Client Alert

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SEC Staff Guidance on Fund Distribution and Sub-Accounting Fees: Emphasis on Process and Fully Informed Directors

By Jay G. Baris

In regulatory guidance published on January 6, 2016, the SEC's Division of Investment Management tackled the knotty issue of how mutual funds, their investment advisers and independent fund directors should evaluate arrangements involving mutual fund distribution and sub-accounting fees.

SUMMARY

In a nutshell, the Division's staff urges fund boards to establish a robust process for evaluating and approving sub-accounting arrangements, and to ensure that funds establish compliance policies and procedures for reviewing and identifying any payments that are made for distribution-related services and that are not paid by a Rule 12b-1 distribution plan.

In the guidance, the staff hones in on the issue of whether payments of fees to intermediaries that are not characterized as distribution fees raise questions of whether some or all of those fees "are being used to pay for activities that are primarily intended to result in the sale of mutual fund shares."[1] This is commonly referred to as "distribution in guise."

The staff summarized its recommendations:

- The board of directors should have a process reasonably designed to evaluate whether a portion of sub-accounting fees are being used to pay directly or indirectly for distribution;
- Advisers and "relevant service providers" should provide boards with sufficient information to make this determination; and
- Advisers and other relevant service providers should inform boards if the arrangements potentially are related to distribution and, if so, boards should "evaluate the appropriateness and character of those payments with heightened attention."

BACKGROUND

The staff recognizes that the use of omnibus accounts by broker-dealers and other financial intermediaries has increased in recent years, and that those intermediaries provide services to fund investors who indirectly own

[1] The staff refers to "sub-accounting fees" as fees paid for services related to sub-transfer agent, administrative, sub-accounting and other shareholder servicing fees.

fund shares maintained in those omnibus accounts.

Enter Rule 12b-1, which prohibits mutual funds from using fund assets to pay for any activity that is primarily intended to result in the sale of fund shares except through a Rule 12b-1 plan.

Boards are responsible for oversight of how funds pay for expenses out of fund assets. This responsibility can become challenging when potential conflicts of interest appear, as they do when payments involve distribution of fund shares.

The staff recognizes that in many cases, distribution and sub-accounting services are joined at the hip: typically the same financial intermediary provides distribution services and legitimate sub-accounting services. The issue is whether the fees for services characterized as "sub-accounting" are indirectly being used to pay for a financial intermediary's distribution activities. Given this possibility:

- *The staff recommends that boards establish a process reasonably designed to assist them in evaluating whether a portion of the fund-paid sub-accounting fees, if paid to financial intermediaries that distribute the fund's shares, is being used to pay directly or indirectly for distribution.*
- *The staff recommends that advisers and relevant service providers provide any necessary information to assist boards in this evaluation process.*

BOARD PROCESS

The staff takes the view that when the "*recipient of payments for services also finances distribution* . . . it raises a question as to the direct or indirect use of fund assets requiring relevant input from the fund's adviser or other relevant service provider and the informed judgment of the fund's board."

So what is a board to do? The basic answer is that boards should establish a robust process to evaluate the proposed arrangements and the inherent conflicts.

The staff addressed similar concerns in 1998, when it published guidance concerning payments to "fund supermarkets." As a result of that guidance, many fund groups established processes to address those kinds of payments. This guidance is still valid, the staff notes, and directors can apply that guidance to their evaluation of sub-accounting fees, which may be paid to financial intermediaries that are not necessarily fund supermarkets. The staff suggests, however, that fund directors may want to consider additional factors, including:

- Information about the specific services provided by a sub-accounting service provider;
- The amounts being paid;
- If the adviser and other service providers are recommending any changes in the fee structure or if any of the services provided have materially changed;
- Whether any of the services could have direct or indirect distribution benefits;
- How the adviser and other service providers ensure that the fees are reasonable; and

- How the board evaluates the quality of services being delivered to beneficial owners (to the extent it has the ability to do so).

The SEC cautions fund directors not to assume that establishing a cap on the amount of sub-accounting fees that a fund can pay will, by itself, satisfy their responsibilities. The staff *recommends* that in considering a cap, directors “may wish to consider whether transfer agent rates used for benchmarking reflect relevant economies of scale, and whether the type and amount of services provided are comparable.” Directors should also consider whether caps are appropriate depending on the varying levels of service provided.

KEEPING BOARDS FULLY INFORMED

The staff emphasizes that investment advisers and service providers should provide “sufficient information” to inform the board “of the overall distribution and servicing arrangements of the funds” to allow them to make an informed decision. This information may include data on payment flows for distribution services.

The staff notes that advisers should disclose to boards whether an increase in sub-accounting fees will reduce the adviser’s revenue sharing obligations. This information, while not dispositive, is “likely to be relevant” in the board’s evaluation of proposed payments.

RED FLAGS THAT MAY INDICATE DISTRIBUTION IN GUISE

The staff summarized arrangements that may raise concerns that payments may in fact be, at least in part, a payment for distribution services. These red flags include:

- Distribution-related activity conditioned upon the payment of a sub-accounting fee;
- Lack of a Rule 12b-1 plan;
- Tiered payment structures (fees paid through a combination of fund assets and revenue sharing);
- Lack of specificity or bundling of services;
- Distribution benefits taken into account when entering into arrangements;
- Large disparities in sub-accounting fees paid to various intermediaries; and
- Sales data provided to advisers.

RELIANCE ON ADVISERS, SERVICE PROVIDERS AND EXPERTS

The staff acknowledges that mutual fund boards typically are not involved in the day-to-day negotiations of sub-accounting agreements. Boards may rely on the adviser, other relevant service providers, counsel and the chief compliance officer to provide and analyze services and to assist them in carrying out their responsibilities. This is especially the case when funds have arrangements with dozens, or hundreds, of financial intermediaries. What’s a board to do? The staff offers some practical and useful guidance here:

> *An effective way to obtain an overall picture of the fund’s intermediary arrangements might be to have the adviser or relevant service providers furnish information in such a way that allows fund directors 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.

OUR TAKE

The SEC's well-publicized "distribution in guise" sweep examinations left funds, advisers and directors wondering whether the SEC would propose new rules, issue new guidance or step up the pace of enforcement proceedings against funds who they allege violate Rule 12b-1. This speculation grew more intense when the SEC settled charges in 2015 with an investment adviser accused of allowing a fund to pay for distribution services outside of a Rule 12b-1 plan.

It appears that the SEC is taking a reasoned approach by providing useful guidance, based on the results of its sweep examination, rather than engaging in regulation by enforcement. This reasoned approach emphasizes board process and fully informed directors. It stands to reason that if fund boards are fully informed and diligent in evaluating sub-accounting arrangements, taking into considerations the SEC staff suggests are important, then they will satisfy their fiduciary obligations when they exercise their business judgment.

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