VIRGINIA LAW & BUSINESS REVIEW

VOLUME 17 | FALL 2022 | NUMBER 1

MUTUAL FUND "CLEAN SHARES": THE FUTURE OR PART OF IT?

Michael B. Weiner†

ABSTRACT

A mutual fund generally offers separate share classes to tailor its distribution fees to meet the needs of different investors. In this way, share classes are like trim levels of a car, where the car's core attributes stay the same, but the trim levels allow consumers to pick the features and cost that best suit them. The world of mutual fund share classes received a jolt of change with the creation of so-called "clean shares," which turn upside down how investors pay for fund distribution. After discussing the regulatory and commercial framework for share classes, this article considers whether clean shares carry through on their promise to improve fee transparency and lower investor costs. Relying on quantitative analysis, the article concludes that while clean shares are a worthy addition to the share class milieu, they are not a death knell for the status quo.

† B.A., Swarthmore College, 2004; J.D., Vanderbilt University Law School, Order of the Coif, 2007. The author serves as counsel to a registered investment adviser and broker-dealer. The views herein are the author's alone.

I. INTRODUCTION

FOR more than 100 million Americans,[1] mutual funds are a crucial means of meeting life's financial needs, from saving for a house, to paying for education and providing for a dignified retirement. With retail investors accounting for almost 90% of the $23.9 trillion invested in mutual funds,[2] mutual funds "demonstrate how 'Wall Street' can connect with 'Main Street' to improve people's lives."[3]

Investors can purchase mutual funds in various ways, which range from working with registered investment advisors that recommend mutual funds as part of a comprehensive financial plan, to choosing their own funds through retirement plans or online "discount" trading platforms. Others purchase shares through brokerage accounts at financial intermediaries that provide advice on a per transaction basis.

Each of these methods for purchasing shares, or "distribution channels," provide investors with a different level of service. To create different price points for different distribution channels, mutual funds generally offer separate share classes. In this way, share classes are like trim levels of a car, where the car's core attributes stay the same, but the trim levels allow consumers to pick the features and cost that best suit them.

The world of mutual fund share classes received a jolt of change with the creation of so-called "clean shares." The term "clean" seeks to convey that the shares externalize the costs of fund distribution. Whereas such costs were previously included in the price of each share, clean shares instead transfer the onus on charging distribution fees to the financial intermediaries that sell them. The concept behind clean shares is that this will improve fee transparency and lower investor costs.[4]

---

1 INV. CO. INST., INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE INVESTMENT COMPANY INDUSTRY 64 (61st ed. 2021).

2 *Id.* at 68.

3 Michael B. Weiner, *A Historical Analysis of the Investment Company Act of 1940*, 10 MICH. BUS. & ENTREPRENEURIAL L. REV. 67, 67 (2020).

4 Capital Grp., SEC Staff No-Action Letter, 2017 WL 105856 (Jan. 11, 2017) [hereinafter

This article discusses whether clean shares carry through on that promise. Section I begins with a description of the business rationale and regulatory framework for mutual fund share classes. Section II describes the share classes that clean shares seek to supplant and how clean shares differ. Section III then compares how these share classes work in practice, which reveals that while clean shares are a worthy addition to the share class milieu, they are not a death knell for the status quo.

II. WHAT ARE SHARE CLASSES?

A mutual fund is an investment product that pools money from the public to invest in securities to pursue a specific investment objective and strategy. The fund then issues shares, which represent a proportionate undivided interest in the pool of securities. Each mutual fund is managed by an investment adviser (the "adviser") that selects the fund's investments and manages its affairs in exchange for a fee.[5] Although share classes create different price points for a particular mutual fund, it is important to keep in mind that each share class invests in the same portfolio of investments and pays the same management fee.

Share classes differ on how they charge (or do not charge) investors for the costs involved with the distribution of shares, which include, among other expenses, educating investors about the value proposition of a particular mutual fund and how that fund fits the investor's needs. Since some distribution channels already charge for and provide such services, mutual funds utilize share classes to protect investors from paying twice for the same service.[6]

By tailoring a share class's fees to the level of service that investors receive, share classes also make it easier for funds to attract more assets. This benefits all shareholders because larger funds can be cheaper for investors, as larger funds spread their fixed expenses over a larger asset base, are more likely to

---

Clean Share Letter]; "*Clean Shares" a Boon for Transparency*, BARRON'S (May 26, 2017) [hereinafter *Barron's on Clean Shares*], https://www.barrons.com/articles/clean-shares-a-boon-for-transparency-1495825438.

5 Weiner, *supra* note 3, at 67.

6 Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds, Investment Company Act Release No. 19,955, 55 SEC Docket 1731 (Dec. 15, 1993), 58 Fed. Reg. 60,074, 68,076 (proposed Dec. 23, 1993) [hereinafter Rule 18f-3 Proposing Release].

experience economies of scale,[7] and if applicable, pay lower management fees to their advisers,[8] "all of which may lower per share fees and expenses."[9]

The Investment Company Act of 1940 (the "Act"), which is the statutory framework that governs the formation, operation, and distribution of mutual funds, actually prohibits a fund from offering different classes of shares. This dissonance is due to the Act's goal of remedying the abuses that occurred in the mutual fund industry during the 1920s and 1930s.[10] With one such abuse being that rogue advisers provided their "insiders" with priority rights over a fund's assets and/or special voting rights that allowed insiders to control an entire fund,[11] the Act's "default setting" is to keep shareholders on equal footing.[12] Share classes, which do the opposite, naturally conflict with the Act's provisions.[13]

With share classes offering substantial benefits to funds and their shareholders, however, the Securities and Exchange Commission (the "SEC") often used its authority to exempt[14] share class arrangements if a fund agreed

---

7 When applied to mutual funds, the term "economies of scale" refers to the theory that if a fund grows in size, the adviser's per unit costs to manage the fund may not increase proportionally. *See In re* Am. Mut. Funds Fee Litig., No. CV 04-5593, 2009 WL 5215755, at *51 (C.D. Cal. Dec. 28, 2009) (citing Kalish v. Franklin Advisers, Inc. 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990)). Since advisers are paid a percentage of a fund's assets, realized economies of scale increase the adviser's profit margin. *See id.* One way advisers seek to share any realized economies of scale is to reduce their fees as the fund grows. *See id.* at 52 (also noting that advisers can share realized economies of scale through other means).

8 *See id.* at 51.

9 Rule 18f-3 Proposing Release, *supra* note 6, at 68,077.

10 *See generally* Weiner, *supra* note 3, at 68-69 (noting the policy concerns that led to the Act).

11 *See id.* at 81.

12 *See* 15 U.S.C. § 80a-1(b)(3) ("[I]t is declared that the national public interest and the interest of investors are adversely affected . . . when investment companies issue securities containing inequitable or discriminatory provisions.").

13 Section 18(f)(1) generally prohibits mutual funds from issuing "senior securities," 15 U.S.C. § 80a-18(f)(1), which are defined by Section 18(g) to include a class of a fund that has priority over another class of the fund with respect to the distribution of assets or payments of dividends, 15 U.S.C. § 80a-18(g). Share classes have been interpreted to conflict with Section 18(f)(1) because expense differences will impact a class's net asset value and dividend per share, and a class with a higher net asset and/or dividend per share "may be considered to have a priority as to the distribution of assets." Rule 18f-3 Proposing Release, *supra* note 6, at 68,077. In addition, Section 18(i) requires that each mutual fund share have equal voting privileges, which conflicts with the practical need for each share class to possess exclusive voting rights on matters that only affect that class. 15 U.S.C. § 18a-18(i); *see also* Rule 18f-3 Proposing Release, *supra* note 6, at 68,077.

14 "Section 6(c) authorizes the SEC to 'exempt any person, security, or transaction' from the provisions of the Act when doing so is 'appropriate in the public interest and consistent with the protection of investors and the purposes' of the Act." Weiner, *supra* note 3, at 70 n.14. The drafters of the Act referred to Section 6(c) as figurative "rubber" that allows the SEC to apply the Act to special or unforeseen circumstances. *See id.* at 69-70. The SEC staff

to conditions that addressed the conflicts of interest that share classes present. To codify and harmonize these exemptions, the SEC adopted Rule 18f-3 in 1995 to permit funds to utilize multiple share classes without having to seek an individual exemptive order.[15]

The Rule requires, among other things,[16] that:

- each share class have a unique distribution and/or shareholder service arrangement[17];
- each share class possess exclusive voting rights as to matters that only affect that class, as well as when the interests of the classes diverge[18];
- each share class allocate advisory and custodial fees in the same manner[19];
- each share class otherwise be treated in the same manner as other share classes[20];
- and that a fund's board, including a majority of its independent directors,[21] determine, on an initial and then annual basis, that the fund's written share class arrangement be "in the best interests of each class individually and the [fund] as a whole."[22]

---

also relies on this concept when it grants "no-action" relief to industry participants seeking assurance that the staff will not recommend an enforcement action on a particular fact pattern. *Id.* at 70 n.14.

15 Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, Investment Company Act Release No. 20,915, 58 SEC Docket 2231 (Feb. 23, 1995), 60 Fed. Reg. 11,876, 11,876 (Mar. 2, 1995) (noting the SEC granted approximately 200 exemptive orders that impose up to 20 conditions "to address various investor protection concerns.").

16 For example, Section (c) prescribes how "[i]ncome, realized gains and losses [and] unrealized appreciation and depreciation" can be allocated among share classes. 17 C.F.R. § 270.18f-3(c)(1) (2022). A fund may only rely on Rule 18f-3 if its board of directors satisfies certain governance standards contained in Rule 0-1 under the Act. 17 C.F.R. § 270.18f-3(e) (2022).

17 17 C.F.R. § 270.18f-3(a)(1)(i) (2022).

18 17 C.F.R. § 270.18f-3(a)(2)-(3) (2022).

19 17 C.F.R. § 270.18f-3(a)(1)(iii) (2022).

20 17 C.F.R. § 270.18f-3(a)(4) (2022).

21 Because a mutual fund is a separate legal entity from its adviser, it has a board of directors to control its affairs. To ensure independent oversight of the adviser, the Act requires that 40% of a fund's directors be independent of the adviser (although independent directors now encompass more than 75% of most fund boards). *See* Weiner, *supra* note 3, at 70-71, 71 n.23.

22 17 C.F.R. § 270.18f-3(d) (2022).

The Rule also allows share classes to have separate conversion and exchange features[23] and for advisers to waive fees or reimburse share classes for expenses that only affect that class.[24]

III. CLEAN SHARES AND THEIR COMPETITION

Clean shares seek to replace Class A shares and Class C shares, which work in conjunction with each other (collectively, the "Class A/C Structure").[25] Under the Class A/C structure, investors have a choice between selecting a Class A share of a mutual fund or a Class C share depending on which class will be more economical over the anticipated investment term. This section describes how each share class works, as well as how clean shares differ.

A. Class A Shares

The hallmarks of a Class A share are a front-end sales charge (also known as a "sales load"[26]) and a 0.25% ongoing distribution fee (also known as a "12b-1" fee due to the SEC rule that made such fees possible[27]). The sales load is deducted from the initial investment so that if a Class A share has a 5.00% front-end sales charge and an investor purchases $10,000 of fund shares, the investor will be charged $500 and $9,500 will be invested.

Sales loads generally decrease as the size of an investment increases (see Figure 1). These reductions are called "breakpoints"[28] and incentivize larger investments.

---

23 17 C.F.R. § 270.18f-3(f)(1)-(2) (2022).

24 17 C.F.R. § 270.18f-3(b) (2022).

25 John Waggoner, *Clean Shares Could Revolutionize the Fund Industry*, INV. NEWS (Feb. 2, 2017) ("Clean shares will be an enormous game changer for mutual funds . . . ."), https://www.investmentnews.com/clean-shares-could-revolutionize-the-fund-industry-70516.

26 *See* 15 U.S.C. § 80a-2(a)(35).

27 Section 12(b) of the Act prohibits a mutual fund from using its assets (i.e., client money) to pay for distribution, as increasing the size of a fund stands to benefit the adviser, whose compensation grows with the size of the fund. 15 U.S.C. § 80a-12(b). Rule 12b-1 provides an exemption from Section 12 if the fund and its independent directors meet requirements aimed at ensuring the fees also benefit the fund. 17 C.F.R. § 270.12b-1(b)(1) (2022).

28 *See* Disclosure of Breakpoint Discounts by Mutual Funds, Investment Company Act Release No. 26,464, (June 7, 2004), 69 Fed. Reg. 33,262 (June 14, 2004).

Figure 1 – Sample Sales Load Schedule	
Amount of Investment	**Sales Charge**
Under $25,000	5.00%
$25,000 but less than $50,000	4.50%
$50,000 but less than $100,000	4.00%
$100,000 but less than $250,000	3.00%
$250,000 but less than $1,000,000	2.00%
$1,000,000 or more	0.00%

Funds generally amplify the power of breakpoints by allowing investors to aggregate their holdings in the same fund, as well as other funds in the same fund family,[29] for the purpose of obtaining a breakpoint. For example, if an investor owns $200,000 in various funds in one fund family and makes a subsequent $50,000 investment, the fund will consider the shareholder to be investing $250,000 and apply a 2.00% sales charge instead of the 4.00% that would otherwise apply to a $50,000 purchase (see Figure 1). The ability for an investor to aggregate their holdings is known as a "right of accumulation" and generally allows investors to also include investments in the same fund family held by members of the investor's household.[30]

Rights of accumulation are related to a "letter of intent," which is another way for investors to reduce a sales load. A letter of intent is a statement by an investor that he or she intends to purchase additional shares of the same mutual fund, or other funds in the same fund family, within a certain amount of time, generally the next 13 months. In exchange for the promise of getting additional assets, the fund family allows the investor to aggregate their future purchases with a current purchase for the purpose of obtaining a breakpoint.[31]

While rights of accumulation and letters of intent reduce sales loads, Class A shares also provide ways to eliminate loads altogether. For example, fund families generally offer "exchange" rights that allow investors to switch to

---

29 A fund family is a group of funds that "[h]old themselves out to investors as related companies for purposes of investment and investor services" or funds that have the same or an affiliated adviser. U.S. SEC. & EXCH. COMM'N, FORM N-1A, ITEM 17, INSTRUCTIONS 1(B)(1)-(2) (2022), https://www.sec.gov/files/formn-1a.pdf.

30 Disclosure of Breakpoint Discounts by Mutual Funds, Investment Company Act Release No. 26,298, 81, SEC Docket 2581 (Dec. 17, 2003), 68 Fed. Reg. 74,732, 74,732-33 (proposed Dec. 24, 2003).

31 *See id.* If an investor fails to purchase enough shares to reach a certain breakpoint, Class A shares will generally "claw back" from the investor the difference between the sales load that the investor stated they would be entitled to and the sales load they wound up qualifying for.

another fund in the same family without paying an additional sales charge.[32] As such, exchanges can be particularly helpful for investors that regularly rebalance their holdings or pursue tactical strategies that involve frequent transactions.

Front-end sales charge "waivers" offer another way to eliminate sales loads. For example, many fund families will not charge a load on Class A shares purchased (1) through a dividend reinvestment program, (2) through certain types of retirement programs, (3) through online discount trading platforms, and (4) by employees of the fund or the fund's adviser. More recently, financial intermediaries have established their own waiver programs.[33] Rule 22d-1 under the Act allows for these "variations" in applying sales loads as long as the mutual fund or financial intermediary applies its waivers "uniformly" to all shareholders who qualify.[34]

One final type of waiver is called a "right of reinstatement," which allows investors to repurchase recently sold shares (or purchase another fund in the same fund family) without paying another sales charge. In this way, rights of reinstatement take exchange rights, which waive the sales charge for simultaneous redemptions and purchases within the same fund family and extend the availability of the feature for a longer period, generally between 60 and 120 days.[35] This protects investors from paying two sales charges on investments for which an exchange likely could have been used.

B. Class C Shares

In contrast to Class A shares, Class C shares do not have sales loads. Instead, Class C shares have a larger 12b-1 fee, typically 1.00% per year.[36] Class

---

32 *Mutual Funds and Exchange-Traded Funds (ETFs) – A Guide for Investors*, OFFICE OF INV. EDUC. & ADVOC., U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/reportspubs/investor-publications/investorpubsinwsmfhtm.html#Returns (Jan. 26, 2017).

33 *See* DIV. OF INV. MGMT., U.S. SEC. & EXCH. COMM'N, IM GUIDANCE UPDATE NO. 2016-06: MUTUAL FUND FEE STRUCTURES http://www.sec.gov/investment/im-guidance-2016-06.pdf (Dec. 2016). For financial intermediaries that sell mutual funds from hundreds of fund families, each of which has its own fee waivers, this allows an intermediary to instead apply one set of waiver rules–its own.

34 *See* 17 C.F.R. § 270.22d-1(a) (2022).

35 *See* FIN. INDUS. REGUL. AUTH., TARGETED EXAMINATION LETTER ON RIGHTS OF REINSTATEMENT (ROR), (Nov. 2020), https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/rights-of-reinstatement.

36 If an investor sells their Class C shares before they have been held for 12 months, most Class C shares deduct a 1.00% sales charge from the redemption proceeds. FIN. INDUS. REGUL. AUTH., MUTUAL FUNDS: SHARE CLASSES, https://www.finra.org/investors/learn-to-invest/types-investments/investment-funds/mutual-funds/share-classes (last visited Sept. 17, 2022).

C shares are useful because they allow investors to put their money to work immediately. Whereas a $10,000 investment in a Class A share with a 5.00% sales load results in $9,500 being invested, the entirety of a Class C share purchase gets invested. Even with a larger 12b-1 fee, this often allows Class C shares to be more economical than Class A shares for a few years. This makes Class C shares well-suited to short-term investments, particularly smaller ones that do not qualify for breakpoints and would otherwise pay a larger sales load.[37]

C. How Class A Shares and Class C Shares Work Together

One way to think of how Class A shares and Class C shares work together is to imagine the two share classes running a race on a track. Other than their differences in expenses, each share class "runs" at the same speed (*i.e.*, has the same return) because they invest in the same portfolio of securities. To represent this, the Class A share, with its smaller 12b-1 fee, runs in the inside lane. As a result, if the Class A share and Class C share were to start at the same point on the track, the Class A share would always win.

But, since Class A shares have sales loads and Class C shares do not, the Class C share gets a "head start." To use the above $10,000 example as an illustration, the Class A share would start the race with $9,500 while the Class C share would start with $10,000. This puts the Class C share "in the lead" for at least some portion of time. The hard part is determining for how long, as despite starting behind the Class C share, the Class A share's inside position will allow it to eventually catch up to and pass the Class C share.

Fortunately, many funds and financial intermediaries have Class C share conversion programs, which convert Class C shares into Class A shares—without the imposition of a sales charge and on a tax-free basis—after the Class C share has been held for a set amount of time. This mitigates (if not eliminates) the possibility that an investor will hold a Class C share past the point when Class A shares become more economical.[38] This allows investors to get the best of both worlds: if an investor anticipates Class C shares to be more economical than Class A shares at the time of purchase but the investor winds up holding the position for longer than expected, the investor will automatically receive Class A shares and a 75% reduction in 12b-1 fees rather than continuing to pay a higher 12b-1 fee. To return to the race analogy, Class

---

37 *See id.*

38 *See* Carmen Germaine, *Shops Speed Up C-Share Conversions*, IGNITES (Sept. 29, 2020) https://www.ignites.com/c/2902923/360743?referrer_module=searchSubFromIG&highlight=Shops%20Speed%20Up%20C-Share%20Conversions.

C share conversion programs allow the runner in the outside lane to cross over to the inside lane after a certain number of laps.

Lastly, it bears asking how an investor in the Class A/C structure should choose between Class A shares and Class C shares. The initial question is whether an investor qualifies for a sales load waiver that eliminates the sales load. If so, then the Class A share will be the more economical choice. If not, the primary drivers will be how long the investor intends to hold their shares and whether the investor qualifies for any breakpoints that reduce the sales load and shorten the Class C share's "head start." To make this process easier, the Financial Industry Regulatory Association ("FINRA"), a self-regulatory organization that oversees broker-dealers, maintains a "Fund Analyzer" that "calculates how a fund's fees, expenses and discounts impact the value of a fund over time."[39] Certain financial intermediaries also utilize share class calculators to help their clients choose between Class A shares and Class C shares.

D. Clean Shares

In 2017, the Class A/C Structure was joined by so-called "clean" shares, which do not include front-end sales charges or 12b-1 fees.[40] If clean shares are defined by how they remove the costs of distribution from a fund's expense ratio,[41] they are also defined by how they enable a financial intermediary to charge a commission on their purchase and sale.[42] As a result, while clean shares externalize the costs of fund distribution, clean shares do not eliminate them.

In this way, clean shares allow mutual funds to mimic exchange-traded funds ("ETFs") registered under the Act, which generally do not impose distribution fees but instead are subject to front-end and back-end commissions charged by financial intermediaries. With ETFs having enjoyed considerable growth since their creation in 1993,[43] clean shares allow mutual funds to

---

39 FIN. INDUS. REGUL. AUTH., FUND ANALYZER OVERVIEW, https://www.finra.org/investors/tools-and-calculators/finra-fund-analyzer-overview (last visited Sept. 26, 2022).

40 *Barron's on Clean Shares*, *supra* note 4.

41 A fund's total fee, including its management fees, 12b-1 fees and other expenses, expressed as a percentage of the fund's assets, is often called its "expense ratio." *See* SEC. & EXCH. COMM'N, *supra* note 32.

42 *Clean Shares,* SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/glossary/clean-shares (last visited Sept. 18, 2022) ("A broker would be expected to charge its customers commissions for effecting transactions in Clean Shares.").

43 *See* INV. CO. INST., *supra* note 1, at 94-95. Some even argue ETFs will eventually replace mutual funds as the dominant "Main Street" investment product. *See* John Rekenthaler,

resemble their competition without jettisoning the mutual fund structure altogether.[44] They also have "a nice ring to it. After all, who wants to invest in dirty shares?"[45]

Clean shares did not exist prior to 2017, which is when an SEC no-action letter[46] confirmed that financial intermediaries can charge commissions on mutual fund shares without violating Section 22(d) of the Act.[47] By way of background, Section 22(d) requires that "dealers" sell mutual funds at prices listed in their prospectuses, which commissions stand to change. Since Section 22 is silent with respect to "brokers," the issue was whether Section 22(d) precluded financial intermediaries acting as brokers in the distribution of fund shares from charging a commission.[48] The SEC staff concluded that it did not because commissions, which a mutual fund cannot control and does not receive, are distinguishable from internalized distribution fees that are "an integral part of the fund's distribution system."[49] As a result, charging a commission would not function to turn a broker into a dealer.[50]

Similar to sales loads, clean share commissions that are priced as a percentage of the transaction amount generally decrease as the transaction amount increases (see Figure 2). Clean share commissions can also include fixed fee components.

Farewell, Mutual Funds, MORNINGSTAR (Sept. 2, 2021), https://www.morningstar.com/articles/1018487/farewell-mutual-funds.

44 Certain mutual funds have converted into ETFs. *See* Joe Morris, *Franklin to Convert Two Mutual Funds to ETFs*, IGNITES (Dec. 15, 2021), https://www.ignites.com/c/3436904/438504?referrer_module=searchSubFromIG&highlight=Franklin%20to%20Convert%20Two%20Mutual%20Funds%20to%20ETFs%27 (describing mutual fund-to-ETF conversions involving multiple fund families).

45 Aron Szapiro, *A Closer Look at the Future of Clean Shares*, MORNINGSTAR (Jun. 7, 2018), https://www.morningstar.com/articles/868754/a-closer-look-at-the-future-of-clean-shares.

46 *See* Clean Share Letter, *supra* note 4.

47 *See id.*

48 *See id.*

49 *Id.* (quoting DIV. OF INV. MGMT. REGUL., SEC. & EXCH. COMM'N, MUTUAL FUND DISTRIBUTION AND SECTION 22(D) OF THE INVESTMENT COMPANY ACT OF 1940 112-13 (1974)).

50 When it comes to the types of payments that can turn a financial intermediary into a dealer, the Clean Share Letter distinguishes between distribution payments made by the fund and those made by the adviser. *See* Clean Share Letter, *supra* note 4. This is consistent with longstanding SEC policy that distribution payments made from a manager's legitimate profits are not "made out of fund assets" nor subject to Rule 12b-1. Inv. Co. Inst., SEC No-Action Letter, 1998 WL 1543541 (Oct. 30, 1998).

Figure 2 – Sample Commission Schedule	
Amount of Investment	**Commission**
Under $1,999	5.00%
$2,000 but less than $9,999	2.00%
$10,000 but less than $24,999	1.75%
$25,000 but less than $49,999	1.20%
$50,000 but less than $99,999	1.00%
$100,0000 but less than $249,999	0.90%
$250,000 or more	0.70%

IV. COMPARING CLEAN SHARES AND THE CLASS A/C STRUCTURE

The introduction of clean shares inevitably led to the question of whether clean shares made the Class A/C structure obsolete.[51] To answer this, this section determines the cumulative distribution fee[52] an investor will pay under various circumstances. We assume:

- Class A shares are subject to the sales load schedule in Figure 1 and a 0.25% 12b-1 fee;
- Class C shares are subject to a 1.00% 12b-1 fee and convert into Class A shares after six years;
- The investor utilizes the FINRA Fund Analyzer and/or invests with a financial intermediary that utilizes a share class calculator; and
- Clean shares are subject to the commission schedule in Figure 2 for both purchases and sales.

We then vary the (1) amount of the investment, (2) time horizon for the investment, and (3) amount of times the investor transacts, with a purchase and sale of a fund being defined as a "round trip."

A. Controlling for a Small Investment

While Figures 3 and 4 control for a small investment, they vary on how long the investor holds the investment and how often the investor transacts. For short-term investments, Figure 3 demonstrates the value of Class C shares, both within the Class A/C structure and as compared to clean shares. First, for

---

51 Daisy Maxey, *'Clean Shares' Get a Boost from Fiduciary Rule*, WALL ST. J. (May 26, 2017, 10:14 AM) https://www.wsj.com/articles/clean-shares-get-a-boost-from-fiduciary-rule-1495808073 ("Is the A share dead? That's pretty likely.").

52 Investing in mutual funds also involves paying each fund's management, administrative and/or other fees.

an investor choosing between Class A and Class C shares, the latter helps investors to save money because it is more economical to pay the Class C share's 1.00% ongoing distribution fee for two years than it is to pay a sales load and a smaller ongoing fee (especially if the investment does not "hit" any breakpoints). Class C shares also best the clean share here due to the charges that clean shares pay on both purchases and sales. This byproduct of transaction-based compensation is magnified when the investor makes more than one round trip.

Figure 3

Share Class Structure	**Investment**	**Time Period**	**"Round Trips"**	**Cumulative Fee**	**Winner**
Class A/C	$10,000	2 years	1	2.00%	***Class A/C*** *(specifically, Class C shares)*
Clean	$10,000	2 years	1	3.50%	
Class A/C	$10,000	2 years	2	2.00%	***Class A/C*** *(specifically, Class C shares)*
Clean	$10,000	2 years	2	7.00%	

However, Figure 4 shows how transaction-based compensation can benefit a buy-and-hold investor over longer time periods, where paying at the beginning and the end of an investment is cheaper than paying ongoing fees the entire time. Adding a round trip, though, causes the clean share and the Class A/C structure to pay the same amount.[53]

Figure 4

Share Class Structure	**Investment**	**Time Period**	**"Round Trips"**	**Cumulative Fee**	**Winner**
Class A/C	$10,000	10 years	1	7.00%	***Clean Shares***
Clean	$10,000	10 years	1	3.50%	
Class A/C	$10,000	10 years	2	7.00%	***Tie***
Clean	$10,000	10 years	2	7.00%	

53 It is worth explaining how the 7.00% cumulative fee was calculated for the Class A/C structure. First, the $10,000 investment did not hit any breakpoints. Thus, choosing a Class A share would mean paying a 5.00% sales load and a 0.25% 12b-1 fee every year for a 7.50% cumulative distribution fee. Applying the Class C share conversion program, however, drops the 1.00% 12b-1 fee to 0.25% after six years and results in a cumulative distribution fee of 7.00%. Adding another round trip would not change this fee if the investor chose another mutual fund in the same fund family. Had the investor chosen a different fund family for the second investment, the free exchange feature would not apply, and the clean share would have been more economical.

B. Controlling for a Large Investment

For larger investments, which reduce the clean share commission, the competition becomes tighter for short-term investments. Here, essentially halving the commission from 1.75% for a $10,000 investment to 0.90% for a $100,000 investment allows the clean share to edge the Class A/C structure[54] when there is only one round trip. However, this changes when an investor transacts more often, as paying a commission four times, even a reduced one, exceeds what the Class A/C structure charges over a short investment term.

Figure 5

Share Class Structure	Investment	Time Period	"Round Trips"	Cumulative Fee	Winner
Class A/C	$100,000	2 years	1	2.00%	***Clean Shares***
Clean	$100,000	2 years	1	1.80%	
Class A/C	$100,000	2 years	2	2.00%	***Class A/C*** *(specifically, Class C shares)*
Clean	$100,000	2 years	2	3.60%	

Lastly, Figure 6 demonstrates the effects of holding a large investment for a long term. Here, clean shares are more economical because the larger investment yields a lower clean share commission, and the longer holding period provides more time for the Class A/C structure's[55] ongoing fees to make an impact. In this example, the advantage persists even with an additional round trip.

Figure 6

Share Class Structure	Investment	Time Period	"Round Trips"	Cumulative Fee	Winner
Class A/C	$100,000	10 years	1	5.50%	***Clean Shares***
Clean	$100,000	10 years	1	1.80%	
Class A/C	$100,000	10 years	2	5.50%	***Clean Shares***
Clean	$100,000	10 years	2	3.60%	

---

54 It is notable that Class C shares remain more economical for a short time even when a $100,000 investment allows a Class A share to qualify for a reduced sales load of 3.00% (see Figure 1). Again, this shows why Class C shares are integral to the Class A/C structure.

55 In this example, Class A shares are more economical than Class C shares due to the size of the investment and its length. This is because the $100,000 investment is subject to a 3.00% sales load (see Figure 1) and a 0.25% 12b-1 fee. This yields a 5.50% cumulative distribution fee, which is lower than the 7.00% that would have been charged on a 10-year investment in Class C shares.

V. CONCLUSION

With the final tally for the eight hypotheticals being four wins for clean shares, three wins for the Class A/C structure and one tie, both competitors can claim to offer value for investors. A decisive result remains elusive because each comparison depends on circumstances that are subject to change. To be sure, the investment amount, investment term, transaction frequency, size of the clean share commission, size of the sales load, use of free exchanges and availability and timing of a Class C share conversion program all serve as material, but malleable, inputs for comparisons like these.

In this environment, it is more constructive to focus on the benefits of each choice. For instance, clean shares offer a simplified approach to investing, as clean shares do away with breakpoints, rights of accumulation, letters of intent, rights of reinstatement, exchanges, conversion programs and front-end sale charge waivers. Externalizing distribution costs also increases opportunities for compounded investment returns (although investors then pay a commission and capital gains taxes on that higher amount whereas a Class A/C investor is taxed on their return net of distribution fees). Alternatively, the Class A/C structure can be more advantageous for investors that transact more often, where paying commissions on every purchase and sale can add up over time. The Class A/C structure, and in particular, Class C shares, are also beneficial for short-term investors that transact at lower amounts.

In the end, there is no doubt that clean shares' simplicity and performance justify their existence. As such, clean shares embody why the SEC adopted Rule 18f-3 and made share classes a part of the mutual fund lexicon, as they increase investor choice and help to reduce fund expenses. With the Class A/C structure still holding its own, however, it is best to think of clean shares as being a part of the future of mutual fund distribution as opposed to being *the* future.