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DOL Fiduciary Rule

Addressing mutual fund share class structures under the Rule

January 19, 2017

Introduction

With approximately three months until the initial April 10, 2017 applicability date for the Department of Labor's (DOL) Conflict of Interest Rule (the Rule),[1] one of the most pressing challenges for covered financial institutions is addressing the existing variability among mutual fund share class structures and fees.

Under Best Interest Contract (BIC) Exemption,[2] financial advisers classified as fiduciaries may continue to receive commission-based compensation as long as they meet specific conditions intended to mitigate conflicts of interest. However, the existence of variability among mutual fund share class structures (including load structures, breakpoints, and waivers) and fees (such as 12b-1 fees and other distribution fees) may create a conflict that cannot be resolved.

To date, mutual fund sponsors have not created a consistent pricing and compensation standard to address this issue. Further, varying preferences by financial intermediaries regarding the composition of a suitable standardized structure has further complicated the issue, as different firms have expressed preferences for different share classes, sales loads, or breakpoints and waivers.

The SEC's Division of Investment Management issued guidance on December 15, 2016 (the "Guidance") that focuses on a streamlined approach for share classes with variations in sales loads and procedural efficiency for the related mutual fund registration statement filing process[3].

Under the Guidance, fund companies can opt to disclose variations in sales loads in an appendix to the prospectus. The appendix, among other things, must be delivered to investors with the prospectus and must be kept current on an ongoing basis with new or modified sales load variations. The Guidance also offers flexibility by providing the option to registrants to request template filing relief for replicate filings provided certain specified representations are made[4]. While the Guidance provides greater efficiencies in terms of the filing process and the probable reduction of the number of new mutual fund share classes required, particular attention will be required to making sure the disclosure regarding sales load variation is kept current and accurate. In addition, financial intermediaries will face greater transparency regarding their fee structures relative to peers.

In addition, on January 11, 2017, the SEC's Division of Investment Management issued interpretative relief holding that the restrictions of Section 22(d) of the Investment Company Act do not apply to a broker when the broker acts as an agent on behalf of its customers and charges its customers commissions for effecting transactions in "clean shares" (i.e., shares without any front-end load, deferred sales charge, or other asset-based fee for sales or distribution). [5]

Relying on this relief, which the Division says "does not depend on whether the broker sells clean shares to investors in retirement accounts or nonretirement accounts," will allow brokers to set their own sales load schedules outside of the mutual fund share class expense structure.

The relief is contingent on several representations, including that the clean shares sold by the broker will not include any form of distribution-related payment to the broker. In addition, the letter notes that it "does not address the effect under section 22(d) of a broker receiving revenue sharing payments from the fund's adviser."[6]

Industry response

Certain financial institutions covered by the Rule have asked mutual fund sponsors for different fee structures that may translate into multiple new share classes per fund. Specifically, some have requested structures with no load, breakpoints, letters of intent, or rights of accumulation. Other institutions have expressed a preference for structures with reduced load with breakpoints (here, different firms have requested different breakpoints).

In order to launch these new or revised share classes, fund companies would be required to take a number of important steps, including:

01. Obtain the approval of the mutual fund board,
02. File a registration statement with the SEC to reflect the new or revised share class, and
03. Onboard the new share classes (including by the fund administrator).

Although the Guidance provides some procedural flexibility and efficiencies, fund companies should nonetheless consider other actions to facilitate implementation of their planned share class changes. For example, with respect to board approval, some changes may require an in-person board meeting (e.g., changes to related 12b-1 plans or agreements for updated underwriting arrangements). Accordingly, fund companies should consider strategizing about the most efficient way to attain the necessary in-person board approvals in light of filing schedules. For example, in advance of the in-person meeting, fund companies may opt to hold a telephonic board meeting to preemptively discuss the proposed changes to share classes before such changes are formally submitted for approval.

In addition, fund companies should consider communicating to SEC examiners their expected filing schedule and whether they intend to seek template filing relief as well as communicate with administrators to determine whether they will need extra time to onboard the new share classes or make adjustments to existing share classes, in each case recognizing that other fund companies may be taking similar steps.

Although these steps would not typically present a challenge in isolation, with many fund groups doing it and so many funds launching the new share classes, firms may face operational and regulatory bottlenecks and challenges. They should focus on the timeline now and communicate with their relevant stakeholders such as administrators and other impacted service providers.

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1 Department of Labor, "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946, (April 8, 2016), available at https://www.gpo.gov/fdsys/pkg/FR- 2016-04-08/pdf/2016-07924.pdf.

2 Department of Labor, "Best Interest Contract Exemption," 81. Fed. Reg. 21002, (April 8, 2016), available at https://www.gpo.gov/fdsys/pkg/FR-2016-04-08/pdf/2016-07925.pdf.

3 Securities and Exchange Commission, Division of Investment Management, Guidance Update, No. 2016-06, (December 2016), available at https://www.sec.gov/investment/im-guidance-2016-06.pdf. Notably, however, the Division states that it "cannot provide any assurances that any approach described in [the guidance] will satisfy the requirements of the DOL Rule." ID, at 5, footnote, 3. Rather, the guidance discusses the requirements under the applicable federal securities laws with respect to funds that wish to use certain fee structure.

4 See Rule 485(a)(b)(1)(vii) under the Securities Act of 1933.

5 Securities and Exchange Commission, Division of Investment Management, No-Action Letter to The Capital Group Companies, Inc. (January 11, 2017), available at https://www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm.

6 ID.

Next steps

Deloitte continues to analyze the DOL Rule and will continue to provide our point of view on what steps organizations should take to implement the substantial changes required by April 10, 2017.

We have designed a structured approach for implementation that helps organizations to both comply with the Rule and capitalize on the opportunities that its disruption has created. Organizations may contact Deloitte with questions about the Rule and activities to support planning, preparation, implementation, and compliance.

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