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## SEC Issues Guidance on Mutual Fund Payment of Distribution Fees to Intermediaries

On January 6, the staff of the Securities and Exchange Commission's (SEC's) Division of Investment Management issued Guidance Update 2016-01, "Mutual Fund Distribution And Sub-Accounting Fees" (the "Guidance").<sup>1</sup> The Guidance outlines the staff's views on issues that may arise when registered open-end investment companies ("mutual funds" or "funds") make payments to financial intermediaries that provide shareholder and recordkeeping services (so-called sub-administrative and sub-transfer agency services) for investors whose shares are held in omnibus and networked accounts maintained with mutual funds. In particular, the Guidance addresses whether a portion of those payments are being used to finance distribution and therefore, if paid by a fund, must be paid pursuant to rule 12b-1 under the Investment Company Act (the "1940 Act").

Under the 1940 Act, funds are prohibited from using their assets, directly or indirectly, to pay brokers and other intermediaries compensation for their sales efforts (also known as fund "distribution expenses") unless they are paid under a written plan approved by the fund's board of trustees that is compliant with rule 12b-1 (a "Rule 12b-1 Plan").<sup>2</sup> The Guidance, in practice, will place additional burdens on fund boards and advisors to evaluate and characterize fund payments to intermediaries as sub-administrative and sub-transfer agency services or Rule 12b-1 Plan distribution services. FINRA Rule 2830(d)(2) effectively imposes a cap on 12b-1 fees, so that re-characterizing a fee as a distribution expense that is currently paid by a fund as a non-distribution expense may prohibit the fund from making the payment.

The Guidance indicates that:

1. mutual fund boards need a formal written process to evaluate the character of payments made to intermediaries,
2. advisors and other relevant service providers are under a duty to provide sufficient information to fund boards for them to complete their evaluation of such payments, and
3. certain fact patterns raise issues as to whether fund payments for sub-administrative and sub-transfer agency services were actually distribution expenses.
4. The issues identified in the Guidance arose during the SEC's recent sweep inspections of mutual fund complexes, investment advisers, broker-dealers and transfer agents. These inspections studied, among other things, the payment of fees to financial intermediaries characterized as non-distribution related sub-transfer agent, administrative, sub-accounting and other shareholder servicing fees (collectively "sub-accounting fees").<sup>3</sup> These inspections also raised a question as to whether some of these payments were for fund distribution expenses. Last year, the SEC instituted an enforcement action against the adviser and distributor of a mutual fund complex

<sup>1</sup> Available [here](#).

<sup>2</sup> Among other things, rule 12b-1 requires a fund's board to re-approve the fund's Rule 12b-1 Plan annually and that the board receive quarterly reports identifying the amounts and the purposes of the expenses paid under the plan.

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alleging they made “payments to two financial intermediaries for distribution related services. The distribution payments were not paid pursuant to a written, approved Rule 12b-1 plan, and were not paid by [the adviser] out of its own resources (e.g., as so-called “revenue sharing payments”). In addition, use of the Funds’ assets to pay for these distribution-related services rendered the Funds’ disclosures concerning payments for distribution-related services inaccurate.”<sup>4</sup> Thus, the SEC staff sees a potential for investors to be misled if fund distribution expenses are mischaracterized as sub-accounting fees.

## Background

The staff recognizes that legitimate non-distribution related, sub-accounting services<sup>5</sup> are typically performed by the intermediaries. These services benefit the fund by reducing the burdens on the fund’s administrator, transfer agent and other fund service providers. The staff is concerned with whether fund boards are properly evaluating the payments to and services received from intermediaries.

## Board Process

The Guidance notes that there is a potential for sub-accounting fees to be used to pay for distribution. “This circumstance is most likely to arise when the recipient of the payments also distributes the mutual fund’s shares.” The SEC views the fund’s directors as substantially responsible “for determining whether fees paid by a mutual fund are for distribution.” The Guidance recommends a board process be established to make these determinations when the fund is paying sub-accounting fees. The fund’s advisor and other service providers may have a conflict of interest where payment of sub-accounting fees by the fund reduces the payment obligations of the advisor or other service provider to the intermediary. Consequently, the fund’s advisor and other relevant service providers should report to the board information concerning their payments and obligations to intermediaries.

In particular, the Guidance adapts the 1998 fund supermarket fee guidance framework. As a process for evaluating the character of sub-accounting fees, a board might generally consider also requesting information from the advisor, other relevant service providers and intermediaries about a number of other issues. Relevant additional information would likely include, but is not limited to:

1. information about the specific services provided under the mutual fund’s sub-accounting agreements;
2. the amounts being paid;
3. if the adviser and other service providers are recommending 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 fees are reasonable; and
6. how the board evaluates the quality of services being delivered to beneficial owners (to the extent of its ability to do so).

The Guidance notes that some fund boards impose a cap on sub-accounting fees. Such caps are often based on the level of fees the mutual fund would otherwise pay its transfer agent for the sub-accounting services performed by the intermediary, or are based on industry surveys or benchmarks obtained from third parties. Nevertheless, the Guidance admonishes fund boards to be sensitive to the actual administrative and transfer agency services provided by intermediaries and the fees it would otherwise be willing to pay for those services. The Guidance suggests that boards may wish to consider whether transfer agent rates used for benchmarking or setting the cap reflect relevant economies of scale, and whether the type and amount of services provided are comparable. The Guidance also suggests that different caps be considered for different intermediaries where the intermediaries are offering differing services for their customers.

<sup>3</sup> These inspections indicated a need for the staff to update its prior guidance on rule 12b-1 compliance, especially the guidance given in 1998 on board responsibilities and compliance frameworks when a mutual fund pays a fee for participating on an intermediary-sponsored fund platform (a “supermarket fee”). Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, Securities and Exchange Commission, to Craig S. Tyle, General Counsel, Investment Company Institute (Oct. 30, 1998).

<sup>4</sup> In the Matter of First Eagle Investment Management, LLC and FEF Distributors, LLC, Investment Company Act of 1940 Release No. 31832 (September 21, 2015) (available [here](#)).

<sup>5</sup> Examples of these services include intermediaries communicating with their customers about their fund holdings; maintaining their financial records; processing changes in customer accounts and trade orders; recordkeeping for customers; answering customer inquiries regarding account status and the procedures for the purchase and redemption of fund shares; providing account balances and providing account statements, tax documents, and confirmations of transactions in a customer’s account; transmitting proxy statements, annual reports and other communications from a fund; and receiving, tabulating and transmitting proxies executed by customers.

The Guidance notes that there are a number of reasonable approaches that a board may take in establishing its rule 12b-1 process for sub-accounting fees. Nevertheless, the absence of any such process indicates to the SEC staff that a fund board might not be able to make an informed judgment regarding the use of fund assets for distribution and the fund's compliance with rule 12b-1(a). Moreover, the Guidance indicates that the board's process be stated as part of its compliance manual established pursuant to rule 38a-1 under the 1940 Act.

## Providing Boards an Overall Picture of Distribution and Servicing Arrangements

The Guidance recommends that the advisor and relevant service providers provide sufficient information to inform the board of the overall distribution and servicing arrangements of the fund. Among the relevant information needed to inform the board's determination, the advisor should provide information about the extent a fund's sub-accounting payments may reduce or otherwise affect advisors' or their affiliates' revenue sharing obligations, or the level of fees paid under a Rule 12b-1 Plan.

## Indicia that a Payment May Be Used to Pay for Distribution

The Guidance notes that, while none of the following indicia are necessarily indicative of payments for distribution services, advisors and relevant service providers must provide the board with information as to whether the activities or arrangements discussed below occur, and if they do, that the board closely scrutinize the appropriateness and distribution character of such payments as part of its evaluation.

- **Distribution-Related Activity Conditioned on the Payment of Sub-Accounting Fees.**
- **Lack of a 12b-1 Plan.** Boards may wish to inquire further regarding how fund distribution expenses, if they exist, are paid.
- **Tiered Payment Structures.** Some intermediaries' overall payments are often structured (formally or informally) so that any payments are first made from rule 12b-1 fees, then fund-paid sub-accounting fees (generally through a fund affiliated entity), and finally any balance is paid by the adviser or an affiliate from revenue sharing.
- **Lack of Specificity as to, or Bundling of, Services.** Such lack of specificity of services provided or bundling with distribution payments raises the question as to whether sub-accounting payments are at least in part for distribution.
- **Distribution Benefits Taken Into Account When Proposing or Changing Sub-Accounting Fees.** Advisers and relevant service providers should furnish information to boards generally about who is negotiating such fees, the process for their approval and the considerations taken into account, with the aim of informing the board's fee approval evaluation process.
- **Large Disparities in Sub-Accounting Fees Paid to Intermediaries.** While this may be a result of competitive pressures, depending on the facts and circumstances (e.g., higher payments for the services are being paid to the mutual fund's newest, largest or fastest-growing distribution partners), such disparities in payments for the same services also may indicate that they are payments for distribution-related activities.
- **Sales Data.** Intermediary provided information about the demographics of fund investors and other information about top sales partners and channels to obtain better understanding of them may indicate that payments for this data are distribution related.

As expressed in the Guidance, "the board's role should focus on understanding the overall distribution process as a whole to inform its reasonable business judgment about whether sub-accounting and other mutual fund-paid fees represent payments for distribution, in whole or in part." The board should request that relevant information be provided in a clear and concise manner. The Guidance suggests that complex mutual fund intermediary relationships be described to highlight relevant conflicts and the general context within which the arrangements are made, as well as the specific details of atypical or particularly significant arrangements.

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