Client Alert

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Mutual Funds Come Clean: Brokers Can Set Fund Share Sales Charges

By Jay Baris

The staff of the SEC's Division of Investment Management effectively allowed brokers to determine the commissions they will charge their customers who buy "Clean Shares" of mutual funds.

In a "no-action" letter dated January 11, 2017, the staff said that it concurs with the view that the restrictions of Section 22(d) of the Investment Company Act of 1940 would not apply when a broker, acting as agent for a customer, charges its customers commissions for effecting transactions of a mutual fund without any front-end, back-end or other asset-based sales charge (so-called "Clean Shares").

Section 22(d) generally prohibits brokers from selling mutual fund shares at a price other than "a public offering price as stated in the prospectus." The original purpose of the restriction was to prevent price discrimination against different types of shareholders. Until now, this provision was interpreted to mean that brokers could not add a sales charge to a no-load fund. That is, brokers could only earn a commission paid from an offering price that included a sales charge (or other sales charge structured as a back-end or asset-based sales charge).

The staff's new interpretation is based on a strict reading of Section 22(d), which does not on its face apply to a broker-dealer acting as a broker. The provision would apply, however, to a broker-dealer acting as a dealer, such as the Fund's principal underwriter.

To sell Clean Shares, a broker must satisfy the following conditions:

- It will represent 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 will not include any form of distribution-related payment to the broker;
- The fund's prospectus will disclose that an investor buying or selling Clean Shares may be required to pay a commission to a broker, and, if applicable, that other shares classes have different fees and expenses;
- The broker must determine the nature, amount and timing of the commissions in a manner consistent with the law, including FINRA and Department of Labor rules; and
- Purchases and redemptions of Clean Shares will be made at net asset value established by the fund.

OUR TAKE

The catalyst for this new interpretation is certainly the Department of Labor's "fiduciary rule," which is scheduled to become effective in April 2017. In a nutshell, the DOL fiduciary rule was designed to mitigate conflicts of interest when brokers provide investment advice to retirement plan participants. (The immediate fate of the fiduciary rule is uncertain in light of the recent freeze on new and pending regulations.)

The fiduciary rule has forced brokers to reconsider how they sell mutual fund shares to retirement accounts (including IRAs). While the fiduciary rule does not apply to mutual funds themselves, the funds have been reacting to the broker's needs by creating new class structures or variations on sales charge waivers particular to individual brokers.

The incoming letter requesting the interpretation argued that Clean Shares provide a way for brokers to "equalize their compensation across all of the funds they recommend," thus eliminating the incentives to recommend funds that offer greater incentives.

In this case, it took more regulation (the DOL fiduciary rule) to serve as a catalyst for less regulation (decentralizing sales charges to the broker level).

We expect that this interpretation is part of a broader shift in how mutual fund shares may be sold. But even if implementation of the fiduciary rule is delayed temporarily (or permanently), as many suspect, Clean Shares will be here to stay.

Note: for a fascinating history of Section 22(d) and the rationale for the restrictions on fund share sales charges, circa 1972, see Scott Hodes, *Current Developments Under Section 22(d) of the Investment Company Act,* 13 B.C.L. Rev. 1061 (1972), http://lawdigitalcommons.bc.edu/bclr/vol13/iss5/5, also available here.

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