

**MEMO# 29615**

January 7, 2016

# **SEC Division of Investment Management Publishes Guidance on Mutual Fund Distribution and Sub-Accounting Fees**

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 1-16  
COMPLIANCE MEMBERS No. 1-16  
OPERATIONS MEMBERS No. 1-16  
PRINCIPAL UNDERWRITERS WORKING GROUP  
SEC RULES MEMBERS No. 2-16  
SMALL FUNDS MEMBERS No. 1-16  
TRANSFER AGENT ADVISORY COMMITTEE No. 2-16 RE: SEC DIVISION OF INVESTMENT  
MANAGEMENT PUBLISHES GUIDANCE ON MUTUAL FUND DISTRIBUTION AND SUB-  
ACCOUNTING FEES

In the wake of the SEC's recent distribution-in-guise sweep, the SEC's Division of Investment Management has published a Guidance Update containing the staff's views and recommendations relating to mutual fund distribution and sub-accounting fees. [\[1\]](#) The Guidance notes that many of the issues it discusses "were brought into focus" by the recent sweep examination. [\[2\]](#) As background to the staff's recommendations, the Guidance discusses the increasing use of omnibus accounts by broker-dealers and other financial intermediaries, the legal requirements of Section 12(b) of the Investment Company Act of 1940, the requirements of Rule 12b-1, and the SEC's 1998 no-action letter on supermarket fees. [\[3\]](#) It then discusses the views of the staff and their recommendations relating to payments by funds to financial intermediaries. The staff's views and recommendations in the Guidance are summarized below.

## **Responsibilities of Fund Directors**

The Guidance expresses the view that "directors bear substantial responsibility for determining whether fees paid by a mutual fund are for distribution." [\[4\]](#) It also notes, however, that the board's role "should focus on understanding the overall distribution process as a whole to inform its reasonable business judgment about whether sub-accounting and other mutual-fund paid fees represent payments for distribution in whole or in part." [\[5\]](#) To fulfill their role, the Guidance notes that the staff "expects that mutual fund directors could receive and rely on the assistance of outside counsel, the fund's chief

compliance officer, or personnel from the adviser or relevant service providers, as appropriate.” [6] According to the staff, “an effective way to obtain an overall picture of the fund’s intermediary arrangements might be to have the adviser or relevant service providers furnish information in such a way that allows fund directors to understand the relevant conflicts and the general context within which the arrangements are made, as well as the specific details of atypical or particularly significant arrangements.” [7]

## **Recommendations of the SEC Staff**

The Guidance includes the following staff recommendations:

1. Regardless of whether a fund has, or is considering adopting a 12b-1 plan, the fund’s board of directors should have a process in place that is reasonably designed to evaluate whether a portion of sub-accounting fees is being used to pay directly or indirectly for distribution.
2. The board’s evaluation process should include advisers and other relevant service providers providing “sufficient information” to inform the board of the overall picture of the intermediary distribution and servicing arrangements for the funds, including how the level of sub-accounting fees (e.g., 12b-1 fees, revenue sharing) may affect other payment flows that are intended for distribution. The process should also be reasonably designed to provide the board enough information so they can (a) make an informed judgment as to whether fund-paid fees are being used to pay directly or indirectly for distribution; and (b) 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 a Rule 12b-1 plan.
3. Advisers and other relevant service providers should inform boards if certain activities or arrangements that are potentially distribution-related exist in connection with the payment of sub-accounting fees and, if they exist, the board should evaluate the appropriateness of those payments “with heightened attention.” [8]
4. Advisers and relevant service providers should provide, or arrange for the provision to boards of, any necessary information to assist the board in its evaluation process. Relevant additional information a board might consider “would likely include, but is not limited to:” [9]
  - a. Information about the specific services provided under the fund’s sub-accounting agreements;
  - b. The amounts being paid;
  - c. Whether the adviser or other service providers are recommending any changes to the fee structure or whether any of the services provided have materially changed;
  - d. Whether any of the services could have direct or indirect distribution benefits;
  - e. How the adviser and other service providers ensure that the fees are reasonable; and
  - f. How the board evaluates the quality of services being delivered to beneficial owners to the extent of its ability to do so.

According to the Guidance, while this information may usually be provided when the board considers implementing or continuing a 12b-1 plan or as part of the 15(c) process, if there are material changes to the fund’s distribution structure, or changes to the distribution arrangements that may pose a material conflict of interest for the adviser, the staff believes that the board should receive and consider such information on a more timely basis in order to inform the board’s evaluation of sub-accounting

fees.

5. If a board uses fee caps as part of its fee structure, it should carefully evaluate any benchmarks used to establish the cap and whether the benchmark takes into account relevant economies of scale and the comparability of the type and amount of services provided. Boards may want to also consider “different payment rates or fee caps to intermediaries depending on the varying kinds of services provided to the mutual fund.” [10]
6. The adviser and relevant service providers should affirmatively provide the mutual fund board with information as to whether activities listed in the Guidance occur and, if so, the board should “closely scrutinize the appropriateness and distribution character of such payments as part of its evaluation.” [11] The activities listed are:
  - a. Distribution-related activities that are conditioned on the payment of sub-accounting fees;
  - b. The payment of fund distribution expenses when the fund lacks a 12b-1 plan;
  - c. Tiered payment structures and whether fund-paid fees reduce or subsidize any fees that the adviser and other relevant service providers might otherwise be responsible for, “which would be a conflict of interest”; [12]
  - d. Lack of specificity or bundling of services, which precludes the board’s ability to determine whether specific fees are primarily for distribution-related services;
  - e. The adviser taking distribution and sales benefits into account when recommending, instituting, or raising sub-accounting fees;
  - f. Large disparities in sub-accounting fees paid to intermediaries, particularly when higher fees for the services are being paid to the mutual fund’s newest, largest, or fastest-growing distribution partners; and
  - g. Fees paid for “sales data” and whether the purchase of such data is distribution related.

### **Rule 38a-1 Compliance Procedures**

Finally, the Guidance notes that, during the sweep exams, “the staff observed that many mutual funds did not have explicit policies and procedures as part of their rule 38a-1 compliance programs designed to prevent violation of section 12(b) and rule 12b-1.” [13] According to the Guidance, all funds should have compliance policies and procedures relating to Section 12(b). Funds with a 12b-1 plan “should have adequate policies and procedures for reviewing and identifying any payments that may be for distribution-related services that are not paid through the plan.” Funds without a 12b-1 plan, “should also have policies and procedures reasonably designed to prevent violations of section 12(b) and rule 12b-1.” [14]

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#### **endnotes**

[1] See *Mutual Fund Distribution and Sub-Accounting Fees*, IM Guidance Update No. 2016-01 (January 2016) (the “Guidance”), which is available at: <https://www.sec.gov/investment/im-guidance-2016-01.pdf>.

[2] Guidance at p. 1.

[3] The supermarket letter was a Letter from Doug Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC, to Craig S. Tyle, General Counsel, ICI, dated October 30, 1998. See Release at fn. 18.

[4] Guidance at p. 3.

[5] Guidance at p. 9.

[6] *Id.*

[7] Guidance at p. 10.

[8] Guidance at p. 2.

[9] Guidance at p. 4.

[10] Guidance at p. 5.

[11] The Guidance acknowledges that while none of these activities “may demonstrate in and of itself that a non-12b-1 payment is for distribution-related activity,” they should warrant further scrutiny. Guidance at p. 7.

[12] Guidance at p. 8.

[13] Guidance at p. 5.

[14] *Id.*