

2007

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John Howat

Linda Reid

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### Recommended Citation

John Howat and Linda Reid, *Compensation Practices for Retail Sale of Mutual Funds: the Need for Transparency and Disclosure*, 12 Fordham J. Corp. & Fin. L. 685 (2007).

Available at: <https://ir.lawnet.fordham.edu/jcfl/vol12/iss4/2>

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# COMPENSATION PRACTICES FOR RETAIL SALE OF MUTUAL FUNDS:<sup>1</sup> THE NEED FOR TRANSPARENCY AND DISCLOSURE

*John Howat, PhD*  
*Associate Professor of Finance*  
*University of Wisconsin-Whitewater*

*Linda Reid, JD*  
*Assistant Professor of Law,*  
*University of Wisconsin-Whitewater*

## I. INTRODUCTION

Mutual fund firms, also known as investment companies or investment trusts, buy and sell stocks, bonds, and other securities.<sup>2</sup> A fund raises money to make its purchases by selling shares in itself. The fund pools the money of many investors—its shareholders—to invest in the securities.<sup>3</sup> Those securities are professionally managed by fund managers on behalf of the shareholders. After the trading costs and expenses of managing and administering the fund are subtracted, the earnings realized by the fund on its investment portfolio are paid out

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1. Technically, a mutual fund is an open-end management company registered with the Securities and Exchange Commission (“SEC” or “Commission”) under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2005) [hereinafter the Investment Company Act]. An “open-end company” is a management company that issues a redeemable security. 15 U.S.C. § 80a-5(a)(1) (2005).

2. Mutual fund firms are also known as *mutual fund complexes* and *mutual fund companies*. For the purposes of consistency in this paper, we refer to them as *mutual fund firms* or *funds*, and to the persons who manage the funds as *mutual fund managers* or *fund managers*.

3. The term redeemable security is defined in Section 2(a)(32) of the Investment Company Act to mean a security the terms of which entitles the holder, upon presentation “to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent thereof.” 15 U.S.C. § 80a-2(a)(32) (2005).

pro-rata to the fund's shareholders. Shareholders may also realize investment gains by selling (or redeeming) their shares back to the fund at the shares' net asset value (the total value of the fund's assets divided by the number of shares outstanding).

Mutual funds have recently become increasingly popular vehicles for individual investors in the United States. In 1980 there were 564 funds with assets totaling \$134.8 billion.<sup>4</sup> As of the end of December 2005 there were 7,977 funds with combined assets of \$8.905 trillion.<sup>5</sup> Similarly, in 1980, 4.6 million households owned mutual fund shares, representing only 5.7% of all households in the United States.<sup>6</sup> As of 2005, 91 million individuals in 54 million households (nearly half of all households) owned mutual funds.<sup>7</sup> It should be noted that the majority of household investments in mutual funds occur through employee retirement plans.<sup>8</sup> A healthy percentage, however, is purchased by the investors themselves, and of those purchases, more than 80% are made through financial professionals.<sup>9</sup>

Individual investors can purchase mutual fund shares on the retail market in one of two ways, either directly from the fund, or through an intermediary seller. In the first case, investors purchase "direct-marketed funds" via phone, mail, or the internet. In the second instance, the fund's underwriter acts as a wholesaler or distributor to an intermediary firm, (e.g. a brokerage firm, an asset management company, a financial planning firm, an insurance agency, or a bank) which in turn sells to the individual investor via a sales force.<sup>10</sup> Some brokerage firms also sell their own private-label funds.

The typical retail shopper who purchases shares through a financial adviser will be given a fund prospectus. The prospectus includes information regarding the investment objective of the fund, the historical

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4. Investment Company Institute, *2006 Investment Company Fact Book* 71 (46th ed. 2006), available at [http://www.ici.org/stats/mf/2006\\_factbook.pdf](http://www.ici.org/stats/mf/2006_factbook.pdf).

5. *Id.*

6. *Id.* at 47.

7. *Id.*

8. *See id.* at 50.

9. *Id.*

10. For the purpose of consistency in this paper, we refer to these salespersons as *investment advisers*. The term *advisor* is also proper and is used by several professional organizations. In specific instances we use the terms *brokerage firms* and *brokers*. Brokers and other financial advisers will have the NASD Series 6 license, which allows them to sell mutual fund products. Many will also have the NASD Series 7 license, which allows them to sell securities.

investment performance of the fund, and the costs and expenses the shareholder will pay. The compensation received by the financial adviser for recommending or selling the shares is included in the fee table in the prospectus; however, in most cases it is not identified explicitly. Adviser compensation information is required to be presented explicitly in the Statement of Additional Information (SAI). The SAI must also include a description of potential conflicts of interest which the adviser's method of compensation might create. Notable, however, is the fact that the SAI is provided to the potential shareholders only if they specifically request it.

Brokerage firms and the various financial advisers who sell mutual funds to retail purchasers may be compensated in a variety of ways, including (1) loads, or sales charges paid directly by the purchaser; (2) marketing fees, also known as 12b-1<sup>11</sup> fees; and (3) fund servicing and operating expenses.<sup>12</sup> Both 12b-1 and fund expense fees are paid out of the assets of the fund, and thus are ultimately paid by the shareholders. Payments from each of these sources compensate financial advising firms and their personnel for providing a wide range of services, including the administering of shareholder records, processing transactions, training the advisers who sell the funds, and investor education. While fund firms assert that these services provide advisers and investors with valuable benefits, others, including regulators, criticize the lack of transparency in brokerage firm compensation, since it is practically impossible for investors to know precisely if, and how, financial advisers are paid out of fund assets.

Financial adviser compensation is often augmented by enhanced compensation arrangements, such as directed brokerage, soft dollar commissions, revenue sharing, and differential cash compensation, each of which has been the source of criticism in recent years, due to potential conflicts of interest inherent in the practices, and the lack of disclosure of the practices to investors. This paper examines the practices and recommends changes to reduce, if not eliminate, the potential harm to investors inherent in their use.

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11. Rule 12b was promulgated under the Securities Exchange Act of 1934 (codified as amended at 15 U.S.C. §§ 78a-III (2005)) [hereinafter the Securities Exchange Act]. See discussion *infra* Part III.B for a detailed discussion of 12b-1 fees.

12. See generally Susan S. Krawczyk, *Compensation Practices for Retail Sales of Mutual Funds*, 4 J. INVESTMENT COMPLIANCE 27 (2004) (discussing compensation practices in detail).

## II. ENHANCED COMPENSATION PRACTICES

A. Directed Brokerage

In directed brokerage arrangements, mutual funds channel trades to brokers who promise to promote those funds in exchange for commissions on the mutual fund's stock and bond transactions. Put another way, in directed brokerage, a mutual fund typically promises to buy a certain amount of brokerage services from a broker-dealer who in turn agrees to promote that mutual fund to investors. Critics level two charges against directed brokerage: (1) the practice can lead a broker to recommend mutual funds that are not in his client's best interest; and (2) it can lead a fund firm to select a broker based on increasing its sales, rather than on getting the best execution of its trades. That can lead to high trading costs being passed to fund shareholders.

As is discussed in Parts III.B and III.D.3 of this paper, the Securities and Exchange Commission (the "SEC") and the National Association of Securities Dealers, Inc. (the "NASD") banned the practice of directed brokerage in 2004, because of its potential for creating conflicts of interest by generating incentives for fund managers to direct fund transactions to firms who were encouraging sales of their funds, rather than to the firms that could provide the best execution or price on fund transactions.

B. Soft Dollar Practices

The SEC is currently examining the practice of soft dollar commissions. Soft dollars refer to an arrangement whereby fund managers direct fund trades through a particular brokerage firm in exchange for brokerage services, including investment research. Fund managers typically use soft dollar payments to pay for investment research because, by doing so, they are able to hide the costs of research in brokerage commissions, when those costs would ordinarily be paid out of fund assets. Transaction costs, including soft dollar commissions, are not included in a fund's expense ratio, because accounting principles dictate that they be included as part of the cost basis of securities purchased or subtracted from the net proceeds of securities sold.

For example, suppose Fund A pays for research by adding to its management fee, which is disclosed in the prospectus fee table. Fund B pays for the same research with soft dollars, commissions paid to the

brokerage firm providing the research. Those costs do not appear in the fee table. Instead, those costs are part of the fund's transactions costs, which are typically disclosed in the Statement of Additional Information ("SAI"). Thus, to most investors, Fund B appears to have a lower expense ratio than Fund A. In reality, the costs charged by the fund and paid by the investor are the same.

Supporters of the practice maintain that soft dollar payments benefit shareholders by giving small fund advisers access to valuable research, thereby enhancing the competitiveness and price efficiency of small mutual funds. Opponents criticize the lack of transparency and oversight in soft dollar arrangements. They also argue that soft dollar compensation can create conflicts of interest for fund managers, because the fund managers may be motivated to select brokers based on their research services rather than on the speed or price of trade execution for fund transactions.

There currently exists a safe harbor rule that allows fund managers to use client funds to purchase "brokerage and research services" for their managed accounts under certain circumstances without breaching their fiduciary duties to clients.<sup>13</sup> Under Section 28(e) of the Securities Exchange Act of 1934 as amended, mutual fund firms may pay higher than normally allowed commissions if the fund firm deems the higher commission is in the best interest of the fund.<sup>14</sup> If it participates in soft dollar practices outside the safe harbor, however, it may be subject to liability for breach of fiduciary duty to clients.

Critics of soft dollar practices have advocated repealing Section 28(e), or outlawing soft-dollar transactions altogether. Others have called for greater oversight and stricter definitions of what can and cannot be bought with soft dollars. As discussed in Part III.D.4 of this paper, the SEC has recently issued a release containing interpretative guidance as to which soft dollar practices are within the scope of the safe harbor established by Section 28(e).

### *C. Revenue Sharing and Shelf-Space Practices*

Most, if not all, mutual funds make payments to brokerage firms that sell the funds' shares. As the SEC defines it, revenue sharing

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13. See Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).

14. See *id.*

occurs when a fund manager agrees to pay a brokerage firm cash compensation not otherwise disclosed in the prospectus fee table to promote the mutual fund to the broker's clients. This type of payment creates a clear conflict of interest by introducing a new factor for an investment adviser to consider—his or her company's own financial profit—when deciding which mutual funds to recommend to an investor. These payments are often referred to as buying “shelf space” at the broker-dealer firm. In some cases, the fund manager may describe those payments as reimbursing the brokerage firm for expenses it incurs in selling the shares. The payments, regardless of whether they are labeled reimbursements or otherwise, may give the brokerage firm a greater incentive to sell the shares of that fund or an affiliate, rather than the shares of funds that don't make such payments.

The SEC is reviewing the disclosure of these so-called revenue-sharing deals. Regulators are looking particularly closely at revenue sharing and shelf space arrangements because of the financial incentives they may create for brokers to recommend one fund over another.<sup>15</sup> While brokers argue that spotlighting a particular fund is no guarantee of sales, others say that compensating brokers for promoting a fund may not be in the best interest of the firms' clients.<sup>16</sup>

#### D. Differential Cash Compensation

Differential cash compensation is the practice of paying sales representatives higher cash compensation for sales of proprietary and “partnered funds.” Proprietary funds are those offered by the sales representative's employer (e.g. brokerage firm or insurance company). Partnered funds are those offered by firms that have an agreement with the sales representative's employer to promote those funds in exchange for cash payments. According to Financial Research Corporation estimates, in 2003 the fifty largest fund companies in the United States paid securities firms roughly \$1.5 billion annually to distribute their funds.<sup>17</sup>

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15. *See generally* CONFIRMATION REQUIREMENTS AND POINT OF SALE DISCLOSURE REQUIREMENTS FOR TRANSACTIONS IN CERTAIN MUTUAL FUNDS AND OTHER SECURITIES, AND OTHER CONFIRMATION REQUIREMENT AMENDMENTS, AND AMENDMENTS TO THE REGISTRATION FORM FOR MUTUAL FUNDS, 69 Fed. Reg. 6438-01, 6451 (Feb. 10, 2004).

16. *Id.*

17. Deloitte Development, *2005 Global Securities Industry Outlook: 2005 Top 10*

Differential cash compensation is currently not prohibited under applicable rules and regulations, but critics charge that, like other types of enhanced compensation arrangements, they create a potential conflict of interest when a securities firm recommends mutual funds and the commission relationship is not adequately disclosed to investors. Even if there is adequate disclosure, the potential conflict of interest remains, and investors must be aware of that.

### III. THE EVOLUTION OF COMPENSATION PRACTICES

Compensation practices for mutual funds have evolved over time. Prior to 1980, compensation to the sellers of fund shares was primarily accomplished through front-end load charges. By the late 1990s, compensation arrangements generally entailed several methods, and the investor usually had a choice in the methods applied. The key change was the approval of 12b-1 plans, which allow for the payment of marketing and distribution expenses from fund assets. These plans allow for both different share classes within a particular fund, and the practice of revenue sharing.

#### *A. A Brief History of Mutual Funds and National Association of Securities Dealers, Inc.*

The first pooled funds were introduced in the United States in the 1890s.<sup>18</sup> In 1924, the Massachusetts Investors Trust became the first open-end mutual fund.<sup>19</sup> Shortly thereafter, in response to the 1929 stock market crash, Congress passed the Securities Act of 1933<sup>20</sup> and the Securities Exchange Act of 1934.<sup>21</sup> The 1933 and 1934 acts require, among other things, that investment funds be registered with the Securities and Exchange Commission and that prospective fund investors be provided with a prospectus. In 1934, Congress also passed

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*Issues*, at 5, available at [http://www.deloitte.com/dtt/cda/doc/content/dtt\\_financial\\_services\\_topten2005-securities\\_013105\(3\).pdf](http://www.deloitte.com/dtt/cda/doc/content/dtt_financial_services_topten2005-securities_013105(3).pdf) (last visited Mar. 23, 2007).

18. K. Geert Rouwenhorst, *The Origins of Mutual Funds* 17 (Yale Sch. of Mgmt., Int'l Center for Fin., Working Paper No. 04-48, 2004), available at <http://ssrn.com/abstract=636146> (last visited Mar. 23, 2007).

19. *Id.*

20. 15 U.S.C. §§ 77a-aa (2005).

21. 15 U.S.C. §§ 78a-III (2005).

the National Industrial Recovery Act (the “NIRA”).<sup>22</sup> The act called for industrial self-regulation and declared that codes of fair competition—for the protection of consumers, competitors, and employers—were to be drafted for the various industries of the country.<sup>23</sup> In 1935, the U.S. Supreme Court invalidated the compulsory-code system, ruling that the NIRA improperly delegated legislative powers to the executive and that the provisions of the poultry code at issue in the case did not constitute a regulation of interstate commerce.<sup>24</sup>

The the NASD grew out of the Investment Bankers Code Committee (the “IBCC”) formed by the investment banking business under the NIRA.<sup>25</sup> When the NIRA was declared unconstitutional, the IBCC was continued on a voluntary basis, becoming the Investment Bankers Conference Committee, its function to be one of discussion and conference with federal agencies looking toward the establishment of an organization to preserve and formalize the values of the code.<sup>26</sup> A successor organization known as the Investment Bankers Conference, Inc. (the “IBC”) was established to proceed more formally towards the objective of a legal entity empowered to administer rules promoting “high standards of commercial honor.”<sup>27</sup> An important objective of the IBC was the development of a plan of self-regulation for over-the-counter markets.<sup>28</sup> By November of 1937, the SEC and an IBC governing committee prepared the draft of legislation to accomplish the self-regulatory objective.<sup>29</sup> The bill, known as the Maloney Act, was signed into law in 1938.<sup>30</sup> The NASD, the successor to the IBC, was registered by the SEC as a national securities association under section 15A of the 1934 Securities Exchange Act.<sup>31</sup>

The NASD is currently the world’s leading private-sector provider of financial regulatory services. Under U.S. law, every securities firm

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22. Ch. 90, 48 Stat. 195 (1933).

23. *Id.*

24. *Schechter Poultry Corp. v. United States*, 295 U.S. 495, 550 (1935).

25. Fulton, Wallace H., *The Origin of the NASD, 1933-1939: The OTC Market’s Venture Into Self-Regulation*, at <http://www.people.hbs.edu/aperold/resource/ISR/Teaching%20Note/AKS%20-%20History%20of%20the%20NASD.doc> (last visited Mar. 23, 2007).

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. Fulton, *supra* note 25, at 1.

doing business with the American public must register with NASD.<sup>32</sup> The NASD registers securities firms, writes rules to govern their behavior, examines them for compliance and, when necessary, brings enforcement actions against those who break those rules. Approximately 5,100 brokerage firms and more than 660,000 stockbrokers and registered representatives currently fall under the jurisdiction of the NASD.<sup>33</sup>

### B. The Evolution of Rule 12b-1

In 1940, Congress enacted the Investment Company Act of 1940 (the "1940 Act"),<sup>34</sup> which is the principal statute under which the mutual fund industry is regulated today. The 1940 Act seeks to prevent abuses through mandating disclosure regarding an investment company's structure, operations, financial condition and policies when shares of the investment company are initially offered to the public and, thereafter, on a regular periodic basis.<sup>35</sup> Investment companies typically register their securities with the SEC under the 1933 Act and their companies under the 1940 Act.<sup>36</sup> Investment advisers use Form ADV to register as an investment adviser with the SEC.

The provisions in the 1940 Act govern, among other things, transactions between the investment company and its affiliates (e.g., investment advisers to the investment company), purchases and sales of investment company shares and the responsibilities of the investment company's directors or trustees.<sup>37</sup>

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32. NASD Rules and Regulations, *available at* <http://www.nasd.com/RulesRegulation/index.htm?ssSourceNodeId=9> (last visited Mar. 27, 2007).

33. About NASD, *available at* <http://www.nasd.com/AboutNASD/index.htm> (last visited Mar. 16, 2007).

34. *See* 15 U.S.C. §§ 80a-1 to -64 (2005).

35. NASD website, *available at* [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&nodeId=608](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=608)

36. Investment advisers use Form ADV to register with the SEC. Generally, an investment adviser that manages \$25 million or more in client assets must register with the SEC. Advisers that manage less than \$25 million must register with the state securities regulator where the adviser's principal place of business is located. Form ADV also is used for state registration. Form ADV has two parts. Part I contains information about the adviser's education, business and an adviser's disciplinary history within the last ten years. Part II includes information on an adviser's services, fees and investment strategies.

37. *See* NASD website, *supra* note 35.

The 1940 Act bans the use of fund assets to pay for the distribution of a fund's shares.<sup>38</sup> However, in the late 1970s, mutual funds experienced a significant and steady outflow of cash from redemptions of shares.<sup>39</sup> This left the remaining shareholders to pay the fixed costs of the funds as the costs were spread over fewer shareholders.

The fund industry lobbied for the use of fund assets to pay for distribution costs and persuaded the SEC to pass Rule 12b-1<sup>40</sup> in October 1980. The rule permits funds to pay the costs of marketing and distribution of fund shares as long as they are properly disclosed and regulated. The annual fee is included in the fund's reported expense ratio. Since 1980, the total of these fees has grown from a few million to over \$10 billion in 2004.<sup>41</sup> This is due in part to the rapid growth of mutual fund assets, but is also due to the significant drop in front-end loads, both in terms of size (the typical load has dropped from 8% in 1980 to 5% today) and in terms of the percentage of funds which charge a front-end load.<sup>42</sup>

Although it was initially meant as a short-term solution to the high level of net redemptions in the 1970s, Rule 12b-1 is largely responsible for the class system of funds used today. A fund will often have various classes of shares that differ in their commission structures.<sup>43</sup> For example, one class might have a high initial sales commission and a small (usually .25%) annual fee paid for by a 12b-1 plan, while another class might have a small initial sales commission and a large (perhaps 1.0%) annual 12b-1 fee. The expense ratio of a fund typically includes three components: an advisory fee, administrative fee (such as legal and accounting costs) and 12b-1 fees. For multiple class shares, the advisory fee is always the same across classes. Administrative fees and 12b-1 fees can vary across classes although the administrative fee is often the same.

The selection of share class by an investor typically depends on the

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38. *Id.*

39. Lori Walsh, U.S. Securities and Exchange Commission, *The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Return*, at 6, available at <http://ftp.sec.gov/rules/proposed/s70904/lwalsh042604.pdf>. (last visited Mar. 19, 2007).

40. 17 C.F.R. § 270.12b-1 (2005).

41. INV. CO. INST., *How Mutual Funds Use 12b-1 Fees, Fundamentals: Investment Company Institute Research in Brief*, Vol. 14, No. 2, p. 2 (2005), available at <http://www.ici.org/statements/fundamentals/fm-v14n2.pdf>.

42. *Supra* note 4, at 4.

43. *Supra* note 39, at 5.

expected holding period. An investor with a short expected holding period might find it beneficial to buy shares with no up-front fee but high annual fees. A long-term investor does better with shares that have a large initial fee but small annual fees.

There are two important differences between load fees and 12b-1 fees besides the obvious one-time fee versus annual fee. First, they differ in the level of transparency. The load charge is clearly stated in the confirmation statement that the investor receives from the fund or the broker who sold the shares. On the other hand, the investor is never explicitly told the amount of the 12b-1 fees—it is neatly buried in the expense ratio. Second, loads are a fixed amount charged at the account level, and each investor pays only for his or her costs. 12b-1 fees are charged at the fund level, and investors may pay for other investors' costs. The aggregate amount that investors pay increases as their holding period increases and as the asset level rises. Because the fees are deducted at the fund level, some investors subsidize the costs of other investors. For example, small accounts typically cost more, as a percent of the account size, than large accounts; and yet both investors pay the same percent.

There is also a crucial difference between brokerage commissions and both load fees and 12b-1 fees in terms of transparency. Commissions are not even disclosed in the expense ratio. When the fund purchases a security the commission is added to the cost basis of the asset, and when a security is sold the commission is deducted from the proceeds of the sale. Assuming a security is bought and sold for a gain, the profit for shareholders is the net profit after deducting the commissions on both the purchase and the sale. The total of all commissions is disclosed as a lump sum (usually labeled as transactions costs) in the SAI which is typically delivered to a shareholder only if requested. Thus, directed brokerage payments and soft dollar commissions are quite unlikely to be uncovered by the vast majority of shareholders.

A recent survey by the Investment Company Institute (the "ICI") showed that funds use most of the 12b-1 fees to compensate financial advisers for assisting fund investors before and after they purchase fund shares.<sup>44</sup> Only a small fraction of the fees are used for advertising and promotion.<sup>45</sup> Thus, the primary use of revenues raised through 12b-1

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44. *Supra* note 41, at 1.

45. *Id.*

fees is to create incentives for advisers to distribute the fund shares, making advisers the main beneficiaries of 12b-1 plans.

On August 14, 2004, the SEC adopted amendments to Rule 12b prohibiting the use of fund brokerage to compensate broker-dealers for selling fund shares.<sup>46</sup> New Rule 12b-1(h)(2) permits a fund to use brokers selling its shares to execute transactions in its portfolio securities only if the fund or its adviser has implemented policies and procedures designed to ensure that the selection of selling brokers for portfolio securities transactions is not influenced by considerations about the sale of fund shares.<sup>47</sup> The rule and correlating NASD Rule 2830(k) are discussed in further detail in Part III.D.3 of this paper.

### C. Congressional Initiatives

The poor performance of mutual funds in the early 2000s, partially as a result of the collapse of the technology bubble and the slowdown in the world economy, led to intense scrutiny of the mutual fund industry by many, including Congress.<sup>48</sup> Criticism focused, in part, on the transparency of fund fees and costs, and specifically the practices of directed brokerage, revenue sharing and soft dollars.<sup>49</sup>

In early 2003, the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises held hearings on mutual fund practices, including mutual fund fee and cost disclosure issues, sales practices and governance. On June 11, 2003, Representative Richard H. Baker and twenty-three co-sponsors introduced H.R. 2420 (the "Mutual Fund Integrity and Fee Transparency Act of 2003").<sup>50</sup> Among other things, H.R. 2420 required the SEC to require disclosure of a number of items and required the adviser to submit an annual report to the fund directors on revenue sharing, directed brokerage and soft

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46. SEC Prohibition on the Use of Brokerage Commissions to Finance Distribution, 17 C.F.R. § 270 (2004), available at <http://www.sec.gov/rules/final/ic-26591.htm>.

47. *Id.*

48. See Thomas R. Smith, Jr., Sidley Austin Brown and Wood, *Mutual Funds Under Fire: Developments Since January 1, 2003* (Jul. 1, 2005), at 1, available at <http://www.sidley.com/db30/cgi-bin/pubs/TRS%20Chronology%20-%20VERSION%2012%20070105.pdf>.

49. *Id.*

50. Thomas R. Smith, Jr., *Mutual Funds Under Fire: Reform Initiatives*, 7 J. OF INV. COMPLIANCE 4 (2006).

dollars.<sup>51</sup> It imposed a fiduciary duty on the fund directors to supervise the arrangements.<sup>52</sup> H.R. 2420 also required brokers to disclose information about differential compensation and conflicts of interest associated with the broker's sale of a particular fund, along with information about commissions that may be charged based on the class of shares the investor has purchased.<sup>53</sup>

By mid-summer, however, efforts to pass H.R. 2420 had stalled.<sup>54</sup> The bill died for a lack of support in the House and the inability to even find a sponsor in the Senate. Instead, the House Subcommittee directed its efforts to having the SEC deal with the matters addressed by H.R. 2420 through rulemaking.<sup>55</sup>

Following market timing, late trading scandals, and subsequent prosecutions by New York Attorney General Eliot Spitzer, Congress renewed its efforts at mutual fund reform. The House passed a beefed up version of H.R. 2420 on November 19, 2003 by a vote of 418-2.<sup>56</sup> Among other things, H.R. 2420 contained additional detailed provisions regarding the disclosure of mutual fund fees, obligations regarding distribution and soft dollar arrangements.

The following bills were introduced in the Senate in the 108<sup>th</sup> Congress:

- S.1882, the "Mutual Fund Transparency Act of 2003" introduced on November 5, 2003 by Senator Daniel K. Akaka (D-HI);<sup>57</sup>
- S.1971, the "Mutual Fund Investor Confidence Restoration Act," introduced on November 25, 2003 by Senators Jon Corzine (D-NJ) and Christopher Dodd (D-CT);<sup>58</sup>
- S.1958, the "Mutual Fund Investors Protection Act," introduced on November 29, 2003 by Senators John Kerry (D-MA) and Edward Kennedy (D-MA);<sup>59</sup>

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51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. *Supra* note 50.

57. S. 1822, 108th Cong., 2003, available at <http://thomas.loc.gov/cgi-bin/query/z?c108:S.1822>.

58. S. 1971, 108th Cong., 2003, available at <http://thomas.loc.gov/cgi-bin/query/z?c108:S.1971>.

59. S. 1958, 108th Cong., 2003, available at <http://thomas.loc.gov/cgi-bin/query/z?c108:S.1958.IS>.

- S.2509, the “Mutual Fund Reform Act of 2004,” introduced on February 10, 2004 by Senators Peter Fitzgerald (R-IL), Carl Levin (D-MI) and Susan Collins (R-ME).<sup>60</sup>
- S.2497, the “Small Investor Protection Act of 2004,” introduced on June 3, 2004 by Senator Joe Lieberman (D-CT).<sup>61</sup>

Each of the bills contained provisions to reform mutual fund sales practices by eliminating certain types of compensation arrangements, including 12b-1 fees, soft dollars, directed brokerage, and revenue sharing arrangements. None of the bills made it out of committee.

On May 16, 2005 Senator Daniel Akaka (D-HA) introduced S.1037, the “Mutual Fund Transparency Act of 2005,” in the 109<sup>th</sup> Congress.<sup>62</sup> Among other things, the proposed bill requires broker point-of-sale disclosure regarding revenue sharing and differential cash compensation.<sup>63</sup>

#### D. Recent SEC and NASD Reforms

A wide range of mutual fund reform initiatives have also been undertaken by the NASD and SEC in the past few years, certain of which specifically address mutual fund enhanced compensation arrangements. These initiatives have resulted in significant changes in the way in which mutual funds, fund directors, and investment advisers do business.

#### I. Code of Ethics

On May 26, 2004, the SEC adopted a rule requiring registered investment advisers to establish, maintain, and enforce a written code of ethics.<sup>64</sup> Specifically, Rule 204A-1 requires that the code of ethics contain, at a minimum, a standard of business conduct that the adviser

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60. S. 2059, 108th Cong., 2003, available at <http://thomas.loc.gov/cgi-bin/query/z?c108:S.2059>.

61. S. 2497, 108th Cong. (2003), available at <http://thomas.loc.gov/cgi-bin/query/z?c108:S.2497>.

62. S. 1037, 109th Cong. (2003), available at <http://thomas.loc.gov/cgi-bin/query/z?c109:S.1037.IS>.

63. *Id.*

64. SEC Investment Adviser Code of Ethics, 17 C.F.R. §§ 270, 275, 279 (IA-2256) (2004), available at <http://www.sec.gov/rules/final/ia-2256.htm>.

requires of its “supervised persons” as defined in Section 202(a)(25) of the Investment Advisers Act of 1940.<sup>65</sup> The standard must reflect the fiduciary obligations of the investment adviser and supervised persons.

Although it might have gone without saying, the rule also specifically requires that supervised persons comply with applicable federal securities laws such as the Securities Act of 1933,<sup>66</sup> the Securities Exchange Act of 1934,<sup>67</sup> the Sarbanes-Oxley Act of 2002,<sup>68</sup> the Investment Company Act of 1940,<sup>69</sup> the Advisers Act,<sup>70</sup> Title V of the Gramm-Leach-Bliley Act,<sup>71</sup> and the Bank Secrecy Act.<sup>72</sup> Amendments to SEC Rule 204-2(a) also require SEC-registered investment advisers to retain as “required records” code of ethics violations and their disposition; records concerning personal securities transactions by certain advisory personnel; and evidence in the form of an acknowledgement that supervised persons received a copy of the code of ethics.<sup>73</sup>

As part of its adoption of new Rule 204A-1, the SEC also made an amendment to Form ADV, the form advisers use to register with the SEC.<sup>74</sup> The change requires investment advisers to describe their code of ethics on Schedule F of their registrations.<sup>75</sup> It also requires investment advisers to indicate that they will provide a copy to any client or prospective client upon request.<sup>76</sup>

## 2. Disclosure Requirements

On August 18, 2004, the SEC finalized new disclosure requirements for mutual funds.<sup>77</sup> The requirements became effective for

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65. 15 U.S.C. § 80b (2004).

66. 15 U.S.C. § 77a-aa (2005).

67. 15 U.S.C. § 78a-mm (2005).

68. Pub. L. 107-204, 116 Stat. 745 (2002).

69. 15 U.S.C. § 80a (2005).

70. 15 U.S.C. § 80b (2004).

71. Pub. L. No. 106-102, 113 Stat. 1338 (1999).

72. 31 U.S.C. §§ 5311-14; 5316-32 (2001).

73. See generally Investment Advisor Code of Ethics, *supra* note 64.

74. CONNECTICUT BANKING COMMISSION, *Investment Advisory Codes of Ethics* (Feb. 2005) available at [http://www.ct.gov/dob/cwp/view.asp?a=2252&dobNAV\\_GID=162&q=299220](http://www.ct.gov/dob/cwp/view.asp?a=2252&dobNAV_GID=162&q=299220).

75. *Id.*

76. *Id.*

77. SEC Disclosure Regarding Portfolio Managers of Registered Management

mutual fund registration filings after February 28, 2005.<sup>78</sup> The rules are designed to achieve increased information about fund portfolio managers, including their identity, incentives, potential conflicts of interest, other accounts they manage, compensation structure and ownership of securities in accounts they manage. Among others, the following disclosures are required:<sup>79</sup>

- A mutual fund must identify in its prospectus each individual who is a “portfolio manager.”
- A mutual fund must provide information in its SAI regarding other accounts managed by any of its portfolio managers, including a description of any material conflicts of interest that may arise in connection with simultaneously managing the portfolio and other accounts.
- A mutual fund must disclose in its SAI the structure of, and the method used to determine, the compensation of each portfolio manager.
- A mutual fund must disclose each portfolio manager’s ownership of securities in the fund. This disclosure is also to be made in the SAI.<sup>80</sup>

### 3. Directed Brokerage

Also on August 18, 2004, the SEC amended Rule 12b-1 to prohibit the practice of directed brokerage, a practice the Commission stated “poses significant conflicts of interests and may be harmful to funds and fund shareholders.”<sup>81</sup> Rule 12b-1(h)(1) prohibits funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker.<sup>82</sup> The prohibition applies both to directing transactions to selling brokers, and to indirectly compensating selling brokers by participation in “step-out” and related

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Investment Companies, 69 Fed. Reg. 33-8458 (Aug. 27, 2004) available at <http://www.sec.gov/rules/final/33-8458.pdf>.

78. *Id.*

79. *Id.*

80. *Id.*

81. See 17 C.F.R. § 240 (2004).

82. *Id.* at § 270.12b-1(h)(1). The rule prohibits funds from financing distribution of fund shares through the direction of any service related to effecting a fund brokerage transaction, including performing or arranging for the performance of any function related to processing a brokerage transaction. The prohibition reaches transactions executed by government securities dealers and municipal securities dealers.

arrangements whereby the selling broker receives a portion of the commission.<sup>83</sup> “The ban extends to any payment, including any commission, mark-up, mark-down, or other fee (or portion of another fee) received or to be received from the fund’s portfolio transactions effected through any broker or dealer.”<sup>84</sup>

From the broker-dealer’s perspective, directed brokerage activities are subject to NASD Rule 2830(k).<sup>85</sup> Effective February 14, 2005, Rule 2830(k) was amended to prohibit the practice.<sup>86</sup> Prior to amendment, Rule 2830(k) prohibited NASD members from favoring the sale of shares of any investment company on the basis of brokerage commissions received or expected to be received from any source, including the investment company.<sup>87</sup> However, subparagraph (7)(B) of the rule allowed an NASD member, subject to the requirements of best execution, to sell the shares of, or act as an underwriter for, an investment company where that investment company “follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker/dealers to execute portfolio transactions . . . .”<sup>88</sup>

The NASD proposed to strike subparagraph (k)(7)(B) and add a new subparagraph, designated (k)(2), which will prohibit NASD members from selling the shares of, or acting as underwriter for, any investment company:

[I]f the member knows or has reason to know that such investment company, or an investment adviser or principal underwriter of the company, has a written or oral agreement or understanding under which the company directs or is expected to direct portfolio securities transactions (or any commission, markup or other remuneration resulting from any such transaction) to a broker or a dealer in consideration for the promotion or sale of shares issued by the company or any other registered investment company.<sup>89</sup>

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83. *Id.* at § 270.12b-1(h)(1)(ii). The prohibition also extends to circumstances in which two funds cooperate to direct brokerage commissions to the selling broker of the other fund. *See* Section 48 under the Investment Company Act (making it unlawful for a person to do indirectly what the person could not do directly).

84. *See* 69 Fed. Reg. 33-8458.

85. NASD, R. 2830(k).

86. *See* Smith, *supra* note 50.

87. *Id.*

88. NASD, R. 2830(k)(7)(B).

89. Self-Regulatory Organizations; Notice of Filing of Proposed R. Change by

The NASD noted in its description of the proposed rule change that proposed new subparagraph (k)(2) “would add an objective proscription, in that the broker-dealer’s intent to favor or disfavor a particular fund would not be relevant to that prohibition.”<sup>90</sup> In approving the amendment in December of 2004, the SEC noted that “[o]ne important purpose of Rule 2830(k) is to help eliminate conflicts of interest in the sale of investment company securities, and the proposed rule change will improve NASD’s ability to achieve this objective.”<sup>91</sup>

The SEC, NASD, and certain states have actively brought enforcement proceedings against firms engaged in directed brokerage activities. In 2005, the NASD set records for the number of new enforcement actions brought and the amount of fines collected for violation of the directed brokerage rules.<sup>92</sup> That year, the NASD settled twenty-seven cases against retail firms for providing preferential treatment to select mutual funds in exchange for brokerage business, in violation of its Anti-Reciprocal Rule. In total, the firms paid nearly \$55 million in fines.<sup>93</sup>

#### 4. Soft Dollar Practices

As discussed in Part II.B. below, Section 28(e) of the 1934 Act provides a “safe harbor” allowing fund managers to use client funds to purchase “brokerage and research services” for their managed accounts under certain circumstances. On July 18, 2006, the SEC published final interpretive guidance (“The Release”) regarding the use of “soft dollars.”<sup>94</sup> The Release clarifies the circumstances under which fund managers may use client commissions to pay for brokerage and research

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Nat’l Ass’n of Securities Dealers, Inc. Relating to Investment Company Portfolio Transactions, 69 Fed. Reg. 64609 (proposed Sept. 17, 2004).

90. *Id.* at 64611 n.5.

91. *Id.* at 64611.

92. News Release, NASD, *NASD: 2005 in Review* (Dec. 27, 2005), available at [http://www.nasd.com/PressRoom/NewsReleases/2005NewsReleases/NASDW\\_015794](http://www.nasd.com/PressRoom/NewsReleases/2005NewsReleases/NASDW_015794).

93. *Id.*

94. Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, 17 C.F.R. § 241 (2006), Exchange Act Release No. 34-54165, File No. S7-13-06 (July 24, 2006), available at <http://www.sec.gov/R.s/interp/2006/34-54165.pdf>. The Release affirms most of the positions taken by the Commission in the proposed release issued in October 2005 (the Proposed Release) and is intended to replace Sections II and III of the Commission’s 1986 interpretive release (the 1986 Release) but is not intended to replace any other section of the 1986 Release.

services under the soft dollars safe harbor and specifically addresses four issues: (1) when do “brokerage or research services” fall within the safe harbor, (2) what constitutes “eligible research,” (3) what constitutes “eligible brokerage services” and (4) what is the appropriate treatment for “mixed-use” items.<sup>95</sup> The Release sets forth a three-part test to determine whether brokerage and research services fall within the safe harbor. They must: (1) acquire “eligible” research products and brokerage services, (2) use those products and services lawfully and appropriately and (3) make a good-faith determination that the commissions they are paying are reasonable in light of the value of the products and services they are receiving.<sup>96</sup>

Significantly, the Release denotes a departure with respect to equipment, such as computer hardware, now considered outside the safe harbor, even if used in connection with research.<sup>97</sup> It also definitively excludes “mass-marketed publications” from safe harbor eligibility.<sup>98</sup> Additionally, the SEC has articulated an interpretative standard under which products and services not clearly constituting research are eligible for the safe harbor if they “reflect the expression of reasoning or knowledge relating to” the components of the definition of research in Section 28(e)(3).<sup>99</sup>

#### IV. CODES OF ETHICS AND OTHER STANDARDS GOVERNING SELLERS OF MUTUAL FUNDS

In addition to being governed by SEC and NASD regulations, many financial advisers, whether broker-dealers, financial planners, insurance agents, or bank representatives, are members of professional organizations and subscribe to a particular code of ethics. Typically, these codes have disclosure and conflict of interest provisions, many of which are relevant to the retail sale of mutual funds. Financial advisers, thus, are subject to scrutiny from several quarters. It is hoped that if dubious practices are employed by any type of financial adviser, and reported, at least one of the institutions having oversight will recognize the inappropriate nature of the practice and take action to stop it. Given the recent mutual fund scandals and number of prosecutions for

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95. *Id.* at 21.

96. *Id.* at 26.

97. *Id.* at 6.

98. *Id.*

99. *Id.*

violations of mutual fund rules, the effectiveness of self-policing by these institutions has been called into question of late.<sup>100</sup>

A. Certified Financial Planners

Certified Financial Planners (“CFPs”) operate under the *Code of Ethics and Professional Responsibility and Financial Planning Practice Standards* adopted by Certified Financial Planner Board of Standards, Inc. (the “CFP Board”). According to the CFP Board, all persons whom it has recognized and certified to use the CFP designation are obligated “not only to comply with the mandates and requirements of all applicable laws and regulations but also to take responsibility to act in an ethical and professionally responsible manner in all professional services and activities.”<sup>101</sup>

The CFP Code of Ethics consists of two parts: Part I consists of the Principles and Part II the Rules.<sup>102</sup> The Principles are “statements expressing in general terms the ethical and professional ideals that CFP Board designees are expected to display in their professional activities.”<sup>103</sup> The seven articulated principles are: (1) Integrity, (2) Objectivity, (3) Competence, (4) Fairness, (5) Confidentiality, (6) Professionalism, and (7) Diligence.<sup>104</sup> The CFP Board describes the Principles as “aspirational in character,” but “intended to provide a source of guidance” for CFPs, and comments follow each Principle and further explain the meaning of the Principle.<sup>105</sup> The Principles are

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100. Beginning in 2003, many of the biggest fund companies, including Janus Capital Group Inc. and Invesco Funds Group Inc., were charged by regulators with allowing some investors to make unorthodox trades that hurt the funds’ long-term shareholders. At the same time, Wall Street firms were charged with withholding commission discounts from mutual-fund investors who had been eligible for the discounts. See Eleanor Laise, *How to Check Up on Your Mutual Fund—New Web Tools Help Investors Take Advantage of Flood of Data Now Required by Regulators*, WALL ST. J., Dec. 14, 2005, at D1 (discussing the ability of consumers to monitor mutual fund institutions).

101. Certified Fin. Planner Bd. of Standards, *Code of Ethics and Professional Responsibility*, available at <http://www.cfp.net/learn/ethics.asp> (last visited Mar. 23, 2007).

102. *Id.*

103. *Id.*

104. Certified Fin. Planner Bd. of Standards, *Code of Ethics and Professional Responsibility: Principles*, available at <http://www.cfp.net/learn/ethicsPrinc.s.asp> (last visited Mar. 23, 2007).

105. See *Code of Ethics and Professional Responsibility*, *supra* note 101.

accompanied by rules that “describe the standards of ethical and professionally responsible conduct expected of [CFPs] in particular situations.”<sup>106</sup>

For example, Principle 1—“Integrity”—states: “A CFP Board designee shall offer and provide professional services with integrity.”<sup>107</sup> The comments to the principle maintain, *inter alia*, that “[i]ntegrity demands honesty and candor which must not be subordinated to personal gain and advantage.”<sup>108</sup> Coordinating Rule 102 requires that, “[i]n the course of professional activities, a CFP Board designee shall not engage in conduct involving dishonesty, fraud, deceit or misrepresentation, or knowingly make a false or misleading statement to a client, employer, employee, professional colleague, governmental or other regulatory body or official, or any other person or entity.”<sup>109</sup>

Principle 4—“Fairness”—and the accompanying Rules are especially relevant to the retail sale of mutual funds and the potential conflicts of interest herein addressed. It requires that CFPs perform their professional services “in a manner that is fair and reasonable to clients, principals, partners and employers, and shall disclose conflict(s) of interest in providing such services.”<sup>110</sup> The comments state:

Fairness requires impartiality, intellectual honesty and disclosure of conflict(s) of interest. It involves a subordination of one’s own feelings, prejudices and desires so as to achieve a proper balance of conflicting interests. Fairness is treating others in the same fashion that you would want to be treated and is an essential trait of any professional.<sup>111</sup>

Rule 402 requires a CFP in a “financial planning engagement [to make] timely written disclosure of all material information relative to the professional relationship.”<sup>112</sup> Further, “in all circumstances and prior to the engagement,” the CFP must disclose in writing conflict(s) of

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106. *Id.*

107. *Supra* note 104.

108. *Id.*

109. Certified Fin. Planner Bd. of Standards, *Code of Ethics and Responsibility: Rules*, <http://www.cfp.net/learn/ethicsR.s.asp> (visited last Mar. 23, 2007).

110. *See Code of Ethics and Professional Responsibility: Principles*, *supra* note 104, at 4.

111. *Id.*

112. *Code of Ethics and Responsibility: Rules*, *supra* note 109, at R. 402.

interest and sources of compensation.<sup>113</sup> The CFP must also “inform the client or prospective client of his/her right to ask at any time for information about the compensation of the [CFP].”<sup>114</sup>

There exists a safe harbor provision for CFPs who provide clients or prospective clients with certain written disclosures using SEC Form ADV or similar disclosure documents. The form must include:

- A statement that in reasonable detail discloses (as applicable) conflict(s) of interest and source(s) of, and any contingencies or other aspects material to, the CFP Board designee’s compensation;
- A statement describing material agency or employment relationships a CFP Board designee (or firm) has with third parties and the nature of compensation resulting from such relationships; and
- A statement informing the client or prospective client of his/her right to ask at any time for information about the compensation of the CFP Board designee.<sup>115</sup>

Rule 403 of the CFP Code of Ethics states that “[u]pon request by a client or prospective client, the [CFP] in a financial planning engagement shall communicate in reasonable detail the requested compensation information related to the financial planning engagement, including compensation derived from implementation.”<sup>116</sup> Rule 404 mandates that disclosures required under Rule 402 shall be offered at least annually for current clients, and provided if requested.<sup>117</sup>

Principle 6 – “Professionalism” – bears upon the matter of self-policing. It states that “[a CFP’s] conduct in all matters shall reflect credit upon the profession.”<sup>118</sup> Generally, Rule 603 requires the CFP who has “non-confidential knowledge” (defined as “no substantial doubt”) that another CFP Board designee has committed a violation of the CFP Code of Ethics “which raises substantial questions as to the designee’s honesty, trustworthiness or fitness” to promptly inform the CFP Board.<sup>119</sup> Rule 604 requires the CFP with non-confidential

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.* at R. 403.

117. *Code of Ethics and Responsibility: Rules*, *supra* note 109, at R. 404.

118. *Code of Ethics and Professional Responsibility: Principles*, *supra* note 104, at Princ. 6.

119. *Code of Ethics and Responsibility: Rules*, *supra* note 109, R. 603.

knowledge which raises a substantial question of unprofessional, fraudulent or illegal conduct by another CFP or other financial professional to “promptly inform the appropriate regulatory and/or professional disciplinary body.”<sup>120</sup> Rule 605 requires the CFP who has reason to suspect illegal conduct within his or her organization to “make timely disclosure of the available evidence” to his or her “immediate supervisor and/or partners or co-owners.”<sup>121</sup> Further, “if the [CFP] is convinced that illegal conduct exists within [his own] organization, and that appropriate measures are not taken to remedy the situation, the [CFP] shall, where appropriate, alert the appropriate regulatory authorities . . . in a timely manner.”<sup>122</sup>

The CFP Code has formal disciplinary procedures in place and several possible forms of discipline defined. The disciplinary procedures were designed to ensure a fair and reasonable process. The steps in that process are:

- (1) Receipt of a written request for investigation.
- (2) Investigation of the complaint by CFP Board Staff Counsel.
- (3) Determination of probable cause by CFP Board Staff Counsel.
- (4) Formation of a hearing panel to review all evidence from both sides.
- (5) Submission of hearing panel findings to the Board of Professional Review, which renders a decision.
- (6) The aggrieved may petition the decision to the Board of Appeals.<sup>123</sup>

The possible forms of discipline are: a private written censure, a public letter of admonition, suspension for up to five years, and permanent revocation of the CFP designation.<sup>124</sup> Notably, the CFP Board recently proposed significant changes to its Code of Ethics and Professional Responsibility and Financial Planning Practice Standards, including:

- Elimination of the written notice informing clients of their right to ask at any time for information about the CFP’s sources of compensation, and an annual offer of disclosure

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120. *Id.* at R. 604.

121. *Id.* at R. 605.

122. *Id.*

123. Certified Fin. Planner Bd. of Standards, *Disciplinary Procedures: Disciplinary Process and Procedures*, available at <http://www.cfp.net/learn/procedures.asp> (last visited Mar. 23, 2007).

124. *Id.* at Forms of Discipline.

of important information about the CFP;

- Elimination of a current requirement that CFPs report infractions of the *Code of Ethics* by other CFPs; and
- Creation of a new fiduciary standard for all certificants, but allowing use of a lower standard if set forth in the client agreement.<sup>125</sup>

The comment period ended September 25, 2006.<sup>126</sup>

### B. Financial Planning Association

The Financial Planning Association (FPA) was created by the union of the International Association for Financial Planning (IAFP) and the Institute of Certified Financial Planners (ICFP).<sup>127</sup> The FPA's "individual members include financial planners, accountants, attorneys, bankers, charitable giving specialists, insurance agents, stockbrokers, money managers, investment consultants, broker-dealer and corporate executives, and others."<sup>128</sup> The FPA has nearly 30,000 financial planners, allied professionals and organizations that advance the financial planning process.<sup>129</sup> Members of the FPA are mandated to adhere to the FPA Code of Ethics.<sup>130</sup> The "FPA's Ethics Committee is charged by its Board of Directors with reviewing alleged violations of the FPA Code of Ethics and advising staff on ways to enhance awareness by FPA members of their obligations under the Code."<sup>131</sup>

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125. See generally Certified Fin. Planner Bd. of Standards, *Exposure Draft*, available at [http://www.cfp.net/Downloads/Attachment\\_A.pdf](http://www.cfp.net/Downloads/Attachment_A.pdf) (last visited Mar. 27, 2007); see generally Certified Fin. Planner Bd. of Standards, *Exposure Draft Overview*, available at <http://www.cfp.net/Downloads/Overview.pdf> (last visited Mar. 27, 2007). For Financial Planning Association member comments regarding the CFP proposed changes see Financial Planning Association website at <http://www.fpanet.org/member/ethicsresponse.cfm> (last visited Mar. 27, 2007).

126. Certified Fin. Planner Bd. of Standards, *Exposure Draft of Proposed Revisions to CFP Board's Ethical Standards: Comment Period Ends Sept. 25, 2006*, CFP Bd. News (Sept. 7, 2006) available at [http://www.cfp.net/certificants/boardreport\\_9\\_2006.asp](http://www.cfp.net/certificants/boardreport_9_2006.asp).

127. Fin. Planning Ass'n, *FPA Overview*, available at <http://www.fpanet.org/global/about/overview.cfm> (last visited Mar. 23, 2007).

128. Fin. Planning Ass'n, *About FPA*, available at <http://www.fpanet.org/member/about/index.cfm> (last visited Mar. 23, 2007).

129. Fin. Planning Ass'n, *Institutional Membership*, available at <http://www.fpanet.org/member/membership/corporate/instindex.cfm> (last visited Mar. 23, 2007).

130. *Supra* note 128.

131. See Fin. Planning Ass'n, Code of Ethics, <http://www.fpanet.org/member>

According to the FPA, its guidelines capture the essence of the Certified Financial Planners Board of Standards Code, addressed above, but make the FPA Code applicable to all FPA members whether or not they are also CFPs.<sup>132</sup> It employs the same seven principles, but does not include the associated rules that the CFP Code puts forth.<sup>133</sup>

C. Chartered Financial Analyst Institute<sup>134</sup>

The Chartered Financial Analyst Institute (the “CFA Institute”) includes 89,981 individual voting members in 130 countries.<sup>135</sup> Individual members either hold the Chartered Financial Analyst (the “CFA”) designation or are active in the investment business.<sup>136</sup> All members must abide by the CFA Institute’s Code of Ethics and Standards of Professional Conduct.<sup>137</sup> The latest Code of Ethics and Standards of Professional Conduct became effective January 1, 2006.<sup>138</sup> Violations may result in disciplinary sanctions by the CFA Institute.<sup>139</sup>

All alleged violations of the code and standards are investigated by the designated officer (a regular member of CFA Institute appointed by the CFA Institute Board of Governors). Upon completion of an investigation, if the designated officer determines a violation of the code and standards occurred, the designated officer recommends a disciplinary sanction. The [CFA] member . . . may accept the designated officer’s recommendation or proceed to a Hearing Panel.<sup>140</sup>

Potential sanctions include revocation of membership and the right

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/about/Princ.s/ethics.cfm (last visited Mar. 23, 2007).

132. *Id.*

133. *Id.* at Princ. 1.

134. Formerly known as the Association for Investment Management and Research.

135. CFA Institute, *About Us*, <http://www.cfainstitute.org/aboutus/index.html> (last visited Mar. 23, 2007).

136. CFA Inst., *About Us: Membership*, <http://www.cfainstitute.org/aboutus/overview/index.html> (last visited Mar. 23, 2007).

137. *Id.*

138. CFA Inst., *Code of Ethics and Standards of Professional Conduct*, <http://www.cfainstitute.org/centre/ethics/code> (last visited Mar. 23, 2007).

139. CFA Inst., CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT: PREAMBLE, [http://www.cfainstitute.org/centre/ethics/code/pdf/english\\_code.pdf](http://www.cfainstitute.org/centre/ethics/code/pdf/english_code.pdf) (last visited Mar. 23, 2007).

140. CFA Inst., *Disciplinary Procedures: Procedure*, <http://cfainstitute.org/aboutus/conduct/complaint/discipline.html> (last visited Mar. 23, 2007).

to use the CFA designation.<sup>141</sup>

The CFA Institute Code of Ethics requires members to:

- Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.<sup>142</sup>
- Place the integrity of the investment profession and the interests of clients above their own personal interests.<sup>143</sup>
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.<sup>144</sup>
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.<sup>145</sup>
- Promote the integrity of, and uphold the rules governing, capital markets.<sup>146</sup>
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.<sup>147</sup>

There are seven sections of the CFA Institute Standards of Professional Conduct: I. Professionalism; II. Integrity of Capital Markets; III. Duties to Clients; IV. Duties to Employers; V. Investment Analysis, Recommendations, and Action; VI. Conflicts of Interest; and VII. Responsibilities as a CFA Institute Member or CFA Candidate.<sup>148</sup>

As its name suggests, Section VI is particularly applicable to the retail sale of mutual funds and the conflicts of interest addressed in this paper, especially subsections A and C:

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141. *Id.*

142. CFA Inst., CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT: THE CODE OF ETHICS, *available at* [http://www.cfainstitute.org/centre/ethics/code/pdf/english\\_code.pdf](http://www.cfainstitute.org/centre/ethics/code/pdf/english_code.pdf) (last visited Mar. 23, 2007).

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.*

147. *Id.*

148. *Supra* note 142.

A. Disclosure of Conflicts. Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employers. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.<sup>149</sup>

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C. Referral Fees. Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from, or paid to, others for the recommendation of products or services.<sup>150</sup>

#### D. American Institute of Certified Public Accountants

Certified Public Accountants (CPAs) are bound by the *Code of Professional Conduct of the American Institute of Certified Public Accountants*. Like the CFP Code, the American Institute of Certified Public Accountants (AICPA) Code consists of two sections: (1) the Principles; and (2) the Rules.<sup>151</sup> The Principles provide the framework for the Rules that govern the performance of professional services by members.<sup>152</sup> “Compliance with the Code of Professional Conduct . . . depends primarily on members’ understanding and voluntary actions, secondarily on reinforcement by peers and public opinion, and ultimately on disciplinary proceedings, when necessary, against members who fail to comply with the Rules.”<sup>153</sup> The Rule most relevant to compensation for mutual fund sales is 503(b) which requires a member in public practice who is not prohibited from receiving commissions and “who is paid or expects to be paid a commission, [to] disclose that fact to any person or entity to whom the member recommends or refers a product or service to which the commission

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149. *Id.* at VI. Conflicts of Interest.

150. *Id.*

151. Am. Inst. of Certified Pub. Accountants, AICPA CODE OF PROFESSIONAL CONDUCT: COMPOSITION, APPLICABILITY, AND COMPLIANCE (2006), available at <http://www.aicpa.org/About/code/comp.htm>.

152. *Id.*

153. *Id.*

relates.”<sup>154</sup> Other similar professional organizations include the Institute of Certified Bankers and the National Association of Insurance and Financial Advisors (LUTC, FSS, ChFC, and CLU designations).

#### V. RECOMMENDATIONS FOR CHANGE

The SEC, NASD, Congress, and the mutual fund industry are investigating ways to provide better and more standardized disclosure of mutual fund fees and expenses. Many experts argue that clearer disclosure of fund fees will not only help investors make better-informed decisions, but will improve price competitiveness within the industry.

In early 2004, the NASD formed the Mutual Fund Task Force to consider issues relating to distribution arrangements, portfolio transaction costs, and soft dollar payments.<sup>155</sup> The Task Force was comprised of industry executives representing mutual fund management companies and broker-dealers, and representatives of the academic and legal communities.<sup>156</sup> The Task Force concluded that,

[m]any of the developments in distribution payments since the adoption of Rule 12b-1 have benefited investors by allowing them to choose to pay distribution costs up-front, over time, or when fund shares are redeemed. At the same time, the variety and complexity of these choices, and the fact that many distribution costs are incurred at the fund level, may tend to obscure the extent of these costs and the incentives that they may create.<sup>157</sup>

The Task Force suggested “that the most important changes that the [SEC] should consider are those that make the costs and potential conflicts associated with mutual fund distribution more visible to the retail investor.”<sup>158</sup> The Task Force also recommended that visibility be increased by the requirement that a short, easy-to-understand document be made available to investors at the point of sale.<sup>159</sup> Dubbed the

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154. Am. Inst. of Certified Pub. Accountants, AICPA CODE OF PROFESSIONAL CONDUCT R. 503(b) (2006), *available at* <http://www.aicpa.org/about/code/sec500.htm>.

155. NASD, REPORT OF THE MUTUAL FUND TASK FORCE: MUTUAL FUND DISTRIBUTION 1, *available at* [http://www.nasd.com/web/groups/R.s\\_regs/documents/R.s\\_regs/nasdw\\_013690.pdf](http://www.nasd.com/web/groups/R.s_regs/documents/R.s_regs/nasdw_013690.pdf) (last visited Mar. 27, 2007).

156. *Id.*

157. *Id.* at 2.

158. *Id.*

159. *Id.*

“Profile Plus,”<sup>160</sup> it is a two-page document that includes key characteristics of the fund and all fees and expenses of the fund, including the costs and potential conflicts associated with mutual fund distribution.<sup>161</sup>

Page one contains a statement describing the fund’s principal investment strategies and principal investment risks.<sup>162</sup> It also includes charts detailing the fund’s total return over the past ten years, “and a chart that shows average annual return of the fund over the past 1-, 5-, and 10-year periods.”<sup>163</sup> Page two focuses on “the costs associated with fund ownership and possible conflicts of interest.”<sup>164</sup> It includes a “Fees and Expenses” table that would “show the total fees and expenses paid by a shareholder - both transaction fees and fund operating expenses - based on the fund’s current prospectus.”<sup>165</sup> The costs are to be presented both in dollars and as a percentage, based on hypothetical investments of \$1,000, \$50,000 and \$100,000.<sup>166</sup> In addition, the fund’s total “operating expenses is not to be presented as a single number, and not broken down into components.”<sup>167</sup> The Task Force believes that investors are interested mainly in the total amount of fees they pay rather than in a detailed breakdown of the various components.<sup>168</sup> Page two also provides an explanation of “portfolio transaction costs and portfolio turnover rates.”<sup>169</sup>

Another major section on page two is titled “Potential Conflicts of Interest.”<sup>170</sup> It provides information about revenue sharing and differential compensation arrangements through two “yes/no” questions.<sup>171</sup> The first is, “Does the fund or its affiliates pay XYZ Firm extra to promote this Fund over other similar funds?”<sup>172</sup> If the answer is yes, an investor can click on a hyperlink to additional information about

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160. *Id.*

161. NASD, *supra* note 155, at 6.

162. *Id.*

163. *Id.* at 7.

164. *Id.*

165. *Id.*

166. *Id.*

167. NASD, *supra* note 155, at 7.

168. *Id.* at 8. It should be noted that shareholders who are interested in a breakdown can find it in the prospectus.

169. *Id.* at 9.

170. *Id.*

171. *Id.*

172. *Id.*

the revenue sharing payments received by the broker/dealer.<sup>173</sup> The second question is, “Does XYZ Firm pay its personnel more for selling this Fund than for selling other similar funds?”<sup>174</sup> Again, if the answer is yes, the investor can access a hyperlink to additional information about the differential compensation arrangements that the broker-dealer has with its registered representatives.<sup>175</sup>

The Task Force also recommended that all broker-dealers be required to provide the Profile Plus, dealer disclosure statement, and the fund’s prospectus on their web sites.<sup>176</sup> It further recommended that a registered representative refer the investor to the Profile Plus at the time that the representative makes a recommendation to invest in a particular fund, stating that the Profile Plus contains important information concerning costs and potential conflicts of interest.<sup>177</sup> In November 2004, the Commission proposed an “access equals delivery” approach to prospectus delivery, under which investors would be presumed to have access to the internet, and issuers and intermediaries could satisfy their delivery requirements by posting the required information on their websites.<sup>178</sup>

## VI. CONCLUSION

It is obvious that something needs to be done to eliminate, or at least to reduce, the conflicts of interest that have been created by revenue sharing, directed brokerage, differential compensation, and soft dollar commissions. It appears there are two alternatives, either to make the practices illegal, as the SEC recently did with directed brokerage, or to make those practices more transparent, so that investors are aware of the potential for conflicts of interest. The Profile Plus document developed and recommended by the NASD’s Mutual Fund Taskforce does a good job of divulging the information that investors need in order to uncover and understand the potential conflicts.

The approval of 12b-1 fees in 1980 made revenue sharing and differential compensation possible. It also led to the formation of different classes of mutual fund shares, which allows investors to choose

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173. NASD, *supra* note 155, at 9.

174. *Id.* at 10.

175. *Id.*

176. *Id.* at 10-11.

177. *Id.* at 11.

178. *Id.* at 13.

the way they pay the fees associated with mutual fund investment. That represents an advantage for potential shareholders, which we feel overcomes the associated costs, and the conflicts of interest for financial advisers. Certainly those practices need to be disclosed to a greater extent, and the Profile Plus does that.

Both directed brokerage and soft dollar payments involve payments to brokerage firms in the form of commissions for executing portfolio transactions in exchange for recommending the funds to clients or for providing services (most commonly investment research). These payments are thus hidden in the overall transaction costs of the fund, and would not be apparent to the vast majority of investors. On the other hand, revenue sharing and differential cash compensation are part of the fund's 12b-1 plan, and are clearly payments made in exchange for recommending the fund to investors.

Each of the four practices involves the potential for conflicts of interest, but in directed brokerage and soft dollar payments, the payments are made in the form of commissions and it is difficult to separate the part of the commission that represents payment for recommending the fund from the payment for the execution of trades. With revenue sharing and differential compensation, there is no question as to what the payments represent. Thus the potential conflict of interest is more transparent.

Some feel, however, that disclosure is not enough. In 2004, Senator Carl Levin (D-Michigan) stated,

Even if an investor is clearly told that his or her broker is getting paid to promote a mutual fund, the investor is left wondering whether the broker's recommendation is based on the mutual fund's merits or the broker's financial benefit. Disclosure does not resolve the conflict; it allows revenue sharing payments to continue to undermine objective investment advice. The better course of action is to ban revenue sharing from the mutual fund marketplace.<sup>179</sup>

Our feeling is that if an investor is "left wondering" whether the broker's recommendation is unbiased, he or she should raise the issue with the broker. If the broker's response is unsatisfactory, the investor should find another broker. If a sufficient number of investors do this,

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179. *Ending Conflicts of Interest at Mutual Funds: The Mutual Fund Reform Act: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs*, 108th Cong. (2004) (statement of Sen. Carl Levin), available at <http://www.senate.gov/~levin/newsroom/release.cfm?id=219868>.

revenue sharing will be eliminated from the marketplace by making the funds and brokers who engage in the practice uncompetitive with those that do not.

Our recommendations are for soft dollar commissions to be eliminated, just like directed brokerage. Those costs are too easily hidden from investors. But revenue sharing and differential compensation should be allowed to continue as long as the Profile Plus and the associated recommendations of the taskforce are implemented. While it is tempting to recommend outlawing those practices as well because they do create the potential for conflicts of interest, we feel the transparency of those practices makes their cost acceptable, given the benefit that different classes of funds provide in allowing investors to choose the way that they pay the costs associated with mutual fund investment.