Investment Company Act of 1940 — Section 22(d)
Capital Group

January 11, 2017

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter dated January 6, 2017 requests assurance that the staff of the Division of Investment Management concur with your view that the restrictions of section 22(d) of the Investment Company Act (the "1940 Act") do not apply to a broker, as that term is defined in the 1940 Act, when the broker acts as agent on behalf of its customers and charges its customers commissions for effecting transactions in a class of shares of a registered investment company ("fund") without any front-end load, deferred sales charge, or other asset-based fee for sales or distribution ("Clean Shares").

Background

You state the following:

The American Funds would like to offer Clean Shares for which brokers could charge customers commissions to effect transactions. You note that section 22(d) of the 1940 Act does not apply to brokers but there is uncertainty about the application of section 22(d), and thus many firms are unsure whether charging a commission for effecting transactions of Clean Shares could cause them to be treated as dealers under section 22(d). Accordingly, you request that we consider whether the restrictions of section 22(d) would apply to a broker acting as an agent on behalf of its customers and charging its customers commissions for effecting transactions in Clean Shares.

Analysis

Section 22(d) of the 1940 Act prohibits a fund from selling its securities except at "a current public offering price described in the prospectus" to any person other than to or through a principal underwriter for distribution. Section 22(d) further states that "if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus." By its terms, section 22(d)'s restrictions do not apply to a broker,[1] as that term is defined in the 1940 Act.[2] In a report to the Senate Committee on Banking, Housing, and Urban Affairs in November 1974, we considered policy arguments in support of permitting brokers to make reasonable charges for services rendered in connection with the purchase of no-load mutual fund shares.[3] We distinguished these intermediary-imposed fees from mutual fund-imposed sales loads[4] that are a component of the fund's public offering price, noting that "if the broker's charge is not required by the fund, no part of it is received by the fund, and it is something over which the fund has no control, it may be viewed as being separate and apart from the price of fund shares…in order to compensate [the broker] for certain services not offered by the fund. These characteristics distinguish such a charge from a sales load which is not only retained in part by the fund underwriter, but is mandated by the fund to cover the cost of the selling effort which is an integral part of the fund's distribution system."[5]

You argue that it is consistent with the wording of section 22(d) of the 1940 Act, and consistent with the views of the Commission and staff to recognize the ability of a broker-dealer acting as a broker to charge a commission to effect transactions in Clean Shares. You acknowledge that section 22(d)'s restrictions apply to dealers, and thus section 22(d) would be implicated if a broker-dealer acted as a dealer in fund shares. You point out that, to the extent that there are concerns that externalizing commissions would facilitate the development of a secondary market in fund shares, section 22(f) permits funds to manage any secondary market in fund shares and preserve an orderly distribution system.[6] You further note that under rule

10b-10 under the Exchange Act, a broker in these circumstances would be required to disclose in writing to a customer for which it transacts information specific to the transaction, including, among other things, whether the broker is acting in an agency or principal capacity and, if it is acting as agent, its remuneration, including any third-party remuneration it has received or will receive. You contend that although a rule recently adopted by the Department of Labor[7] may have prompted your request, there is no reason under section 22(d) to treat differently the activities of a broker selling Clean Shares to retirement investors from the activities of a broker selling Clean Shares to nonretirement investors.

You further make the following representations:

- 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;[8]
- 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).

You conclude, therefore, that subject to the preceding representations, a broker, acting as agent for its customer, may charge a commission for effecting transactions in Clean Shares without violating section 22(d). You point out that under your proposal, a fund's shares will be sold at net asset value, a secondary market in fund shares will not develop, and investors will benefit from being able to choose the brokerage compensation model that suits their needs. You also believe that your proposal will provide investors with greater clarity into the services and costs offered by different brokers and will subject fund commissions to the same competitive pressures placed on equity and ETF commissions.

Conclusion

In our view, under the circumstances described above, 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. We also believe that section 22(d) does not prohibit a principal underwriter of Clean Shares from entering into a selling agreement with a broker under these circumstances. Our position does not depend on whether the broker sells Clean Shares to investors in retirement accounts or nonretirement accounts.

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Senior Counsel

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[1] Section 2(a)(6) of the 1940 Act defines a "broker" as having the same meaning as given in section 3 of the Securities Exchange Act of 1934 ("Exchange Act") (*e.g.*, any person engaged in the business of effecting transactions in securities for the account of others), except that such term does not include any person solely by reason of the fact that such person is an underwriter for one or more investment companies. Similarly, section 2(a)(11) of the 1940 Act defines a "dealer" as having the same meaning as given in the Exchange Act (*e.g.*, any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise), but does not include an insurance company or investment company.

[2] *See* Proposed Rule: Mutual Fund Distribution Fees; Confirmations, Investment Company Act Rel. No. 29367 (July 21, 2010) ("2010 Proposal") at footnote 264 ("By its terms, section 22(d) only applies to principal underwriters and dealers in fund shares and does not apply to brokers") and citing to United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1975). *See also* Linsco/Private Ledge Corp., SEC Staff No-Action Letter (Nov. 1, 1994), Charles Schwab & Co., Inc., SEC Staff No-Action Letter

(Aug. 6, 1992); A. Wayne Harrison, SEC Staff No-Action Letter (Sept. 20, 1977).

[3] *See* Report of the Division of Investment Management Regulation on Mutual Fund Distribution and Section 22(d) of the Investment Company Act of 1940 (Aug. 1974) ("1974 Report"). The 1974 Report was submitted to the Senate Committee on Banking, Housing, and Urban Affairs in November 1974.

[4] Section 2(a)(35) of the 1940 Act defines a "sales load" to mean "the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer (or in the case of a unit investment trust, by the depositor or trustee), less any portion of such difference deducted for trustee's or custodian's fees, insurance premiums, issue taxes, or administrative expenses or fees which are not properly chargeable to sales or promotional activities."

[5] *See* 1974 Report at 112-113 (footnote omitted).

[6] Section 22(f) of the 1940 Act provides that "no registered open-end company shall restrict the transferability or negotiability of any security of which it is the issuer except in conformity with the statements with respect thereto contained in its registration statement nor in contravention of such rules and regulations as the Commission may prescribe in the interests of the holders of all of the outstanding securities of such investment company." *See also* 2010 Proposal at text accompanying footnote 264 and National Ass'n of Sec. Dealers, Inc. 422 U.S. 694, *supra* note 2.

[7] Definition of the Term ''Fiduciary''; Conflict of Interest Rule – Retirement Investment Advice, 81 Fed. Reg. 20946 (Apr. 8, 2016) (the "DOL Fiduciary Rule"). You state that the DOL Fiduciary Rule was designed to mitigate conflicts of interest in the provision of investment advice to retirement plan participants, including individual retirement account investors. In your view, the DOL Fiduciary Rule suggests that one way to address a particular conflict of interest for brokers recommending funds to their retirement account investors is for brokers to equalize their compensation across all of the funds they recommend, thus eliminating brokers' incentives to recommend the fund that offered brokers' greater financial incentives. You believe that an "externalized" fee structure for funds, *i.e.*, where brokers would charge their customers commissions for effecting transactions in Clean Shares, would help facilitate addressing such conflicts of interest.

[8] This letter does not address the effect under section 22(d) of a broker receiving revenue sharing payments from the fund's adviser.

Incoming Letter

The Incoming Letter is in Acrobat format.

http://www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm

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