Blogs
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Distribution in Guise Settlement Orders Reinforce Need for Better Compliance, Contracting, and Disclosure Practices (Part 1)

In two back-to-back enforcement cases arising from the SEC's now four-year old distribution sweep exam, a Chicago-based mutual fund adviser has agreed to a $4.5 million civil money penalty and a Maryland-based firm has agreed to pay disgorgement of $17.8 million plus $3.8 million in interest and a $1 million penalty. Both cases reinforce the importance of compliance oversight, contracting, and disclosure around distribution and sub-transfer agency ("sub-TA") payments. This post will review the findings in each case (which the firms neither admitted nor denied). A subsequent post will recommend steps to mitigate the risk of improper distribution payments.

First Settlement Order

The settlement order in the Chicago case (the "First Order") details three separate sets of violations. In the first, the firm was found to have negligently used approximately $902,000 in fund assets outside of a board-approved Rule 12b-1 plan to pay for marketing and distribution services provided by third party financial intermediaries. The improper use of fund assets occurred when the firm "inadvertently misclassified [revenue sharing] agreements as being for sub-TA services and caused the funds to pay for those services outside of a Rule 12b-1 plan for approximately two years." In the second set of findings, the fund's board had imposed caps on "the amount of fees to be paid out of fund assets to each intermediary for sub-TA services," which in turn were disclosed in the funds' prospectuses. The funds were to reimburse the firm for its actual sub-TA payments up to the caps. However, due to operational errors in calculating the fees payable under sub-TA agreements with two intermediaries, fund assets were used to reimburse payments of approximately $356,000 in excess of the caps. In addition to reducing the net asset value of the funds by $1.25 million, the First Order states that both sets of conduct were contrary to the funds' disclosures with respect to the source of payment for distribution and sub-TA services and the requirement to cap fees. Finally, the Chicago firm had arrangements in place under which it provided certain shareholder administrative services to particular fund share classes. The firm indicated that it would contract with various intermediaries to perform the services and represented to the board that the fees would not be retained by the firm, "but would rather be passed through to the various financial intermediaries providing these administration services." In fact, the First Order states, the firm provided the services itself and pocketed the fees.

Second Settlement Order

The SEC findings in the settlement order regarding the Maryland firm (the "Second Order") were similar. There, the findings involved the "improper use of mutual fund assets to pay nearly $18 million for the distribution and marketing of fund shares outside of a written, board-approved Rule 12b-1 plan, as well as to pay expenses in excess of the mutual funds' expense caps" that did not comply with the funds' prospectus disclosures. Agreements with certain intermediaries described in the Second Order called for the provision of distribution and marketing services that the distributor was to pay for with fees "from its own resources." The Maryland firm, however, was found to have treated the agreements as being for sub-TA services and to have "improperly caused the funds to pay approximately $14.87 million for those services outside of a Rule 12b-1 plan." The funds also paid intermediaries approximately $2.96 million for sub-TA services in excess of an annual 30-basis-point expense limitation. In addition to violating prospectus disclosures, the Maryland firm was found to have made inaccurate disclosures to the fund board concerning the payments. Part 2 of this blog will discuss lessons learned and best practices arising from these cases.

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