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Fund Boards and Advisers Called to Action by SEC “Distribution in Guise” Update - Part Two



This post continues my [discussion](#) of the [IM Guidance Update](#) released on January 6, 2016, in which the SEC staff urges boards to consider the following factors in meeting the staff's expectations of boards, vis-à-vis Rule 12b-1 and Rule 38a-1, in overseeing the use of fund assets to cover what the staff has dubbed "Sub-Accounting Fees" for recordkeeping, sub-transfer agent, and other purely administrative services ("Sub-Accounting Services") that intermediaries provide to shareholders:

- the specific services provided under relevant Sub-Accounting Services agreements and the amounts paid for them;
- any changes to the fee structure recommended by fund advisers, transfer agents, distributors, and/or administrators ("Service Providers"), and whether the Sub-Accounting Services have changed materially;
- "whether any of the services could have direct or indirect distribution benefits;"
- how Service Providers "ensure that the fees are reasonable" and monitor the quality and legitimate provision of Sub-Accounting Services;
- payment flows to intermediaries "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;"
- the extent to which Sub-Accounting Fees "may reduce or otherwise affect" Service Providers' "revenue sharing obligations, or the level of fees paid under a Rule 12b-1 plan;" and
- the following factors identified in the SEC's 1998 [fund supermarket letter](#): the nature of the services provided; whether the services provide non-distribution-related benefits and are typically provided by Service Providers; "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 the characterization of the services by the intermediary itself.

In addition, boards might incorporate regular evaluation of the base fees paid to Service Providers into their oversight process as a means of ensuring that Service Providers are not unnecessarily incentivized to, through

Sub-Accounting Fees, lead funds "to bear distribution-related expenses to help [them] grow and maximize assets under management, increasing [Service Provider] fee revenues." The IM Guidance Update also identifies what the SEC staff views as indicia of distribution payments in guise. These include arrangements where:

- an intermediary conditions its provision of distribution-related activities and services on the payment of Sub-Accounting Fees;
- a fund group lacks of a board-approved 12b-1 plan and/or does not impose sales charges;
- intermediaries are compensated in a formal or informal tiered structure involving a combination of fees paid out of fund assets and revenue sharing;
- distribution-related and Sub-Accounting Services are bundled in that they are covered by a single contract or single fee structure;
- distribution benefits are taken into account by Service Providers in setting sub-accounting fee rates;
- there are significant disparities between the Sub-Accounting Fees paid by funds to different intermediaries providing similar services; and
- intermediaries offer provide "strategic sales data" in connection with the services they provide.

The SEC staff emphasizes that its recommendations are informed by the findings of the distribution sweep examination that began in 2013, and explains that while boards bear "substantial responsibility" under Rule 12b-1 for ensuring distribution costs are properly financed, boards should be able to rely on Service Providers "to affirmatively provide information about the existence of any[non-compliant] activities or arrangements, as well as summary data about expenses and activities related to distribution-related activities." It is with noting that in September 2015, the SEC brought an [enforcement action](#) against an adviser that "caused a fund to pay for certain specific distribution-related activities outside of a 12b-1 plan." The extent to which unaffiliated intermediaries that sell fund shares and service fund shareholders will be capable of providing, and willing to provide, the data envisioned by the SEC staff in the IM Guidance Update remains to be seen. The staff has not explicitly required intermediaries to deliver the data to fund boards or Service Providers, although it may become commercially necessary for intermediaries to do so as standard practices evolve following the release of the IM Guidance Update. Fund boards and Service Providers might consider working with counsel to incorporate contractual terms regarding the provision of such data in their selling and servicing agreements with third party intermediaries. For additional background on this topic, see my articles "[Tackling Mutual Fund Risks in the Omnibus Channel](#)" and "[Mutual Fund Distribution Trends, the SEC Sweep Exam and the Backdrop of Rule 12b-1](#)."

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