K&L GATES

LEGAL INSIGHT

September 29, 2015

Practice Groups:

Investment Management, Hedge Funds and Alternative Investments

Broker-Dealer

Government Enforcement

SEC Announces First "Distribution in Guise" Case

By Arthur C. Delibert, Lori L. Schneider, and Marguerite W. Laurent

The Securities and Exchange Commission ("SEC") on September 21, 2015, brought the first of its long-awaited "distribution in guise" cases against a mutual fund adviser and distributor. The case follows a number of warnings delivered in speeches by SEC staff members that they had this issue in their sights, and a 2014 sweep exam focused on the issue. The case centers on findings that agreements with two intermediaries described the services provided to the funds as distribution and marketing services, yet the services were paid for by the funds outside of a Rule 12b-1 plan and were inaccurately characterized in reports to the fund board as sub-transfer agency, rather than distribution, services. The respondents settled the case without admitting or denying the allegations.

The Law and SEC Staff Pronouncements

Rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act") makes it unlawful to use fund assets to finance "any activity which is primarily intended to result in the sale of [fund] shares" unless such payments are made pursuant to a plan adopted under the rule. Financial Industry Regulatory Authority, Inc.'s ("FINRA's") Rule 2830, which applies to fund distributors, effectively limits the annual amounts that can be paid under a Rule 12b-1 plan to 75 basis points for distribution and 25 basis points for shareholder servicing, in each case calculated on the assets held through customer accounts of the intermediary receiving the payments.

Most funds today make their shares available through arrangements with intermediaries, generally broker-dealers, banks, insurance companies, and retirement plan administrators, which maintain omnibus accounts with the funds. The intermediaries provide a range of recordkeeping and other services for the accounts of the individual customers, similar to those traditionally provided by fund transfer agents, and the funds pay the intermediaries for such services (commonly referred to as "sub-TA" services). Issues can arise because these intermediaries may be providing both distribution and non-distribution services.

FINRA rules do not appear to limit the amount that can be paid for sub-TA services. In a 1998 letter to the Investment Company Institute, generally known as the "Supermarket Letter," the SEC staff said that it was appropriate for funds to make use of intermediaries that provide both distribution and non-distribution services, and fund assets could be used to pay for the non-distribution services.[1] However, the letter said, it was important to assure that fund assets were not being used to pay for the distribution portion of the services except pursuant to a Rule 12b-1 plan. The letter said that fund boards are responsible for determining whether the amount paid by the fund outside of a Rule 12b-1 plan is reasonable in relation to the non-distribution services provided.

[1] Although the letter originally addressed the handful of fund supermarkets then in existence, the SEC staff has made clear in talks at industry events that it views the letter as applying more broadly to any arrangement in which an intermediary provides both distribution and other services to a fund.

SEC Announces First "Distribution in Guise" Case

The *First Eagle* Case

The SEC has now found that First Eagle Investment Management, LLC ("First Eagle"), a registered investment adviser, and its affiliate, FEF Distributors, LLC ("FEF"), a registered broker-dealer, used mutual fund assets to pay intermediaries for distribution services outside of the funds' Rule 12b-1 plans.[2] According to the SEC Order, FEF had two agreements with an entity described only as "Intermediary One." One agreement provided for "a variety of sub-TA services that are typically paid for out of fund assets."[3] The SEC does not appear to have taken issue with the nature of those services or the $16 to $19 per account that the funds paid for them.

FEF's second agreement with Intermediary One was termed a "Selected Dealer Agreement," under which Intermediary One was "to become a selected dealer to *distribute shares* of the [Funds]" (Order at 4; emphasis added by the SEC). The services to be provided included "due diligence, legal review, training, [and] marketing." The following specific fees were associated with these services: a one-time fee of $50,000, a 25-basis point fee on new gross sales, and a 10-basis point annual fee on shares held for more than one year. These fees were paid from fund assets and were specified to be above and beyond any 12b-1 fees paid to Intermediary One.

> FEF's agreement with "Intermediary Two" provided for the following services:
>
> (i) provide email distribution lists of correspondent broker-dealers that have requested 'sales and marketing concepts' from Intermediary Two; (ii) market the Funds on its internal website; (iii) invite the Funds to participate in special marketing promotions and offerings to correspondent broker-dealers; (iv) invite First Eagle to participate in Intermediary Two's annual conference; (v) provide quarterly statements detailing which correspondent broker-dealers are selling the Funds; and (vi) waive all trading fees charged to correspondent broker-dealers relating to the Funds

(Order at 5). The funds paid an annual fee of 5 basis points on shares sold by Intermediary Two.

According to the SEC's Order, the adviser and distributor, after consulting with their counsel, represented to the funds' board of trustees that the contracts provided only for sub-TA services. The funds' registration statement stated that "FEF Distributors or its affiliates bear distribution expenses to the extent they are not covered by payments under the [Rule 12b-1] Plans" (Order at 5).

For these actions, First Eagle, a registered investment adviser, was found to have violated Section 206(2) of the Investment Advisers Act of 1940, an anti-fraud provision. (The Order notes that *scienter* – i.e., knowledge that one's actions are improper – is not required to establish a violation of this section; simple negligence is sufficient.) In addition, First Eagle

[2] In the Matter of First Eagle Investment Management, LLC and FEF Distributors, LLC, Investment Advisers Act Release No. 4199 (September 21, 2015) ("Order").

[3] These services are described as: "(i) maintaining separate records for each customer in the omnibus account for each fund; (ii) transmitting purchase and redemption orders to the Funds; (iii) preparing and transmitting account statements for each customer; (iv) transmitting proxy statements, periodic reports, and other communications to customers; (v) providing periodic reports to the Funds to enable each fund to comply with state Blue Sky requirements; and (vi) providing standard monthly contingent deferred sales charge reports" (Order at 4).

was found to have violated Section 34(b) of the 1940 Act, which prohibits making a materially false or misleading statement in an SEC filing.[4] The Commission also found that First Eagle and FEF had caused the funds to violate Section 12(b) of the 1940 Act and Rule 12b-1 thereunder. For these violations, First Eagle was censured and ordered to pay disgorgement and prejudgment interest of more than $27 million; FEF was ordered to retain an independent compliance consultant; and both First Eagle and FEF were jointly ordered to pay a civil money penalty of $12.5 million. We note that, notwithstanding what the SEC described as the "remedial acts promptly undertaken by Respondents and cooperation afforded the Commission staff," the amount of the fine imposed by the SEC on First Eagle and FEF was still quite significant, equal to approximately 50% of the amount of the disgorgement.

What We Can Discern From This Case

Although this case has been described by some commentators as one in which the SEC merely picked the "low-hanging fruit," it offers several helpful insights. First, we note that many fund advisers responded to the news of the SEC staff's distribution-in-guise sweep by reviewing the terms of their largest intermediary relationships. While this is an important step, especially for firms that have hundreds of relationships entered into over many years, managers should realize that SEC examiners may not take a similar approach. They may seek out agreements that have the words "distribution," "marketing." or "dealer" in the title or agreements that provide for a fee structure similar to that in the distribution provisions of FINRA Rule 2830 – i.e., a certain percentage of "new gross assets." (The reference to a fee based on new assets or new sales is to be distinguished from a set-up fee for new accounts, which is a very common administrative service for which funds pay outside of their Rule 12b-1 plans.) From their visits to other fund groups, SEC examiners also may already be familiar with certain agreements they regard as troubling and may ask about them specifically.

Second, for mutual fund boards that are familiar with the SEC staff's Supermarket Letter and are concerned about how far they have to inquire into the nature of the contractual arrangements with intermediaries, it is noteworthy that the trustees in this case, who accepted the adviser's representations that the contracts were only for sub-TA services, were not charged in this case. Nor is there any suggestion in the Order that the trustees failed to satisfy the duties identified in that letter. That is, despite the responsibility that the Supermarket Letter places on boards to determine whether fund assets are being used to pay for distribution, the Order does not suggest that, in the absence of red flags, the board members here had an obligation to go beyond what they were being told by the adviser and personally review the intermediary agreements or retain a consultant or counsel to do so. Indeed, the Order contains no discussion of the board's review of the fees paid out of fund assets or the board's consideration of whether or not those fees were reasonable in relation to the non-distribution services provided. This is important in view of the explosion in the number of intermediaries since the Supermarket Letter was issued, as some fund groups now deal with hundreds of such arrangements. (Boards may be well advised to understand management's process for reviewing the description of services provided under the

[4] By finding that First Eagle made a false statement in the funds' registration statement, rather than that First Eagle aided and abetted or caused a violation of Section 34(b) by the funds, the SEC appears to be either disregarding the Supreme Court's decision in *Janus Capital Group v. First Derivative Traders,* 131 S. Ct. 2296 (2011), which held that the registrant is the "maker" of the statements in its registration statement, or, perhaps, treating that decision as limited to private cases brought under Rule 10b-5.

intermediary agreements, as well as the compliance process for confirming that funds are not paying for distribution services outside of a Rule 12b-1 plan under any of those agreements.)

Third, the Order does not question the funds' payment of fees for the sub-TA services, nor the amount of those fees. It thus appears to reconfirm the Commission's acceptance of the staff position set forth in the 1998 Supermarket Letter that it is appropriate for a fund to pay fees outside of a Rule 12b-1 plan for services that are neither for distribution nor for shareholder services to an entity that is also engaged in distribution.[5]

Fourth, the Order notes that FEF had entered into arrangements with other intermediaries, the details of which are not discussed in the Order. It is unclear how many other such agreements there were but, as noted, some mutual fund complexes make their shares available through hundreds of such arrangements. It is clear from the Order, however, that the SEC examiners honed in on individual arrangements. This was not a matter that was decided by the average amount that the funds were paying for sub-TA services across the various channels. Rather, it was a matter that arose from a review of individual contracts and finding two among them that had provisions that the SEC staff deemed improper in that they included distribution services and allowed the funds to pay for those services outside of a Rule 12b-1 plan. The implication here is that fund managers and boards considering the propriety of intermediary payments may not want to be satisfied with simply knowing that the average amount the fund is paying intermediaries is within industry norms; they may also want to ask whether any of the individual contracts call for fees well outside of industry norms, whether they expressly provide for distribution services and, if such services are being provided, who is paying for them – the funds or the adviser.

There are still important questions related to "distribution in guise" for which this case offers no insight. Thus, while we can discern from the order that the SEC did not object to the size of the fees paid for the services that the Order describes as sub-TA services, we cannot discern any outer boundary for such payments or if the SEC staff even has one in mind. Also, because the fees paid are stated in terms of dollars per account and we do not know the average account size, we also do not know how these fees translate into basis points.

There is considerable uncertainty about the level of fees that might be reasonable for non-distribution services. When the Supermarket Letter was written in 1998, the realm of the transfer agent and the services it provided were fairly well understood. Now, however, the prevalence of intermediary arrangements has so upended traditional transfer agency services that it can be difficult for boards to find a solid basis for comparison. Fund supermarkets and other intermediaries can provide a wealth of services in addition to traditional transfer agency or recordkeeping services, such as 24-hour on-line account access, customer support by telephone and statements that combine all of an investor's

---

[5] SEC Release 34-30897 (July 7, 1992), which approved the NASD rule changes to regulate broker-dealers' receipt of asset-based sales charges, such as Rule 12b-1 fees (now FINRA Rule 2830), acknowledges three separate types of charges: a sales charge of up to 75 basis points (subject to certain long-term aggregate limits); a shareholder service fee of up to 25 basis points for "personal services"; and fees for sub-transfer agency, maintenance, and custodian services, for which the rule sets no limit. However, because the rule does not regulate fees for sub-TA, maintenance and custody services, the references to such fees in the SEC's release are somewhat oblique. The release does make clear that the shareholder service fees and the fees for sub-TA, maintenance and custody are not sales charges. NASD Notice to Members 93-12 (see SEC Release No. 34-32118 (April 8, 1993)) explicitly states that services such as sub-TA fees are not deemed to be within the 25 basis points limit that applies to service fees under the FINRA rule. In other words, under NASD/FINRA interpretations, it is permissible to pay – outside of a 12b-1 fee – up to 25 basis points for shareholder services such as ongoing liaison with shareholders *and* additional fees for sub-TA services.

holdings. Are these to be taken into account when a board considers whether a sub-TA fee is "reasonable," or are these under the rubric of "shareholder servicing" and covered by a separate fee? Because Intermediary One is not identified by name in the Order, we cannot discern the range of services it might offer. We can only note that the list of services identified in the Order as the sub-TA services provided by Intermediary One is quite "plain vanilla" and does not extend beyond the services provided by a traditional transfer agent.

There are many other areas in which the Supermarket Letter has left boards uncertain, that the *First Eagle* case does not even touch on. The letter says, for example, that in some cases, boards are supposed to consider whether the intermediary services provide any distribution benefits. It is unclear how this is to be evaluated in light of Rule 12b-1, where the stated test is whether an activity is "primarily intended" to result in the sale of shares. Did the Supermarket Letter mean to convert the legal standard from one of intent, as expressed in the rule, to one of effects? And if so, then by what authority? There is no guidance on that important issue.

Most importantly, we do not know whether the *First Eagle* case will be followed by another enforcement action, focused on the role of a fund's independent trustees. The SEC staff has shown a special penchant in recent years for cases primarily intended to school fund trustees in the staff's view of their responsibilities. Many in the industry expect such a case in the area of intermediary payments, given the Supermarket Letter's heavy emphasis on the board's role. In light of the many uncertainties that boards face in this area, it would seem that such a case, if it is brought, would have to involve fees that were of a size that the SEC staff felt did not bear any reasonable relationship to the non-distribution services provided, a board that knew the very facts that the First Eagle Funds board apparently did not know – that the contracts specifically provided for services that could be deemed for distribution and the funds were paying for those services outside of a Rule 12b-1 plan – or a board that simply closed its eyes to everything and had no process for reviewing fund payments to intermediaries. That case, if it comes, is not likely to shed much light on the issues with which conscientious fund trustees are wrestling in this area. It would serve only to tell us what the *First Eagle* case has already told us – that the SEC staff is serious about distribution in guise – but now that the *First Eagle* case has intensified everyone's focus on this area, other forms of SEC guidance about the many open questions in this area would be much more helpful.

Authors:

Arthur C. Delibert
arthur.delibert@klgates.com
+1.202.778.9042

Lori L. Schneider
lori.schneider@klgates.com
+1.202.778.9305

Marguerite W. Laurent
marguerite.laurent@klgates.com
+1.202.778.9403

K&L GATES

Anchorage Austin Beijing Berlin Boston Brisbane Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt Harrisburg Hong Kong Houston London Los Angeles Melbourne Miami Milan Moscow Newark New York Orange County Palo Alto Paris Perth Pittsburgh Portland Raleigh Research Triangle Park San Francisco São Paulo Seattle Seoul Shanghai Singapore Spokane Sydney Taipei Tokyo Warsaw Washington, D.C. Wilmington

K&L Gates comprises more than 2,000 lawyers globally who practice in fully integrated offices located on five continents. The firm represents leading multinational corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organizations and individuals. For more information about K&L Gates or its locations, practices and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

© 2015 K&L Gates LLP. All Rights Reserved.