

January 13, 2016

## SEC Issues Guidance on Oversight of Fund Payments of Sub-Accounting Fees

On January 6, 2016, the SEC's Division of Investment Management issued a Guidance Update titled, "Mutual Fund Distribution and Sub-Accounting Fees" (the "Guidance," available [here](#)). The Guidance arises from a multi-year SEC staff review of mutual fund payments for shareholder, sub-transfer agency and recordkeeping services paid to intermediaries that distribute fund shares ("sub-accounting fees"). The staff's goal has been to determine whether a portion of sub-accounting fees were, in fact, "payments for distribution in guise" and, therefore, required to be paid pursuant to a Rule 12b-1 plan or by the adviser out of its "legitimate profits."

With respect to "bundled" services fee payments to an intermediary (including sub-accounting fees), funds and their boards have relied on prior SEC and staff statements and guidance to the effect that there can be no precise definition of what types of expenditures constitute indirect use of fund assets for distribution, and fund directors, particularly the disinterested directors, would bear substantial responsibility for making that judgment based on the facts and circumstances of each individual case.<sup>1</sup> **The Guidance expressly reaffirms these prior statements and guidance.**

The Guidance contains the SEC's recommendations concerning the process by which a board should determine whether a portion of a fund's payment of sub-accounting fees are payments for distribution. The recommendations address (i) a reasonably designed board process for a board to make this determination, (ii) the types of information a board should be provided so that its determination is an informed judgment and (iii) indicia of a potential distribution component in sub-accounting fees.

These recommendations are discussed in detail below.

### I. Board Process

**A Framework.** The Guidance notes that many boards already have a process in place to assist in evaluating sub-accounting fees, often based on the framework described in the 1998 no-action letter on mutual fund supermarket fees (the "Supermarkets Letter").<sup>2</sup> The Guidance states that the factors and analyses described in the Supermarkets Letter may serve as a useful framework to establish a process by which a fund's board evaluates sub-accounting fees. In the Supermarkets Letter, the SEC staff identified the following non-exhaustive list of factors as relevant to the determination of whether a portion of a bundled fee was for distribution:

- the nature of the services provided;
- whether the services provide any distribution benefits;
- whether the services provide non-distribution-related benefits and are typically provided by fund service providers;

<sup>1</sup> See *Bearing of Distribution Expenses by Mutual Funds*, Rel. No. IC-11414 (Oct. 28, 1980). *Accord* *Payment of Asset-Backed Sales Loads by Registered Open-End Management Investment Companies*, Rel. No. IC-16431 (Jun. 13, 1988) at n. 173 ("Whether or not payments are for distribution is a question of fact to be decided by the fund's board of directors in light of the surrounding circumstances"); *The Shareholder Services Group, Inc.*, SEC No-Action Letter (pub. avail. Aug. 12, 1992).

<sup>2</sup> Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management to Craig S. Tyle, Esq., General Counsel, Investment Company Institute, SEC No-Action Letter (pub. avail. Oct. 30, 1998).

- costs that the fund could reasonably be expected to incur for comparable services if provided by another party, relative to the total fee; and
- the characterization of the services by the broker-dealer.

In applying the Supermarkets Letter's framework to sub-accounting fees, the Guidance states that a board might consider requesting additional information from the adviser, service providers, and intermediaries about a number of other topics, including the following:

- information about the specific services provided under the fund's sub-accounting agreements;
- the amounts being paid;
- 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;
- whether any of the services could have direct or indirect distribution benefits;
- how the adviser and other service providers ensure that the fees are reasonable; and
- how the adviser and other service providers evaluate the quality of services being delivered to beneficial owners (to the extent it is possible to do so).

**Use of Caps.** The Guidance notes that some mutual fund boards also have instituted a maximum or "cap" on the amount of sub-accounting fees that funds may pay, frequently based on the amount that the fund would pay its transfer agent for the services and/or based upon third-party surveys. The Guidance cautions that fees paid to transfer agents may differ from fees that a fund would have to pay for the same services if purchased elsewhere. More specifically, the Guidance recommends that, if a board uses such fee caps, the board also might consider whether (i) the transfer agent rates underlying the caps reflect a transfer agent operating with appropriate economies of scale, (ii) the sub-accounting services provided by intermediaries are comparable to those provided by the transfer agent and (iii) multiple caps, instead of one cap, are appropriate, depending on the level of service that different intermediaries provide.

**Related Rule 38a-1 Policies and Procedures.** The Guidance also reports that many funds do not have written policies and procedures designed to prevent violations of Section 12(b) of the 1940 Act and Rule 12b-1. According to the Guidance, the adoption of a Rule 12b-1 plan, by itself, would not satisfy the requirements of Rule 38a-1. Instead, the Guidance states, a fund (regardless of whether it has adopted a 12b-1 plan) should have written policies and procedures for evaluating fund payments to identify portions that may be for distribution but that are not paid under a Rule 12b-1 plan.

## II. Providing Boards an Overall Picture

The Guidance recommends that a fund's adviser and relevant service providers provide adequate information to the fund's board regarding the fund's overall distribution and servicing arrangements. More specifically, the Guidance states that, in order for a board to determine whether a portion of fund-paid sub-accounting fees is for distribution and to assess any conflicts of interest, the adviser and other relevant service providers should provide information to the board 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." In other words, a board should see the full scope of payments to intermediaries that distribute fund shares.

In addition, the Guidance recommends that a fund's adviser and other relevant service providers provide the board with sufficient information so that the board can determine whether and to what extent sub-accounting payments may affect revenue sharing obligations and/or the level of fees paid under a Rule 12b-1 plan. In other words, in addition to

seeing the full scope of payments to intermediaries, the board should be able to evaluate whether one stream of fees to intermediaries affects any another payment stream.

The Guidance states that a fund board should be able to rely on the adviser and other relevant service providers to provide information about the existence of any of the “indicia” described below, “as well as summary data about expenses and activities related to distribution-related activities.” The Guidance states that a board should focus on understanding the scope of the distribution process as a whole to form a reasonable business judgment about whether sub-accounting fees are partially or wholly for distribution.

The Guidance notes that a fund board could utilize the assistance of outside counsel, the fund’s chief compliance officer, or employees of the adviser or service providers in making its business judgments. The Guidance recognizes that some funds have agreements with hundreds of intermediaries (and have multiple agreements with an intermediary) and recommends that, in requesting assistance, a board should request that information be presented in a concise form, including appropriate summaries.

### III. Indicia that a Payment May be Used to Pay for Distribution

In its lengthiest section, the Guidance discusses various activities and arrangements involving fund payments for purported non-distribution services that may raise questions about whether the payments may be for distribution. The Guidance recommends that advisers and relevant service providers provide a fund board with information when any of the following activities or arrangements is observed. Then, the board should “closely scrutinize” the reported activities and arrangements for any distribution component.

- **Distribution-Related Activity Conditioned on the Payment of Sub-Accounting Fees.** Some intermediaries have conditioned providing distribution-related services (*e.g.*, access to wholesalers, distribution through mutual fund supermarkets, or placement on a preferred fund list) on a fund’s paying (or increasing its payments) of sub-accounting fees. According to the Guidance, these types of conditions may be a signal that some portion of the sub-accounting fees is payment for distribution.
- **Lack of a 12b-1 Plan.** For a fund that has not adopted a Rule 12b-1 plan (or class of shares not covered by such a plan), the Guidance recommends that a board should inquire how fund distribution expenses, if any, are paid.
- **Tiered Payment Structures.** The Guidance notes that some advisers have entered into intermediary agreements pursuant to which the intermediary provides multiple services, which may include a distribution component. These agreements provide for payment according to a “tiered” structure whereunder an intermediary may be paid a fee out of fund assets and also receive revenue sharing payments. The Guidance reports that the payments under these agreements frequently provide that payments are paid first from Rule 12b-1 fees, then as fund-paid sub-accounting fees (usually through an adviser’s affiliate) and, finally, the remaining amount due an intermediary is paid by the adviser or an affiliate as revenue sharing. The Guidance states that this tiered payment structure may be problematic because it tends to obfuscate which services a *fund* is paying for and raises the question of whether the use of fund-paid fees reduces/subsidizes fees for which the adviser or an affiliate otherwise would be responsible.
- **Lack of Specificity or Bundling of Services.** In some instances, an agreement with an intermediary may not enumerate clearly the services to be provided in exchange for sub-accounting fees, or the agreement may bundle payments for sub-accounting services and distribution. The Guidance states that this lack of specificity may raise the question of whether sub-accounting fees are at least partially for distribution. The Guidance recommends that sub-accounting services and distribution services should be separately identified in a clear manner and monitored as such. The Guidance notes that in some instances, boards have evaluated whether the *overall payment* for bundled services is, in fact, a payment for distribution. The Guidance states that this approach is inconsistent with the express requirements of Rule 12b-1, which requires that *any activity* that is primarily intended to result in the sale of fund shares, if paid from fund assets, must be paid pursuant to a

Rule 12b-1 plan. Therefore, notwithstanding the bundling of services, if any specifically identified service among the bundled services is a distribution service, then payment for that service, if paid by a fund, must be paid pursuant to a Rule 12b-1 plan.

- **Distribution Benefits Taken into Account.** The Guidance notes that, in some cases, an adviser or other relevant service provider may take distribution benefits into account when recommending, instituting or raising sub-accounting fees. The Guidance cites an example where an adviser's employee, or service provider's employee engaged principally with share distribution, is involved in determining the level of sub-accounting fees. The Guidance states that when such employees are involved in setting or negotiating sub-accounting fees, there is a greater risk that distribution services, at least in part, underlie the arrangement. Accordingly, the Guidance recommends that advisers and relevant service providers furnish information to a fund board generally about who is negotiating sub-accounting fees, the process by which sub-accounting fees are approved and the considerations that are taken into account.
- **Large Disparities in Sub-Accounting Fees Paid to Intermediaries.** The Guidance recognizes that a fund may pay different sub-accounting fees to intermediaries that are providing substantially identical services due to competitive pressures. The Guidance cautions that such disparities may also signal that the payments are for distribution, especially if the higher payments are being paid to the mutual fund's newest, largest or fastest-growing intermediaries. The Guidance recommends that a board may wish to examine whether services being provided by intermediaries are comparable and, if the services are comparable, the rationale for different sub-accounting fees.
- **Sales Data.** The Guidance notes that intermediaries may offer to sell "strategic sales data" to a fund (or its adviser or other relevant service providers) designed to further the data purchaser's understanding of fund investors and relevant sales channels. The Guidance recommends that a board should carefully consider the extent to which any payments for such data are payments for distribution.

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As recently as 2010, in its release on distribution fees,<sup>3</sup> the SEC appeared to be aware of the fact that the distinction between distribution expenses and non-distribution expenses may not always be easy or even practical to identify and quantify. The Guidance reaffirms (i) that there can be no precise definition of what types of expenditures (including sub-accounting payments, in whole or in part) constitute prohibited use of fund assets for distribution and (ii) that a fund's directors, particularly the disinterested directors, bear substantial responsibility for making that judgment based on the facts and circumstances of each case. The Guidance reiterates that whether a mutual fund is making payments for distribution "is a facts and circumstances evaluation to be made by the board of directors in their reasonable business judgment based on information provided by mutual fund advisers and other relevant service providers."

The Guidance also is a useful reminder that the SEC staff believes that a fund should have Rule 38a-1 written policies and procedures for evaluating fund payments to identify portions that may be for distribution but that are not paid under a Rule 12b-1 plan.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.

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<sup>3</sup> Mutual Fund Distribution Fees; Confirmations, Rel. No. IC-29367 (Jul. 21, 2010) at notes 153 and 159 and accompanying text ("A fund [and, presumably, its board] need not determine which portion of the fee is primarily for distribution services or which portion is primarily for administrative [i.e., non-distribution] services, and it may be impractical and burdensome to require funds to allocate expenses").