IGNITES

Commonwealth Found Liable for Rev-Share Disclosure Failures

A judge ruled that the broker-dealer violated the Advisers Act by failing to properly disclose that its representatives were incentivized to steer clients into certain mutual funds.

By Ben Miller | April 11, 2023

Commonwealth Financial Network is liable for failing to disclose that its investment advisor representatives were incentivized to sell certain products because of a revenue-sharing arrangement that the firm had with a clearing broker, a Massachusetts district court judge wrote on Friday.

The broker-dealer kept under wraps a revenue-sharing arrangement with **Fidelity** affiliate **National Financial Services** through which Commonwealth collected fees from certain mutual funds that advisors sold to clients, according to an August 2019 **suit** filed by the **Securities and Exchange Commission** in Massachusetts district court. The firm failed to disclose the revenue-sharing agreement from 2014 and 2018.

Judge **Indira Talwani** granted the SEC's request for early judgment in the case, holding Commonwealth responsible for the disclosure issues, and rejecting the firm's argument that the SEC did not provide fair notice of the disclosure obligations in the lawsuit.

The judge's order does not state whether Commonwealth will have to pay a fine or face another penalty.

Commonwealth had argued that the SEC did not prove its fee arrangement with NFS created conflicts of interest. The Waltham, Massachusetts-based broker-dealer also claimed that the regulator changed its disclosure standards without giving the firm

Commonwealth believes that its disclosures were "appropriate," wrote General Counsel **Peggy Ho** in an email.

SEC spokespeople did not respond to requests for comment.

NFS gave Commonwealth a cut of the payments it received from funds sold on behalf of companies within its FundsNetwork program, the judge noted. The firm also charged Commonwealth a fee for selling mutual funds from companies that did not pay to participate in the clearing broker's FundsNetwork program.

In addition, Commonwealth's finance department allegedly withheld information from its compliance department regarding cheaper share classes and lower-cost investment alternatives, Talwani wrote. Though the firm built a tool to help identify lower-cost share classes for clients, it failed to distribute it widely to representatives, she noted.

Commonwealth violated disclosure obligations under the Advisers Act that require fiduciaries to disclose conflicts of interest, she ruled. In addition, the broker-dealer's disclosures about the revenue-sharing arrangement were inadequate, she noted. The firm also made material omissions in disclosures and acted negligently by failing to disclose economic conflicts inherent to its arrangement with NFS.

> "The court finds that to the extent that Commonwealth did not disclose that Commonwealth may have a potential conflict of interest where it receives revenue-sharing payments on mutual fund class shares that have higher expenses as compared to others

mutual fund class shares or class shares of the same fund existed with lower internal expenses, such disclosure is inadequate under the Advisers Act," Talwani wrote.

Commonwealth's disclosures initially stated that the broker-dealer and its representatives may receive commissions for some transactions, court filings show.

Revenue-sharing disclosures should be explicit, said **Brian Rubin**, partner at **Eversheds Sutherland**, who is not involved in the case.

"The SEC has made clear, and so far courts have made clear, that they don't like the word 'may,' if in fact firms did receive this revenue or it did cause a conflict," he said. As a result, many firms have expanded their disclosures, he noted.

"As different revenue-sharing issues pop up, firms will have to look at their disclosures and conflicts, and regulators will be doing the same thing," Rubin added.

The SEC has gone after other firms for similar revenue-sharing conflicts. For example, **Cetera last year** was order to pay $9 million for failing to disclose details about its revenue-sharing arrangement with **Pershing**, as well as for selling pricey share classes. Cetera similarly failed to disclose that its arrangement with Pershing incentivized representatives to steer clients into mutual funds on the clearing broker's platform.

Financial firms should collaborate with one another to ensure that their disclosures comply with the SEC's standards, said **Sander Ressler**, managing director of **Essential Edge Compliance Outsourcing Services**. "Look at what your competition is doing, and attempt to mimic what they're doing," he said.

Broker-dealers can learn what kind of disclosure language to avoid from the Commonwealth suit, he noted.