SEC Staff Issues Guidance on Mutual Fund Distribution Arrangements

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Recently issued SEC staff guidance reminds mutual fund directors of their obligations to evaluate fund payments to financial intermediaries and emphasizes investment advisers’ and other service providers’ obligation to provide boards of directors with sufficient information necessary to assist in their evaluation process.

Earlier this month, the staff of the US Securities and Exchange Commission’s (SEC’s) Division of Investment Management (IM) released a guidance update on the role of mutual fund boards of directors with respect to payments made out of fund assets to broker-dealers and other financial intermediaries that provide shareholder and recordkeeping services for omnibus accounts. The trend to use omnibus accounts has grown substantially in recent years.[1] The staff noted that examples of these services—often generally referred to as subaccounting services—include communicating with financial intermediaries’ customers about their investments in the funds; maintaining financial records; processing changes to customer accounts; processing trade orders; maintaining customers’ records; answering customers’ questions about their accounts and the process for redeeming fund investments; providing account statements, tax documents, trade confirmations; and customer account balances; transmitting fund annual reports, proxy statements and other shareholder communications; and transmitting and tabulating executed proxies.

In particular, the staff warned that, in some instances, subaccounting fees purportedly used for subtransfer agent services, administrative and subaccounting services, and other shareholder services (all of which are nondistribution services) are instead being used directly or indirectly to pay for mutual fund distribution activities.[2] The staff also reminded investment advisers and other relevant service providers of their obligation to provide fund boards of directors with sufficient information to assist with a board’s evaluation process. The guidance was informed by a recent sweep examination of payments for “distribution in guise” and follows a recent SEC enforcement action against an investment adviser that caused a fund to pay for certain distribution-related activities outside of a Rule 12b-1 plan.[3]

Background

Section 12(b) of the Investment Company Act of 1940 (1940 Act) prohibits the use of mutual fund assets to pay, directly or indirectly, for marketing and distribution expenses. Rule 12b-1 under the 1940 Act provides an exemption from this general prohibition that permits a fund to use fund assets for marketing and distribution expenses, subject to certain requirements and conditions set forth in the rule. One condition is that such fees must be paid pursuant to a written plan that has been approved by a mutual fund’s board of directors and shareholders (a so-called “12b-1 plan”). Any use of fund assets for marketing and distribution expenses that does not comply with Rule 12b-1 violates the 1940 Act. The section 12(b) prohibition includes payments purportedly made for a nondistribution purpose, such as shareholder and recordkeeping services, but that are actually used to finance the distribution of fund shares—which the SEC’s examination and enforcement staff has termed “distribution in guise.”

Pursuant to Rule 12b-1, a mutual fund’s board of directors plays a crucial role in overseeing the use of fund assets to pay for distribution and in ensuring that fund assets are not used to pay for distribution outside of a
Rule 12b-1 plan. In this regard, the IM staff’s guidance aims to help boards of directors develop a process reasonably designed to ensure that mutual fund assets are not used to pay for distribution in violation of section 12(b) and Rule 12b-1. The staff notes that its guidance applies regardless of whether a fund has adopted a Rule 12b-1 plan.

Process for Reviewing Use of Fund Assets

The IM staff recommends that, in developing a process reasonably designed to provide boards of directors with sufficient information to allow them to make an informed reasonable business judgment about whether a portion of any subaccounting fees is being used directly or indirectly to pay for fund distribution, boards should first focus on understanding a fund’s overall distribution and servicing arrangements.

In the staff’s view, regardless of whether a mutual fund has adopted a 12b-1 plan, its Rule 38a-1 compliance program should include policies and procedures reasonably designed to prevent violations of section 12(b) and Rule 12b-1 thereunder. Although the staff acknowledged that there are a number of reasonable approaches that a board could take to comply with section 12(b), the staff expressed doubt that a board could make an informed reasonable business judgment regarding the use of fund assets for distribution and compliance with Rule 12b-1 without having a framework or process in place to evaluate the use of fund assets. In addition, the staff indicated that a board should apply additional scrutiny when evaluating fees paid to service providers that also distribute the fund’s shares.

The staff indicated that, when evaluating fees paid to affiliated entities that subsequently make distribution payments, a board should follow a process similar to its advisory contract approval process under section 15(c) of the 1940 Act, during which a board may evaluate the distribution and marketing services provided directly or indirectly by the fund’s investment adviser. The staff noted that section 36(b) of the 1940 Act (which imposes a fiduciary duty on a fund’s adviser with respect to receiving compensation and is the only provision of the 1940 Act that expressly provides a private right of action to shareholders) also applies to payments to any affiliated person of the adviser.

The staff also described factors that a board may want to consider when assessing subaccounting fees in the context of distribution services. In particular, the IM staff pointed to factors described in its 1998 letter to the Investment Company Institute—the so-called “Supermarket Letter”—regarding the use of mutual fund assets to pay fees to participate on the sales platforms of financial intermediaries. The staff acknowledged, however, that not all factors set forth in the Supermarket Letter may be relevant to a particular board’s analysis. Beyond the factors identified in the Supermarket Letter, the IM staff stated that a board might also consider requesting additional information from the adviser and other service providers, including about the following:

1. Information about the specific services provided under the subaccounting agreements
2. The amounts being paid by the fund
3. Whether the adviser and other service providers recommend any changes to the fee structure or if any of the services provided have materially changed
4. Whether any of the services could have direct or indirect distribution benefits
5. How the adviser and other service providers ensure that the subaccounting fees are reasonable
6. How the quality of services delivered to fund shareholders is evaluated

In addition, the staff observed that some mutual fund boards have established maximum allowable subaccounting fees to be paid with fund assets (or “caps”), which are often based either on the amounts payable to a transfer agent for the subaccounting services or on industry surveys or benchmarks obtained by third parties. Fees paid in excess of the cap may be viewed by fund boards with heightened scrutiny or with an assumption that they are likely for distribution services. The staff cautioned, however, that benchmarks may not reflect the actual cost for subaccounting services provided by an intermediary—in other words, such benchmarks may not provide an apt comparison. In this regard, the staff recommends that boards carefully evaluate any benchmarks used in establishing caps, including whether the rates used for benchmarking reflect relevant economies of scale and whether the type and amount of services are comparable to those that a particular fund would receive. The staff suggests that boards might consider having different payment rates or fee caps depending on the varying kinds of services provided to a fund by an intermediary.

Although very focused on the need for mutual fund boards to have a process in place for evaluating the payment of subaccounting fees, the staff did not bless any particular approach and acknowledged that there are a number of reasonable approaches that a board could take.
Providing Information on Distribution and Servicing Arrangements

Because a mutual fund board is responsible for overseeing a fund’s overall structure and typically is not involved in day-to-day fund operations, the IM staff recommends that investment advisers and other service providers give a board sufficient information to assist the board in its evaluation process. This should include relevant information about subaccounting payments and other intermediary payment flows made in support of servicing and distribution activities and arrangements, as well as other information sufficient for the board to evaluate whether and to what extent subaccounting payments may reduce or otherwise affect other payment flows (e.g., 12b-1 fees and revenue sharing).[5]

The IM staff also recommends that investment advisers and other service providers provide the board with information about whether any of the following activities or arrangements occur, because, according to the staff, they could be indicia of payments being used for distribution in violation of the 1940 Act:

- Any financial intermediary that conditions distribution-related activity on the payment of subaccounting fees or an increase in the amount of such fees
- The absence of a 12b-1 plan or sales charges, which may raise questions about how fund distribution expenses are actually paid
- If the fund adviser uses a tiered payment structure in which payments are first made from 12b-1 fees, then by subaccounting fees paid by the fund, and finally by the adviser from revenue sharing
- Where distribution and nondistribution services are bundled or there is a lack of specificity about services received and related payments
- Whether the investment adviser and other service providers take into account distribution and sales benefits when recommending, instituting, or raising subaccounting fees, such as where personnel involved in distribution are also involved in setting subaccounting fees
- If there are large disparities in subaccounting fees paid to intermediaries, and if so, whether they are being paid to the fund’s newest, largest, or fastest-growing distribution partners
- Whether payments are made to intermediaries for “strategic sales data”

To the extent that any of these arrangements exist, the IM staff believes that the board should closely scrutinize the appropriateness and characterization of the payments and services. The staff indicates that a board conducting this analysis could receive and rely on the assistance of outside counsel, the fund’s chief compliance officer, or personnel of the fund’s investment adviser or other service providers.

Marketplace Implications

Because the staff’s guidance follows an extensive examination of many mutual fund complexes, during which the staff collected a wide range of information on market practices, mutual funds and their boards of directors should carefully consider the staff’s views and recommendations set forth therein. Fund boards may want to consider taking a fresh look at the process by which they evaluate arrangements with fund service providers, including the level of reporting they receive, particularly where service providers are used in connection with the distribution of fund shares. Boards that have not already done so may also want to consider requesting that fund advisers and distributors present an overview of how fund shares (including particular classes of shares) are sold, the roles that financial intermediaries play, and how the intermediaries are paid (and by whom) for the various services that they provide. Importantly, the staff’s guidance repeatedly clarifies that it is a board’s responsibility to determine whether subaccounting fees are being used to pay for distribution services. If a robust process designed to foster an informed evaluation exists, the SEC should be expected to respect the exercise of the board’s reasonable business judgment on the matter.[6]

[1] In an omnibus account structure, a fund’s transfer agent does not interface with each underlying fund shareholder, but rather interfaces with financial intermediaries, each of which may act on behalf of many underlying shareholders. These financial intermediaries, in turn, provide many of the services to shareholders that transfer agents have historically provided, and mutual funds or their service providers often compensate the financial intermediaries accordingly. These subtransfer agency services are commonly referred to as “sub-TA services” or “subaccounting services” and may be paid out of fund assets.


[4] The Supermarket Letter identified five factors that a fund board should consider: (1) the nature of the services provided; (2) whether they provide any distribution-related benefits; (3) whether they provide any nondistribution-related benefits 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) how the intermediary characterizes the services. See Letter from Douglas Scheidt, Assoc. Dir. and Chief Counsel, Div. of Inv. Mgmt., Secs. & Exch. Comm’n, to Craig S. Tyle, Gen. Counsel, Inv. Co. Inst. (Oct. 30, 1998) (stating that where fees paid by fund are for both distribution-related and nondistribution-related services, boards should then determine whether portion paid for nondistribution-related services is reasonable in relation to (1) the value of services and benefits received by a fund and its shareholders and (2) any payments that a fund would otherwise need to make to another entity to perform the same services).

[5] In making this recommendation, the IM staff pointed to an investment adviser’s fiduciary duty under section 206(1) and (2) of the Investment Advisers Act of 1940 to either eliminate relevant conflicts of interest or to mitigate and provide full and fair disclosure of those conflicts.

[6] See, e.g., Jones v. Harris Associates L.P., 130 S. Ct. 1418 (2010) (“Where a board’s process for negotiating and reviewing investment adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process . . . . Thus, if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently.”).

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