

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

Since the SEC's mutual fund distribution sweep examination began in 2013, the industry has become increasingly focused on the various types of payments made to intermediaries selling fund shares and providing services to shareholders. Fund assets may, of course, be used to compensate intermediaries for marketing and other distribution-related costs, including "shelf space" on sales platforms, only under a board-approved [Rule 12b-1](#) plan. Outside of a 12b-1 plan, Fund assets may be used to cover what the SEC has dubbed "Sub-Accounting Fees" for recordkeeping, sub-transfer agent, and other purely administrative services ("Sub-Accounting Services") that intermediaries provide to shareholders. In an [IM Guidance Update](#) released on January 6, 2016, the staff of the SEC's Division of Investment Management offered substantial guidance on what it expects from boards overseeing funds' Sub-Accounting Fees and what information it expects fund advisers, transfer agents, distributors, and administrators ("Service Providers") to provide to boards to facilitate their oversight. With the IM Guidance Update, the staff also makes clear that it fundamentally believes that, regardless of whether a fund has adopted a 12b-1 plan, Rule 38a-1 requires "policies and procedures reasonably designed to prevent violations of section 12(b) and Rule 12b-1," that include "policies and procedures for reviewing and identifying any payments that may be for distribution-related services that are not paid through [a 12b-1] plan." Noting the elevated potential for Sub-Accounting Fees to be used indirectly for distribution costs in situations where an intermediary both sells fund shares and provides Sub-Accounting Services, the staff explains that:

- boards should have a process in place that is "reasonably designed to evaluate" whether any Sub-Accounting Fees are used for distribution costs;
- boards should establish processes that call for Service Providers to provide "sufficient information to inform the board of the overall picture of intermediary distribution and servicing arrangements for the mutual fund," including data regarding how Sub-Accounting Fee levels may affect "other payment flows (such as 12b-1 fees and revenue sharing) that are intended for distribution;" and
- Service Providers should pro-actively bring to boards' attention any "activities or arrangements that are potentially distribution-related" in connection with the payment of Sub-Accounting Fees so that, if such circumstances exist, boards can "evaluate the appropriateness and character of those payments with heightened attention."

While many boards have adopted some form of intermediary oversight in the wake of the shift to omnibus accounting and the SEC's distribution sweep, no best practices have yet emerged. In meeting the SEC's expectation that they "make an informed judgment as to whether fund-paid fees are being used to pay directly or indirectly for distribution," boards might consider working with Service Providers, the funds' CCO, and counsel to develop contractual service level standards. These standards would identify the bona fide services provided by intermediaries and track execution of those services and the payment of 12b-1 fees, Sub-Accounting Fees, and/or revenue sharing payments to cover them. Boards might also engineer a reporting dashboard that flushes out red flag issues such as an intermediary that continues to sell fund shares and receive Sub-Accounting Fees following the expiration of its selling and/or servicing agreement. Part Two will discuss (1) the factors that the SEC staff recommends boards consider in assessing whether Sub-Accounting Fee payments are tied to distribution costs and (2) facts the staff sees as presenting a high likelihood that Sub-Accounting Fees are actually distribution fees in guise. 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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