On Monday, September 21, 2015, the Securities and Exchange Commission (SEC) charged a New York-based investment adviser and its affiliated distributor with misusing mutual funds’ assets to pay distribution and marketing expenses outside of an approved Rule 12b-1 plan. These are the first charges brought under the SEC’s recent “distribution-in-guise” initiative that seeks to identify improper use of mutual fund assets to pay distribution-related fees. The adviser and distributor have agreed to settle the charges for approximately $40 million and institute remedial action, without admitting or denying the SEC’s findings.

Under Rule 12b-1 of the Investment Company Act of 1940 (the 1940 Act), any payment for marketing and distribution made out of a fund’s assets must be in accordance with a written Rule 12b-1 plan previously approved by the fund’s board of directors and, where applicable, a majority of its shareholders. According to the SEC’s order, from January 2008 to March 2014, the adviser and distributor in this case unlawfully caused the affected mutual funds to pay almost $25 million in distribution and marketing expenses beyond what was approved under the funds’ Rule 12b-1 plan.

The SEC found that the adviser and distributor had inaccurately represented to the funds’ board that these additional distribution payments were sub-transfer agent fees, which are commonly paid out of a fund’s assets. Moreover, according to the SEC, the adviser engaged outside counsel to review its practices with respect to payment for sub-transfer agent fees. The adviser shared counsel’s report, which concluded the payments were for sub-transfer agent fees, with the board. This, the SEC continued, enabled the adviser and distributor to pay for distribution-related services out of the funds’ assets without the board oversight required under Rule 12b-1. Further, the SEC noted that the funds’ prospectus disclosures during the relevant time period had stated inaccurately that the adviser and distributor paid all distribution costs outside the funds’ Rule 12b-1 plan. The SEC has not charged the funds’ board with any violations.

In addition to finding that the adviser and distributor caused violations of Section 12(b) of the 1940 Act and Rule 12b-1 thereunder, the SEC found that the adviser had willfully violated Section 34(b) of the 1940 Act in connection with the inaccurate prospectus disclosures as well as Section 206(2) of the Investment Advisers Act of 1940 (the Advisers Act). Section 206(2) of the Advisers Act prohibits an adviser from engaging in any practice that “operates as a fraud or deceit upon any client.” Notably, the SEC pointed out in its order that a finding of simple negligence is sufficient to establish a violation of Section 206(2). These charges highlight the importance of reviewing sub-transfer agent and shareholder servicing expenses and the relevant agreements to ensure that fund assets are not being used, either inadvertently or purposefully, to pay for distribution-related services.

©2015 Drinker Biddle & Reath LLP. All Rights Reserved
