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Enforcement Action Puts Bull's-Eye on Mutual Funds with ETF Clones

Broker-dealers' requirements under Regulation Best Interest prevent them from selling mutual funds when identical ETFs are available on their platforms, attorneys and compliance professionals say.

By David Isenberg, Alyson Velati | November 6, 2024

When brokers or financial advisors offer mutual funds and ETFs that are clones of one another, a recent enforcement action suggests they ought to sell the ETF, attorneys and compliance professionals say.

Last week, **JPMorgan** brokers agreed with the **Securities and Exchange Commission** to repay more than $15 million to customers to whom it sold mutual funds when it could have sold cheaper, identical ETFs.

The case heightens the regulatory risks of offering clone mutual funds and ETFs on the same advisory channel or brokerage platform, said **William Whitt**, strategic advisor at **Datos Insights**.

"When the ETFs are materially cheaper and it's a clone, there really is no argument for selling the mutual fund," he said.

Between 2020 and 2022, JPMorgan Securities, a dual-registrant subsidiary, sold mutual funds to 10,500 retail clients when cheaper identical ETFs were available, resulting in more than $14 million in higher fees and expenses, according to an SEC release.

JPMorgan neither admitted nor denied the findings in the settlement, and a spokesperson for the SEC declined to comment.

"When issues are identified, we fix them and engage with our regulators to resolve any concerns," a spokesperson for JPMorgan stated.

There are about 130 clone ETFs on the market, said **Loren Fox**, director of research at **Fuse Research**.

More and more identical ETFs are actively managed, which means more clones may begin to become admitted onto the same distribution platform as their mutual fund twins, Whitt said.

In August, **Merrill Lynch** announced plans to triple the number of actively managed ETFs on its platform, including ETF clones. And in September, **Wells Fargo** announced plans to double the number of ETFs on its recommended list.

With more identical ETFs on brokerage platforms, advisors and brokers should expect to see many more enforcement actions like the one announced against JPMorgan last week, Whitt said.

Fund firms should educate advisors and brokers about the expenses, he said.

What might determine whether a platform will face scrutiny is the difference in price, Fox said.

For example, if a mutual fund costs 20 basis points but its ETF clone is 18 bps, "that's only 2 bps but that's 10% difference" and brokers will want that clarified, Fox said.

Some brokers have policies around when to sell identical ETFs over mutual funds if the price is 25% cheaper than the clone, he said.

After JPMorgan's enforcement action, that number may tighten, Fox said.

Fees may not be straightforward, because certain mutual funds and share classes within them may have different sales loads, said **Tom Grygiel**, senior principal consultant at **ACA Group**.

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And brokers may have fund-specific revenue-sharing agreements and breakpoints that could also factor into fees and incentives to sell certain funds over others.

Another challenge is the ambiguity of Regulation Best Interest, the 2019 broker-dealer standard of conduct rule, Grygiel said.

"The SEC has said, 'Well, it's based on facts and circumstances.' Then another time they say, 'Well, you know, you're supposed to consider fees, costs, risks and rewards,'" Grygiel said.

"Another time they'll say, 'The lowest cost doesn't necessarily mean that it's the appropriate, the best option,'" he said.

Reg BI was a "huge step" in investor protection that makes brokers' standard of conduct much closer to an advisors' fiduciary duty, said **Michael Evans**, founder of **Vega Compliance Consulting**.

Reg BI requires brokers who choose more expensive products to have a rationale for doing so, said **Jessica Price**, a partner at **Ropes & Gray**.

Mutual funds may also differ from their ETF clones in terms of other factors, such as track record, said **Patrick Chism**, managing director of broker-dealer compliance at **Vigilant Compliance**.

Fund firm wholesalers also must be transparent in their sales pitches to brokers and other intermediaries, be cognizant of the risks, and evaluate the appropriateness of a mutual fund versus an identical ETF, Whitt said.

Information sent to a distribution intermediary can be less detailed than that sent to a retail investor, but it should also never contradict such information, Evans said.

The compliance concerns of clones likely won't pause the rollout of identical ETFs, "because the whole industry is going that way and all the flows are going that way," Whitt said.

However, some fund firms are also rolling out "cousin ETFs," whose strategy is similar to a mutual fund's but not identical, Fox said.

Cousin ETFs may have one or two portfolio managers overlapping, but not the entire portfolio management team.

To date, at least 100 cousin ETFs have launched, Fox said.

Cousin ETFs "might become even more popular, because then it's much easier to avoid any regulatory complications, because you're not comparing apples to apples," he said.