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SEC Interpretive Letter Permits Brokers to Charge Commissions on Sales of “Clean Shares” of Mutual Funds

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On January 11, 2017, the staff of the SEC’s Division of Investment Management issued an interpretive letter (the Interpretive Letter) expressing its view that, under the circumstances described in the letter, a broker that sells so-called “Clean Shares” –a class of mutual fund shares without any front-end load, deferred sales charge or other asset-based fee for sales or distribution–may charge its customers a commission for the sale of such shares.

The SEC staff issued the Interpretive Letter in response to a request by Capital Group Companies, Inc. (Capital Group), parent of Capital Research and Management Company, the investment adviser to the American Funds, which had noted that guidance from the staff “would alleviate many of the issues that have arisen for the mutual fund industry under the Department of Labor’s fiduciary rule” (the DOL Rule) and, by letting brokers charge commissions for Clean Shares, “allow for a brokerage model where funds, ETFs, individual securities and other ‘like’ investment options could compete on returns and fees.” The DOL Rule, which significantly expands the scope of who is considered a “fiduciary” of employee benefit plans, individual retirement accounts (IRAs) and other accounts and arrangements subject to the Employee Retirement Income Security Act of 1974 (ERISA) or Section 4975 of the Internal Revenue Code, poses considerable challenges to broker-dealers selling mutual funds to retirement plans. As Capital Group explained in its letter to the SEC staff requesting “narrowly-tailored interpretive guidance,” the DOL Rule was designed to mitigate conflicts of interest in the provision of investment advice to retirement plan participants and, in seeking to address conflicts by eliminating financial incentives that could cause a broker to recommend one investment over another, the DOL Rule “shows a preference for arrangements in which the financial adviser receives payments only from the investor and not from third parties.”

Section 22(d) of the 1940 Act prohibits a fund, its underwriter or any “dealer” from selling fund shares except at a current public offering price described in the prospectus. Rule 22d-1 permits mutual funds to sell shares at prices that reflect scheduled variations in, or elimination of, sales loads provided such sales load variations are disclosed in the prospectus and, pursuant to the Rule and SEC form disclosure requirements, each variation is applied uniformly to particular classes of investors or transactions and disclosed with specificity, among other conditions. Taken together, Section 22(d) and Rule 22d-1 generally have been interpreted as requiring that funds, and not broker-dealers, set the pricing on sales charges to investors. Consequently, Capital Group states in its letter, “broker-dealer firms would appear unable to unilaterally adjust their business models to preserve a

brokerage option that meets the requirements of the DOL Rule."

Capital Group notes that certain broker-dealer firms are considering a brokerage platform on which they will apply their own commission to fund transactions, but "[o]ther firms are taking a more cautious approach, in part due to uncertainty around the applicability of Section 22(d)." In this regard, Capital Group notes that firms are unsure whether their sales-related activities under these new business models (i.e., commissions charged by brokers) could cause them to be treated as "dealers" by the SEC.
In response, the SEC staff concludes that, under the circumstances described in the Interpretive Letter, the restrictions of Section 22(d) of the 1940 Act do not apply to a broker, when the broker acts as agent on behalf of its customers and charges its customers commissions for effecting transactions in Clean Shares. The Interpretive Letter also clarifies the staff's view 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. In addition, the staff notes that its position does not depend on whether the broker sells Clean Shares to investors in retirement accounts or nonretirement accounts.

In reaching its conclusions regarding the interpretation of Section 22(d), the SEC staff noted the following representations made by Capital Group:

• The broker 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 sold by the broker will not include any form of distribution-related payment to the broker;

• The fund's prospectus will disclose 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 would be determined by the broker consistent with the broker's obligations under applicable law, including, but not limited to, applicable FINRA and Department of Labor rules; and

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

A copy of the Interpretive Letter is available here.

In a related development, the Investment Company Institute (ICI) issued a memorandum to its members and various constituents on February 1, 2017, to respond to "numerous questions from members regarding whether a broker could, consistent with the [SEC] staff's analysis in the [Interpretive Letter], receive a non-distribution related sub-transfer agent, administrative, sub-accounting or other shareholder servicing fee from fund assets ("sub-accounting fee")." The ICI states that the SEC staff's reasoning in the

Interpretive Letter "implicitly allows a broker to receive non-distribution related subaccounting fees," noting that the SEC staff describes Clean Shares as not having "any front-end load, deferred sales charge, or other asset-based fee for sales or distribution." The ICI also notes that, in concluding that Section 22(d)'s restrictions do not apply to a broker when it acts as its customers' agent and

charges its customers commissions for effecting transactions in Clean Shares, the SEC staff emphasizes that those Clean Shares will not include any form of distribution-related payment to the broker. Thus, the ICI concludes that the SEC staff's reasoning "would be consistent with a broker receiving nondistribution related sub-accounting fees."

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