The Securities and Exchange Commission (SEC) has issued its long-awaited guidance following the recent and well-publicized "distribution-in-guise" sweep examination. The Guidance was released by the Staff of the Division of Investment Management (the Staff) on Jan. 6 regarding mutual fund distribution payments and sub-accounting/shareholder servicing fees (collectively Sub-TA fees).

The examination considered whether the payment of all or a portion of the fees by funds to financial intermediaries for sub-accounting and shareholder services were, in reality, payments primarily intended for distribution of fund shares, and therefore could only be made through a valid Rule 12b-1 Plan. The SEC’s Office of Compliance Inspections and Examinations (OCIE) and a number of other offices and divisions at the SEC conducted the investigation.

The Staff’s “distribution-in-guise” Guidance has been issued in the form of a Guidance Update from the Staff and not through proposed rule-making. It therefore was issued without an opportunity for public comment and, while it does not technically constitute new law, as we will see, the Guidance does seek to ensure that funds, and in particular fund boards, follow a certain course of action with regard to establishing, reviewing and approving Sub-TA fees.

We review the major elements of the Guidance below. We will be meeting with each of our clients to help them craft a meaningful and effective program for appropriately responding to the Guidance.

Overview

Viewed broadly, the Guidance does not appear to impose new law or to change prior interpretations of law. Instead, the Guidance seeks to move boards and fund advisers to impose a more comprehensive and structured process i) whenever instituting Sub-TA arrangements or seeking to increase fees associated with existing arrangements, ii) to periodically review existing arrangements and the reasonableness of the fees and the quality of the services provided thereunder, and iii) to ensure that the fund’s compliance program has appropriate policies and procedures to protect against the use of Sub-TA fees to finance distribution of fund shares. In doing so, the Staff goes to some length to emphasize that directors, particularly disinterested directors, “bear substantial responsibility for determining whether fees paid by a mutual fund are for distribution”. At the same time, the Guidance recognizes the board’s role as one of oversight and reaffirms the important place that the business judgment plays in the board’s deliberations.

The devil, as always, is in the details. The Guidance notes that:

- Regardless of whether a fund has a 12b-1 plan, fund boards must ensure that the fund has a process that is reasonably designed to assist the board in evaluating whether Sub-TA fees are being used to pay, directly or indirectly, for distribution;

- Advisers and other service providers must provide the board with sufficient information to inform the board of the overall picture of intermediary distribution and servicing arrangements, including how the level of
Sub-TA fees may affect the amount of distribution-related fees, such as revenue sharing payments and 12b-1 fees; and

- Advisers and other service providers must inform boards if certain activities or arrangements that are potentially distribution-related exist in connection with Sub-TA arrangements and, if so, boards must evaluate the appropriateness and character of those payments with heightened attention.

Elements of the Guidance

Board Process

The Guidance states that, regardless of whether a fund has a 12b-1 plan, the board must ensure that there is a process in place that is reasonably designed to assist them in evaluating whether any portion of a Sub-TA fee, if paid to an intermediary that also distributes fund shares, is being used directly or indirectly to finance distribution. The Guidance has suggested the following framework to accomplish this:

Understanding the Overall Picture - The Staff recommends that the adviser or other relevant service provider present the board with sufficient information to inform the board of the overall distribution and servicing arrangements for the funds it oversees. This information should include:

- Information about specific services provided under the Sub-TA agreements;
- The amounts being paid by fund service providers (including the adviser) to intermediaries for both distribution (including 12b-1 fees) and non-distribution services (discussed further below);
- If Sub-TA fees are proposed to be increased with respect to existing arrangements, whether services have also increased or been enhanced;
- Whether the current or proposed Sub-TA services could have a direct or indirect distribution benefit;
- The reasonableness of the Sub-TA fees compared to fees that could be expected to be incurred for comparable services if provided by another party (more on this below);
- The process employed by the adviser or other service provider to ensure that Sub-TA fees are reasonable; and
- How the board should evaluate the quality of Sub-TA services delivered to shareholders (to the extent they are able to do so).

Interestingly, the Guidance downplays the relevance of the characterization of such services and payments by intermediaries as a factor for the board to consider. This is in contrast to its 1998 letter on fund supermarket fees, where the SEC stated that the characterization of the services provided by the intermediary as a Sub-TA service was a factor for the board to take into account.

Understanding Intermediary Relationships - The Guidance acknowledges the fact that the board’s role is one of oversight and that the board does not have responsibility for day-to-day negotiation of agreements. In addition, the Guidance states that boards should be able to rely on summary data provided by the adviser and other service providers, including summary data as to expenses and activities that might be related to distribution-related activities. The Guidance further notes that directors may rely on outside counsel, the chief compliance officer and personnel from the adviser and other service providers and may request that information be provided in a clear and concise manner with summaries and overviews. As such, the Guidance does not mandate that directors be presented with information regarding each intermediary, rather that information be provided in a way that enables directors to understand the relevant conflicts involved and the general context in which these arrangements are made, with specific details regarding particularly significant arrangements.

Nevertheless, the Guidance states that there are some circumstances where more detailed information is required. In particular, as noted above, the Guidance provides that the board should receive information about the payment flows (of whatever nature) from fund service providers to the intermediaries. These payments would, therefore, include Sub-TA payments as well as revenue sharing and 12b-1 payments. In describing such payments, the board should be apprised as to the extent to which the Sub-TA payments to one or more intermediaries may reduce the service provider’s revenue sharing obligation or the amount of 12b-1 fees to be paid to that intermediary.

Other Thoughts

Fee Caps - The Guidance notes that many funds currently employ some sort of fee cap establishing the maximum
allowable amount of Sub-TA fees that will be paid by the fund. The Guidance further acknowledges the common practice of setting a cap in relation to the Sub-TA fees that would have been incurred by the fund if the accounts in question had been serviced by an internal service agent (the Avoided TA analysis) or in relation to industry surveys or benchmarks (Benchmarks) provided by third parties. The Guidance cautions boards that if they are to use an Avoided TA or Benchmark analysis, they must ensure that the analysis used to establish the caps properly takes into account any differences in the nature of services provided, as well as the impact that economies of scale may have with respect to the comparison. In addition, the Guidance notes that fee caps should not be blindly applied to all intermediaries, but should take into account any differences in services provided by different intermediaries.

15(c) process – The Guidance cautions that boards should understand the nature and amount of payments made by an adviser to support the distribution function. This is particularly so if a fund does not have a 12b-1 fee and the adviser is supporting a substantial amount of the distribution costs through revenue sharing arrangements. The Guidance reminds directors that while it may be appropriate for advisers to pay for distribution expenses out of their legitimate profits, it would be inappropriate for the level of the advisory fee to include an element to compensate the adviser for these distribution payments.

Indicia of Distribution

The Guidance next takes the opportunity to comment on a number of circumstances where the Staff believes boards must be particularly attentive, as they may present indicia that Sub-TA payments may be being used for distribution. These circumstances may raise questions, but do not necessarily indicate that the Sub-TA payment is improper. Boards, however, would be well-advised to ensure that they consider these situations carefully and document their considerations appropriately.

- **Distribution-related activity conditioned on the payment of Sub-TA fees.** In some respects all Sub-TA arrangements are conditioned on the existence of a distribution arrangement. After all, an intermediary who does not offer the fund for sale has no need for a Sub-TA arrangement. However, the sweep exam apparently uncovered other situations where benefits such as access to wholesalers or placement on preferred lists were conditioned on the payment of a Sub-TA fee or an increase in a Sub-TA fee. Such arrangements should be viewed with skepticism.

- **Lack of a 12b-1 plan.** The Guidance cautions boards in this circumstance to ensure that they understand how distribution expenses are being paid, apparently reflecting a Staff view that there is a greater risk of the mis-use of Sub-TA fees when there are no 12b-1 arrangements in place to help defray the cost of distribution.

- **Tiered Payment Structures.** Here the Guidance is referring to arrangements where payments to an intermediary are paid first from 12b-1 fees, then out of Sub-TA fees up to a cap, and finally out of revenue sharing. The Guidance casts a cloud over such arrangements, noting they call into question what services are being paid for with what fees.

- **Bundling of services.** Similar to the tiered payment structure noted above, bundled arrangements lack the specificity necessary to tie Sub-TA payments to specific Sub-TA services. The Guidance states that if services remain bundled, (i.e., the contract does not specifically tie Sub-TA fees to specific Sub-TA services) then the portion of the fee that is tied to distribution services (however small) must be considered to be distribution-related and may only be paid out of a Rule 12b-1 plan.

- **Distribution Benefits Taken into Account.** The Guidance refers to the process put in place by the adviser or other service provider when recommending, instituting or raising Sub-TA fees. The Guidance notes that boards should pay particular attention when the individuals responsible for evaluating Sub-TA arrangements are also involved in the distribution function. The Guidance recommends that boards receive information as to who is negotiating and reviewing Sub-TA arrangements, the process for approval and factors considered.

- **Large Disparities in Sub-TA fees Paid to Intermediaries.** The Guidance questions the payment of different Sub-TA rates to different intermediaries for substantially the same services. While acknowledging the existence of competitive considerations in the establishment of Sub-TA fees, the Guidance nonetheless cautions that such disparities may indicate that distribution considerations have played a role in the setting of such fees.

- **Receipt of Sales Data.** The Guidance notes that if intermediaries provide strategic sales data to funds, boards should consider to what extent payments for such data are distribution-related and should be paid through a 12b-1 plan.
Compliance Program Implications

Finally, the Guidance notes that during the course of the sweep exams, the Staff observed that many funds did not have explicit policies and procedures in their 38a-1 compliance programs to provide for the review and identification of Sub-TA payments to ensure that such payments were not being made for distribution services. The Guidance sets forth the Staff’s view that such policies and procedures are required to be part of the 38a-1 program.

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