Opinion

Directors Must Prepare for Clean Shares, Passive Shift

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Recent regulatory and market developments are causing rapid changes to the traditional distribution model for mutual fund shares. Payments for distribution – including 12b-1, subaccounting and revenue-sharing fees – are being eliminated in favor of advisory and brokerage fees assessed directly to an investor's account.

A January letter from the Securities and Exchange Commission also paved the way for a new kind of share class: clean shares. These products are stripped of all distribution payments and permit intermediaries to charge their customers directly for services rendered. They also allow broker-dealers to determine their own commission structures.

Independent fund directors must be prepared for these changes and should look for opportunities to reduce or eliminate distribution costs for the funds they oversee.

Why Distribution Models Are Changing

The Department of Labor's fiduciary rule has prompted more fund complexes to roll out plans to offer clean shares. In fact, the agency's recent request for information indicated that it may be willing to give firms more time to develop this share class. The development of clean shares is going to have a large impact on fund distribution practices, as more than $7.5 trillion resides in retirement accounts subject to the fiduciary rule, according to data from the Investment Company Institute.

Large inflows into low-cost index products and ETFs are also pressuring the traditional fund distribution model to change. More than $250 billion flowed out of actively managed funds in the 12 months that ended May 31, according to data from **Morningstar**. During the same time, investors poured $281 billion into passive products. This shift is going to force advisers and fund boards to reevaluate their fee structures so they can remain competitive in attracting and retaining investor funds.

Establish a Robust Process to Evaluate Distribution Arrangements

These regulatory and marketplace changes provide an opportunity for fund directors to take a harder look at all intermediary fee arrangements to ensure that they are in the best interest of shareholders.

As a first step, boards should reexamine the internal processes used to oversee the distribution of fund shares by large broker-dealers and other intermediaries. A robust evaluative process should be part of a fund board's responsibility. In fact, this is specifically required, according to 2016 SEC guidance on distribution payments.

Advisers will always tell fund directors that distribution payments are the price of admission to being sold on certain broker-dealer and intermediary platforms. However, the advent of clean shares is going to eliminate distribution fees from fund assets. Directors should question whether distribution costs should remain at current levels for other share classes.

Look for Opportunities to Reduce Costs of Distribution Services

Clean shares and other pressures within the industry are forcing fund complexes to decrease fees for all products. To keep all share classes competitive with clean shares, directors must demand better pricing for distribution-related services.

One example of a service for which directors can negotiate the pricing is recordkeeping. Mutual fund complexes pay an average of $22 per position to large broker-dealers for subaccounting services, according to a review of public disclosures and SEC filings. In contrast, third-party recordkeepers charge only about $13 per position for the same services.

Rules from the SEC and Financial Industry Regulatory Authority require broker-dealers to perform these recordkeeping and shareholder services as a part of their customer relationships. Broker-dealers are also compensated for these services by their customers directly. To keep prices low, fund boards should refuse to pay for any services that are already required under existing regulations, especially at inflated prices.

Ask Hard Questions About Intermediary Services

Clean shares will not permit fund assets to be used to pay for subaccounting or other distribution-related services. Fund boards should use this opportunity to demand better investor-level services from their intermediaries using omnibus accounts. As a part of its regular evaluation of distribution costs, fund directors should examine all intermediary payments from fund assets and ask what services are actually being rendered to the funds.

The arrival of clean shares and growing investor interest in passive investing will force a reevaluation of current fund distribution arrangements. In this new environment, fund directors should more closely scrutinize the services that distribution intermediaries provide and look for opportunities to reduce distribution costs.