Mutual Fund Sales by Intermediaries – Fall-Out from DOL Fiduciary Rule and FINRA Enforcement

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Mutual fund sales and distribution arrangements are once again under review.[1] It has been reported that fund intermediaries are re-examining their practices relating to sales charges, share class structures and product offerings, in response to several Financial Industry Regulatory Authority (FINRA) enforcement proceedings in recent years involving the alleged misapplication of mutual fund sales charges, as well as to the new and amended fiduciary "investment advice" regulations issued in April 2016 (Fiduciary Rule) by the U.S. Department of Labor (DOL) under the Employee Retirement Income Security Act of 1974.[2] As the mutual fund industry continues to evaluate the plans and proposals that may be advanced by intermediaries in light of these developments, it is important to be mindful of potential business, legal and regulatory implications, each of which presents distinct challenges.

This *OnPoint* summarizes recent enforcement and regulatory developments thought to be primarily responsible for this re-examination, as well as responses that are reportedly being proposed or considered by intermediaries with respect to mutual fund sales charges and share class structures. In addition, this *OnPoin*t provides an overview of the legal and regulatory background of mutual fund sales charges and share class structures under the Investment Company Act of 1940 (1940 Act) and highlights certain potential implications that the mutual fund industry may wish to consider in navigating these anticipated proposals.[3] This *OnPoint* is not intended to provide a complete summary of considerations that may apply to all mutual funds, but rather highlights certain issues under the 1940 Act that may be relevant to the mutual fund industry and intermediaries, as well as certain possible regulatory responses to these developments.

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1 In recent years, the SEC's Office of Compliance Inspections and Examinations (OCIE) has identified as an examination priority payments by funds to intermediaries that sell or promote fund shares, and OCIE has conducted sweep examinations of funds and investment advisers with respect to payments to intermediaries that distribute or promote fund shares. In September 2015, the SEC settled an enforcement action resulting from one of these OCIE examinations. *See* Investment Company Act Rel. No. 31832 (Sept. 21, 2015) (stating that fund assets were used to pay for distribution and marketing services outside of a plan adopted pursuant to Rule 12b-1 under the 1940 Act and that the respondents therefore did not bear the additional distribution and marketing expenses not covered by the plan, as had been disclosed).

In January 2016, the staff of the SEC's Division of Investment Management (Staff) published a Guidance Update related to mutual fund distribution and sub-accounting fees. *See* IM Guidance Update No. 2016-01, Mutual Fund Distribution and Sub-Accounting Fees (Jan. 6, 2016). For further information, please refer to *Dechert OnPoint*, SEC Staff Publishes its Views on Oversight of Certain Payments to Financial Intermediaries.

2 *See, e.g.,* Beagan Wilcox Volz, *Firms Seize On '40 Act Reform to Prevent DOL-Driven Share-Class Chaos*, IGNITES (Oct. 12, 2016); Michael Wursthorn, *Edward Jones Shakes Up Retirement Offerings Ahead of Fiduciary Rule*, THE WALL STREET JOURNAL (Aug. 17, 2016); Hannah Glover, *Merrill Prepping Major Fund Platform Overhaul*, IGNITES (May 6, 2016).

3 For further information regarding the Fiduciary Rule, please refer to the following *Dechert OnPoints*: The New DOL Fiduciary Rule: Impact on Mutual Fund Distribution; Navigating the DOL's New Fiduciary Rules: A Game Plan for Broker-Dealers; and The Brave New Fiduciary World has Arrived: The DOL Tries to Find a More Ideal Balance in the Final "Investment Advice" Rules.

Recent Enforcement and Regulatory Developments

FINRA announced in May 2016 a sweep examination of member firm sales practices regarding mutual funds and the application of sales charge waivers. In particular, the examination letter sought information about mutual fund sales to retirement plans and charitable accounts. It also inquired about the sales charge waivers that funds make available to eligible purchasers, as well as the processes and supervisory controls that member firms have implemented to ensure that fund sales charge waivers are provided to eligible customer accounts.[4] FINRA announced this examination following the imposition of significant financial penalties on member firms – totaling over $80 million in restitution payments since 2014 – in connection with alleged improper share class sales, failure to observe breakpoints in sales charges, failure to provide sales charge waivers to eligible investors and other violations of sales policies disclosed in fund prospectuses.[5]

In April 2016, the DOL issued the final version of the Fiduciary Rule, which is anticipated to significantly impact the financial services industry, including the sale of mutual fund shares. Although the mutual fund industry and intermediaries continue to study the Fiduciary Rule and its application, the changes will impact the sale of fund shares to "retirement investors" (as defined in the Fiduciary Rule), which generally include both retirement plans and individual retirement accounts. The Fiduciary Rule has the potential to disrupt many established practices by which funds are currently marketed and sold to retirement investors, as it affects the compensation or commissions that may be paid to intermediaries or financial advisers for selling shares to certain investors.[6] The Fiduciary Rule also has the potential to cause a re-examination of broader sales practices and arrangements (*i.e.,* to non-retirement investors) as intermediaries and financial advisers evaluate the impact of these changes on an enterprise-wide basis.

Intermediary Responses and Potential Proposals

Mutual fund distribution and sales arrangements are likely to be significantly affected by these recent developments. For example, it has been reported that the operational and compliance burden of implementing and monitoring the wide variations in fund-established sales charge waiver arrangements, breakpoint schedules and other applicable share class features has prompted at least some intermediaries to question these features and explore the possibility of streamlined or standardized waiver menus for funds sold by those intermediaries.[7] It is anticipated that funds will encounter proposed intermediary-developed sales charge waiver arrangements that are designed to mitigate the potential misapplication of sales charges and the intermediaries' exposure to regulatory sanctions. These proposals may have far-reaching implications for mutual funds, as implementation of the proposals may require changes to existing fund distribution arrangements, including sales charge schedules and waiver policies. Moreover, the specifics of the proposals may vary significantly from intermediary to intermediary, requiring fund sponsors to grapple with difficult legal and practical issues as they try to satisfy the demands made by the intermediaries on whom they depend to distribute their funds. Separately, it also has been reported that intermediaries are considering whether to revise existing compensation or commission arrangements relating to the sale of fund shares to come into

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4 For further information, please refer to *Dechert OnPoint*, Déjà Vu All Over Again – FINRA Takes Another Look at Mutual Fund Sales Charge Waivers.

5 Jill Gregorie, *B-Ds Zero In on Share Class Structures Amid Regulatory, DOL Pressure*, IGNITES (Sep. 7, 2016). Copies of certain FINRA press releases relating to these disciplinary proceedings can be found here and here.

6 The Fiduciary Rule became effective on June 7, 2016, with a compliance date of April 10, 2017.

7 *See* Glover, *supra* note 2.

compliance with the Fiduciary Rule.[8] Depending on the nature of these proposals, mutual funds may need to evaluate the potential impact of intermediary-specific modifications on existing share class characteristics (such as sales charge breakpoint schedules) or the possibility of creating additional share classes that meet certain intermediary-proposed specifications.

Background under the 1940 Act

Although the exact contours of the possible intermediary-developed sales charge structures and share class specifications remain to be seen, these developments potentially implicate various considerations under the 1940 Act, notably matters relating to Section 22(d) and Rule 18f-3.[9]

Section 22(d) and Rule 22d-1

Rule 22d-1 furnishes an exemption from the provisions of Section 22(d) of the 1940 Act, which generally prohibits mutual funds, or underwriters or dealers, from selling fund shares at a price other than the current offering price described in fund prospectuses. Rule 22d-1 permits variations in, or the waiver of, initial sales charges, provided that variations or waivers are applied uniformly to "particular classes of investors or transactions" and are adequately disclosed in accordance with requirements relating to fund registration statements.[10] Rule 6c-10 imposes similar requirements in the context of deferred sales charges.

The SEC's view of Section 22(d) and Rule 22d-1 may be considered to be quite broad, as the SEC and the Staff have struggled to apply what many consider to be, in effect, an anti-competitive provision of the 1940 Act.[11] When the SEC initially proposed the 1985 amendments to Rule 22d-1 (proposed in 1983 as Rule 22d-6), the proposal would have permitted negotiated sales charges, subject to compliance with certain conditions.[12] However, after consideration of comments received on the proposed rule, the final rule amendments did not permit such negotiation, but were limited to scheduled waivers and variations disclosed in fund registration statements.[13] Nevertheless, the SEC and the Staff have long interpreted and applied Rule 22d-1 in a manner designed to provide funds with maximum flexibility to offer investors lower sales charges. To this point, since the rule was adopted, the Staff has issued several no-action letters that, when viewed collectively, provide funds with a high degree of flexibility in

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8 Wursthorn, *supra* note 2; Joe Morris, *LPL Building No-Transaction-Fee Fund Option*, IGNITES (Aug. 29, 2016).

9 It is possible that other provisions of the federal securities laws may be implicated by these proposals. However, this *OnPoint* is generally limited to a summary of the relevant aspects of Rule 22d-1 and Rule 18f-3.

10 *See*, *e.g.*, Item 12(a) to Form N-1A. It should be noted that the reference to "classes" in Rule 22d-1 predates the development of Rule 18f-3 (governing multi-class fund structures) by several years. Accordingly, the reference should not be read to require a multi-class structure.

11 Section 22(d) appears to support "retail price maintenance" (*i.e.,* the determination of prices by manufacturers rather than distributors, possibly to encourage distributors to provide a certain level of service). Ultimately, Section 22(d) acts as a ban on price competition in sales charges. The history of the statute suggests that Congress intended to prevent three abuses that occurred in the distribution of fund shares prior to 1940: dilution of fund assets caused by riskless trading by insiders; disruption in the orderly distribution of fund shares; and unjust discrimination resulting from shareholders being charged different prices without a rational basis. *See* Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices that Reflect Different Sales Loads, Investment Company Act Rel. No. 13183 (Apr. 22, 1983) (Rule 22d-6 Proposing Release).

12 *Id*. For purposes of this *OnPoint*, "negotiated sales charges" means sales charges established at the intermediary level.

13 Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices that Reflect Different Sales Loads, Investment Company Act Rel. No. 14390 (Feb. 22, 1985).

structuring the manner in which their shares are sold and in offering lower sales charges and other benefits to investors.[14]

Mutual fund complexes may face multiple requests to accommodate intermediary-specific sales charge schedules, variations in existing schedules and/or shareholder privileges that, to comply with Rule 22d-1 or other applicable disclosure requirements, will likely trigger the need for intermediary-specific disclosures to be added to their prospectuses and/or statements of additional information. Doing so may necessitate disclosure clearly identifying the intermediary or group of intermediaries to which the schedules, variations and privileges apply (possibly by name). This approach may help to avoid shareholder confusion but may increase the length and complexity of fund registration statements and the costs associated with preparing and maintaining the accuracy of such disclosure documents.

Rule 18f-3

The intermediary-developed proposals might also raise considerations under Rule 18f-3, which allows funds to offer multiple classes of shares without obtaining exemptive relief from Sections 18(f) and 18(i) of the 1940 Act. This rule requires a written plan that sets forth the separate arrangements of each class (which may include sales charges and exchange/conversion privileges), and such plan must be approved by a fund's board of trustees prior to the issuance of shares of such class. In addition, the rule requires that, prior to any vote on a multi-class plan, the board must request and evaluate such information as may be reasonably necessary to evaluate the plan.

To respond to various intermediary-developed proposals and requests, funds may choose to create additional share classes and/or customize conversion, exchange or other share class characteristics.[15] These funds will need to present amended multi-class plans to boards, along with information reasonably necessary to evaluate the amendments, to reflect additional share classes and may need to do so to revise certain share class characteristics. Depending on the number and variations of intermediary-specific requests, funds may wish to consider the appropriate level of detail for amendments to multi-class plans to satisfy the rule, while preserving reasonable flexibility as these specifications may continue to evolve.

Practical Implications / Considerations

The following is an overview of some of the potential practical implications and considerations that funds may wish to consider in connection with evaluating the intermediary-developed proposals described above and other similar

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14 *See, e.g.*, Portico Funds, Inc. (pub. avail. Apr. 11, 1996) (Staff agreed not to recommend enforcement action under Section 22(d) in connection with a program that offered benefits to banking customers who also had invested in a fund affiliated with the customers' banks); American Municipal Securities (pub. avail. June 28, 1988) (Staff agreed not to recommend enforcement action under Section 22(d) against a broker-dealer that proposed to offer discounts on its commissions for selling non-mutual fund securities when the proceeds of those sales would be invested in mutual funds and/or bonds); Coleman Financial Services (pub. avail. Apr. 17, 1987) (Staff agreed not to recommend enforcement action to the SEC under Section 22(d) against a broker-dealer that proposed to offer discounts on its commissions for selling non-mutual fund securities when the proceeds of the sales would be invested in mutual funds).

15 Fund transfer agent arrangements may also be affected by the creation of additional share classes and the establishment of new or additional conversion, exchange, or other share class characteristics. Funds may wish to keep transfer agents informed of developments relating to these proposals to enable transfer agents to take appropriate steps in advance of implementing these changes.

proposals. In each case, the potential implications or considerations would depend on a fund's existing policies, sales charge schedules and share class structures, as well as on the details of any intermediary-developed proposal.

- ***Existing Sales Charge Schedules and Waiver Policies.*** Funds may wish to consider conducting a review of their current sales charges, breakpoints and waiver schedules, comparing any proposed changes against existing arrangements. Current sales charges and breakpoint levels may have been the result of considerations relating to a fund's asset class as well as historical sales and marketing practices. Similarly, funds may have waived or reduced sales charges in connection with past fund mergers, effectively "grandfathering" certain shareholders. Accordingly, funds considering changes to their sales charges should be mindful of the historical development of their sales charges and waiver policies and of the rationale for specific waivers, if applicable. Ultimately, modifying existing sales charge structures to conform to one or more intermediaries' proposals may be desirable as an efficient way of ensuring the funds remain eligible for a particular intermediary's distribution channel.

- ***Disclosure.*** Funds may wish to review existing registration statement disclosures relating to sales charges, as well as waivers and breakpoints, to understand the extent of disclosure revisions that may be necessary to accommodate changes proposed by intermediaries (*e.g.*, summary prospectus, prospectus and/or statement of additional information). In addition, a review of applicable disclosure requirements under Form N-1A might inform potential disclosure implications (such as compliance with Rule 22d-1) or marketing considerations (such as the disclosure of maximum sales charges in fee and expense tables or the use of different prospectuses on a share class-by-share class basis).

- ***Multi-Class Plans and Fund Selling Agreements.*** Funds may wish to review their multi-class plans under Rule 18f-3 to determine whether any proposals might require amendments to the plans, either to create new share classes or to modify the features of existing share classes. Funds may also wish to proactively review selling agreements to assess whether amendments would be necessary or advisable to account for these proposals and/or the Fiduciary Rule.

- ***Board Involvement and Communications.*** It may be appropriate for fund management to communicate the recent developments relating to fund distribution and sales arrangements to fund boards, as well as to provide relevant coverage from industry news sources. In addition, fund management may wish to apprise the board of the dialogue about potential intermediary-developed proposals at an appropriate stage in the process. Board approval of certain matters may be necessary depending on the nature of the proposals and a fund's preferred response (*e.g.*, creation of new share classes, which may also trigger the need for an in-person meeting of the board, the review and/or approval of new fund sales charge schedules or the anticipated approach for addressing these developments). A board may need time to be brought up to speed on the relevant considerations and to evaluate significant changes to fund distribution and service arrangements, as well as share class and/or sales charge structures.

- ***Implementation.*** Funds may wish to respond to intermediary proposals through a variety of means. It may be helpful to remain aware of timing in light of applicable compliance dates (*e.g.*, scheduling board meetings, if necessary, and preparing and filing appropriate fund documents with the SEC), as well as the potential costs associated with initially implementing proposals and maintaining the disclosure going forward. For example, if a fund ultimately discloses unique sales charge waiver schedules for several intermediaries, it is possible that changes in those schedules by one or more intermediaries might necessitate prospectus and/or statement of additional information supplements and mailings. Funds may

wish to consider the appropriate party to bear these costs, as well as the costs associated with the registration of any new share classes in response to the intermediary proposals.

- ***Operational Matters.*** Funds may wish to consider how to properly navigate cases where shareholders have purchased shares of a fund prior to the implementation of an intermediary-developed proposal that affects their holdings. For example, if a proposal impacts letters of intent or rights of accumulation policies applicable to certain shareholders, the fund will have to decide whether those shareholders should be "grandfathered" for purposes of proposed changes.

- ***Litigation and Enforcement Exposure.*** Funds may wish to assess the potential basis for claims by shareholders relating to the implementation of these proposals, such as whether the fund may become the subject of a claim by a shareholder who holds shares directly or through an intermediary and who does not receive the benefit of more favorable sales charge waivers offered to customers of another intermediary. Funds might also assess the potential basis for an SEC enforcement action (or FINRA disciplinary action against an affiliated principal underwriter) relating to Rule 22d-1 or an intermediary's application of its own waiver schedule or sales charge breakpoints. To this point, it may be advisable to seek indemnification protection in favor of the fund relating to intermediary-developed proposals. Even if the possibility of litigation or enforcement is deemed to be remote or can be mitigated, funds may wish to consider steps to address possible investor complaints about the availability or unavailability of certain sales charge waivers or variations.

Potential Pathways Forward

As these anticipated intermediary-developed proposals become more prevalent or finalized, the SEC or the Staff may choose to consider regulatory responses or provide guidance regarding this development in mutual fund distribution and sales practices (or recommend action by Congress). Such response or guidance could take one or more of a variety of forms, including: statute and/or rule amendments; formal or informal Staff guidance through a no-action letter or Guidance Update; or relief through the exemptive application process.

- ***Regulatory Amendments.*** Currently, Rule 22d-1 requires registration statement disclosure regarding variations in or waivers of sales charges and does not expressly permit negotiated sales charges. As originally proposed in 1983, Rule 22d-6 would have permitted negotiated sales charges with a maximum sales charge typically established by a fund, a concept that re-emerged in a Staff report published in 1992 and in a 2010 release proposing Rule 12b-2 and amendments to other rules (not subsequently adopted). In the 1992 report, the Staff recommended that Congress amend Section 22(d) to end retail price maintenance and permit the development of price competition among dealers, as well as to promote a secondary market in mutual fund shares, finding that compelling reasons no longer existed to retain retail price maintenance.[16] Although the Staff favored a legislative amendment in 1992, it may be possible for the Staff to accomplish a similar result through SEC rulemaking. In connection with proposing Rule 12b-2, the SEC proposed to amend Rule 6c-10 to give funds the option of offering shares that could be sold with sales charges

16 Protecting Investors: A Half Century of Investment Company Regulation, May 1992 at 307-308.

established at the intermediary level.[17] The SEC anticipated that this elective sales charge and distribution model would, among other things, promote greater price competition and possibly lower costs for investors.[18] The SEC viewed this proposal as potentially simplifying the operations of dealers, permitting dealers to process transactions pursuant to a single, uniform fee structure rather than by complying with myriad distribution arrangements – this could help avoid mistakes that harm customers and avoid exposing dealers to liability for errors in processing these charges.[19]

- ***Staff No-Action Letter or Staff Guidance Update.*** Based upon the reasoning summarized above for prior efforts to permit negotiated sales charges, the Staff could consider issuing a no-action letter or Guidance Update with respect to the permissibility of certain approaches under Section 22(d) or Rule 22d-1.[20] In this regard, it should be noted that in proposing Rule 22d-6, the SEC recognized the practical disclosure consequences of permitting negotiated sales charges, as the charges would not be determined until the time of negotiation and therefore could not be disclosed accurately in prospectuses (other than disclosing the maximum permitted load).[21] As the Staff considers whether to provide such relief or guidance, the practical implications of disclosing sales charges to investors should be similarly recognized and appropriately addressed.

- ***Exemptive Relief.*** In proposing Rule 22d-6, the SEC noted that the proposed rule "would obviate the necessity for ... applications requesting exemptive relief from section 22(d) in many circumstances where" funds must file such applications.[22] At that time, the Staff had been processing several such applications per year. However, the Staff had not received any applications for relief permitting negotiated sales charges, and stated in the Rule 22d-6 Proposing Release that "there have undoubtedly been instances in which investment companies have not pursued a system of varied sales loads because of the cost and delay involved in applying for exemptive relief."[23] This history may suggest that the SEC could be receptive to exemptive applications seeking relief to permit negotiated sales charges. However, given the length of time and the Staff resources necessary to process such applications, as well as the inefficiency of requiring each fund complex to obtain individual exemptive relief, requiring funds to go through the exemptive application process might not be the most efficient manner for the SEC and the Staff to address these issues.

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17 Mutual Fund Distribution Fees; Confirmations, Investment Company Act Rel. No. 29367 (July 21, 2010) (proposing release) at 39, 90 (referred to as "account-level sales charges" or "externalized fee arrangements"). Under the proposal, an intermediary could impose a sales charge other than as established and disclosed by a fund or "a fund (or a class of the fund) could issue shares at net asset value (*i.e.,* without a sales load) and dealers could impose their own sales charges based on their own schedules and in light of the value investors place on the dealer's services." *Id.* at 39, 86.

18 *Id.* at 90.

19 *Id.* at 92-93.

20 In addition to the no-action letters referenced above, the Staff issued a no-action letter in 1992 in connection with the imposition of different fees on customers of an intermediary. *See* Charles Schwab and Co, Inc. (pub. avail. Aug. 6, 1992). In this letter, the Staff stated that the restrictions under Section 22(d) did not apply to Schwab's involvement in the subject transactions, because Section 22(d) does not apply to a broker and Schwab acted solely as a broker (as defined under the 1940 Act) in effecting the transactions.

21 *See* Rule 22d-6 Proposing Release, *supra* note 11. Rule 22d-6 would have required, in the case of negotiated sales charges, intermediaries to provide this information to investors prior to agreement on price.

22 *Id.*

23 *Id.*

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