

March 8, 2017

SEC Issues Guidance to Ease Fund Implementation of “Clean Shares”

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In January, we authored a post^[i] discussing an SEC no-action letter, dated January 11, 2017, to Capital Group (the “Capital Group Letter”), the parent company of American Funds. ^[ii] In the Capital Group Letter, the SEC agreed that Section 22(d) of the Investment Company Act of 1940 (the “Act”), which prohibits selling securities except at “a current public offering price described in the prospectus”, does not apply to brokers when acting as agent on behalf of its customers and charging customers commissions for effecting transactions in so-called “Clean Shares”. ^[iii]

Clean shares are mutual fund shares stripped of any front-end load, deferred sales charge, or other asset-based fee for sales or distribution that are sold by brokers who set their own commissions in connection with such sales.^[iv] We noted in January that the ability to replace the distribution fees typically charged by its mutual funds with commissions charged by a broker would give funds a new measure of flexibility to meet the demands of the Fiduciary Rule and competition generally, and we anticipated that many mutual fund companies would explore the concept of Clean Shares.

On February 15, 2017, just a month after publication of the Capital Group Letter, the SEC was compelled to issue guidance (the “FAQ”) addressing some of the questions it had received from mutual fund companies to-date. ^[v] Below, we summarize FAQ as it relates to Funds seeking to implement Clean Shares.

Initial Implementation of Clean Shares

A mutual fund company issuing Clean Shares must, of course, amend its registration statement to include disclosure of the new share class. Such an amendment might be affected through a Rule 485(a) filing or through a Rule 485(b) filing, depending on whether the amendment is “material”. ^[vi] Typically, funds prefer Rule 485(b) filings because they become effective immediately,^[vii] while Rule 485(a) filings are subject to a 60 day review.^[viii]

In the FAQ, the SEC confirmed that “Funds should create these new Clean Shares, like any new class, by making a filing under Rule 485(a).” To minimize the burdens of filing under Rule 485(a), if the only disclosures being amended are those describing the new share class, we advise mutual fund companies to seek selective review of the Rule 485(a) filing. The request for a selective review should be made in the cover letter accompanying the 485(a) filing and must include (i) a statement as to whether the disclosure in the filing has been reviewed by the staff in another context; (ii) a statement identifying prior filings that the registrant considers similar to, or intends as precedent for, the current filing; (iii) a summary of the material changes made in the current filing

from the previous filings; and (iv) any specific areas that the registrant believes warrant the SEC staff's particular attention.^[ix]

Adding Clean Shares to Multiple Funds

A mutual fund family adding Clean Shares to multiple funds need not file Rule 485(a) filings for each fund. Instead, the FAQ confirms that mutual funds companies introducing Clean Shares across multiple funds can request Template Filing Relief pursuant to Rule 485(b)(i)(vii). A registrant requesting Template Filing Relief would make a single Rule 485(a) filing with a Template Filing Relief request for all other funds with "substantially identical disclosure".^[x]

We note, however, that a request for Template Filing Relief must include (i) the reason for making the post-effective amendment; (ii) the identity of the Template filing;^[xi] (iii) the identity of the registration statements that intend to rely on the relief ("Replicate filings").^[xii] Additionally, the registrant must represent to the SEC that (i) the disclosure changes in the template filing are substantially identical to disclosure changes that will be made in the replicate filings; (ii) the replicate filings will incorporate changes made to the disclosure included in the Template filing to resolve any staff comments thereon; and (iii) the replicate filings will not include any other changes that would otherwise render them ineligible for filing under rule 485(b).^[xiii] Selective Review and Template Filing Relief can save registrants adding Clean Shares to existing funds time and money.

Existing Share Classes Qualify as Clean Shares

One of the more interesting aspects of the FAQ was the acknowledgement by the SEC that certain existing share classes of funds (such as institutional class shares) might already meet the requirements of Clean Shares, thereby offering a path to offering Clean Shares to many registrants without a Rule 485(a) filing.^[xiv] In such a case, the SEC noted that a 485(a) filing would not be necessary "solely to add the prospectus disclosure described in the [Capital Group Letter]"^[xv] where the fund already offers a share class that meets the requirements of the Capital Group Letter.^[xvi] Instead, a Rule 485(b) or Rule 497 filing will suffice.

Conclusion

The introduction of Clean Shares to the mutual fund industry presents an opportunity for mutual fund companies to improve the competitive position of their products, and we anticipate that there will be continued interest in Clean Shares even if the Department of Labor's Conflict of Interest Rule does not become effective.^[xvii] If you have questions about Clean Shares of the SEC's recent guidance, we encourage you to contact us.

^[i] Andrew Sachs and John I. Sanders, *Effects of the DOL Fiduciary Rule Reach Mutual Fund Industry*, Kilpatrick Townsend: Investment Management News and Notes (Jan. 27, 2017), <http://blogs.kilpatricktownsend.com/investmentmanagement/>.

[ii] SEC, *Response of the Office of Chief Counsel Division of Investment Management*, available at <https://www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm> (“Capital Group Letter”).

[iii] *Id.*

[iv] John Waggoner, *Brace for Thousands of New DOL Fiduciary-Friendly Mutual Fund Share Classes*, INVESTMENT NEWS (Jan. 6, 2017), <http://www.investmentnews.com/article/20170106/FREE/170109955/brace-for-thousands-of-new-dol-fiduciary-friendly-mutual-fund-share>.

[v] SEC, *Frequently Asked Questions on IM Guidance Update 2016-06 (Mutual Fund Fee Structures)*, available at <https://www.sec.gov/divisions/investment/guidance/frequently-asked-questions-mutual-fund-fee-structures.htm> (“FAQ”).

[vi] 17 CFR 230.485(a)-(b) (2017).

[vii] 17 CFR 230.485(b) (2017).

[viii] 17 CFR 230.485(a) (2017).

[ix] SEC: IM Guidance 2016-06, available at <https://www.sec.gov>.

[x] *Id.*

[xi] This identifying information should include the name of the Fund and the registrant, the Securities Act file number, and the filing date of the rule 485(a) filing.

[xii] This identifying information should include the name of the registrant, the Securities Act file number, and the series and class name for each of the Funds that intend to rely on the relief.

[xiii] SEC: IM Guidance 2016-06, available at <https://www.sec.gov>.

[xiv] FAQ, *supra* note 7.

[xv] *Id.* at Question 5.

[xvi] See, Capital Group Letter, *supra* note 2 (Listing the registrant’s representations to the SEC: 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).

[xvii] Paul Foley and John I. Sanders, *Department of Labor Set to Eliminate the Fiduciary Rule*, JD SUPRA (March 3, 2017), <http://www.jdsupra.com/legalnews/department-of-labor-set-to-eliminate-92801/>.