The Asset Management Industry
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INVESTMENT COMPANY INSTITUTE

MEMO# 29360

September 21, 2015

SEC Settles Case Involving Payment of Distribution Expenses Outside of Funds' 12b-1 Plan

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TO:

BANK, TRUST AND RETIREMENT ADVISORY COMMITTEE No. 32-15
BROKER/DEALER ADVISORY COMMITTEE No. 43-15
COMPLIANCE MEMBERS No. 27-15
OPERATIONS MEMBERS No. 26-15
SEC RULES MEMBERS No. 54-15
SMALL FUNDS MEMBERS No. 41-15
TRANSFER AGENT ADVISORY COMMITTEE No. 50-15

RE:

SEC SETTLES CASE INVOLVING PAYMENT OF DISTRIBUTION EXPENSES OUTSIDE OF FUNDS' 12b-1 PLAN

The Securities and Exchange Commission has announced the settlement of a case involving the payment of distribution fees by Funds outside of a 12b-1 plan. The SEC described it as the first case under its "Distribution-in-Guise Initiative." [1] According to the Order, the Respondents' conduct violated Section 12(b) of the Investment Company Act and Rule 12b-1 thereunder as well as the antifraud provisions of the Investment Advisers Act of 1940 and the Investment Company Act of 1940. [2] As a result of the violations, the Funds' adviser and its principal underwriter were ordered to cease and desist, required to undertake various remedial actions, [3] and ordered to pay disgorgement, prejudgment interest, and a civil monetary penalty of approximately $40 million. [4] The facts of this case, which are briefly summarized below, involved agreements between the Funds' distributor and two intermediaries, Intermediary One and Intermediary Two.

Agreements with Intermediary One

With respect to Intermediary One, the Funds' distributor entered into two agreements: a Financial Services Agreement and a Selected Dealer Agreement. In the **Financial Services Agreement**, Intermediary One agreed to provide a variety of sub-TA services that are typically paid for out of fund assets. These services included:

- Maintaining separate records for each customer in the omnibus account for each Fund;
- Transmitting purchase and redemptions orders to the Funds;
- Preparing and transmitting account statements for each customer;
- Transmitting proxy statements, periodic reports, and other communications to customers;
- Providing periodic reports to the Funds to enable their Blue Sky reporting; and
- Providing standard monthly contingent deferred sales charge reports.

In return for these services, Intermediary One received fees paid by the Funds in the amount of $16-19 per account.

The **Selected Dealer Agreement** between the distributor and Intermediary One provided, in part, that the distributor had "invited [Intermediary One] to become a selected dealer *to distribute shares* of the [Funds]." [5] [Emphasis added in the Order.] The services provided by this agreement included "due diligence, legal review, training, [and] marketing," as well as fees that were in addition to any Rule 12b-1 plan fees paid to Intermediary One by the funds. These fees included 25 basis points of total new gross shares sold by Intermediary One and 10 basis points of the value of fund shares it sold that were held for more than one year.

Pursuant to Selected Dealer Agreement, the Funds' advisor and its distributor caused the Funds to pay total fees of approximately $24.6 million to Intermediary One from January 1, 2008 to March 31, 2014. According to the Order, "[t]he services to be provided under the Selected Dealer Agreement were generally marketing and distribution, not sub-TA services." As a result, "Respondents were prohibited from using the Funds' assets to make payments to Intermediary One under this agreement, unless such payments were made pursuant to the Funds' written, approved Rule 12b-1 plan (which they were not)." [6]

Agreement with Intermediary Two

With respect to Intermediary Two, the distributor entered into a "Correspondent Marketing Program Participation Agreement" ("CMPPA"). While the CMPPA was entered into as of December 3, 2007, the Funds had been paying Intermediary Two for substantially the same services provided under the CMPPA since 2005. The CMPPA provided for Intermediary Two to provide the following services:

- Provide email distribution lists of correspondent broker-dealers that have requested "sales and marketing concepts" from it;
- Market the funds on its internal website;
- Invite the Funds to participate in special marketing promotions and offerings to correspondent broker-dealers;
- Invite the adviser to participate in Intermediary Two's annual conference;
- Provide quarterly statements detailing which correspondent broker-dealers were

selling the Funds; and
- Waive all training fees charged to correspondent broker-dealers relating to the Funds.

In exchange for these services, Intermediary Two charged an annual fee equal to 5 basis points of the net asset value of the outstanding shares of the fund sold by Intermediary Two. Between January 1, 2008 and March 31, 2014, the Funds' adviser and distributor caused the Funds to pay approximately $290,000 to Intermediary Two pursuant to the CMPPA. According to the Order, because the services covered by the CMPPA "were generally marketing and distribution, not sub-TA services, Respondents were prohibited from using the Funds' assets to make payments to Intermediary Two under the CMPPA, unless such payments were made pursuant to" the funds' approved 12b-1 plan "(which they were not)." [7]

Board Disclosures

The Order also finds that, in reporting to the Funds' board regarding the agreements with Intermediary One and Intermediary Two, "the fees under the Selected Dealer Agreement and the CMPPA were inaccurately included as sub-TA fees." The Funds' adviser shared with the board the results of a review that the adviser asked outside counsel to conduct regarding its practices with respect to sub-TA payments. According to the Order, the review by outside counsel "indicated that all of the fees paid to Intermediary One and Intermediary Two under the Financial Services Agreement, Selected Dealer Agreement, and CMPPA were for sub-TA services." [8]

Prospectus Disclosures

The Funds' prospectus disclosure stated that the Funds' distributor or their affiliates bore the "distribution expenses to the extent they are not covered by payments under the [Rule 12b-1 plan]." The Order finds, however, that "in connection with the Selected Dealer Agreement and CMPPA, the Funds, and not [the distributor] or its affiliated, bore the additional distribution and marketing expenses not covered by the Funds' 12b-1 plans."

Violations

Based on the above, the Order finds that: (1) the Funds' adviser willfully violated the antifraud provision of Section 206(2) of the Investment Advisers Act of 1940; (2) the Funds' adviser and distributor caused the Funds to violate Section 12(b) of the Investment Company Act of 1940 and Rule 12b-1 thereunder; and (3) the Funds' adviser willfully violated the antifraud provisions of Section 34(b) of the Investment Company Act of 1940.

Tamara K. Salmon
Associate General Counsel

endnotes

[1] See SEC Press Release: "SEC Charges Investment Adviser With Improperly Using Mutual Fund Assets to Pay Distribution Fees" (September 21, 2015), available at http://www.sec.gov/news/pressrelease/2015-198.html.

[2] *See In the Matter of First Eagle Investment Management, LLC and FEF Distributors*, SEC Release No. IA-4199, IC-31821 (September 21, 2015), which is available on the SEC's website at http://www.sec.gov/litigation/admin/2015/ia-4199.pdf (the "Order").

[3] The remedial actions include hiring an Independent Compliance Consultant to conduct a comprehensive review of the distributor's supervisory, compliance, and other policies designed to prevent and detect the prohibited use of the Funds' assets to engage, directly or indirectly, in financing any activity that is primarily intended to result in the sales of shares issued by the Funds.

[4] The breakdown of the $40 million penalty includes approximately $25 million in disgorgement; $2.3 million in prejudgment interest; and a civil monetary penalty of $12.5 million.

[5] Order at p. 4.

[6] Order at p. 4.

[7] Order at p. 5.

[8] Order at p. 5.
