



K&L GATES

2017 WASHINGTON D.C. INVESTMENT MANAGEMENT  
CONFERENCE

## Mutual Fund Distribution

R. Charles Miller, Partner, K&L Gates LLP

Steven B. Levine, Associate, K&L Gates LLP

# MUTUAL FUND DISTRIBUTION – TODAY'S AGENDA

- Multiple Distribution Channels
- Methods of Compensating for Distribution
  - Sales Loads
  - Rule 12b-1 Fees/Service Fees
  - Revenue Sharing
  - Sub-transfer Agent Payments
- Omnibus Accounts – Noteworthy Recent Developments
- Share Classes
- ETF Differences

# MULTIPLE DISTRIBUTION CHANNELS

- Distribution channels:
  - Direct (No-Load) Channel
  - Broker-Dealer Channel
  - RIA Channel
  - “Supermarket” Channel
  - Retirement Plan Channel
  - Institutional Channel
  - Insurance Company Channel
- Each Distribution Channel
  - Level and types of intermediary services vary
  - Distribution costs and payment structures vary
    - Sales Loads
    - Rule 12b-1 fees current)
    - Service Fees
    - Revenue Sharing Payments
    - Sub-transfer agent-type fees from Funds
  - Multiple share classes

# MULTIPLE SHARES CLASSES

- Rule 18f-3
  - Permits mutual funds to issue multiple classes of voting stock representing interests in the same portfolio
  - Classes must differ in how they distribute their securities, in the services they provide to shareholders, or both
  - Allocation of income and expenses among classes
  - Master-Feeder Structure – An alternative to multiple share classes permitted by SEC interpretations

# SHARE CLASSES

- **Class A**
  - Front-end sales load
  - 12b-1 fee (service fee ~ 25 basis points)
  - Breakpoints may be available
- **Class B**
  - CDSC decreases each year (such as to 5%, 4%, 3%, 2%, 1%, 0)
  - 12b-1 fee (asset-based sales charge and service fee ~ 100 basis points)
  - Converts to Class A share after 6-8 years, thus lowering 12b-1 fee
- **Class C**
  - Level 12b-1 fees (asset-based sales charge and service fee ~ 100 basis points)
  - CDSC of 1% in the first year
- **Institutional**
  - No-load and no or low 12b-1 fee
  - Retirement/RIA
- **Retirement**
  - Different levels of fees (Class R Shares)

# SALES LOADS

- Front-end Sales Load
  - Upfront fee that decreases amount of investment
  - Section 22(d) – fixes sales load and prevents variations
  - Rule 22d-1 permits disclosed variations in sales loads on class level (e.g., breakpoints)
- Deferred Sales Load (“CDSC” or “back-end”)
  - Investor pays load, if any, at redemption pursuant to Rule 6c-10
  - Load based on lesser of offering price at purchase or specified % of NAV
- No Load
  - Adviser pays for distribution from its profits
  - Fund can be “no load,” even if charges up to a 25 basis points fee from fund assets
- Amount of loads limited by FINRA Conduct Rule 2830

## SUITABILITY OF SHARE CLASS – FINRA CONDUCT RULE 2310

- Considerations for share class suitability include:
  - Investment amount (are load reductions available?)
  - Expected term of the investment
  - Sales loads, fees, and expenses
- These factors affect the total return on the investment
- An intermediary duty; not a mutual fund duty

## RULE 12B-1 FEES

- Rule 12b-1 (adopted in 1980) permits funds to use fund assets to directly pay for distribution expenses:
  - Written plan
    - Initially approved by directors (including majority of independent directors)
    - Initially approved by shareholders (unless adopted prior to public sales of fund shares)
    - Annual approval of directors (including majority of independent directors)
  - Board approval
    - Finding that there is “reasonable likelihood that plan will benefit fund and shareholders”
  - Board quarterly review of written report of amounts spent and reasons for expenditures



## RULE 12B-1 FEES *(CONTINUED)*

- Distribution expenses:
  - Compensate intermediaries for ongoing advice and/or services to current investors
  - Compensate intermediaries for administrative services to current investors (e.g., recordkeeping, account statements to investors)
  - Advertising, printing and mailing prospectuses and sales materials to prospective investors

## RULE 12B-1 FEES *(CONTINUED)*

- Maximum fee limited under FINRA Conduct Rule 2830
  - 100 basis points maximum
    - 75 basis points maximum for asset-based sales charge
    - 25 basis points maximum for service charge
  - NASD Notice to Member 93-12 defines “service fees”
- Rule 2830 limits aggregate amount of sales load and/or 12b-1 fee
- Used as alternative or in addition to a sales load
  - Issues: transparency and complexity

## **RULE 12B-1 FEES** *(CONTINUED)*

- Some 12b-1 plans are structured as so-called “reimbursement” plans
- Some 12b-1 plans are structured as so-called “compensation” plans

## REVENUE SHARING

- Fund adviser or affiliate pays for fund distribution
- Adviser can pay from “legitimate” profits that are not “excessive” per SEC interpretation

### Disclosure of revenue sharing arrangements

- Fund disclosure
- Possible point of sale disclosure

# OMNIBUS ACCOUNTS

- The Growth in Use of Such Accounts
- Permissible Services
- Increased Fees/Source of Payments
- SEC Guidance Regarding Payments (1998)
- FINRA Guidance Regarding Payments (1993)(NTM 93-12)
- Required Findings by Mutual Fund Boards
- Developing Due Diligence Activities

## ETFs

- ETFs only sell and redeem their shares at NAV *directly* to unaffiliated broker-dealers with whom the ETF has entered into an agreement (“Authorized Participants”)
- Exemption to Section 22(d): permits price competition by permitting selling brokers to set sales commission for share classes offered at NAV without ongoing sales charge
- All “primary market“ transactions by ETFs occur in large blocks of (at least 25,000) shares called “Creation Units”

## ETFs *(CONTINUED)*

- Authorized Participants purchase and redeem Creation Units in kind in exchange for the “Creation Basket”
  - Pro rata slice requirement
  - Exceptions to pro rata slice requirement
  - Custom baskets
- Authorized Participants who purchase Creation Units sell individual fund shares on the stock exchange
- No sales loads (or CDSCs) or Rule 12b-1 fees on ETFs

# DISTRIBUTION IN GUISE HISTORY

- 1980: Adoption of Rule 12b-1
- 1998: ICI Supermarket Letter
- Evolution of mutual fund marketing and sales efforts (e.g., introduction of omnibus accounts)
- 2014-2015: SEC “distribution in guise” sweep examinations
  - “These exams...highlighted the need to clarify and update our existing guidance”
  - The Staff focused on the payment of fees by funds to intermediaries characterized by funds as non-distribution-related fees, including sub-transfer agent, administrative, sub-accounting, and other shareholder servicing fees (“sub-accounting fees”)



# SEC STAFF GUIDANCE

- SEC has increased scrutiny of payments to intermediaries out of fund assets, both in the inspection and enforcement context, in recent years
- The Staff noted that the sweep exams raised questions as to whether part of sub-accounting fees being paid out of fund assets were actually for distribution-related activity, a practice the staff termed “distribution in guise”
- January 2016: IM Staff issues a Guidance Update titled “Mutual Fund Distribution and Sub-Accounting Fees”
- The Guidance Update notes that “[m]utual fund fees have a direct impact on investor returns. For example, because investors may evaluate funds based on the specific levels of 12b-1, management, and other fees, potential mischaracterization of fees may lead them to invest in funds that they would not otherwise have selected...in light of this possibility, as well as the potential for the inappropriate use of fund assets and the prohibition of Rule 12b-1(a) on a mutual fund directly or indirectly paying for distribution-related activities outside of a Rule 12b-1 plan, the staff [makes these recommendations]”

# SEC STAFF GUIDANCE

- The Staff's guidance makes recommendations in three primary areas.
  - That a mutual fund board have a process that is “reasonably designed” to evaluate whether a portion of sub-accounting fees are being used to pay directly or indirectly for distribution
  - That advisers and other service providers provide the board with sufficient information to inform the board of an overall picture of intermediary distribution and servicing arrangements
  - That advisers and other service providers inform the board if certain activities or arrangements that are potentially distribution-related exist in connection with the payment of sub-accounting fees, and if so, the board evaluate the appropriateness and character of those payments

# CLOSING STAFF OBSERVATIONS

- A board should be able to rely on the adviser and other service providers to affirmatively provide information about the existence of any of these activities and arrangements
- Advisers and service providers should also provide summary data about expenses and activities related to distribution-related activities
- A board's role should focus on understanding the overall distribution process as a whole to inform its "reasonable business judgment about whether sub-accounting and other mutual fund-paid fees represent payments for distribution, in whole or in part" [Emphasis added]
- Fund directors could receive and rely on the assistance of outside counsel, the fund's CCO, or personnel from the adviser or other service providers to assist them in making these judgments
- A board may wish to request that the information be provided in a clear concise manner with summaries and overview documents

# FIDUCIARY RULE DEVELOPMENTS

- The Department of Labor’s (“DOL”) Fiduciary Rule imposes duties and restrictions on broker-dealers and their sales personnel who provide advice, which is a broadly defined term
- The Fiduciary Rule’s Best Interest Contract Exemption (“BIC Exemption”) allows registered investment advisers and broker-dealers that are ERISA fiduciaries to be compensated in ways that would otherwise constitute a prohibited transaction
- The BIC Exemption includes Impartial Conduct Standards that require advice to be in a client’s best interest, “without regard to the financial or other interests of the [ERISA fiduciary]”
- The BIC Exemption’s conditions have raised the question of whether an intermediary can qualify for the BIC Exemption where compensation received by the firm differs from product to product
- Some firms are concerned that it may be difficult to demonstrate that recommendations are not influenced by the compensation a firm will receive when the firm receives more from some fund groups than from others

## FIDUCIARY RULE DEVELOPMENTS *(CONTINUED)*

- In response to the Fiduciary Rule, a number of intermediaries that intend to rely on the BIC Exemption have requested that mutual fund sponsors establish intermediary-specific fee structures
- The SEC Staff has taken the following measures to help facilitate responses by mutual funds to these requests:
  - On December 15, 2016, the Staff of the SEC's Division of Investment Management issued an IM Guidance Update regarding the disclosure of intermediary-specific variations in sales loads and registration of new share classes
  - On January 11, 2017, the SEC Staff issued an interpretive letter clarifying the application of Section 22(d) of the Investment Company Act of 1940, as amended, to underwriters, dealers, and brokers of mutual funds
- We are aware of the following responses to the Fiduciary Rule in light of recent developments
  - Class T Shares
  - Intermediary-Specific Sales Load Variations
  - Clean Shares

## QUESTIONS?

### Contact information:

R. Charles Miller

Phone: 202.778.9372

Email: [charles.miller@klgates.com](mailto:charles.miller@klgates.com)

Steven B. Levine

Phone: 202.778.9231

Email: [steven.levine@klgates.com](mailto:steven.levine@klgates.com)



Questions?



K&L GATES