19 January 2017

Practice Groups:

Investment Management, Hedge Funds and Alternative Investments

Global Government Solutions

SEC Staff Addresses Mutual Fund Fee Structures in Response to DOL's Fiduciary Rule

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Summary of Recent SEC Staff Actions

As the April 10, 2017, compliance date for the United Stated Department of Labor's ("DOL") new fiduciary rule (the "Fiduciary Rule") approaches, many mutual fund sponsors have received requests from financial intermediaries to implement changes to mutual fund fee structures designed to facilitate the intermediaries' compliance with the Fiduciary Rule. The staff of the Securities and Exchange Commission (the "SEC") has taken the following measures to help facilitate responses by mutual funds to these requests: (1) on December 15, 2016, the staff of the SEC's Division of Investment Management issued an IM Guidance Update regarding the disclosure of intermediary-specific variations in sales loads and registration of new share classes (the "Staff Guidance");[1] and (2) on January 11, 2017, the SEC staff issued an interpretive letter clarifying the application of Section 22(d) of the Investment Company Act of 1940, as amended (the "1940 Act"), to underwriters, dealers, and brokers of mutual funds (the "Section 22(d) Letter").[2] This alert discusses the Section 22(d) Letter and the Staff Guidance.

Background

The Fiduciary Rule

The Fiduciary Rule greatly expanded the definition of "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA"). ERISA subjects fiduciaries to a number of duties and responsibilities, including duties of prudence and loyalty, and strict prohibited transaction restrictions. In particular, the Fiduciary Rule imposes duties and restrictions on broker-dealers and their sales personnel who provide advice, which is a broadly defined term. Simultaneous with the adoption of the Fiduciary Rule, the DOL issued the Best Interest Contract Exemption ("BIC Exemption"), which allows registered investment advisers and broker-dealers that are ERISA fiduciaries to be compensated in ways that would otherwise constitute a prohibited transaction. In particular, the BIC Exemption is intended to provide a way for broker-dealers who become fiduciaries under the Fiduciary Rule to continue offering existing compensation structures that otherwise would be impermissible. Current compensation structures with respect to mutual fund shares typically include the receipt of 12b-1 fees, brokerage commissions, sales loads, and revenue sharing payments.

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[1] IM Guidance Update No. 2016-06, Mutual Fund Fee Structures (Dec. 15, 2016), *available at* http://www.sec.gov/investment/im-guidance-2016-06.pdf.

[2] Capital Group, SEC Interpretive Letter (Jan. 11, 2017), *available at* http://www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm.

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The BIC Exemption includes Impartial Conduct Standards that require advice to be in a client's best interest, "without regard to the financial or other interests of the [ERISA fiduciary]."[3] The DOL's adopting release for the BIC Exemption explains that "an Adviser and Financial Institution do not have to recommend the transaction that is the lowest cost or that generates the lowest fees without regard to other relevant factors."[4] However, the burden of demonstrating compliance with the BIC Exemption falls upon the party claiming the exemption.

The BIC Exemption's conditions have raised the question of whether an intermediary can qualify for the BIC Exemption where compensation received by the firm differs from product to product. Some firms are concerned that it may be difficult to demonstrate that recommendations are not influenced by the compensation a firm will receive when the firm receives more from some fund groups than from others.

Requests From Intermediaries in Response to the Fiduciary Rule

In response to the Fiduciary Rule, a number of intermediaries that intend to rely on the BIC Exemption have requested that mutual fund sponsors establish intermediary-specific fee structures. These are fee structures that have been established specifically to accommodate one or more intermediaries to facilitate their sales of fund shares. An intermediary arguably could more easily demonstrate that its recommendations are not influenced by the compensation that it will receive when its compensation structure is the same for all of the funds it offers clients.

Some intermediaries' requests have proven challenging for mutual fund sponsors because most mutual fund complexes have entered into distribution arrangements with multiple intermediaries. To accommodate the intermediaries' requests, mutual fund sponsors must either: (i) offer a share class with varying sales load discounts or waivers, each of which applies uniformly to investors that purchase shares through a single intermediary (or category of multiple intermediaries); (ii) establish new share classes, each of which reflects the fee structure requested by a given intermediary; or (iii) offer Clean Shares, which are subject to sales charges imposed by intermediaries executing transactions as a broker. Mutual fund sponsors may have to consider pursuing a mixture of these approaches in order to accommodate the preferences of multiple intermediaries.

A mutual fund sponsor unable or unwilling to accommodate a request risks losing the intermediary relationship. This could impact sales of mutual fund shares and even lead to redemptions of fund shares by the intermediary's customers.

Section 22(d)

Text and Effect of Section 22(d)

Section 22(d) provides, in relevant part, that no registered investment company shall sell:

> any redeemable security … except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if

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[3] 81 Fed Reg. at 21002 (Apr. 8, 2016).

[4] *Id.*

> such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus.

Section 22(d) generally prohibits the sale of mutual fund shares (i.e., redeemable shares) by a principal underwriter or dealer at any price other than the "current public offering price described in the prospectus." The public offering price of mutual fund shares consists of the net asset value per share, plus any applicable sales load. Thus, the effect of Section 22(d) is retail price maintenance that prohibits competition among principal underwriters and dealers with respect to sales loads.

Legislative and Regulatory History

Section 22(d) was enacted primarily to promote the orderly distribution of mutual fund shares. It was intended to address the concerns of mutual funds that dealers could maintain inventories of shares with little or no market risk because the funds would be required to redeem shares on any day at net asset value. A related issue was the "backward pricing" system used by mutual funds prior to the enactment of the 1940 Act and for a number of years thereafter. When mutual funds used backward pricing, dealers and investors could buy and redeem shares for a price based on the prior day's net asset value. Thus, dealers and investors could profit from today's general rise in the market by purchasing shares of a fund at the prior day's closing net asset value. If the market suffered a large drop, they could also redeem those shares today based on the prior day's higher net asset value.

For a number of years, the SEC's Division of Investment Management has criticized Section 22(d) as a relic of the past. In 1992, the SEC staff published a report that stated "[t]here no longer are any compelling reasons to retain retail price maintenance."[5] In July 2010, in connection with proposals to amend Rule 12b-1 under the 1940 Act, the SEC proposed amendments to Rule 6c-10 under the 1940 Act that would have allowed funds to offer their shares without a front-end sales charge and permitted dealers in those shares to set and impose their own sales charges.[6]

Proposed Rule 6c-10 would have left the amount of dealer-imposed charges, and the manner and timing of their collection, to the dealers' discretion, subject to compliance with other applicable requirements (e.g., FINRA rules concerning excessive compensation). It would have allowed mutual funds to unbundle the sales charge components of distribution from the price of fund shares. However, the proposal was not adopted, and the retail price maintenance provisions of Section 22(d) continue to apply to principal underwriters and dealers.

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[5] SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (May 1992), *available at* http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

[6] *See* SEC Release No. IC-29367, *available at* http://www.sec.gov/rules/proposed/2010/33-9128.pdf [hereinafter, the "Proposing Release"].

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Prior SEC Staff Interpretations of Section 22(d)

The SEC staff has acknowledged for many years that the express language of Section 22(d) makes it clear that the requirements do not apply to an entity acting only as a broker, as that term is defined in the 1940 Act.[7] Thus, brokers (in contrast to principal underwriters and dealers) may charge commissions in connection with the purchase of mutual fund shares without violating Section 22(d). Prior to the issuance of its recent interpretive letter, the SEC staff had not addressed whether the principal underwriter of a fund may enter into an agreement with an intermediary to facilitate brokerage transactions in which customers are charged brokerage commissions.

Recent Interpretive Letter Regarding Section 22(d)

The Section 22(d) Letter clarifies that the restrictions of Section 22(d) do not apply to a broker when it acts as agent on behalf of its customers and charges its customers commissions for effecting transactions in "Clean Shares." Clean Shares are defined as a class of shares of a mutual fund without any front-end load, deferred sales charge, or other asset-based fee for sales or distribution. The Section 22(d) Letter also clarifies that Section 22(d) does not prohibit a principal underwriter of Clean Shares from entering into a selling agreement with a broker that, acting as agent on behalf of its customers, charges its customers commissions for effecting transactions in Clean Shares. Relying on the representations in the letter submitted to the SEC staff requesting relief, the Section 22(d) Letter establishes five conditions:

- The broker represents in its selling agreement with the fund's underwriter that it is acting solely on an agency basis for the sale of Clean Shares;
- The Clean Shares sold by the broker do not include any form of distribution-related payment to the broker;
- The fund's prospectus discloses that an investor transacting in Clean Shares may be required to pay a commission to a broker, and, if applicable, that shares of the fund are available in other share classes that have different fees and expenses;
- The nature and amount of the commissions and the times at which they would be collected are determined by the broker consistent with the broker's obligations under applicable law, including, but not limited to, applicable FINRA and DOL rules; and
- Purchases and redemptions of Clean Shares are made at net asset value established by the fund (before imposition of a commission).

The Section 22(d) Letter states that the SEC staff's position does not depend on whether a broker sells Clean Shares to investors in retirement accounts or non-retirement accounts. Therefore, an intermediary acting as a broker may charge sales commissions in connection with transactions in Clean Shares.

The Section 22(d) Letter specifies that only brokers acting as agents are exempt from the restrictions of Section 22(d). Section 2(a)(6) of the 1940 Act defines a "broker" as having the same meaning as given in Section 3 of the Securities Exchange Act of 1934, as amended

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[7] *See* the Proposing Release, at footnote 264; Linsco/Private Ledger Corp., (pub. avail. Nov. 1, 1994); Charles Schwab & Co., Inc., (pub. avail. Aug. 6, 1992).

("Exchange Act") (e.g., any person engaged in the business of effecting transactions in securities for the account of others). Similarly, Section 2(a)(11) of the 1940 Act defines a "dealer" as having the same meaning as given in the Exchange Act (e.g., any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise).

The Section 22(d) Letter expressly states that it does not address whether a broker may receive revenue sharing payments from a fund's adviser. Ultimately, though, a broker's receipt of revenue sharing payments does not change the fact that the broker is engaged in the business of effecting transactions in securities for the account of others, and not as a dealer. Therefore, the legal analysis would suggest that a broker acting only as an agent should not be deemed to be converted into a dealer that is subject to the restrictions of Section 22(d) merely due to the broker's receipt of revenue sharing payments.

Clean Shares may include asset-based sub-transfer agency fees that are paid outside of a Rule 12b-1 plan for non-distribution services. In addition, a fund should be able to offer a class of Clean Shares subject to a service plan fee for non-distribution services. The Section 22(d) Letter defines "Clean Shares" as share classes without any front-end load, deferred sales charge, or other asset-based fee for sales or distribution. If a share class has a service plan fee or sub-transfer agency fee that compensates intermediaries for non-distribution services, the share class should fall within the definition of Clean Shares.

The Section 22(d) Letter enables intermediaries to apply their own fee schedules when effecting transactions in mutual fund shares without subjecting mutual fund sponsors to the administrative costs and burdens associated with the launch of a variety of new share classes or the disclosure of numerous sales load variations, as provided for in the Staff Guidance.

Approaches to Accommodating Intermediaries' Requests Pursuant to the Staff Guidance

Sales Load Variation Approach

The Staff Guidance was issued in December 2016 to clarify the SEC staff's views on various SEC rules and Form N-1A disclosure requirements that permit a fund to sell shares at prices that reflect scheduled variations in, or elimination of, a sales load. In particular, the Staff Guidance focuses on Rule 22d-1 under the 1940 Act and Item 12(a)(2) of Form N-1A. Rule 22d-1 permits variations or elimination of sales loads to particular classes of investors or transactions provided four conditions are satisfied:

1. The investment company, the principal underwriter, and the dealers must apply the reduced sales load to all offerees in the class specified.
2. The shareholders and prospective investors must receive such information regarding scheduled variations as is required to be included in the fund's registration statement.
3. Before a new sales load variation is made available, it must be described in the fund's prospectus and statement of additional information.

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4. The company must advise existing shareholders of any sales load variation within one year of the date when that variation is first made available to purchasers of the company's shares.

Item 12(a)(2) describes the information regarding scheduled variations that is required to be included in a fund's registration statement, including that a fund identify each class of individuals or transactions to which the arrangements apply. The Staff Guidance states that the reference to "class" in Item 12(a)(2) should not be read to refer to a multi-class structure, but rather to a category of persons. Thus, a fund may make particular sales load variations available to investors who purchase fund shares through a single intermediary, as long as the applicable Form N-1A disclosure requirements are satisfied.

The following table summarizes the Form N-1A disclosure requirements discussed in the Staff Guidance:

Disclosure Requirements for Sales Load Variations	
Form N-1A Item Number	Disclosure Requirement
Item 12(a)(2)	(1)[B]riefly describe any arrangements that result in breakpoints in, or elimination of, sales loads. (2) Identify each class of individuals or transactions to which the arrangements apply. (3) State each different breakpoint as a percentage of both the offering price and the net amount invested.
Instruction following Item 12(a)(5)	All information required by Item 12(a) must be presented in a clear, concise, and understandable manner; and must include tables, schedules, and charts where doing so would facilitate understanding.
General Instruction C.3.A Instruction following Item 12(a)(5)	All information about distribution arrangements must be disclosed in one place in the prospectus. In particular, all of the information required by Item 12(a) must be adjacent to the table required by Item 12(a)(1).
Item 3	The fund's fee table must alert investors to the existence of sales load discounts or waivers and provide a cross-reference to the section and page of the prospectus and statement of additional information that describes these arrangements.

The Staff Guidance also states that, when particular sales load variations are made available to investors who purchase fund shares through a single intermediary, those investors must be treated as a "class of individuals" under Item 12(a)(2). Therefore, the Staff Guidance requires that a fund's disclosure in response to Item 12(a)(2) specifically identify each intermediary whose investors receive a sales load variation.

Recognizing that this requirement will lead to lengthy prospectus disclosure for funds that have distribution arrangements with numerous intermediaries, the Staff Guidance advises that the SEC staff "would not object if lengthy sales load variation disclosure for multiple Intermediaries is included in an appendix to the statutory prospectus." The Staff Guidance sets forth the following conditions for a fund to use an appendix to satisfy its disclosure requirements under Item 12(a)(2):

- The section of the prospectus that includes disclosure that is required by Item 12 should include a prominent statement to the effect that different intermediaries may impose different sales loads and that these variations are described in an appendix to the prospectus (the specific appendix should be named).
- The cross-reference in the narrative explanation to the fee table must cross-refer to the appendix.
- The appendix must specifically identify the name of the intermediary as required by item 12(a)(2). It also should include sufficient information to allow an investor that purchases fund shares through a specific intermediary to determine which scheduled variation applies to its investment, which may depend on the type of account held at the intermediary. For example, individual retirement accounts, retail taxable accounts, and 529 plan accounts available through the same intermediary each may have variations in their sales load structures.

The Staff Guidance provides that an appendix may be a standalone document so long as the fund:

- Incorporates the appendix into the prospectus by reference and files the appendix with the prospectus;
- Includes a legend on the front cover page of the appendix explaining that the information disclosed in the appendix is part of, and incorporated in, the prospectus;
- Includes a statement on the outside back cover page of the prospectus that information about the different sales loads variations is provided in a separate document that is incorporated by reference into the prospectus;
- Delivers the appendix with the prospectus; and
- Posts the appendix on its website consistent with rule 498(e) under the Securities Act of 1933 ("Securities Act"), if the fund uses a summary prospectus.

New Share Class Approach

Although implementing variations in sales loads to accommodate intermediaries' requests subjects mutual funds and their sponsors to considerable disclosure requirements, the approach permitted by the Staff Guidance enables funds to meet the needs of a variety of intermediaries without having to create a special share class for each intermediary. However, the approach is available only to the extent that various intermediaries request fee structures that include the same Rule 12b-1 fee, sub-transfer agency fees, or service fees, since such fees are applied to the assets of a share class as a whole and do not vary among classes of investors within a share class.

To the extent mutual fund sponsors receive requests from intermediaries for fee structures that include different Rule 12b-1 fees, funds will need to offer new share classes that differ with respect to Rule 12b-1 fees. Additionally, certain intermediaries may prefer to offer an intermediary-specific share class on their platforms rather than having their sales load variations compared to the sales load variations of other intermediaries in a prospectus. Mutual fund sponsors will need to register new share classes to accommodate these requests.

Administrative Procedures

Type of Filing

The Staff Guidance indicates that, "[t]o add disclosure about sales load variations, a Fund will need to file the amendment to its registration statement under Rule 485(a) under the Securities Act." The Staff Guidance does not specify whether it is the addition of an appendix or the addition of disclosure regarding sales load variations that triggers the Rule 485(a) filing requirement. Prior to the issuance of the Staff Guidance, a fund could add disclosure to the body of its prospectus in response to Item 12 of Form N-1A without submitting a Rule 485(a) filing. Therefore, many industry participants have taken the view that only the addition of an appendix requires the submission of a Rule 485(a) filing.

The addition of a new share class also requires a Rule 485(a) filing. Whether adding an appendix or a share class, the filing should be submitted under Rule 485(a)(1), which provides that the filing will become effective 60 days after filing or at a later date if so designated by the registrant, which date shall be no later than 80 days after the date on which the amendment is filed.

Template Filing Relief

The Staff Guidance states that funds should consider whether it is appropriate to request relief under rule 485(b)(1)(vii) under the Securities Act ("Template Filing Relief") when adding an appendix or a share class. Template Filing Relief may be requested to avoid the need to file multiple Rule 485(a) filings in circumstances in which a mutual fund complex makes substantially identical changes to multiple funds. To request Template Filing Relief, a fund complex can file a single rule 485(a) filing (a "Template filing") for SEC staff review, together with a Template Filing Relief request for other funds with substantially identical disclosure.

Requests for Template Filing Relief must be submitted in correspondence filed on the EDGAR system under the central index key (CIK) of the Template filing as soon as possible after the submission of the Template filing. The request should: (i) state the reason for making the post-effective amendment; (ii) state the identity of the Template filing, including the name of the fund and the registrant, the Securities Act file number, and the filing date of the Rule 485(a) filing; (iii) state the identity of the registration statements that intend to rely on the relief ("Replicate filings"); and (iv) make the following representations:

1. The disclosure changes in the Template filing are substantially identical to disclosure changes that will be made in the Replicate filings.

2. The Replicate filings will incorporate changes made to the disclosure included in the Template filing to resolve any staff comments thereon. (If the Template filing is already effective, this representation should be replaced with the following: The Replicate filings incorporate changes made to the disclosure included in the Template filing to resolve any staff comments thereon.)
3. The Replicate filings will not include any other changes that would otherwise render them ineligible for filing under Rule 485(b).

Any Rule 485(b) filing relying on Template Filing Relief should include a cover letter or an explanatory note in the filing explaining that it is relying on the relief.

Selective Review

The SEC Guidance states that a request for selective review may be appropriate for the Rule 485(a) filing of a fund that first reflects a new share class or sales load variation, so long as the filing otherwise contains disclosure that is not substantially different from the disclosure contained in one or more prior filings by the fund or other funds in the fund complex. Requests should be made in the cover letter accompanying the filing and include: (i) a statement as to whether the disclosure in the filing has been reviewed by the SEC staff in another context; (ii) a statement identifying prior filings that the registrant considers similar to, or intends as precedent for, the current filing; (iii) a summary of the material changes made in the current filing from the previous filings; and (iv) any specific areas that the registrant believes warrant particular attention. Requesting selective review enables the SEC staff to focus its review of the Rule 485(a) filing on the material changes from previous filings that have already been reviewed by the SEC staff.

Industry Responses to the Section 22(d) Letter and the Staff Guidance

The availability of a variety of approaches to facilitating the intermediaries' compliance with the Fiduciary Rule has triggered a wave of SEC filings. Until intermediaries settle on a preferred approach, funds appear to be positioning themselves to accommodate the variety of requests that they may receive. We are aware of the following responses to the Fiduciary Rule in light of recent developments:

Class T Shares

Prior to the issuance of either of the Staff Guidance and the Section 22(d) Letter, a number of intermediaries had requested Class T shares, which many fund complexes have registered or are in the process of registering. Class T shares generally include a maximum front-end sales load of 2.50% and a Rule 12b-1 fee of 0.25%. We are not aware of requests to include disclosure regarding intermediary-specific sales load variations in connection with the offering of Class T shares. To the extent certain intermediaries intend to comply with the Fiduciary Rule by offering Class T shares on their platforms, funds need only register one new class of shares to accommodate the needs of these intermediaries.

Intermediary-Specific Sales Load Variations

At least one large intermediary is requesting that funds include disclosure regarding sales load variations that will be available to investors purchasing fund shares through its platform. To remain on the platform of an intermediary making this type of request, a fund will either need to add the requested disclosure to the body of its prospectus or a new appendix to its prospectus.

Clean Shares

The issuance of the Section 22(d) Letter has prompted many intermediaries to consider making Clean Shares available on their platforms. Therefore, fund sponsors should consider whether an existing share class is appropriate, and whether to register new share classes or modify existing share classes, to ensure that Clean Shares are available to intermediaries who prefer this approach.

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As the compliance date for the Fiduciary Rule approaches, it is clear that, as a practical matter, the preferences of the intermediaries will determine the approaches that mutual funds must pursue in order to retain or gain access to distribution platforms. If a standard approach does not emerge, mutual funds will need to continue to pursue a variety of approaches. We continue to monitor regulatory and industry developments prompted by the Fiduciary Rule.

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