CARLTON FIELDS

SEC Provides Long-Awaited Guidance on Fund Distribution and Sub-Accounting Fees

January 25, 2016

Guidance Update No. 2016-01, published this month by the SEC's Division of Investment Management, provides extensive guidance concerning the possibility that payments from mutual funds are being used to promote sales of the funds under the guise of some other purpose. **Background**

It is common for mutual funds or certain of their service providers to make payments to financial intermediaries that hold fund shares in omnibus or networked accounts. These financial intermediaries include broker-dealer firms and fund transfer agents, as well as insurance companies that hold fund shares to support variable annuity and variable life insurance products that they issue. Under the Investment Company Act of 1940 ("1940 Act"), any use of mutual fund assets to directly or indirectly pay for any activity that is primarily intended to promote sales of the fund's shares (a "distribution-related activity") is illegal, unless the payment is made pursuant to a "Rule 12b-1 Plan" in compliance with all the SEC's requirements for such plans. For some time, the SEC has been investigating the possibility that some payments actually are for distribution-related activities, although they are characterized by the mutual funds or their advisers as being for other types of services. There is a wide variety of such non-distribution services, including transfer agency, sub-transfer agency, other shareholder record-keeping, accounting, reporting, and other administrative

services; and the Guidance Update refers to payments for any such non-distribution services as "sub-accounting payments." **The Guidance Update's General Approach**

The extent to which a given payment should be deemed to be made, directly or indirectly, by a mutual fund for distribution-related activity is often unclear, and the Guidance Update, in effect, requires an analysis of the facts and circumstances in such cases. The Guidance Update asserts, for example, that, when the recipient of payments for services also finances distribution of fund shares, "it raises a question as to the direct or indirect use of fund assets *requiring* relevant input from the fund's adviser and other relevant service providers and the informed judgment of the fund's board" (emphasis added). Nevertheless, although the Guidance Update discusses numerous procedures and practices that could be useful, or factors that could be relevant, in resolving such questions, it generally does not describe them as mandatory. Rather, it identifies some that "should" be observed or considered by mutual fund boards or service providers. As to others, it "recommends" or says they "may" be observed or considered. On its face, therefore, the Guidance Update appears to provide fund boards and service providers with considerable flexibility in developing practices, procedures, and analyses that are appropriate to their own facts and circumstances. Such flexibility seems appropriate, in light of the complexity of the issues that may arise in some cases and the many variations in fact patterns that may exist. On the other hand, the SEC and its staff clearly have serious continuing concerns about the possibility that illegal payments for distribution-related services are being made. In 2015, the SEC brought its first enforcement action in this area, and there are indications that future enforcement actions may be forthcoming. It is foreseeable, therefore, that in making future enforcement decisions the SEC and its staff will weigh heavily—with the benefit of hindsight—the extent to which a fund board or service provider has taken the Guidance Update to heart. Fund boards and service providers, therefore, will be under considerable pressure (a) to consider each element of the Guidance Update, and (b) as to any apposite elements that they do not adopt, to have and document persuasive reasons for not doing so. Set forth below is summary information about the roles that the Guidance Update envisions for the key players. Industry participants will want to conduct a careful review of the Guidance Update, which runs 15 single-spaced pages. **Role of Mutual Fund Board**

The Guidance Update:

- recommends that the board have processes in place reasonably designed
    - to assist them in evaluating whether a portion of fund-paid sub-accounting fees, if paid to intermediaries that distribute fund shares, is being used to pay directly or indirectly for distribution-related activities and
    - to provide them enough information to make informed judgments about such matters.

These recommendations apply even if the fund has a Rule 12b-1 Plan, inasmuch as there may still be a question as to whether the plan in fact covers all payments that are legally required to be

subject to such a plan;

- recommends that the board "closely scrutinize" the appropriateness of payments if the adviser or another service provider notifies the board of the existence of any of the following seven activities or arrangements, which "may raise concerns that a payment, though ostensibly not for distribution-related activities, may in fact be (at least in part) a payment for such services":

1. 1. distribution-related activity that is conditioned on the payment of sub-accounting fees,
   2. the absence of any Rule 12b-1 Plan,
   3. certain "tiered" payment arrangements, such as where payments for a number of services are made first from Rule 12b-1 fees, then from fund-paid sub-accounting fees, and then by the adviser or its affiliate via "revenue sharing,"
   4. lack of clarity about what services are provided in exchange for sub-accounting fees or the "bundling" of sub-accounting fees and payments for distribution-related services within a single contract,
   5. advisers or other service providers that take fund share "distribution and sales benefits" into account when recommending, instituting, or raising sub-accounting fees,
   6. large disparities in the rates of sub-accounting fees that a mutual fund pays to different intermediaries that provide "substantially the same set of services" to the fund, and
   7. sales by intermediaries of "strategic" fund share sales data to the fund, the adviser, or other relevant service providers; and

- seems generally to assume that the board's determinations will be afforded the protection of the "business judgment rule."

Role of Service Providers to Mutual Fund

The Guidance Update:

- recommends that advisers and relevant fund service providers provide or arrange for provision to fund boards of

    - any necessary information to assist boards in evaluating sub-accounting fees paid to intermediaries that distribute fund shares, including “payment flows from service providers” and other “information to inform the board about the overall distribution and servicing arrangements of the fund,” and

    - “information sufficient for fund boards to evaluate whether and to what extent sub-accounting payments may reduce or otherwise affect advisers’ or their affiliates’ revenue sharing obligations, or the level of fees paid under any Rule 12b-1 Plan";

- states that “advisers and relevant service providers should provide to boards information about sub-accounting payments, and other intermediary payment flows made in support of the fund’s distribution and servicing activities and arrangements that would be relevant to a facts and circumstances analysis of whether the payments could be for distribution"; and

- recommends and asserts that advisers and relevant fund service providers have an affirmative responsibility to provide fund boards with information about whether any of the activities or arrangements listed in numbered clauses 1-7 above are present.

Role of Mutual Fund
The Guidance Update states that, whether or not they have Rule 12b-1 Plans in place, mutual funds should have policies and procedures reasonably designed to prevent violations of Section 12(b) of the 1940 Act and Rule 12b-1 thereunder.

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