

Client Alert

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A Case of Appendicitis: SEC Staff Guidance on Sales Load Variation Disclosures Sends Funds Scrambling

By Matthew J. Kutner and Jay G. Baris

A [Guidance Update](#) published in December 2016 by the SEC's Division of Investment Management has sent funds scrambling to beef up prospectus disclosures to accommodate changes to fees charged by financial intermediaries before the Department of Labor's (DOL) "conflicts of interest" rule kicks in on April 10, 2017.

The conflicts of interest rule, which the DOL finalized on April 8, 2016, generally subjects financial intermediaries (e.g., broker-dealers) that sell certain retirement products, including IRAs funded by mutual fund shares, to a fiduciary standard, rather than the "suitability" standard that now applies only to non-retirement accounts. To comply with the rule, broker-dealers must effectively level the compensation that funds pay them for the sale of fund shares. The financial intermediaries, in turn, have pressured funds to streamline the sales load structures of fund share classes. For example, financial intermediaries may require simplified costs and tailored sales charge waivers relating to specific classes of fund shares. In an effort to eliminate conflicts of interest, some intermediaries may decide to charge the same fee for all mutual funds, as opposed to different charges.

Funds seeking to accommodate the myriad financial intermediaries that sell their shares, however, may face the daunting task of revising their prospectus disclosure. SEC rules require funds to disclose specific arrangements that result in, among other things, variations or eliminations of sales loads that apply to each individual class of shares. Investors who purchase shares through an intermediary would be a "class" under the rule and, therefore, the disclosure should specifically identify each intermediary whose investors received a sales load variation. This requirement can lead to clunky and confusing disclosures when many intermediaries have special arrangements.

The Division's Guidance Update offers substantive and procedural guidance related to the disclosure challenges that funds face as they attempt to keep up with the barrage of new requirements from financial intermediaries, who, in some cases, are requesting funds to include specific prospectus disclosures.

The challenge. Many funds had planned to complete their annual update by filing a post-effective amendment that goes effective immediately upon filing. (To accomplish this, funds must confirm that the filing contains no material changes other than updated financial information and other non-material information.) The Division's guidance, however, requires that funds give the staff 60 days to review disclosure amendments that add information about sales load variations. This requirement has sent funds scrambling to figure out how to revise disclosures that may cut across many funds with prospectuses containing multiple dates and fiscal years in time to meet the effective date of the DOL's conflicts of interest rule in April.

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The appendix. The staff recognized that adding lengthy disclosures about sales load variations particular to multiple financial intermediaries may make it difficult for investors to slog through bulked-up prospectuses. The guidance lets funds relate this disclosure to an “appendix” that may be a separate document, provided that the funds comply with certain conditions. To use an appendix, among other things:

- the prospectus must prominently disclose that different intermediaries may impose different sales loads, and that these variations are described in the appendix; and
- the cross-reference in the narrative explanation to the fee table must cross-refer to the appendix, and the appendix must specifically identify the name of the intermediary and provide enough information to allow investors that buy shares through the intermediary to determine which of the scheduled fee variations apply to the investment; this may depend on the type of account held at the intermediary (e.g., retirement versus non-retirement account).

Moreover, funds must include a legend on the front cover page of the appendix explaining that the information disclosed in the appendix is part of, and incorporated in, the prospectus; and a statement on the back cover page of the prospectus stating that information about sales charge variations is included in the appendix, which is incorporated in the prospectus. Funds must deliver the appendix along with the prospectus to investors, and must generally post the appendix on the fund’s website.

New share classes. The staff said that when a fund files an amendment to register shares of a new class, it will focus on fund fees, performance and distribution arrangements.

Procedural issues. The staff encouraged funds that file an amendment to add disclosures about sales charge variations, or to create a new share class that varies from other classes only in the distribution arrangements, to request “selective review.” That is, in the cover letter to the filing, the fund would highlight the disclosures that vary from disclosures in existing prospectuses, and ask the staff to focus principally on those changes.

When a fund complex anticipates making substantially identical disclosure changes to multiple funds complex-wide, the staff suggested that funds request permission to make a “template filing.” That is, if the staff reviews and comments on new disclosures for one fund (made in a 60-day filing), funds can ask the staff to let the other funds in the complex skip the 60-day requirement and file amendments with the same new disclosures to go effective immediately. This would prevent the need to file multiple amendments each having a 60-day review period.

OUR TAKE

Funds are likely to incur substantial legal, administrative, printing and mailing costs to help financial intermediaries comply with the DOL’s new conflicts of interest rules. These costs may be further increased when funds must change their production schedules to account for the required 60-day review of post-effective amendments containing new disclosures about sales load variations. While the future of the conflicts of interest rule may be uncertain, one thing is for sure: funds will incur additional costs as intermediaries move to comply with the new rules, and may again if the new rules are changed, delayed or repealed in the coming months.

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Contacts:

Kelley A. Howes

(303) 592-2237

khowes@mofo.com

Matthew J. Kutner

(212) 336-4061

mkutner@mofo.com

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