SEC's division of investment management offers new guidance on "distribution in guise" payments

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Abstract

Purpose – *To explain the January 6, 2016 written guidance (the "New Guidance") issued by the Securities and Exchange Commission's Division of Investment Management on payments made by mutual funds to intermediaries for distribution and non-distribution-related services.*

Design/methodology/approach – *Explains the SEC's earlier guidance in the 1998 "Supermarket Letter," the provisions of Rule 12b-1, the practice termed "distribution in guise," the emphasis in the "New Guidance" on the role of a fund board's business judgment, how Rule 12b-1 compliance fits into Rule 38a-1 compliance programs, specific fund activities and arrangements with intermediaries that are of concern to the SEC staff, and the focus of the New Guidance on an adviser's fiduciary duty to mitigate or eliminate conflicts of interest.*

Findings – *The New Guidance articulates clear expectations that fund boards will have a process to evaluate the nature of intermediary payments and that fund advisers will provide boards with information in the advisers' possession that the boards need to carry out that evaluation. Another intent of the New Guidance is apparently to give the SEC a clearer basis to bring enforcement actions concerning the use of fund assets to pay intermediaries for distribution-related activities.*

Originality/value – *Practical guidance from experienced investment management lawyers.*

Keywords *Distribution in guise, Rule 12b-1, Rule 38a-1, Secutiries and Exchange Commission (SEC), Sub-accounting fees, Supermarket Letter*

Paper type *Technical paper*

On January 6, 2016, the Securities and Exchange Commission's ("SEC") Division of Investment Management issued its first written guidance ("New Guidance")[1] on payments made by mutual funds to intermediaries for distribution and non-distribution-related services since its letter to the Investment Company Institute dated October 30, 1998 ("Supermarket Letter").

Mutual funds typically make their shares available to investors through arrangements with intermediaries, generally broker-dealers, banks, insurance companies, and retirement plan administrators, which maintain omnibus accounts with the mutual funds. The intermediaries provide, and the funds and/or their sponsors pay for, a range of recordkeeping and other services for individual customer accounts, many of which are similar to those traditionally provided by fund transfer agents. Issues relating to payments made pursuant to Rule 12b-1 under the Investment Company Act of 1940, as amended (" 1940 Act"), may arise because many intermediaries provide both distribution and non-distribution services.

Rule 12b-1 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 ("Rule 12b-1 Plan"). The staff's New Guidance stems from a 2014 SEC sweep exam that studied, in part, the payment of fees to intermediaries characterized as non-distribution-related fees, including sub-transfer

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agent, administrative, sub-accounting, and other shareholder servicing fees ("sub-accounting fees"). In particular, the staff notes that the sweep exams raised questions as to whether part of the sub-accounting fees paid out of fund assets were actually for distribution-related activity[2], a practice the staff termed "distribution in guise."

As we discussed in a prior Legal Insight, the SEC brought its first "distribution in guise" enforcement action against a mutual fund adviser, First Eagle Investment Management, LLC, and distributor, FEF Distributors, LLC, in September 2015[3]. The case followed a number of warnings delivered in speeches by SEC staff members that they had this issue in their sights, and the recent sweep exam focused on the issue. The case centered 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 New Guidance sheds some light on questions left open by the Supermarket Letter and the September 2015 enforcement action.

Exercise by the Board of Its Reasonable Business Judgment

The New Guidance is noteworthy for its emphasis on the role of a fund board's business judgment. The staff made clear in the Supermarket Letter that they believe it is the responsibility of a fund's board to determine whether any portion of a fee paid to a supermarket sponsor out of fund assets is for distribution; if so, the fee must be paid pursuant to a Rule 12b-1 Plan. Until now, mutual fund boards have relied on the guidance contained in the Supermarket Letter, which provides that the determination as to whether a fee is paid for distribution or non-distribution services is a "question of fact," and sets forth specific criteria that the staff believed a board should consider when making such a determination[4]. The Supermarket Letter, however, did not make clear that the determination was a matter for the board's business judgment. Rather, that letter could be read to suggest that the board was playing a "right/wrong" game and had to live in terror of getting it wrong.

The New Guidance, in contrast, cites the SEC's 1980 release adopting Rule 12b-1 for the assertion that "there can be no precise definition of what types of expenditures constitute indirect use of fund assets"[5]. It expressly states that the question of whether sub-accounting and other mutual fund-paid fees represent payments for distribution is a matter for the board's reasonable business judgment. As courts generally defer to reasonable business judgments made by informed and independent directors, the New Guidance seems to acknowledge that board decisions in this area should be afforded such deference. The New Guidance makes clear that boards may rely on the assistance of outside counsel, the fund's chief compliance officer, and personnel from the adviser or relevant service providers[6], as appropriate, to assist them in making these judgments.

New Policies and Procedures and the Implication of Rule 38a-1

Along with its clearer recognition of the role of a board's business judgment, the New Guidance also places considerable emphasis on the need for a process to help assure that the board's business judgment is an informed one. The staff recommends that, regardless of whether a fund has a Rule 12b-1 Plan, boards establish a process "reasonably designed to evaluate whether a portion of fund-paid sub-accounting fees, if paid to intermediaries that distribute fund shares, is being used to pay directly or indirectly for distribution." As part of the evaluation process, the staff recommends that

advisers and other relevant service providers provide sufficient information for the board to understand the overall distribution and servicing arrangements, including how the level of sub-accounting fees may affect other payment flows that are intended for distribution (such as Rule 12b-1 fees and revenue sharing).

The staff notes that while the factors and analysis described in the Supermarket Letter are a useful framework for establishing such a process, a board may also want to request from the adviser, service providers, and intermediaries, among other things, information about the specific services provided under the sub-accounting agreements, the fee amounts being paid, and whether the services could have direct or indirect distribution benefits. It is unclear how this concept of "indirect distribution benefits" squares with the language of Rule 12b-1, which refers to any activity "primarily intended to result in the sale" of fund shares.

Those items are not significantly different from the ones listed in the Supermarket Letter. Two additional items, however, inject new points for consideration: "how the adviser and other service providers ensure that the fees are reasonable," which could be read to place a burden back on the adviser to support this essential determination; and "how the board evaluates the quality of services being delivered to beneficial owners (to the extent of its ability to do so)," which is one of several explicit acknowledgments in the New Guidance that the fund board will likely have a limited ability to view facts that service providers, including intermediaries, do not provide.

The staff's suggestion that additional information be provided to the board by the adviser and other service providers is significant, because one of the challenges boards have faced in making a determination as to whether a portion of a fee is being paid for distribution-related services has been getting intermediaries to provide information about the nature and quality of the services they provide to their clients. Although the New Guidance does not expressly state that intermediaries are required to provide the relevant information, intermediaries should cooperate in this process in an effort to provide the board sufficient information to protect its judgments from later challenge. (The staff notes that where a Rule 12b-1 Plan already exists or is being recommended, Rule 12b-1(d) requires a board to request, and the parties to related agreements to provide, "any information reasonably necessary to make an informed determination of whether such plan should be implemented or continued.") With respect to fund advisers and their affiliates, the New Guidance asserts that they have a conflict of interest in recommending the use of fund assets to pay for distribution; accordingly, the staff states, advisers are required by their fiduciary duty either to refrain from recommending the payments or to provide complete information to the fund board.

The New Guidance specifically discusses one common board process – setting numerical limits on the sub-accounting fees to be paid with fund assets. These limits are often based on the level of fees the fund would otherwise pay to a traditional transfer agent for the same services (or are based on benchmarks derived from industry surveys) and require that any sub-accounting fees paid in excess of the limit be paid pursuant to a Rule 12b-1 Plan or other allowable source such as revenue sharing. The New Guidance warns that, although these limits may be perceived as reasonable, the sub-accounting fees may exceed the reasonable compensation for the services rendered because fees paid to, and services provided by, one transfer agent may differ from those provided by another.

The New Guidance also recommends that those boards that set numerical limits on the sub-accounting fees carefully evaluate any benchmark used in establishing the limit. In particular, a board should consider whether the fees used for the benchmark reflect relevant economies of scale and whether the type and amount of services provided are comparable. This discussion by the staff can make life difficult for fund boards,

because boards attempting to determine if sub-accounting fees are reasonable often struggle to find bases for comparison. The fund's own transfer agency fees and rates derived from industry surveys have been important benchmarks, but the staff now appears to assert that they cannot necessarily be taken at face value. The New Guidance does recognize, however, that there may be other reasonable approaches that a board may take in establishing its processes[7].

The New Guidance also invokes Rule 38a-1 under the 1940 Act (which was adopted in 2004, and so did not exist when the Supermarket Letter was issued), in describing the legal framework within which the board and the fund are operating and the nature and legal status of the procedures that the staff recommends. Rule 38a-1 requires a fund to adopt and implement policies and procedures "reasonably designed" to prevent the fund from violating the federal securities laws. The staff notes that, as it discovered during the sweep exams, many funds do not have, as part of their Rule 38a-1 compliance programs, policies and procedures to prevent violations of Section 12(b) and Rule 12b-1. The staff recommends that, where a fund has a Rule 12b-1 Plan, the fund should establish, as part of its Rule 38a-1 compliance program, adequate policies and procedures for reviewing and identifying any payments that may be made for distribution-related services that are not paid pursuant to the plan. The staff notes that funds that have not adopted a Rule 12b-1 Plan should also have policies and procedures in place that are reasonably designed to ensure that the funds are not making distribution payments in the absence of such a plan.

The reference here to Rule 38a-1 is significant. The Supermarket Letter and the New Guidance are not law; one cannot be charged with violating them. However, the clear suggestion of the New Guidance is that the SEC could charge a fund, its chief compliance officer, or its directors with violating Rule 38a-1 if the fund did not have compliance policies and procedures sufficient to make the determinations of compliance with Rule 12b-1 that the staff asserts are necessary. Such a case might be brought regardless of whether the SEC examiners conclude that payments to an intermediary violated Rule 12b-1 and regardless of whether the fund in question has a Rule 12b-1 Plan[8].

Specific Arrangements of Concern to the Staff

The staff cites certain activities and arrangements observed during the sweep exams that it believes raise questions as to whether funds are paying for distribution outside of a Rule 12b-1 Plan, especially when the fees are paid to an intermediary that distributes fund shares. Fund advisers and fund boards are well-advised to review their arrangements in light of the activities and practices identified in the New Guidance. Specifically, the staff recommends that advisers and relevant service providers provide a fund's board with information as to whether these specific activities or arrangements occur and states that boards should be able to rely on the adviser and other service providers to "affirmatively provide" such information. If such activities do occur, the staff recommends that the board scrutinize the appropriateness and distribution character of related payments. Activities or arrangements identified in the New Guidance include:

- distribution-related activity that is conditioned on a fund's payment or rate increase of sub-accounting fees;
- the absence of a Rule 12b-1 Plan for a particular fund or share class;
- tiered payment structures involving a combination of fees paid out of fund assets and revenue sharing paid by the adviser;
- lack of specificity or bundling of services into a single arrangement without a clear list of services provided in exchange for sub-accounting fees;

- distribution and sales benefits being taken into account by the adviser and other relevant service providers when instituting or raising sub-accounting fees;
- large disparities in sub-accounting fees paid to intermediaries that may be providing substantially the same set of services to the fund; and
- intermediaries offering sales data about the demographics of fund investors and other information about top sales partners and channels.

The New Guidance includes a number of specific suggestions for fund boards as to how to evaluate these activities and arrangements. First, with respect to sub-accounting and distribution services that are bundled into a single arrangement, the staff clarifies its view that it is not consistent with Rule 12b-1 for boards to evaluate whether the *overall payment* for a bundled set of services or activities is a payment that is primarily for distribution-related services. Rather, Rule 12b-1 requires that any *activity* that is primarily intended to result in the sale of fund shares be paid for through a Rule 12b-1 Plan if paid by the fund. Second, with respect to the negotiations of particular agreements, the staff recommends that advisers and relevant service providers furnish boards with general information about who at the firm is negotiating the fees, the process for their approval, and the considerations taken into account. Third, with respect to disparities of fees among intermediaries, the staff acknowledges that these disparities may be the result of competitive pressures, depending on the facts and circumstances, but cautions that disparities in payments for the same services may indicate that they are payments for distribution-related activities. The New Guidance suggests that directors may want to consider whether there are differences between the services provided that support different payment rates. The staff also notes that higher payments made to the fund's newest, largest, or fastest-growing distribution partners may suggest that the higher payments are for distribution.

The staff also acknowledges in the New Guidance that some funds may have distribution agreements and service agreements with hundreds of intermediaries and perhaps multiple agreements with any one intermediary. In order for a board to obtain an overall picture of the fund's intermediary arrangements, the staff suggests having the adviser or relevant service provider provide information in a way that allows the board to understand the "relevant conflicts and the general context within which the arrangements are made, as well as the specific details of atypical or particularly significant arrangements." The New Guidance appears to be suggesting here that, once boards gain an understanding of the overall distribution arrangements and typical services and fees, they should focus on outliers and ask why one intermediary's fees are higher or what enables another intermediary to provide seemingly similar services for lower fees.

One element from the Supermarket Letter that can be very important to fund boards was carried over into the New Guidance. Along with sub-transfer agent services, a supermarket arrangement will always provide at least minimal "distribution" benefits in that the supermarket provides a place where investors can buy a listed fund, even if the supermarket is not making any effort to sell it or to give it any special exposure. The Supermarket Letter does not require that boards necessarily allocate between the distribution and non-distribution benefits of such an arrangement. Rather, it allows a board to determine whether the amounts paid to the intermediary are reasonable in relation to the non-distribution services provided. The New Guidance, by quoting that portion of the Supermarket Letter, can be read as continuing to endorse that approach.

An adviser's potential conflicts of interest

As noted in the Rule 12b-1 Adopting Release and cited in both the Supermarket Letter and the New Guidance, Rule 12b-1 was intended in part to address the conflicts of interest that could arise when a fund pays its own distribution expenses, as the adviser

and other relevant service providers could benefit from an increase in the fund's assets, which would typically increase the adviser's fee revenues. The New Guidance offers more specificity around the issue of an adviser's conflicts of interest. For example, the staff highlights an adviser's fiduciary duty to either eliminate conflicts of interest or mitigate them and provide full and fair disclosure thereof. Citing two SEC enforcement actions, both subsequent to the Supermarket Letter, against advisers and service providers for improperly using service fees for fund distribution and not providing the fund boards with adequate information on such use, the staff notes that advisers and service providers are often involved in recommending that sub-accounting fees be instituted or increased and may be subject to conflicts of interest to the extent that such payments reduce the payment obligations the advisers and other service providers would otherwise bear. Accordingly, the staff recommends that advisers and relevant service providers provide the board with any necessary information to assist the board in its evaluation of whether a sub-accounting fee is being used to pay directly or indirectly for distribution.

The staff also raises the question of fund advisers' potential exposure under Section 36 of the 1940 Act for failing to provide sufficient information to make sure the board is fully informed. Section 36 provides that an adviser has a fiduciary duty with respect to payments of a material nature paid by a fund to the adviser or any affiliated person of the adviser.

The New Guidance indicates that the staff expects fund boards to "assess any conflicts of interest" faced by the adviser, by which they appear to mean the extent to which an adviser's obligation to pay revenue share out of its assets may be alleviated by payments from the fund, whether made under a Rule 12b-1 Plan or otherwise. It is unclear how a board is supposed to assess this factor, since the Rule 12b-1 Adopting Release clearly acknowledges that the use of fund assets to pay for distribution is often beneficial to the fund, and FINRA Rule 2830, which was approved by the SEC in 1993, sets forth the amount that a fund may pay for distribution and shareholder services[9]. The New Guidance could be construed to mean that in making the less-than-bright-line judgment about whether recommended payments to intermediaries include a component for distribution, boards should simply bear in mind that the adviser's recommendation may be affected by this sort of conflict of interest.

Conclusion

Although issued without the input that might have been gained from a formal notice and comment process, the New Guidance gives the distinct impression that its style and content were influenced by a give-and-take with industry representatives, perhaps contentious discussions, stemming from the sweep exams, about whether the earlier guidance provided a sufficient basis for the SEC to bring enforcement actions against fund advisers and directors in circumstances less clear cut than those asserted in the SEC's 2015 distribution-in-guise enforcement action. Be that as it may, with the New Guidance, the staff appears intent on providing precisely such a basis. Cases based on this guidance are probably not imminent, but one should not be surprised to see such cases after the staff has given funds, their boards, and their advisers a decent interval of time to implement the recommendations. Hopefully, any cases that are brought will not ignore the practical challenges at play here – such as the difficulty of obtaining complete information from intermediaries or the lack of clear benchmarks against which to assess the reasonableness of any fees paid out of fund assets for non-distribution services given the potentially wide range in the nature and quality of services from one intermediary to another – but will focus on a real failure on the part of a fund adviser or a fund board to have a reasonably designed process around these evaluations or the blatant disregard of obvious red flags.

Notes

1. SEC, Division of Investment Management, IM Guidance Update (January 2016), No. 2016-01, "Mutual Fund Distribution and Sub-Accounting Fees."
2. Rule 12b-1(a)(2) provides that distribution-related activity includes, but is not limited to, advertising; compensation of underwriters, dealers, and sales personnel; the printing and mailing of prospectuses to other than current shareholders; and the printing and mailing of sales literature.
3. SEC Announces First "Distribution in Guise" Case, available at: www.klgates.com/sec-announces-first-distribution-in-guise-case-09-29-2015/
4. The Supermarket Letter articulated the staff's positions that the board should determine whether the portion of the fee that the fund pays for non-distribution-related services "is reasonable in relation to (a) the value of those services and the benefits received by the fund and its shareholders and (b) the payments that the fund would be required to make to another entity to perform the same services." The factors involved in this determination as outlined in the Supermarket Letter include: (1) the nature of the services provided; (2) whether the services provide any distribution-related benefits; (3) whether the services provide non-distribution-related benefits and are typically provided by fund service providers; (4) the costs that the fund could reasonably be expected to incur for comparable services if provided by another party, relative to the total amount of the fee; and (5) the characterization of the services by the intermediary.
5. New Guidance at 3, citing Investment Company Act Release No. 11414 (Oct. 28, 1980) ("Rule 12b-1 Adopting Release").
6. The New Guidance uses the term "relevant service providers" to include fund transfer agents, distributors, and administrators, "to the extent they have relevant information or obligations" (Note 4).
7. One question that was left unclear in the Supermarket Letter was whether a board could determine to pay an intermediary more than it would pay its traditional transfer agent if the board concluded that the intermediary provided more or better services than the transfer agent. This question is important because some intermediaries do provide a range of services that transfer agents may not provide – for example, 24-hour online account access, combined statements for all of an investor's holdings, and various types of analytical tools and materials. The New Guidance seems to endorse language from a 2007 report of the Independent Directors Council clearly indicating that a board can determine to pay additional fees for such services: "As another example, if a fund's sub-transfer agent fees exceed the per account charge for the fund's transfer agent, the board may wish to examine whether the services for such fees are demonstrably different and justifiable" [New Guidance at n.22, citing Independent Directors Council, Board Oversight of Certain Service Providers (June 2007)].
8. In a similar vein, the staff has tightened the legal authority underlying the New Guidance. The Supermarket Letter cited as authority for several points SEC pronouncements made in a release that proposed amendments to Rule 12b-1 that were never adopted, leaving the legal import of those pronouncements in limbo. The New Guidance avoids that pitfall by relying on SEC releases issued in connection with rules that were ultimately adopted.
9. 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-transfer agency, 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-transfer agency, 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-transfer agency fees are not deemed to be within the 25 basis point 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 Rule 12b-1 fee – up to 25 basis points for shareholder services such as ongoing liaison with shareholders *and* additional fees for sub-transfer agency services. The New Guidance makes no mention of FINRA Rule 2830.

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