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When Best Execution Isn't Best: Mutual Fund Share Class Selection

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Selection of mutual fund share classes for investment advisory client accounts remains a key focus of the Securities and Exchange Commission (SEC) and its Staff. In addition to recently establishing a self-reporting initiative for disclosure-based violations under the Investment Advisers Act of 1940 (Advisers Act), the SEC has brought a number of enforcement actions that focus on mutual fund share class selection. Although these cases center on the failure to adequately disclose conflicts of interest associated with selecting or recommending that advisory clients invest in a higher-cost share class that pays the adviser or its affiliates 12b-1 fees when a lower-cost share class is otherwise available, many of these cases also include a violation of the duty to seek best execution.[1] The SEC's inclusion of a best execution violation in mutual fund share class selection cases is a novel approach that seems to diverge from established SEC guidance, which is limited to brokerage selection. Accordingly, while investment advisers certainly must recommend and select mutual funds, like all other securities, in a manner that is consistent with their fiduciary duty to clients, we question whether best execution is the appropriate legal framework for evaluating share class selection practices.

The Recent Cases: Best Execution in the Context of Share Class Selection

Prior to January 2016, the SEC had characterized the failure to put clients in the lowest-cost share class as a best execution violation only on two occasions, and in cases whose underlying facts did not, at the time, appear to have broad application to the industry. In the October 2013 *Manarin Investment Counsel, Ltd. et al. (Manarin)* case, the SEC found that the adviser, which managed three fund-of-funds vehicles that each principally invested in mutual funds, breached its fiduciary duties by causing each of the fund-of-funds vehicles to purchase Class A mutual fund share classes that paid 12b-1 fees to the adviser's affiliated broker-dealer, when a lower-cost institutional share class of the same mutual funds was available. The SEC next found a violation of the duty to seek best execution in connection with an adviser's share class selection practices in the June 2015 *Pekin Singer Strauss Asset Management, Inc. et al.* (*Pekin Singer*) case. In that case, the SEC alleged that the investment adviser had failed to seek best execution where it invested the separate accounts of its high net-worth clients in a more expensive share class of a mutual fund that the adviser itself managed, even after it instituted a lower-cost share class

of that mutual fund that it knew was available to its clients.

While in retrospect the *Manarin* and *Pekin Singer* enforcement cases appear to be the start of a new trend of the SEC including best execution violations in certain mutual fund class selection cases, at the time that these cases were published, they were still outliers. In *Manarin*, the mutual fund investments at issue were selected and executed by the adviser for multiple fund-of-funds products that it managed, and did not relate to separately managed accounts, which are the focus of the more recent mutual fund share class selection cases. The *Pekin Singer* case is also distinct; that case involved a number of alleged compliance program failures, and the best execution violation in *Pekin Singer* related to share class selection for separate accounts only with regard to a mutual fund that the adviser itself managed, and for which it knew lower-cost share classes were available. Consequently, it wasn't until the more recent (2016 forward) share class selection cases that the SEC began to advance, with regularity, the theory that an adviser could breach its duty to seek best execution in connection with its selection of mutual fund share classes.

Historical Overview of the Duty of Best Execution

An investment adviser that has trading authority over client accounts has a fiduciary duty to seek best execution of client transactions. However, the SEC's interpretation of the duty of best execution has historically focused on the quantitative and qualitative factors that bear on an adviser's selection of broker-dealers to execute securities transactions. In this way, the SEC's characterization in enforcement actions of best execution as applicable to mutual fund share class selection diverges from the prior guidance because it extends beyond broker selection to securities selection, and it suggests that the duty of best execution requires selection of a share class based on *cost alone*, without consideration of other qualitative factors that can influence an investment adviser's decision as to the appropriate share class.

While SEC enforcement actions do not mention best execution in the context of mutual fund share class selection until 2013,[2] the SEC's interpretation of best execution and related guidance precedes that date by decades.[3] The SEC's most recent interpretive guidance on the duty to seek best execution—and the guidance that the SEC cites to substantiate the duty of best execution in its most recent share class selection cases—is reflected in its 1986 release interpreting the safe harbor for soft dollar arrangements in Section 28(e) of the Securities Exchange Act of 1934 (the 1986 Release).[4] In the 1986 Release, the SEC stated that an investment adviser's duty to seek best execution requires it to "execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances."[5] This guidance has historically framed the duty to seek best execution as involving the selection of broker-dealers to execute securities transactions.[6] As a result, the 1986 Release reminds advisers that in connection with placing brokerage (that is, "execut[ing] securities transactions") they should "periodically and systemically evaluate the execution performance of broker-dealers executing their transactions."[7] The 1986 Release further establishes that the duty to seek best execution relates to broker selection by devoting considerable focus to incentives associated with the placement of securities orders with affiliated broker-dealers.[8]

SEC guidance makes clear that the amount of the transaction cost is not the sole determinative factor in seeking best execution.[9] An investment adviser should consider the full range and quality of a broker-dealer's services, including, among other things, execution capability, the value of research provided, commission rates, and responsiveness to the investment adviser.[10] In this regard, the concept of best execution for an investment adviser always has included both a quantitative and a qualitative assessment that takes into consideration a wide range of factors, including commissions. In the 1986 Release,

the SEC went so far as to "remind money managers that *the determinative factor is not the lowest possible commission cost* but whether the transaction represents the best qualitative execution for the managed account."[11] More recently, the SEC's proposed interpretation regarding investment adviser standards of conduct[12] further reinforced that cost is not the sole factor, stating that, in the context of the duty of best execution, "maximizing value can encompass more than just minimizing cost," and that when seeking best execution, an adviser should consider "the full range and quality of a broker's services in placing brokerage," citing to the factors enumerated in the 1986 Release.

Reconciling the SEC's Application of Best Execution to Share Class Selection

While we understand the SEC's focus on mutual fund share class selection practices and related disclosure[13], the SEC's extension of best execution obligations to share class selection does not appear to have as strong of a legal basis. Indeed, there are a number of reasons why best execution is not the appropriate legal framework through which to analyze mutual fund share class selection practices. To the extent the SEC wishes to extend the duty of best execution to mutual fund share class selection practices, it would be preferable for the SEC to articulate this theory through the issuance of affirmative guidance, rather than summarily stating that it applies in settled administrative proceedings.

Investment Adviser Best Execution Historically Refers to Broker Selection

With the exception of the settled share class selection enforcement actions, there is no SEC rule, regulation or interpretation holding that an investment adviser fails to satisfy its best execution obligation if it does not select the lowest-cost share class that is available to a client. Rather, the SEC takes the position that its interpretive statements around the duty of best execution in the 1986 Release extend to the obligation to select the lowest-cost share class available to a client. This approach, however, does not appear to be supported by the SEC's own statements around the duty of best execution. As discussed above, the 1986 Release focuses exclusively on the selection of broker-dealers, both in terms of the factors that lead an investment adviser to select a particular broker-dealer, and on the adviser's obligation to "periodically and systemically evaluate the execution performance of broker-dealers executing their transactions."[14] Moreover, the authority to which the SEC cites in the 1986 Release to substantiate the duty to seek best execution itself relates to an investment adviser's fiduciary obligations when *executing* securities transactions for client accounts.[15] Significantly, where it has alleged a violation of the duty to seek best execution in the context of share class selection cases, the SEC has cited to a case that focuses on best execution solely in the context of broker selection.[16] Moreover, with the exception of the share class selection cases at issue, the SEC's enforcement actions involving best execution historically relate to an investment adviser's trading practices or the failure to disclose related conflicts.[17]

Although the SEC's settled enforcement actions undoubtedly impact the behavior of market participants, they do not have the weight of legal precedent associated with SEC rulemaking or interpretive guidance because, among other things, settled enforcement actions are not subject to notice and comment and generally do not include the legal reasoning or factual detail required for investment advisers to discern the basis for the SEC's position. Further, confusion within the industry as to an appropriate legal standard can result to the extent there are differences in the interpretation or application of the law between enforcement actions. To this point, the SEC appears to take the position in certain actions that the failure to invest clients in a lower-cost share class may be a *per se* violation of the adviser's duty to seek best execution.[18] However, in other actions with substantially similar facts, the

SEC more clearly states that the violation of the duty to seek best execution was triggered by a failure to disclose that "best execution would not be sought."[19] The result is confusion as to whether an adviser would be violating its fiduciary duty of best execution whenever it invests clients in a higher-fee share class when a lower-cost share class is available, or whether that best execution violation is tied to the adviser's disclosure around its share class selection practices.

In our view, the reality is actually somewhere in between. The application of the duty of care suggests that advisers should have a defined process for assessing the quantitative and qualitative factors associated with selection of an appropriate share class. However, it is the duty of loyalty that should be driving the share class selection cases. To the extent that an investment in a higher-fee share class creates a financial incentive, that presents a conflict of interest that investment advisers must disclose pursuant to their fiduciary duty of loyalty.[20] Failure to adequately disclose these financial conflicts should not result in a violation of the duty to seek best execution.

Applications of Best Execution to Share Class Selection Have Not Been Consistent

To complicate matters further, the SEC has not applied its new best execution standard in a consistent manner, either in its settled enforcement actions regarding mutual fund share class selection, or in the SEC's own Share Class Selection Disclosure Initiative (the Share Class Initiative).[21] Subsequent to the *Manarin* case, which, as noted above, is the first enforcement action that suggests that best execution can apply in the share class context, settled enforcement actions addressing share class selection are inconsistent in their inclusion of best execution.[22] In the Share Class Initiative, the SEC does not identify best execution as one of the possible violations of Section 206(2) that would give rise to a need to self-report.[23] To the contrary, the SEC takes the position that advisers participating in the Share Class Initiative will not be subject to a best execution violation ("even where the facts would support" such violations).

Recent guidance from the SEC's Office of Compliance Inspections and Examinations (OCIE) and the Staff of the Division of Investment Management also appear to be inconsistent with the connection drawn by the SEC between best execution and mutual fund share class selection. In the SEC's proposed interpretation regarding investment adviser standards of conduct,[24] the SEC directly addresses mutual fund share class selection in the best interest discussion.[25] However, the SEC does not connect mutual fund share class selection in any respect with an adviser's obligation to seek best execution, which is separately addressed in the release. Given the current SEC focus, we would have expected the SEC to discuss the broad interpretation of best execution reflected in many of the mutual fund share class cases. Instead, the SEC refers to the 1986 Release and discusses best execution exclusively in relation to trade execution "where the adviser has the responsibility to select broker-dealers to execute client trades." Significantly, this guidance was published subsequent to most of the share class selection enforcement actions that implicated best execution to date, including the suite of settled actions released on April 6, 2018.[26]

Further, OCIE has issued a July 2018 risk alert (2018 Risk Alert) on compliance issues for investment advisers related to best execution that does not contain any reference to mutual fund share class selection, notwithstanding the fact that OCIE routinely raised mutual fund share class selection in many of the examinations conducted during the time period from which its observations were based.[27] The 2018 Risk Alert identifies the failure to evaluate qualitative factors as one of the common compliance deficiencies OCIE identified, but significantly, those qualitative factors are referenced only in the context of broker selection and further support the proposition that cost is not a determinative factor when assessing execution quality. OCIE had previously issued a risk alert in connection with its 2016 Share Class

Initiative (2016 Risk Alert) that references the duty of best execution; however, the 2016 Risk Alert only stated that OCIE would examine whether advisers are "seeking best execution when recommending or selecting mutual fund" investments, and did not explain or otherwise cite to authority for why the duty to seek best execution implicates mutual fund share class selection.[28]

Best Execution Is Not Necessary for an Advisers Act Section 206(2) Violation

The SEC's enforcement actions involving mutual fund share class selection, including the standardized settlement terms for advisers that participate in the Share Class Initiative, generally allege a violation of the antifraud provisions of Advisers Act Section 206(2) in connection with the adequacy of an adviser's disclosure around its practices for share class selection.[29] Section 206(2) is also the statutory violation applied by the SEC to best execution allegations, both in the subset of share class selection cases that include a best execution component and in enforcement actions more generally.[30] In this regard, the inclusion of a best execution violation in mutual fund share class selection cases is not necessary to support a violation of Advisers Act Section 206(2). Advisers that are agreeing to a settled enforcement action in connection with their disclosure around mutual fund share class selection will have already agreed to a Section 206(2) violation. Separating a best execution violation from these actions therefore does not appear to alter the legal basis for the action or otherwise impact the outcome (including an order of disgorgement) obtained by the SEC.

Investment in Higher-Fee Share Classes May Be Warranted

While we are not suggesting that best execution should apply to mutual fund share class selection, if it were to apply, the SEC should permit advisers to make a reasonable assessment of both quantitative *and* qualitative factors, and not cost alone. Certainly, an assessment of the costs associated with an investment recommendation is an important component of an investment adviser's fiduciary duty. However, it would be inconsistent with long-standing principles of best execution to require investment advisers to ensure that clients are invested in the lowest-cost share class, to the exclusion of any other considerations as to why a different share class may be appropriate under the circumstances. Cost alone is not determinative, and the position that an investment adviser *de facto* violates the duty of best execution by not investing clients in the lowest-cost share class available does not take into account a number of valid reasons for why an adviser could determine that it is reasonable, or even preferable, for a client to invest in a higher-fee share class, even where a lower-cost share class is available. These considerations include:

- Whether lower-cost share class was available through the fund company at the time the shares were purchased;
- Whether the client or the adviser would have been eligible to qualify for the lower-cost share class;
- Whether the lower-cost share class was available on the broker-dealer platforms used by the adviser at the time the shares were purchased for the client's account;
- Whether there were other client objectives in holding shares of a particular share class (for example, portability, time horizon, or anticipated holding period);
- Whether clients who purchased shares of the lower-cost share classes would have been subject to transaction charges;
- Whether operational considerations affected the availability of lower-cost share classes;
- Whether the investment advisory fee applicable to the client's account was reduced to take into consideration the receipt of 12b-1 fees associated with the higher-cost share class; and
- Whether the mutual fund would support a tax-free exchange, or whether the client would incur

negative tax consequences in connection with a conversion from the higher-cost share class shares.

These considerations could be viewed as a parallel to the qualitative factors that investment advisers have the ability to consider when selecting and evaluating broker-dealers, yet they have often been minimized or dismissed in the context of the share class selection cases.

Conclusion

Investment advisers must act consistent with their fiduciary responsibilities when managing client accounts, which includes the recommendation or selection of appropriate mutual fund share classes and disclosure of related conflicts of interest. In this regard, advisers should establish appropriate policies and procedures around share class selection and thoroughly disclose to clients any financial conflicts of interest. However, the SEC's application of best execution to share class selection cases, and its own interpretive guidance, provide more questions than answers for why best execution is an appropriate or necessary component of the analysis. It is therefore our view that the SEC should continue to evaluate share class selection practices based on disclosure and the adoption of appropriate policies and procedures, and not through the lens of best execution.

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NOTES

1 *See, e.g., In re Capital Analysts, LLC*, Investment Advisers Act Rel. No. 5009 (Sept. 14, 2018); *In re Harbour Investments, Inc.,* Investment Advisers Act Rel. No. 5006 (Sept. 13, 2018); *In re First Western Advisers, Inc.,* Investment Advisers Act Rel. No. 4995 (Aug. 24, 2018); *In re PNC Investments, LLC*, Investment Advisers Act Rel. No. 4878 (April 6, 2018); *In re Geneos Wealth Management, Inc.*, Investment Advisers Act Release No. 4877 (Apr. 6, 2018); *In re Securities America Advisors, Inc.*, Investment Advisers Act Release No. 4876 (Apr. 6, 2018); *In re SunTrust Investment Services, Inc.*, Investment Advisers Act Rel. No. 4769 (Sept. 14, 2017); *In re Cadaret, Grant & Co., Inc.*, Investment Advisers Act Rel. No. 4736 (Aug. 1, 2017); *In re Credit Suisse Securities (USA) LLC*, Investment Advisers Act Rel. No. 4678 (Apr. 4, 2016); *In re Everhart Financial Group, Inc.*, Investment Advisers Act Rel. No. 4314 (Jan. 14, 2016); *In re Pekin Singer Strauss Asset Management Inc.*, Investment Advisers Act Rel. No. 4126 (June 23, 2015); and *In re Manarin Investment Counsel, Ltd.*, Investment Advisers Act Rel. No. 3686 (Oct. 2, 2013).

2 We note that, although best execution was included in some orders relating to multiple share classes (*see, e.g., Manarin*, *Everhart*, and *Pekin Singer*), there is no reference to a violation of the obligation to seek best execution associated with the share class selection practices in certain other cases (*see infra* n.22).

3 *See Applicability of Commission's Policy Statement on the Future Structure of Securities Markets to Selection of Brokers and Payment of Commissions by Institutional Managers*, Securities Act Rel. No. 5250 (May 9, 1972), 37 Fed. Reg. 9988 (May 18, 1972) (1972 Release).

4 *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Securities Exchange Act Rel. No. 23170 (Apr. 23, 1986), 51 Fed. Reg. 16004, 16011 (Apr. 30, 1986); *see, e.g., Cadaret,* Investment Advisers Act Rel. No. 4736 at p. 6, *supra* n.1.

5 See 1986 Release.

6 *See Id. See also, e.g., In re Kidder, Peabody & Co., Inc.,* Advisers Act Rel. No. 232 (Oct. 16, 1968) (hereinafter *Kidder*).

7 1986 Release; *see also* Market 2000 Report: Study V, Best Execution, 1994 SEC LEXIS 136, at *42 n.65 ("[M]oney managers in fulfilling their duties

of best execution . . . must evaluate periodically the performance of the broker-dealers that execute their transactions").

8 1986 Release at n.37 ("Where an investment manager, in return for research services, pays an affiliated broker-dealer more than normal charges for execution of brokerage transactions, the manager 'would be under a heavy burden to show that such payment were appropriate.'" (citing Securities Act Rel. No. 6019 (Jan. 30, 1979)).

9 1986 Release.

10 *Id*.

11 1986 Release (emphasis added).

12 *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, Investment Advisers Act Rel. No. 4889 (Apr. 18, 2018), 83 Fed. Reg. 21203 (May 9, 2018) (Proposed Interpretation).

13 We leave for another article a discussion of how the legal principles surrounding disclosure of conflicts of interest align with those articulated by the Staff of the SEC's Division of Enforcement in its Share Class Selection Disclosure Initiative.

14 1986 Release.

15 1986 Release at n.58 (citing 1972 Release; *Kidder*).

16 1986 Release; *In re Fidelity Mgmt. & Research Co. & FMR Co.*, Investment Advisers Act Rel. No. 2713, Investment Company Act Rel. No. 28185 (Mar. 5, 2008) (finding adviser violated Section 206(2) of the Advisers Act by failing to disclose material conflicts of interest that arose from the receipt by certain executives of travel, entertainment, and gifts from brokers seeking and obtaining securities transactions for the adviser's clients).

17 *See, e.g., In re Michael L. Smirlock*, Investment Advisers Act Rel. No. 1393 (Nov. 29, 1993) (respondent, the chief investment officer of an investment adviser, ordered execution of client cross trades at a price set by the respondent and "failed to ask the broker for an independent evaluation of the price, or to ask the broker to confirm with his trading desk that the prices set by [r]espondent were accurate market prices," in disregard of the duty to seek best execution); *In re Portfolio Advisory Services*, Investment Advisers Act Rel. No. 2038 (Jun. 20, 2002) (respondent "violated its duty to seek best execution by systematically interposing a broker-dealer between clients and market makers on OTC principal trades"); *In re Goelzer Investment Management, Inc.*, Investment Advisers Act Rel. No. 3638 (July 31, 2013) (respondent described as having failed to seek best execution because it "did not assess itself as broker for its clients and did not compare what it offered clients to the services and costs available at other brokerage firms … [did not] conduct any analysis of its brokerage services that gave it a basis for using itself as broker … [and instead] used itself as broker for its advisory clients by default rather than as a result of a best execution analysis"); *In re Mark Bailey & Co.*, Investment Advisers Act Rel. No. 1105 (Feb. 24, 1988) (finding adviser violated Section 206(2) of the Advisers Act by failing to disclose that it would not negotiate commissions on directed trades or that the adviser may be in a better position to negotiate commissions in batched transactions if they were not directed to the broker); *In re Delaware Management Co.*, Securities Act Rel. No. 4875, Securities Exchange Act Rel. No. 8128 (July 19, 1967) (sanctioning an adviser to two mutual funds for interposing a dealer of those funds to execute securities transactions for the funds); *Kidder* (sanctioning an adviser for engaging in principal trades in circumstances where the total cost to clients was greater than if the trades were executed as agent); *In re Consumer-Investor Planning Corp. et al.*, Securities Exchange Act Rel. No. 8542 (Feb. 20, 1969) (finding adviser engaged in "give-up" practices and obtained other compensation from broker-dealers that it selected to execute portfolio transactions).

18 *See, e.g., First Western Advisors*, *supra* n.1.

19 *See, e.g., Credit Suisse*, *supra* n.1.

20 *See* Proposed Interpretation, *supra* n.12, at text accompanying n.30 ("if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other available options when

the adviser is receiving compensation that creates a potential conflict and that may reduce the client's return, the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client and obtain informed client consent to the conflict").

21 US Securities and Exchange Commission, Division of Enforcement, "Share Class Selection Disclosure Initiative" (Feb. 12, 2018), *accessible at https://www.sec.gov/enforce/announcement/scsd-initiative*.

22 The SEC has declined to include a best execution-related violation in certain recent settled mutual fund share class selection cases. *See, e.g., In re Royal Alliance Associates, Inc. et al.*, Investment Advisers Act Rel. No. 4351 (Mar. 14, 2016); *In re Barclays Capital, Inc.*, Investment Advisers Act Rel. No. 4705 (May 10, 2017); and *In re Envoy Advisory, Inc.*, Investment Advisers Act Rel. No. 4764 (Sept. 8, 2017).

23 *Supra* n.21.

24 Proposed Interpretation, *supra* n.12.

25 *Id.* (explaining in Section II.A.i that "the fiduciary duty does not necessarily require an adviser to recommend the lowest cost investment product or strategy. We believe that an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance. For example, if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other available options when the adviser is receiving compensation that creates a potential conflict and that may reduce the client's return, the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client and obtain informed client consent to the conflict. Furthermore, an adviser would not satisfy its fiduciary duty to provide advice that is in the client's best interest by simply advising its client to invest in the least expensive or least remunerative investment product or strategy without any further analysis of other factors in the context of the portfolio that the adviser manages for the client and the client's investment profile.").

26 See *Securities America, Geneos Wealth Management,* and *PNC Investments, supra* n.1.

27 Compliance Issues Related to Best Execution by Investment Advisers, National Exam Program Risk Alert, US Securities and Exchange Commission, Office of Compliance Inspections and Examinations (July 11, 2018) available at *https://www.sec.gov/enforce/announcement/scsd-initiative*.

28 OCIE's 2016 Share Class Initiative, National Exam Program Risk Alert, US Securities and Exchange Commission, Office of Compliance Inspections and Examinations (July 13, 2016), available at *https://www.sec.gov/files/ocie-risk-alert-2016-share-class-initiative.pdf*.

29 *See supra* n.21.

30 *See, e.g., supra* nn.1, 17.