

Currently, there are literally hundreds of different categories of registration among the 13 provincial and territorial securities regulators. That number will be reduced to 5 categories of dealer registration and 2 categories of adviser registration and will add the new category of "investment fund manager."

There will also be 5 individual categories of registration, including "ultimate designated person" and "chief compliance officer," discussed further, below.

Compliance Regime

NI 31-103 will create for the first time in Canada a uniform approach to compliance across all types of registered firms.

"Ultimate Designated Person"

All registered firms will be required to appoint an "ultimate designated person"[4] (the "UDP") who will be responsible for supervising the activities of the firm that are directed towards ensuring compliance with securities legislation by the firm and each individual acting on its behalf and for promoting compliance with securities legislation within the firm[5]. The UDP must be the most senior office of the firm or the most senior officer of the division of the firm whose activities require the firm to be registered[6].

Chief Compliance Officer

All registered firms must also appoint a chief compliance officer (the "CCO"), who must be an officer of the firm[7] and who will be responsible for (a) establishing and maintaining policies and procedures for assessing compliance by the firm, and individuals acting on its behalf, with securities legislation, (b) monitoring and assessing compliance by the firm, and individuals acting on its behalf, with securities legislation, (c) reporting to the UDP with respect to any "substantial non-compliance" with securities legislation by the firm or any individual acting in its behalf, and (d) submitting an annual report to the firm's board of directors to assist them in performing a compliance assessment[8].

Compliance System

Registered firms must establish, maintain and apply a system of controls and supervision sufficient to (a) provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation and (b) manage the risks associated with its business in conformity with prudent business practices. Firms' systems of controls and supervision must take the form of written policies and procedures.[9]

This description of firms' compliance systems is very far reaching and compliance professionals and legal advisers should be careful not to overlook several important elements. First, the compliance system must include both "controls" and "supervision." Second, it is only

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required to provide "reasonable" assurance regarding compliance with securities legislation. Third, in addition to compliance with securities legislation, the compliance system must be designed to manage "risks associated with [the firm's] business in conformity with prudent business practices."

As currently drafted, the Companion Policy provides helpful clarification of some, but not all, of these issues. For example, with respect to the requirement to implement a supervisory system, the Companion Policy indicates that the compliance system should ensure that everyone in the firm, including the board of directors, management, employees and agents (whether they are registered on not) understands the standards of conduct for their role[10]. It also indicates that managers or others with authority to supervise specific, registered individuals have a responsibility to take all reasonable measures to ensure that the staff under their supervision act honestly and in good faith toward clients, comply with securities legislation and the firm's own policies and procedures and maintain proficiency[11].

However, the Companion Policy currently provides no guidance with respect to a firm's obligations to "manage the risks associated with its business in conformity with prudent business practice." Presumably, this obligation requires firms to consider things such as financial, operational and reputational risk, as well as the risk that the firm could be used for money-laundering purposes, and to adopt a system of controls and supervision sufficient to manage those risks. In other words, this provision of the Instrument imposes on firms a legal obligation to implement policies and procedures designed to address a broad range of non-legal risks and firms, their UDPs and CCOs should pay particular attention to this issue when reviewing their readiness for NI 31-103.

Compliance Recordkeeping

The recordkeeping requirements under the Instrument include a number of provisions that relate specifically to compliance matters. For example, there is a general obligation to maintain records to demonstrate compliance with applicable requirements of securities legislation[12] which is supplemented by a requirement that those records include records that (a) demonstrate compliance with internal control procedures, (b) demonstrate compliance with the firm's own policies and procedures, and (c) document compliance and supervision actions taken by the firm[13].

Since the Instrument makes it a legal requirement to adopt policies and procedures designed to manage the non-legal risks associated with a firm's business (as discussed above), firms, their UDPs and CCOs should pay close attention to the creation and maintenance of records demonstrating their compliance with their risk management obligation.

"Fit and Proper" Requirements and Conduct Rules

The Instrument contains extensive rules regarding, among other things, proficiency of individuals and solvency and financial records of firms (known as the "fit and proper" requirements) and account opening, relationships with clients and complaint handling (known as the conduct rules).

Proficiency

In addition to the prescribed educational and work experience requirements for most of the individual categories of registration, the Instrument contains a general proficiency principle which requires that when a registered individual performs an activity that requires registration, the individual must have the education and experience reasonably necessary to perform the activity[14]. Presumably, the CSA will rely on this principle when reviewing applications for registration of UDPs (a category for which there are no prescribed proficiency requirements) and when considering applications for exemptions from the prescribed proficiency requirements in other categories.

Solvency

All registered firms (except exempt market dealers[15] that do not handle, hold or have access to any client assets, including cheques and other instruments) are required to maintain excess working capital and bonding or insurance in prescribed amounts.[16]

Financial Statements

All registered firms must deliver to their regulator within 90 days of the end of their fiscal year audited annual financial statements and a prescribed form showing the firm's excess working capital as at the end of the fiscal year and the immediately preceding fiscal year.
Registered dealers and investment fund managers must also file unaudited quarterly financial statements for the first, second and third quarters of their fiscal years within 30 days of the end of each quarter, together with the prescribed form showing the firm's excess working capital as at the end of the quarter and the immediately preceding quarter.

Investment fund managers' annual and quarterly financial statements must also be accompanied by a description of *any* net asset value adjustment ("NAV") made during the period (i.e. the year or the quarter), including a description of the cause of the adjustment, the dollar amount of the adjustment and the effect of the adjustment on the NAV per share or unit and any corrections made to purchase and sale transactions affecting either the fund or the securityholders of the fund. It is important for investment fund managers, their CCOs and their finance departments to take note of the fact that the requirement

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to report on NAV adjustments contains no materiality test and, in particular, is not linked to the standard contemplated by Bulletin #22 of the Investment Funds Institute of Canada, which contemplates NAV adjustments only for errors of 50 bps or greater.

Account Opening

Registered dealers and advisers must maintain account opening documentation for each client, although exempt market dealers are not required to do so in respect of any clients for whom the dealer does not handle, hold or have access to assets, including cheques and other similar instruments.

Among the "know-your-client" obligations is an obligation for registered dealers and advisers to take reasonable steps to establish "the reputation of the client" where there may be cause for concern. Although this obligation exists currently in some of the provinces[17], it is not an obligation that is frequently discussed. Its inclusion in NI 31-103 suggests that the CSA wishes to place a greater obligation on all registered dealers and advisers to protect themselves, and the Canadian financial system generally, from being used for illegal or unscrupulous purposes.

Relationship Disclosure Information

The Instrument contains fairly detailed provisions requiring disclosure to clients regarding the nature of the account they are establishing, the products and services that may be offered by the dealer or adviser, a discussion of risks, a discussion of the registered firm's conflicts and so on.[18] This section of the Instrument is intended to reflect much of the work that was done in the Ontario Securities Commission's proposed Fair Dealing Model several years ago.

Dealers that are members of the Investment Dealers' Association of Canada (the "IDA") or the Mutual Fund Dealers' Association of Canada (the "MFDA") are exempt from this section of the Instrument if they comply with the IDA's or MFDA's by-laws, regulations and policies dealing with the same issue[19]. The IDA published a proposed Client Relationship Model, one element of which was the creation of an IDA-specific client relationship disclosure regime[20]. The MFDA is also expected to publish a proposal.

Complaint Handling

Registered dealers and advisers must adopt policies and procedures regarding the documentation of and responses to client complaints[21]. Dealers and advisers are required to participate in an independent dispute resolution service or any such service established by the local securities regulator[22]. On January 30 and July 30 of each year, dealers and advisers are required to deliver a report to securities regulators listing (a) each complaint made to the firm during the reporting period, (b) each complaint that was resolved during the period and (c) each complaint that remained unresolved as of the end of the period[23].

The Companion Policy provides guidance with respect to what the CSA will consider to be a "complaint." It indicates that a complaint may be made orally or in writing and consists of (a) a reproach against the firm, (b) real or potential harm that a client has experienced or may experience because of the actions of the firm or its representatives and (c) a request for the firm to take remedial action[24]. It is important to note that the Companion Policy also indicates that firms must document and respond to *every* complaint, not just those relating to possible violations of securities legislation[25]. The Companion Policy provides helpful guidance with respect to the processes that should be part of any complaint handling policy and procedure.[26]

Although the Instrument indicates that investment fund managers are exempt from the prescriptive complaint handling requirements in the Instrument itself[27], the Companion Policy contains no such exclusion. Since both National Instrument 81-107 and provincial securities legislation impose fiduciary obligations on investment fund managers with respect to the funds they manage[28], CCOs of investment fund managers should consider very carefully whether they should, nevertheless, adopt complaint handling policies and procedures that look very much like those contemplated by the Instrument and the Companion Policy.

Conflicts of Interest

General

All registered firms have an obligation under the Instrument to make reasonable efforts to identify conflicts of interest between the firm, individuals acting on behalf of the firm and the firm's clients[29] and to "respond" to any conflicts identified[30]. The Companion Policy contemplates three types of potential responses to conflicts (namely avoidance, control and disclosure) and provides guidance with respect to implementing each of them. With respect to controlling conflicts, the Companion Policy provides relatively extensive suggestions regarding the use of committees, monitoring of market activity, creation of effective organizational structures, remuneration and monitoring of various outside business activities and relationships[31].

The Instrument also contains a number of detailed prohibitions or restrictions with respect to principal trading between a registered firm (or people acting on its behalf) and its clients[32], making recommendations or advising in respect of the firm's own securities or those of its "related issuers" or "connected issuers"[33] and the allocation of investment opportunities[34].

Referral Arrangements

Under the Instrument, firms may enter into referral arrangements, provided that the terms of the arrangement are set out in a written agreement between the firm and the person or company making or receiving the referral and that all referral fees are recorded on the firm's records[35].

Firms are also required to ensure that prescribed information regarding the referral arrangement is provided to the client prior to the opening of an account or the provision of any services under the referral[36].

The Instrument requires a registered firm that refers a client to any other person or company to take reasonable steps to satisfy itself that the person or company has the appropriate qualifications to provide the services and, if applicable, is registered to provide those services[37]. Accordingly, firms, their UDPs and CCOs should consider implementing a due diligence policy and procedure to be applied to any person or company to whom a client might be referred.

Effect on Non-Canadian Entities

Many non-Canadian entities currently carry on business in Canada in reliance on exemptions from the registration requirement or, in certain provinces, in reliance on limited registrations such as Ontario's "international dealer" and "international adviser" categories. NI 31-103 will clarify and frequently simplify their ability to conduct business in Canada.

The Instrument provides exemptions from registration for firms that satisfy the definition of "international adviser" and "international dealer" provided that they comply with certain restrictions on their Canadian activities, including that they deal solely with "permitted clients." Firms that are currently registered in Ontario or Newfoundland and Labrador as an "international dealer" will have their registration automatically converted to the category of "exempt market dealer"[38], although they should consider whether their business model would require them to maintain that registration.

Investment fund managers, including non-Canadian investment fund managers, will only need to be registered in that category in the province from which they actually manage the funds. In other words, non-Canadian firms who offer funds in Canada but manage them from outside Canada will not need registration.[39]

Conclusion

It is very likely that the CSA will receive a significant number of comments on this draft of the Instrument and the Companion Policy and, as indicated above, there is still a significant amount of other work to be done by the CSA (and by provincial legislatures) before NI 31-103 can be implemented. However, since there is likely to be very little substantive change between the current draft of the Instrument and its final form, firms should use this lead time to consider any changes they will need to make to their "system of controls and supervision."

1. For non-Canadian readers who may not be familiar with the Canadian securities regulatory regime, it is important to note that securities regulation is a matter of provincial jurisdiction. The Canadian Securities Administrators is the umbrella association comprising all 13 provincial and territorial securities regulators.
2. The members of the CSA work closely together on a broad range of issues to develop National Instruments and Companion Policies which are applied in all jurisdictions. National Instruments are a form of subordinate legislation and are implemented in each of the provinces and territories in a manner that gives them the force of law; Companion Policies provide guidance with respect to the interpretation and application of National Instruments, but do not, themselves, have the force of law.
3. The Ontario Ministry of Finance has published proposed amendments to the *Securities Act* (Ontario), which can be found at http://www.fin.gov.on.ca/english/consultations/securities/amendments.html
4. NI 31-103, s. 2.9(1)
5. NI 31-103, s. 5.24
6. NI 31-103, s. 2.9(2)
7. NI 31-103, s. 2.10
8. NI 31-103, s. 5.25
9. NI 31-103, s. 5.23
10. Companion Policy, s. 5.9.1
11. Companion Policy, s. 5.9.4
12. NI 31-103, s. 5.15(1)(b)
13. See NI 31-103, s. 5.15(2)(d), (e) and (m).
14. NI 31-103, s. 4.3
15. "Exempt market dealer" is one of the 5 new categories of dealer registration. This category is similar to the "limited market dealer" category that currently exists only in Ontario and Newfoundland and Labrador. Generally, registered exempt market dealers will be permitted to trade only in securities that either were or could have been distributed under an exemption from the prospectus requirement set out in National Instrument 45-106.
16. See NI 31-103, Part 4, Division 2.
17. See, for example, Ontario Securities Commission Rule 31-505, s. 1.5(1)(a)
18. NI 31-103, s. 5.4
19. NI 31-103, s. 3.3(1)(h) and 3.3(2)
20. The IDA's proposal can be found at: http://ida.knotia.ca/Knowledge/View/ViewAttachment.aspx/Board%20Paper%20-%20CRM%20-%202008Apr24%20FINAL%20(en).pdf?kType=445&dBID=200803361&ftID=Board%20Paper%20-%20CRM%20-%202008Apr24%20FINAL%20%28en%29.pdf
21. NI 31-103, s. 5.30
22. NI 31-103, s. 5.29(1)
23. NI 31-103, s. 5.31(1)
24. Companion Policy, s. 5.12.2
25. Companion Policy, s. 5.12.2
26. Companion Policy, s. 5.12.5
27. NI 31-103, s. 5.27(a)
28. See NI 81-107, s. 2.1 and, for example, *Securities Act* (Ontario), s. 116
29. NI 31-103, s. 6.1(1)
30. NI 31-103, s. 6.1(2)
31. Companion Policy, s. 6.4
32. NI 31-103, s. 6.2
33. NI 31-103, s. 6.5 and 6.6
34. NI 31-103, s. 6.7
35. NI 31-103, s. 6.12
36. NI 31-103, s. 6.12(c) and 6.13
37. NI 31-103, s. 6.14
38. NI 31-103, s. 10.1(2)
39. Companion Policy, s. 2.8

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