ROPES & GRAY

ALERT

Asset Management

January 30, 2017

DOL Fiduciary Rule Compliance—SEC Says Brokers Can Impose Their Own Commissions on Sales of "Clean" Fund Shares

On January 11, 2017, the SEC staff issued a no-action letter (the "Letter") to Capital Research and Management Company in which the staff confirmed that the restrictions of Section 22(d) of the 1940 Act do not apply to a broker-dealer when, as agent on behalf of its customers, the broker-dealer charges its customers commissions for effecting transactions in "Clean Shares" of a fund.

- Clean Shares are a class of shares of a fund that are offered without any front-end loads, deferred sales charge or other asset-based fees for sales or distribution.
- The offering of Clean Shares is one strategy that fund families have been exploring to simplify intermediaries' compliance with the Department of Labor's "conflict of interest" or "fiduciary" rule (described in Ropes & Gray's Alert available here) (the "DOL Rule").

The Letter and its potential impact on intermediaries' DOL Rule compliance strategies are discussed below.

Background. Section 22(d) prohibits a fund from selling its shares except at "a current public offering price described in the prospectus" to any person (other than to or through a principal underwriter for distribution). Section 22(d) also states that "if 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." In 1941, the SEC's General Counsel provided guidance stating that "the term dealer, as used in Section 22(d), refers to the capacity in which a broker-dealer is acting in a particular transaction."[1]

On its face, Section 22(d) does not apply to a broker, and the statute would be implicated only if a broker-dealer were deemed to be a dealer when transacting in fund shares. Each broker-dealer selling fund shares is a party to a selling agreement with the fund's principal underwriter, and many of these agreements are titled "selling dealer agreement." Therefore, the question underlying the Letter is whether, under the circumstances described in the Letter, a broker-dealer would be deemed a broker or a dealer for purposes of Section 22(d).

The Letter. The Letter and the Capital Research incoming letter (the "Incoming Letter") limited their facts to a broker-dealer with a selling agreement that acts as its customers' agent and charges its customers commissions to effect purchases in a fund's Clean Shares.

The staff agreed with the Incoming Letter's argument that it would be consistent with the plain meaning of Section 22(d) and the views of the SEC and its staff that a broker-dealer, acting as an agent for its customers, is permitted to charge a commission (not described in the applicable fund's prospectus) to effect transactions in Clean Shares. The Letter cited prior no-action letters concerning the application of Section 22(d) to broker-dealers in which the SEC staff agreed not to recommend enforcement action under Section 22(d) where a broker-dealer that was party to a selling agreement proposed to charge a transaction fee or commission for services it provided to its clients in

[1] Rel. No. IC-87 (March 14, 1941).

connection with the purchase of fund shares.[2] In the prior letters, the staff conditioned its response on the following conditions:

- A broker-dealer's fee or commission cannot duplicate any sales load or other distribution fee imposed by the fund or its principal underwriter (to avoid "double dipping" by the broker-dealer, which could occur if the investor both paid for distribution costs through a sales load or distribution-related Rule 12b-1 fees and paid an additional sales-related fee that covered the same distribution costs),

- A broker-dealer must act independently from the fund complex in imposing any fee or commission (to ensure that the broker-dealer's commission is payment for the services of the broker-dealer and is separate from the price of the fund shares), and

- Both the existence of the fee or commission and the possibility of avoiding these charges by dealing directly with the fund are adequately disclosed to investors.

In particular, with respect to Section 22(d) and fees for a broker-dealer's services – the second bullet point, above – the Letter acknowledged that the Division of Investment Management had already distinguished broker-imposed service fees from mutual fund-imposed sales loads that are a component of the fund's public offering price:

> [I]f the broker's charge is not required by the fund, no part of it is received by the fund, and it is something over which the fund has no control, it may be viewed as being separate and apart from the price of fund shares in order to compensate the broker for certain services not offered by the fund. These characteristics distinguish such a charge from a sales load which is not only retained in part by the fund underwriter, but is mandated by the fund to cover the cost of the selling effort which is an integral part of the fund's distribution system.

Separately, the Incoming Letter asserted that any concerns that externalization of commissions by broker-dealers might facilitate the development of a secondary market in fund shares – an outcome that Section 22(d) was intended to prevent– were assuaged by Section 22(f) of the 1940 Act and Rule 10b-10 under the Exchange Act. The Letter agreed with the Incoming Letter's assertion that Section 22(f) permits a fund, in its prospectus, to restrict share transactions to purchases from and redemptions by the fund and cited to the SEC's 2010 proposal to eliminate Rule 12b-1 wherein the SEC made the same point concerning Section 22(f). With respect to Rule 10b-10, the Letter agreed with the Incoming Letter's statement that Rule 10b-10 requires a broker-dealer to disclose in writing to a customer whether the broker-dealer is acting as agent for the customer or as a principal and, if it is acting as agent, to disclose its compensation to the customer, including any third-party compensation.

The SEC staff repeated the following representations from the Incoming Letter:

1. A broker-dealer will represent in its selling agreements with each fund complex's principal underwriter that it is acting solely on an agency basis for the sale of Clean Shares,

2. The Clean Shares sold by a broker-dealer will not include any form of distribution-related payment to the broker-dealer,

3. The fund's prospectus will disclose that an investor transacting in Clean Shares may be required to pay a commission to a broker-dealer and, if applicable, that shares of the fund are available in other share classes that have different fees and expenses,

[2] The staff cited Linsco/Private Ledger Corp., SEC Staff No-Action Letter (pub. avail. Nov. 1, 1994); Charles Schwab & Co., Inc., SEC Staff No-Action Letter (pub. avail. Aug. 6, 1992); and A. Wayne Harrison, SEC Staff No-Action Letter (pub. avail. Oct. 20, 1977).

4. The nature and amount of the commissions and the times at which they would be collected would be determined by the broker-dealer consistent with the broker-dealer's obligations under applicable law, including but not limited to applicable FINRA and Department of Labor rules, and

5. Purchases and redemptions of Clean Shares will be made at net asset value established by the fund (before imposition of a commission).

Importantly, in a footnote to representation #2, the staff stated that "This letter does not address the effect under section 22(d) of a broker-dealer receiving revenue sharing payments from the fund's adviser." This point is discussed below.

Based on the foregoing, the SEC staff agreed that Section 22(d) does not apply to a broker-dealer when, as agent on behalf of its customers, the broker-dealer charges its customers commissions for effecting transactions in Clean Shares of a fund. In addition, the staff agreed that Section 22(d) does not prohibit a principal underwriter of Clean Shares from entering into a selling agreement with a broker-dealer under these circumstances.

Discussion.

1940 Act. The conditions of the Letter are consistent with the conditions in prior no-action letters (summarized in the bullet points above):

- Clean Shares do not generate fund-imposed sales loads or distribution payments that a broker's transaction fee or commission can duplicate.

- Each broker-dealer will determine the commission and fees it charges its customers apart from the fund complexes.

- The Clean Shares' prospectus will disclose the existence of potential broker fees or commissions and the possibility of avoiding these charges by dealing directly with a fund.

Thus, the Letter is a logical extension of the prior no-action letters, and it eliminates any uncertainty regarding the potential application of Section 22(d) in the circumstances described in the Letter. For this reason, the Letter is likely to drive demand by broker-dealers for funds with a class of shares that qualify as Clean Shares.

The Letter expressly takes no position with respect to whether the staff believes that a broker-dealer's receipt of revenue sharing payments would disqualify the broker-dealer from the Letter's scope. As discussed below, many broker-dealers that rely on the Letter are likely to rely on DOL Rule compliance strategies that prohibit the receipt of Third Party Payments, including revenue sharing payments for retirement accounts. A broker-dealer that instead contemplates receiving revenue sharing payments may desire to focus special attention on whether the receipt of such payments in connection with Clean Shares for retirement accounts is consistent with the terms of the Letter, the BIC Exemption and their DOL Rule compliance strategy.

The Letter also does not mention fund payments for sub-transfer agency and recordkeeping services paid to broker-dealers that have a selling agreement with a fund complex's principal underwriter ("sub-accounting fees"). Provided the sub-accounting fees are not hidden payments for distribution in guise, under the terms of the Letter, the fees should not interfere with a class of shares being deemed Clean Shares. However, the DOL has made it clear that sub-accounting fees are Third Party Payments, along with revenue sharing, 12b-1 fees, distribution fees, payments for seminars, and a variety of similar items. Such Third Party Payments require special attention to ensure compliance with the terms of the BIC Exemption and the broker-dealer's DOL Rule compliance strategy.

DOL Rule Compliance. A significant number of broker-dealers have publicly announced that they will retain commission-based accounts for retirement investors.[3] Clean Shares are expected to be especially helpful to broker-dealers that want to offer commission-based advice to clients, while relying on the so-called "regular" Best Interest Contract Exemption. To rely on the regular BIC Exemption, a broker-dealer may not offer Proprietary Products to clients or receive Third Party Payments with respect to those clients' assets (including in connection with selling shares to small plan and IRA clients), as those terms are defined by the DOL. Broker-dealers that offer Proprietary Products or receive Third Party Payments must comply with significant additional requirements to rely on the BIC Exemption.

Clean Shares appear to be tailor-made for a broker-dealer offering commission-based advice to retirement investors and relying on the regular BIC Exemption. Clean Shares permit this type of broker-dealer to create its own commission and transaction fee schedule based on the services the broker-dealer provides. Because this type of broker-dealer will be able to charge a client similar commissions or transaction fees regardless of the products recommended and would not accept Third-Party Payments, compliance with the DOL's Impartial Conduct Standards is likely to be less burdensome than it would be if, instead, the broker-dealer received variable one-time sales loads/fees. Moreover, this type of broker-dealer can use the commission or transaction fees charged to clients to replace some or all of the compensation that it would have received from a fund or its sponsor in connection with the sales of other classes of shares.

SEC Guidance Update. Finally, the Letter follows on the heels of the December 2016 Guidance Update titled, *Mutual Fund Fee Structures* (described in Ropes & Gray's Alert available here). The Guidance Update, which also was driven by the DOL Rule, focuses on disclosure issues and procedural requirements arising from (i) funds offering intermediary-specific variations (including waivers) of their sales loads, and (ii) funds offering a new share class. Therefore, funds wishing to launch a class of Clean Shares will want to consider the Guidance Update.

[3] For retirement investors who desire advice but who are not expected to have a significant number of transactions in their accounts, a one-time commission may be less expensive than an ongoing asset-based charge.