The "Many Faces" of Mutual Fund Revenue Sharing

JOHN A. HASLEM

JOHN A. HASLEM
is Professor Emeritus of Finance in the Robert H. Smith School of Business at the University of Maryland in College Park, MD.
jhaslem@rhsmith.umd.edu

[Following prohibition of directed brokerage,] revenue sharing agreements appear to the be the new means of increasing fund inflows.

—George Serafeim [2008]

The U.S. Securities and Exchange Commission (SEC) prohibition of *directed brokerage* in 2004 ceased mutual fund payments of excessive trade commissions to reward broker sales. Fund advisers paid for distribution by bartering fund brokerage commissions for broker promotion of fund sales. The SEC [2004] ruled that the Investment Company Act of 1940 governs fund share distribution, and the new rule prohibits funds from paying for distribution with brokerage commissions. The goal is to end a practice that posed significant conflicts of interest for fund shareholders. Rule 12b-1 permits mutual fund advisers to use fund assets to pay brokers for distribution, but it was revised to prohibit fund advisers from directing brokerage (directed brokerage) to selling brokers, including *step out* arrangements and broker fees received from fund portfolio transactions.

With the loss of directed brokerage, brokers pressured mutual funds to share their generous profits. Mutual funds responded by turning to revenue-sharing payments to reward brokers for loss of directed brokerage.

DIRECTED BROKERAGE AND REVENUE SHARING

Serafeim [2008] examines the consequences of SEC regulations prohibiting mutual funds from rewarding broker sales and promotion efforts with increased trading commissions. The regulations were intended to eliminate conflicts of interest among brokers, funds, and investors. The new rule indirectly affects fund-management style, fees, performance, and competitive industry dynamics. The rule decreased portfolio turnover and increased fund returns. Subsequently, funds began compensating brokers for lost revenues by implementing revenue-sharing payments. As a result, inflows declined for the former fund providers of directed brokerage due to reduced broker sales favoritism. Broker profits also declined from these funds due to reduced sales commissions.

Revenue-sharing payments have numerous implications for mutual funds and brokers, relative to prior use of directed brokerage:

1. Less costly aggressive trading
2. Lower trade commissions and execution fees
3. Lower portfolio turnover with fewer trades
4. More efficient portfolio management with less trading

5. More best-execution trades with fewer trades
6. More efficient trading strategies
7. Less trading activity, making it easier to find and track investment opportunities
8. More financial bargaining power with brokers
9. Portfolio management increases focus on stock picking and longer investment horizons
10. Less distraction from focus on future performance
11. Revenue sharing may regain broker preferences for funds
12. Lower fund total trading costs
13. Elimination of agency-conflicted directed brokerage, which lowered fund performance
14. Each positive effect increases shareholder returns

The implications of decreasing fund returns include:

1. Loss of directed brokerage reduces sales of fund shares and profits
2. Broker pressure for revenue sharing increases management fees, lowers fund inflows, and reduces profits
3. Higher defensive 12b-1 fees increase expenses, reduce fund inflows, and reduce profits
4. Lower growth in fund assets under management lowers fund adviser profits
5. Magnitude of lower turnover associated with magnitude of higher management fees
6. Slightly higher expense ratios reduce profits
7. Higher back-end loads offset by lower front-end loads
8. Competition restrains significantly higher fees, loads, and profits
9. Investors get upset about past use of directed brokerage, which increases fund outflows and reduces profits
10. Brokers may not continue to favor sales of fund shares and reduce fund profits
11. Investors are now more aware of high fund fees that reduce potential profits
12. Revenue sharing is agency conflicted and reduces shareholder returns
13. Each negative effect reduces shareholder returns

The implications for broker returns include:

1. Prohibition of directed brokerage reduced sales and profits
2. Reduced trade commissions and execution fees reduced profits
3. Receipts of revenue-sharing payments increase profits
4. Receipts of defensive 12b-1 fees increase profits
5. Higher back-end loads reduce sales of fund shares and profits

USE OF 12B-1 FEES

The use of Rule 12b-1 fees has changed over the years. The Investment Company Institute (ICI) [2000] reports 12b-1 fees are "most often" used to provide: 1) broker compensation and related expenses (63%), 2) fund service provider expenses (32%), and (3) fund advertising and promotion expenses (5%).

Later, in ICI [2011], 12b-1 fees are most often used to provide: 1) fund distributor compensation (6%), 2) mutual fund advertising and promotion expenses (2%), 3) broker compensation for initial sales of fund shares (40%), and 4) broker compensation for ongoing customer account servicing (52%). Effectively, 12b-1 fees compensate brokers for sales of fund shares and motivate further sales.

There have been periodic efforts by mutual fund observers and the SEC to revise or even prohibit use of 12b-1 fees. In SEC [2007a], Chairman Cox states that "[i]t is high time for a thorough re-evaluation . . ." of 12b-1 plans. He also states fund independent directors should further review use of 12b-1 fees. However, fund shareholders have yet to obtain any relief.

Jaffe [2010] reviews issues facing the SEC's then new "top fund cop." One issue is revision or prohibition of 12b-1 fees. "If the SEC cuts back or eliminates 12b-1 fees, one easy way the fund companies could get around it would be to raise costs and simply create a revenue-sharing plan with the advisers who sell the fund."

In SEC [2010], it was proposed to replace rule 12b-1. One concern related to the growth in frequency and amount of mutual fund adviser revenue-sharing payments to brokers. Because fund advisers derive earnings from sources including fund advisory fees, adviser payments for distribution could involve indirect use of fund assets. Because Rule 12b-1 explicitly applies to both

direct and indirect financing of distribution, revenue-sharing payments could be construed as indirect use of fund assets, which is unlawful unless made pursuant to 12b-1 plans. The SEC has historically held that fund adviser financing of distribution would not necessarily involve indirect use of fund assets if revenue-sharing payments were made from legitimate and nonexcessive adviser profits, that is, profits derived from advisory contracts that do not breach fiduciary duties under the Investment Company Act. However, an indirect use of fund assets may result if advisory fees were increased ahead of adviser distribution payments.

Another concern was that revenue-sharing payments may give broker/dealers and other recipients incentives to market particular funds or fund classes, through *preferred lists* or otherwise. Such incentives create conflicts of interest that may not be adequately disclosed, such as the broker suitability obligation to its customers and its self-interest in maximizing revenue.

Finally, Christoffersen et al. [2013] analyze whether mutual fund flows from investor decisions are affected by broker incentives. Fund payments to brokers are significantly positively related to fund inflows. Interestingly, due to different incentives, load sharing with brokers predicts poor fund performance, but not so for revenue sharing. Fund front-end loads are transparent to investors, but revenue sharing is opaque. Fund family distribution channels play a major role in whether broker distribution is used. For predominately broker-sold family funds, it is likely that a new fund will be broker sold.

DEFENSIVE 12B-1 PLANS

Discussions of *defensive* 12b-1 plans include direct and nuanced statements of their nature and use. The SEC [2000] states: "Rule 12b-1 fees are most commonly used to pay for sales commissions, printing prospectuses and sales literature, advertising, and similar expenses. Some funds, however, adopt 12b-1 fees to cover expenses considered by other funds to be advisory or administrative expenses for which no plan may be required. To complicate the issue further, a fund might pay broker/dealer firms under a 12b-1 plan for services provided to fund shareholders who are the broker/dealer's customers while paying banks under an administrative agreement for providing the same services to fund shareholders who are bank customers. In addition, because it is unclear what expenses are properly considered distribution expenses, some funds, out of an abundance of caution, adopt 'defensive' 12b-1 plans. Defensive plans exist solely to ensure that if a court finds any fund operating expense to be also a distribution expense, the expense would be covered under a 12b-1 plan. The result: some funds have 12b-1 plans although no assets are used for distribution purposes. Similarly, other funds, that do use their assets to pay for distribution, extend their 12b-1 plans to cover operating expenses as well."

The ICI [2007] finds: "At the same time that many mutual funds were using 12b-1 plans as a substitute for traditional sales loads, other funds were adopting 12b-1 plans with an eye to avoiding liability in the event a regulator or shareholder alleged that a fund's assets were being used indirectly to finance distribution. These plans, referred to as 'defensive plans,' do not authorize separate payments from the fund's assets to a distributor; rather, they stipulate that a portion of the fund's advisory fee may be used by the adviser to finance the distribution of fund shares. Defensive 12b-1 plans arguably permit directors to consider distribution expenses paid by advisers when assessing the reasonableness of the fund's advisory fee. With regard to these types of plans, the SEC reiterated its position that an adviser is not indirectly using a fund's assets to pay for distribution expenses so long as those costs are paid out of the adviser's own resources. The SEC emphasized that the adoption of a defensive plan was unnecessary if a fund's directors reasonably concluded that the advisory contract was 'not a conduit' for the payment of costs associated with the sale of fund shares."

The SEC's semiannual report for investment companies (N-SAR form) for mutual fund disclosure focuses on fund payments, and Financial Industry Regulatory Authority (FINRA) requires revenue sharing to be paid directly by fund advisers. N-SAR does not require reporting of revenue sharing as directly as it does the portion of fund sales loads paid to brokers. However, N-SAR does provide for fund adviser revenue-sharing payments in defensive 12b-1 plans.

Christoffersen et al. [2013] analyze mutual fund defensive 12b-1 plans. The analysis assumes defensive 12b-1 plans include all revenue-sharing payments. For funds with 12b-1 plans, 12b-1 fees average 0.30% of fund total net assets. Defensive 12b-1 plans for these funds are 0.17% of total net assets. Funds with defensive 12b-1 plans represent 12% of funds with 12b-1 plans.

The SEC's required N-SAR filing disclosure form does not address revenue sharing as directly as it does load sharing. Revenue sharing is an alternative way for fund advisers to compensate brokers and occurs when these payments are not otherwise included in prospectus fee tables. N-SAR focuses on fund adviser revenue-sharing payments to brokers. N-SAR also enables funds to report revenue sharing in defensive 12b-1 plans for services that funds have not specifically reimbursed fund advisers.

If mutual funds make revenue-sharing payments pursuant to 12b-1 plans, they are to be reported in N-SAR question 44. This question is also where funds are to report revenue sharing pursuant to defensive 12b-1 plans, which includes services for which funds have not specifically reimbursed fund advisers. Defensive 12b-1 plans reveal the magnitudes of revenue-sharing payments, but not whether they are asset based or sales based.

Christoffersen et al. [2013] state: "A defensive 12b-1 plan is a window onto revenue sharing because it exists to defend a fund family against the charges that its revenue sharing constitutes an indirect use of fund assets for distribution. That is, when an investment adviser both receives revenue from a fund and pays revenue to brokers selling fund shares, it raises the question whether the former feeds the latter, which might support a charge that management fees from fund assets are indirectly paying for distribution, which the 1940 Investment Company Act, as amended, limits to 12b-1 plans. So the fund often chooses to have a defensive 12b-1 plan which it does not apply to fund assets, but instead just leaves it there unused so that if this question is later raised, the fund can argue that the revenue sharing was part of its 12b-1 plan (that is, the fund retroactively reallocates the revenue sharing paid by the investment adviser to the 12b-1 plan paid by the mutual fund).

"Revenue sharing is estimated . . . from the defensive plan reported in reply to Question 44. To account for the possibility that not all funds sharing revenue choose not to defend it legally with defensive 12b-1 plans, our tests simply assume that for the funds that do have defensive plans, the size of the plan indicates the magnitude of revenue sharing."

The ICI [2007] discusses the working group discussion of 12b-1 fees and defensive 12b-1 plans prepared by industry officials and reports: "Another change to Rule 12b-1 fees that has been suggested is prohibiting payments for distribution (as opposed to distribution) expenses. One difficulty with this approach is that there is no single industry convention (nor any explicit regulatory standard) about how funds classify or label their services; nor is there a bright line that differentiates various kinds of services under 12b-1 plans. Different funds often use different labels for similar shareholding servicing fees they pay and/or use common labels to refer to different things. Moreover, in prospectus fee tables, some funds combine 12b-1 fees and service fees together and others list service fees separately from 12b-1 fees under 'other expenses.'

"The SEC staff has recognized that it can be difficult to determine how Rule 12b-1 fees apply when a fund is paying for a mix of distribution and nondistribution services. . . . Because of difficulties in drawing meaningful distinctions between distribution and servicing fees, requiring differentiation may subject the judgment calls made by fund directors about the nature of particular payments to second-guessing and potential liability. Adoption of a 12b-1 plan gives a fund, its directors, and its sponsor enhanced regulatory assurance that the payment of fees to third parties who provide administrative services that benefit the fund's shareholders will not be considered an impermissible use of fund assets for distribution. . . .

"To avoid potential liability regarding a board's determination about the nature of particular payments, some funds adopt so-called defensive 12b-1 plans to cover both distribution and administrative fees. These plans do not impose separate payments from the fund's assets to a distributor: rather they stipulate that the adviser to finance the distribution of fund shares may use a portion of the fund's advisory fee."

DISTRIBUTION WITH A DIFFERENCE

Haslem [2014] states 12b-1 fees are required to be "directly earmarked for distribution." Mutual fund directors must ensure these "direct payments" are not excessive or "indirectly channeled" for distribution. With respect to revenue-sharing payments, the SEC states fund advisers must use "their own resources (profits)" and make direct payments for distribution. For this reason, funds were permitted to avoid separately disclosing revenue-sharing payments in the fund expense ratio. For funds without 12b-1 fees, revenue-sharing payments may be included in the expense ratio.

The reality is that so-called use of mutual fund adviser profits to make revenue-sharing payments may be facilitated by first *bundling* these payments in fund-management fees that are then paid to advisers. So, how can the SEC consider revenue-sharing payments that are thusly "indirectly channeled" to be "direct-distribution fees?" In this case, the only logical argument for revenue-sharing payments being "direct distribution" is that fund advisers rather than funds write the checks. However, this misses the most important point. The SEC appears to have enabled fund advisers to also make revenue-sharing payments from receipts of fund-management fees, and without their separate disclosure in the fund expense ratio, under the guise fund advisers make the payments entirely out of profits.

Elton et al. [2004] confirm this view: "It might seem surprising that the part of expenses labeled 'management fee' does not simply compensate managers. *Conversations with fund managers indicate they can and do sometimes pay brokers part of the management fee.*"

Haslem [2014] discusses that the SEC has yet to revisit its problematic interpretation of revenue sharing whereas the mutual fund industry approves of the status quo because it allows larger distribution costs to be paid with no transparency in the fund expense ratio. Fund advisers are not altruistic, and they apparently have been very successful in skirting around the issue and bundling huge amounts of revenue-sharing payments within reported management fees. Huge revenue-sharing payments have enabled larger broker sales of fund shares to the benefit of fund advisers. Larger sales of fund shares have led to greatly increased dollars of the fund-management fees fund advisers receive and possibly larger savings from economies of scale.

The same cannot be said for mutual fund shareholders who continue to pay directly for distribution with management fees and 12b-1 fees. When funds pay these fees, current fund net asset values (NAVs) and shareholder returns decline.

Brokers favor revenue-sharing payments because they provide higher rewards for high sales of funds shares and also help defray costs of managing and servicing fund shareholder accounts. These payments also allow brokers to enhance their advertising and promotional efforts to sell fund shares. Brokers also benefit from higher amounts of brokerage commissions and execution fees from larger fund portfolio trades.

The SEC has found some limited evidence of overly aggressive use of revenue-sharing payments. In these instances, they identified revenue sharing that should have been paid directly from *un-enhanced* fund adviser profits. That is, the fund advisers were too aggressive in including bundled revenue-sharing payments in management fees, which are supposed to be regulatory violations.

To indicate how little explicit attention revenue sharing gets from mutual fund directors and the SEC, at the SEC's [2007c] Rule 12b-1 Roundtable, R.M. Richards states ". . . if there is one thing the commission should do, that I think, above all else, cries out for doing, is to reform the role of directors, not only with respect to 12b-1, but to oversight of the distribution system. . . .

"And it calls for directors' oversight of the entire distribution system, an understanding of how funds are distributed, what kind of money goes into the distribution, where it comes from. No one here, for example, this entire day, has mentioned revenue sharing, a very important component of the financing of the distribution of fund shares.

"Directors should understand how distribution is financed, where it comes from, the manager or its affiliates, the fund, or the shareholder. Directors should understand who gets it, how much they get, what are the conflicts.

"Barbara Roper then adds, 'As Dick was saying, revenue-sharing payments, for example. If you bring certain things out into the open and leave certain things hidden, or relatively hidden, you're creating an incentive to shift costs into a place where they can be hidden.'"

If revenue-sharing payments were to be designated explicitly as line-item costs included in the expense ratio, this change would reflect a change from regulatory and fund adviser sleights of hand to fee transparency and reality. There have been some small moves in this direction, but industry opposition has stalled the efforts. The SEC has discussed use of online disclosure of revenue-sharing arrangements, and later FINRA began initial consideration of this disclosure. However, revenue-sharing payments conflict with continuing shareholder fiduciary interests and should be made transparent, if not prohibited.

REVENUE-SHARING NUANCES

Revenue-sharing payments are known as one of the mutual fund industry's so-called "dirty little secrets." First, InvestorPlace.com [2010] states: "Revenue sharing, as defined by the SEC, occurs when the investment adviser to a fund makes payments to a broker/dealer. In some cases, the investment adviser may describe these payments as reimbursing the broker/dealer for expenses it incurs in selling the shares. These payments . . . give the broker/dealer or adviser a greater incentive to sell the shares of one fund versus another which does not offer to pay revenue sharing. . . . Revenue sharing can take many forms, including the use of 12b-1 fees. Revenue-sharing fees are based as a percentage of the money invested or as a stated dollar amount. These fees can be paid out for as long as an investor owns the fund. As a result, revenue sharing provides an incentive for a financial adviser to promote some funds relative to others, regardless of performance or investor suitability."

Second, InvestorPlace.com [2010] states: "What if objective criteria [for selecting mutual funds] were compromised by a fund company which made cash payments to advisers who sold their funds? How common is this and how does it change the relationship between adviser and client? . . . These are serious questions that affect thousands of shareholders. But these questions involve a practice called revenue sharing that is largely unknown to investors. . . . And while it is a common industry practice, revenue sharing and related expenses such as 12b-1 fees are difficult to understand—and commonly not explained by investment advisers. In many cases, these mutual fund fees can compromise fiduciary relationships between advisers and clients and drag down an investor's net return. In addition to these fees not being well understood by the public, they have been controversial in the industry for years and been the subject of numerous lawsuits. . . . While revenue sharing and 12b-1 fees have a business role in the sale of mutual funds, many professionals say they teeter on the borderline of ethical disclosure."

Third, the Government Accounting Office (GAO) [2004] states: "Revenue sharing occurs when mutual fund advisers make payments out of their own revenue to broker/dealers to compensate them for selling that adviser's fund shares. Broker/dealers that have extensive distribution networks and large staffs of financial professionals who work directly with and make investment recommendations to investors increasingly demand that fund advisers make these payments in addition to the sales loads and 12b-1 fees that they earn when their customers purchase fund shares. For example, some broker/dealers have narrowed their offerings of funds or created preferred lists that include the funds of just six or seven fund companies that then become the funds that receive the most marketing by these broker/dealers.

"In order to be selected as one of the preferred fund families on these lists, the mutual fund adviser often is required to compensate the broker/dealer firms with revenue-sharing payments. According to an article in one trade journal, revenue-sharing payments made by major fund companies to broker-dealers may total as much as $2 billion per year. According to the officials of a mutual fund research organization, about 80% of fund companies that partner with major broker/dealers make cash revenue-sharing payments.

"However, revenue sharing payments may create conflicts of interest between broker/dealers and their customers. By receiving compensation to emphasize the marketing of particular funds, broker/dealers and their sales representatives may have incentives to offer funds for reasons other than the needs of the investor. For example, revenue-sharing arrangements might unduly focus on particular mutual funds, reducing the number of funds considered as part of an investment decision—potentially leading to inferior investment choices and potentially reducing fee competition among funds.

"Finally, concerns have been raised that revenue-sharing arrangements might conflict with securities self-regulatory organization rules requiring that brokers recommend purchasing a security only after ensuring that the investment is suitable for the investor's financial situation and risk profile.

"A June 2003 report recommended SEC consider requiring that more information be provided to investors to evaluate these conflicts of interest; SEC and the National Association of Securities Dealers (NASD) [now FINRA] have recently issued proposals to require such disclosure. Although broker/dealers are currently required to inform their customers about the third-party compensation the firm is receiving, they have generally been complying with this requirement by providing their customers with the mutual fund's prospectus, which discloses such compensation in general terms.

"On January 14, 2004, the SEC proposed rule changes that would require broker/dealers to disclose to investors prior to purchasing a mutual fund whether the broker/dealer receives revenue-sharing payments or portfolio commissions from that fund adviser as well as other cost-related information. Similarly, NASD has proposed a change to its rules that would require broker/dealers to provide written disclosures to a customer when an account is first opened or when mutual fund shares are purchased that describe any compensation that they receive from fund advisers for providing their funds 'shelf space' or preference over other funds.

"The SEC is also proposing that broker/dealers be required to provide additional specific information about the revenue-sharing payments they receive in the confirmation documents they provide to their customers to acknowledge a purchase. This additional information would include the total dollar amount earned from a fund's adviser and the percentage that this amount represented of the total sales by the broker/dealer of that adviser's fund shares over the four most recent quarters."

The NASD [2005] (now FINRA) states: "Revenue-sharing arrangements occur when an investment adviser agrees to pay a broker/dealer cash compensation not otherwise disclosed in the prospectus fee table. Thus, revenue sharing includes payments for shelf-space and marketing support to distribute the investment company's shares but does not include payments made to fund intermediaries for services such as subaccounting for fund shareholders." Only 12b-1 fees are authorized to be paid directly for fund share distribution.

Wilson [2011] adds: "While revenue sharing itself is not illegal, it becomes very problematic when fund assets are used to pay for distribution. . . . [R]evenue sharing can become an issue for regulators if the fund board at the time of agreeing to the management contract makes the management fee larger because of what the manager has spent to persuade brokers to push the fund's shares."

Next, mutual fund revenue-sharing payments may create incentives for brokers to improperly favor paying funds over nonpaying funds. Brokers should also be required to disclose to investors the cash payments and expense reimbursements received from funds as revenue sharing. Broker compensation for sales of fund shares include discounts, sales concessions, service fees, commissions, and asset-based fees.

Further, FINRA prohibits brokers from making payments of most kinds of noncash compensation to registered representatives, such as lavish gifts and trips to resorts. The "training and education exception" forbids reimbursements for tours, golf outings, and other entertainments at so-called training and education meetings.

TYPES OF REVENUE-SHARING PAYMENTS

Haslem [2012] discusses that revenue sharing includes several types of mutual fund payments: 1) marketing pool payments, 2) bonus compensation, 3) networking fees, and 4) subtransfer agency fees (broker and pension plans). The first two types of payments reflect high broker sales of mutual fund shares. Fund payments are based on broker dollar sales (sales fees) and/or dollar holdings (asset fees) of fund shares for specified periods. The third type of payment is based on broker costs of investor account networking fees. The fourth types of payments are based on charges of 401(k) pension plan account record keepers and on broker costs of investor account services. These are asset-based fees.

Marketing pool payments are payments from individual sales pools to brokers that sell large amounts of mutual fund shares. *Bonus compensation* is paid to sales programs offered by the very top-selling brokers of mutual fund shares. *Networking fees* are mutual fund adviser payments to defray broker costs of transmitting investor account information and transaction data through the Networking Securities Clearing Corporation. Monthly servicing fees are normally $4–$12 per customer account, depending on the level of service provided.

In addition, there are *adviser fall-out benefits*, which include agreed amounts of *excess* mutual fund revenue-sharing payments that brokers rebate directly to fund advisers. Fall-out benefits thus motivate fund advisers to make additional revenue-sharing payments, which also benefit brokers, and exaggerate the effective use of revenue sharing for distribution. Fall-out benefits should be repaid to fund assets to the extent revenue sharing derives via fund-management fees, which would negate their use by fund advisers. Mutual fund shareholders do not benefit financially from larger revenue-sharing payments, and they certainly do not benefit from larger fund-management fees.

Mutual fund subtransfer agency fees are included in mutual fund management fees paid to fund advisers to *compensate brokers* for record keeping of individual shareholder fund accounts. These individual investor accounts are then combined to fund single omnibus accounts. Subtransfer agency fees reduce fund payments to traditional fund transfer agents, which are often fund adviser subsidiaries. In the latter case, reduced traditional subtransfer agency fees reduce fund adviser revenues and profits.

Mutual fund subtransfer agency fees are included in fund-management fees paid to fund advisers to compensate 401(k) pension plan record keepers for managing individual participant fund accounts when funds provide investment services. These individual participant accounts are then combined to fund single omnibus accounts.

Pozen and Hamacher [2011] find subtransfer omnibus accounts provide several advantages to broker/intermediaries: 1) make it easier to comply with fund account size minimums, 2) provide greater direct control over investor accounts, and 3) obtain fees for administering shareholder account service functions. However, subtransfer omnibus accounts have several disadvantages for mutual funds: 1) identity of individual account holders unknown for marketing purposes, 2) harder to enforce prospectus rules and restrictions on frequent trading, and 3) cannot directly follow up on detected investor violations.

FUND VIEWS AND ACTIONS

To gain insight into the origins of *additional dealer compensation*, a discussion between two mutual fund officials is useful. Additional compensation likely began when some fund advisers selectively agreed to defray broker costs of sales conferences and meetings. The growth in broker compensation appears to have evolved in two ways: 1) broker requests to fund distributor/advisers to defray costs of sales and marketing programs, and 2) the increasing complementary desire of fund distributors/advisers to be engaged in these programs.

In one special sales incentive, the broker receives *additional ongoing concession revenues* of 25% of stated minimum quarterly growth in fund dollar assets under broker management for a specified period of time. The program applies only to broker fund asset holdings above a minimum threshold.

In another additional dealer-concession program, the broker receives a percentage of mutual fund distributor sales concessions based on increasing levels of quarterly dollar sales of stated fund shares. For broker dollar sales of fund shares below $100,000, $100,000–$249,999, $250,000–$499,999, $500,000–$999,999, $1,000,000–$2,499,999, $2,500,000–$4,999,999, and $5,000,000 and over, the fund distributor receives sales concessions of 0.65%, 0.65%, 0.50%, 0.40%, 0.20%, 0.10%, and 0.05%, respectively. The broker in turn receives 40% of distributor concessions at each level of sales.

In one monthly *account-maintenance fee agreement*, the broker is paid based on the level of networking service provided to customer accounts holding fund shares. Level 1 provides all fund shareholder services, but only limited shareholder access—$4 per account. Level 3 provides all fund shareholder services and access—$12 per account. Level 4 service is provided primarily by the fund, which includes all shareholder access—$4 per account.

REVENUE-SHARING SUMMARY

Revenue-sharing payments have numerous attributes and implications: 1) reward brokers for high and higher sales and/or asset holdings of fund shares and further defray current and higher broker costs of advertising and promotion, ongoing broker servicing of fund investor accounts, and educational support; 2) higher broker sales increase fund assets under management (higher inflows) and profits; 3) higher broker sales of fund shares increase sales concessions and distribution fees; 4) higher assets under management increase trade size and broker commissions, trade execution, and profits; 5) revenue-sharing payments are to be direct payments from fund adviser profits, but may be bundled in fund-management fees paid to advisers who write the checks; 6) revenue-sharing payments via management fees increase their size and fund outflows; 7) brokers rebate fall-out benefits from excess revenue-sharing payments directly to fund advisers; 8) fall-out benefits motivate higher revenue-sharing payments and higher broker profits; 9) revenue-sharing payments via management fees reduce current fund NAVs and shareholder returns; 9) most retail investors are not aware of the existence, nature, and costs of revenue-sharing payments; and 10) beyond account servicing, revenue sharing is agency conflicted with shareholder interests and returns.

To gain some perspective on the size of mutual fund revenue sharing, in one year a single broker received more than $252 million from 90 fund companies. The largest broker receipts from a single fund was more than $59 million.

DISCLOSURE ISSUES

Mutual fund directors are now required to explain in annual reports the real reasons (not boilerplate) for approval of management contracts and fees. Wilson [2005] adds: "So what are boards doing? Running around in circles, screaming and shouting with no disclosure ready. . . . There is scrambling as boards try to do the job they ought to have been doing all along—which is patently obvious they haven't."

FundAction.com [2010] reports a FINRA concept release to mutual funds asking for comments on what they would like to see in disclosure. What was to be included is "any arrangement in which the firm receives any economic benefit (including cash, revenue sharing, commissions, equipment, research or nonresearch services) from any person, including an issuer or product manufacturer in connection with providing a particular product, investment strategy, or service to a customer." Reading between the lines, it appears soft-dollar commissions and soft-dollar rebates may be included. However, to date, no formal statement has been approved.

REVENUE SHARING AND 401(K) PLANS

In "Revenue Sharing Taints 401(k) Plans," Epstein [2011] discusses a GAO study. "[T]he financial services industry's typical way of doing business involving revenue sharing (aka kickbacks to the [401(k) pension] plan administrator, record keeper, custodians, and anyone else getting cash from the plan) creates a conflict of interest.

"Unfortunately, for millions of plan participants, this has been going on for years . . . that is, money which in some form should have gone to the 401(k) plan participants themselves, commonly in the form of lower plan administrative expenses.

"Of course, participants will never see a penny of it because revenue sharing is the grease that lubricates the machinery of many mutual funds in the 401(k) plan business. This will *only* change if DOL regulations on fee disclosure go into effect.

"Revenue sharing and other forms of adviser-paid fees mask the lack of competition in the commoditized mutual fund business. Revenue sharing is the money that gets the attention of registered reps and brokers who have to choose among . . . funds. . . . It's also the sexiest part of any [fund] wholesaler's presentation to a financial adviser.

"That's why a few special dinners, lunches, barbeque sets, golf accessories, 'customer appreciation nights,' logo clothing, and hard cash can make an objective evaluation of a dozen or so . . . funds a lot easier. In the trade, this is a key part of the process known as 'building relationships.'

"In the 401(k) business, revenue sharing serves a similar purpose, but it can be used to reduce plan expenses or pay for the 'education' of plan participants or the people who sit on the 401(k) board. . . . Applied to the 401(k) world, the revenue-sharing deals make it harder to fire a manager or record keeper, for instance, even when asked to provide a straightforward answer about the actual costs of administering the company 401(k) plan."

PENSION PLAN SUBTRANSFER AGENCY FEES

Subtransfer agency fees include mutual fund company payments via fund-management fees to 401(k) pension plan record keepers for maintaining individual participant accounts and providing other services, including provision of account statements, trade confirmations, tax statements, and customer service. Haslem [2011] discusses fund and pension plan fees, services, and performance.

St. Goar [2004] reports on revenue sharing "in which fund companies make payments to administrators or record keepers of 401(k) plans, using fees drawn from fund assets, to ensure that their products are among those offered as part of a 401(k) plan." Subtransfer agency fees include record keeping and administrative services and do not have to be included in fund prospectuses.

There are roughly 50 to 60 different fee structures charged to 401(k) plans. St. Goar [2004] states: "It's a bit of a shell game. If it's cheap over here, then there must be more charges elsewhere." Fees have increased as plan par-

ticipants demand more services, such as self-directed brokerage windows and wireless access to accounts. The fees come as asset-based fees or flat-account fees charged on a per-participant or per-plan basis. Most plan sponsors do not know which fees pay for what service and how much. They often do not know how much they are paying for service providers and may even overpay them.

St. Goar [2004] states: "Subtransfer agency fees are collected by the plan administrator (also known as the record keeper) from the investment manager; the investment manager, in turn, collects these charges by deducting a pool of fees directly from fund assets." The asset-based fees usually range from 5 to 25 basis points, but may reach 65 basis points. Subtransfer agency fees are included in fund expense ratios and do not have to be disclosed to fund sponsors.

In addition, subtransfer agency fees may include asset-based fees for participant education and communication services, security custody, and multicurrency accounting for international funds. In some cases, participant services are charged separately, ranging from 5 to 25 basis points.

In some cases, participant charges are supplemented by asset-based "wrap fees," which may include investment sales commissions, totaling some 5 to 100 basis points. The fee is charged as a supplement to plan internal expenses.

The plan administrator is either a stand-alone entity or a unit of the company that owns the plan's asset manager. The administrator collects flat fees paid directly from the plan sponsor, which can range from $10 to $250 per participant annually. Some record keepers charge separate fees for voice response systems or Internet access. Per-plan fees for small plans are approximately $2,500, but fees are higher for larger plans. Some plans pay both per-plan and per-participant administrative fees. Some flat fees and asset-based fees cover the same expenses. One plan with 500 participants paid $870 per participant, or a total of $435,000.

Fred Reish, in a report from the U.S. Department of Labor's [2007] Working Group on Revenue Sharing Practices, discusses various forms of revenue sharing by size of pension plans. There are usually no 12b-1 fees for brokers, but revenue sharing is used to pay plan costs. Subtransfer agency fees pay for what in mutual funds are called transfer agent record keeping and shareholder services, depending on share class.

In midmarket plans, there is a mix of fees, usually subtransfer agency fees or investment-management fees. There may be 12b-1 fees if a broker is involved. In small market plans, there is a combination of subtransfer agency fees and 12b-1 fees, especially for annuity products with broker charges.

Salisbury [2009] reports that many company sponsors of 401(k) pension plans are unaware of plan administrative costs charged to plan participants in their mutual fund plan accounts. The use of revenue-sharing payments is a controversial aspect of pension plans. Because collection of data on use of subtransfer agency fees in pension plans is scarce, plan participants may not realize they are paying for plan back-office costs, as well as for investment management.

The problem is made more obscure because 401(k) pension plan administrative costs are not charged equally to plan funds. Only about one in eight plans includes all plan funds in paying administrative costs. High-cost (and more profitable) actively managed funds pay a higher percentage of plan administrative costs than do basic plan options, such as index funds. Actively managed funds typically pay annual fees of approximately 0.35% of plan assets toward costs of large plans. For smaller plans, funds may direct 0.06% of plan assets toward costs. Although plan participants find it difficult to determine how much they are paying for plan administrative costs, they may be approximated by the size of fund 12b-1 fees in each plan.

Plan administrative costs have increased as 401(k) plan participants request more specialized services such as self-directed brokerage windows, wireless account access, and others. Asset-based fees are sometimes charged to plan participant accounts, and other times flat fees are charged on a per-participant or per-plan basis.

Plan administrators also collect flat fees from plan sponsors that are paid directly from sponsoring company assets. Flat fees range from $10 to $250 per plan participant or upwards of $2,500, based on dollar asset size of plan menu funds. Some plan administrators charge both types of fees.

Plan administrators make large profits. For example, a small 401(k) plan with 531 participants and assets of $33 million pays a flat fee of $16,641, a fund subtransfer agency back-charge fee of $66,000, a wrap fee of $26,400, and other costs. The total cost per plan participant is $870. It thus behooves the Department of Labor (DOL) and plan sponsors to be much more atten-

tive to the various charges to ensure plan administrators follow fiduciary and legal practices.

In 2009, the House Education and Labor Committee filed a report on its pension plan fee disclosure bill stating unbundling of revenue-sharing payments is necessary if plan sponsors are to know if fees are reasonable. The payments may be unknown to plan sponsors, yet participants are charged 1.50% to 5.75% of account assets annually. The committee cites a witness "who said the amount 'is like a car dealer taking a $10,000 commission on a $30,000 vehicle.'"

The recent economy has kept many pension plan sponsors from reducing revenue-sharing payments. About 50% of plan sponsors use mutual fund subtransfer agency fees, and the rest use hard dollars.

SCHWAB REVENUE SHARING

Baum [2005] reports on mutual fund revenue-sharing payments paid to Charles Schwab & Company (Schwab). American Century Investments and American Funds topped the list of the 25 most generous revenue-sharing arrangements out of 1,500 funds offered through a Schwab brokerage unit for third-party pension plan administrators (TPAs).

Revenue-sharing arrangements are grouped within the trust services section of Schwab's third-party pension administrator platform and payments range from 0 to 95.5 basis points. More than a dozen American Century and American Funds paid an average TPA of 81.5 basis points. The industry standard is usually 5 to 8 basis points. Fund revenue-sharing payments are paid from expense ratios to compensate TPAs and reimburse plan sponsors for other expenses.

A number of mutual funds on the Schwab platform do not pay revenue-sharing payments. They mainly offer compensation through 12b-1 fees and subtransfer agency fees, the latter being strictly for administrative and record keeping expenses. Plan expense payments differ by lumping together all plan costs, including TPAs, into single categories.

There has been more pressure to disclose revenue-sharing payments since Morgan Stanley and American Express Financial Advisors were fined for not disclosing these payments with fund providers, which posed potential conflicts of interest.

Schwab negotiates fee agreements with mutual fund advisers that include service fees for shareholder servicing, record keeping, and subtransfer agency functions. Schwab Trust Company keeps a set portion of these payments for plan administration and passes the balance to TPAs for plan expenses and to plan sponsors.

The American Funds also carry separate 12b-1 fees of 75 basis points normally paid to brokers.

The revenue-sharing arrangements were grouped under "plan expense payment rate" within the trust services section of Schwab's TPA source platform. However, the information was available only to plan administrators and industry insiders. Schwab negotiated arrangements with funds that included service fee payments for shareholder servicing, record keeping, and transfer agent functions. Charles Schwab Trust Company keeps a portion of the transfer agency payment for plan administration, with the balance paid to plan administrators and pension plan sponsors. Plan administrators use these payments for related plan expenses.

A number of mutual funds, including ING Funds and Van Kampen Funds, compensated Schwab through 12b-1 fees and pension plan subtransfer agency fees, the latter strictly designated for administrative and record-keeping expenses. American Funds denied using revenue sharing because its broker payments are included in retirement share classes. The funds pay 81.5 basis points plus separate 12b-1 fees of 75 basis points, but for R^2 Share Class (retirement plans) the 81.5 basis point charge may actually reflect both 12b-1 fees and subtransfer agency fees.

THE SEC VERSUS EDWARD D. JONES

The SEC's [2007b] administrative proceeding charged Edward D. Jones & Company (Jones) with using undisclosed financial incentives to sell primarily shares of seven fund families identified as preferred families. Violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 were found, and a cease-and-desist order was issued. Jones had sales agreements with more than 240 funds. This brief discussion highlights these illegal revenue-sharing practices.

In the late 1980s, Jones approached certain long-standing mutual fund families to pay 25% in revenue sharing on fund assets purchased or held by Jones clients, and in some cases to be given equity interests in fund advisers and distributors.

Preferred families paid up to 25% in revenue-sharing payments calculated as follows:

1. Flat fees based on annual total fund assets held by Jones
2. 7.5 to 10 basis points based on average annual fund assets held by Jones clients
3. 12.5 basis points based on gross sales of funds or
4. 25% of fund advisory fees attributable to average annual assets of certain family fund shares held by Jones clients

Revenue sharing was paid in addition to 12b-1 fees, expense reimbursements, and pension subtransfer agency fees. One fund family agreed to give Jones a 5% interest in its distributor if Jones reached a designated level of sales.

Jones told its sales brokers that those who make the sales get bonuses from revenue sharing. Preferred family funds were promoted exclusively online and to brokers and in sales literature and newsletters, research reports, and internal training. In 2003, Jones's receipts of revenue-sharing payments were 33% of net income of its parent holding company. Until 2003, Jones also received millions in directed brokerage commissions, and assigned *step outs* from trade-execution brokers to high-selling brokers.

Jones did not disclose the amounts of revenue sharing, directed brokerage, and other payments received from preferred families, or the potential agency conflicts created by these payments. Jones claimed they provided disclosure in fund prospectuses and statements of additional information (SAIs). Prospectuses were provided to investors at points of sale and with sales confirmations. Sales brokers were not required to provide SAIs unless requested. However, much of this information failed to disclose adequately the potential conflicts of interest. Jones also did not ensure that prospectuses and SAIs properly disclosed revenue-sharing payments, directed brokerage commissions, and other financial incentives.

The SEC censured Jones and required specified future disclosure of revenue-sharing payments from preferred family funds and ruled that none were to be received from other mutual funds. The cease-and-desist order prohibited future such violations. Of the $82 million Jones received in revenue sharing, the settlement required the firm to pay a $37.5 million fine and to repay investors $37.5 million in "ill-gotten gains and interest." Jones had told investors it chose funds based on exceptional performance and investment objectives. FundAction.com [2011] quotes another fund manager who said, "It is corruption any way you look at it."

Subsequently, Jones disclosed to customers that "[r]evenue sharing . . . involves a payment from a mutual fund company's adviser or distributor, a 529 plan program manager, an insurance company or the entity that markets an insurance contract, or a retirement plan provider. It is not an additional charge to you. These payments are in addition to standard sales loads, annual sales fees, expense reimbursements, subtransfer agent fees for maintaining client account information and providing other administrative services for mutual funds (shareholder accounting and networking fees), and reimbursements for education, marketing support, and training-related expenses."

Some mutual funds pay Jones an annual asset-based fee of 7.5 basis points per dollar, and others pay a one-time sales-based fee of 25 basis points per dollar invested.

MORGAN STANLEY DISTRIBUTION FEES

As Glover [2012, 2013] reports, the cost of mutual fund distribution is facing increasing demands for higher revenue-sharing payments, advisory platform fees, and due-diligence fees. These increases impact fund adviser profits and shareholder returns.

Morgan Stanley's recent fee increases go beyond mutual fund adviser revenue-sharing payments on fund investor assets held in commission-based brokerage accounts; they impact investor fund assets held in its fee-based advisory programs that directly impact fund expenses. These higher fees may draw regulatory scrutiny.

Until recently, Morgan Stanley's fee-based advisory programs were exempt from revenue-sharing charges. The decision to raise platform fees suggests that as advisory accounts become more important, ways will be found to make up for the decline in revenue-sharing revenue due to reduced commission-based business.

In 2012, Morgan Stanley increased mutual fund adviser revenue-sharing payments on investor fund assets to 0.16%, eliminated breakpoint discounts, and required minimum annual payments of $250.000. The increase includes fund assets in brokerage accounts and also advisory accounts. Morgan Stanley no longer applies these fees only to institutional share classes with lower fees, which is especially costly for fund advisers.

Morgan Stanley increased platform fees in advisory programs for transfer agent subaccounting and other fund services. Advisory programs normally allow only for institutional or other share classes without 12b-1 fees and other sales and marketing fees. Unlike revenue-sharing payments, service fees are included in each fund's expense ratio. Subaccounting and other services are generally included under other expenses in the expense ratio.

Morgan Stanley increased charges to mutual fund advisers to 0.16% on fund investor assets held in advisory accounts. Excluded are Employee Retirement Income Security Act (ERISA) retirement plans and the Morgan Stanley TRAK program. These nondiscretionary accounts rely on Morgan Stanley Consulting Group models and are advised by external subadvisors.

Morgan Stanley increased service fees on mutual fund brokerage accounts traded on an omnibus basis. These omnibus fees may be up to $21 per account or up to 0.15% on fund investor assets held in commission-based brokerage accounts. Fund advisers may choose between account-based and asset-based fees.

Many mutual fund advisers effectively pay less by including the fees in expense ratios as capped by the prospectus. If capped, fund advisers will have to pay the flat rate, which may lead to higher fund fees, or pay the difference between what the prospectus allows and Morgan Stanley demands from fund adviser profits.

Traditional mutual fund Class A shares may use portions of fund 12b-1 fees to pay for fees not covered by service fees. Institutional shares and other fee-based share structures have no 12b-1 fees to fall back on.

For mutual fund advisers, the risks of higher distributor fees make their funds less attractive to financial advisers, especially with the option of lower-cost exchange-traded funds. The threat of higher fees is even more important for smaller fund advisers, which lack the bargaining strength with distributors of larger advisers.

As a final note, consider a statement relative to mutual fund purchases in traditional commission-based accounts in the Morgan Stanley channel of Morgan Stanley Smith Barney [2013]: "From each fund family offer, Morgan Stanley Smith Barney seeks to collect a mutual fund support fee, or what has come to be called a revenue-sharing payment. These revenue-sharing payments are in addition to the sales charges, annual distribution and service fees (referred to as 12b-1 fees), applicable redemption fees and deferred sales charges, and other fees and expenses disclosed in the fund's prospectus fee table. Revenue-sharing payments are paid out of the investment adviser's or other fund affiliate's revenues or profits and not from the fund's assets. However, fund affiliate revenues or profits may in part be derived from fees earned for services provided to and paid for by the fund. No portion of these revenue-sharing payments is made by means of brokerage commissions generated by the fund. . . . It is also important to note that advisers receive no additional compensation as a result of these revenue-sharing payments."

However, this statement provides a possibly unintended interpretation of how revenue sharing is channeled for so-called direct payments. Revenue-sharing payments may not necessarily be paid cleanly as direct distribution fees from fund adviser profits. The payments may very well be bundled with fund-management fees as effectively indirect distribution fees.

CONCLUSION

The objective of this article is to take some of the mystery out of mutual fund revenue sharing, but without being able to say investors have transparent disclosure. It appears that most in the world of regulation and practice of revenue sharing lacks clarity, consistency, proper redress, and investor transparency, such as the so-called direct distribution of revenue-sharing payments from mutual fund adviser profits.

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