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Mutual Fund Distribution Trends, the SEC Sweep Exam and the Backdrop of Rule 12b-1

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The traditional mutual fund distribution model has undergone significant change over the past decade, and the Securities and Exchange Commission (the SEC) recently launched a targeted sweep examination of how mutual fund sponsors arrange and pay for distribution. It is important for mutual fund officers, directors, and counsel to keep in mind the legal framework against which these evolving distribution dynamics and regulatory scrutiny lie, namely the history of Rule 12b-1 (Rule 12b-1) under the Investment Company Act of 1940 (the Investment Company Act).

Recent Trends in Mutual Fund Distribution—A Summary

The vast majority of individual retail investors have transitioned from holding mutual fund shares directly through fund transfer agents to investing through omnibus accounts provided by third party fund distribution partners such as fund supermarkets, financial advisors, broker/dealers, and retirement plan sponsors and administrators (RPAs). In addition to offering a means of investing in multiple mutual funds at one time, these financial intermediaries provide a variety of crucial shareholder services (known as sub-accounting or sub-transfer agent (sub-TA) services) to the individual beneficial fund shareholders' underlying omnibus accounts. This "one stop shopping" approach to investing provided by third party distribution platforms stands in stark contrast to the historic model of mutual fund distribution and shareholder servicing in which investors

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generally purchased fund shares and received shareholder services exclusively through funds or their affiliated transfer agents.

Mutual fund investors have always paid for distribution and shareholder/sub-TA services in one way or another. Sales loads are collected directly from shareholder accounts and paid to third party intermediaries as commissions for selling fund shares, while Rule 12b-1 distribution fees, shareholder service fees, sub-TA fees and other expenses embedded in the fund expense ratio are paid from fund assets to intermediaries as compensation for selling fund shares or as reimbursement for servicing shareholders. Although technically, revenue sharing payments are to be paid only from the bona fide profits of a mutual fund's investment adviser, fund shareholders might also be said to indirectly compensate third party intermediaries through the revenue sharing practices of the fund's adviser and its affiliates, including the fund's principal underwriter and transfer agent. Using legitimate profits earned from fees paid by funds, advisers and their affiliates pay for ongoing access fees ("shelf space"), shareholder service fees and/or sub-TA fees charged by third party intermediaries that exceed the amounts collectable from fund assets. To cover their costs and generate revenue, third party intermediaries have traditionally calculated these fees based on the number of direct shareholder accounts attributable to the intermediary's distribution or sub-TA contract with affiliated fund service providers.

But as the number of direct fund accounts has dwindled in the wake of the retail exodus to omnibus accounts, so have the payments to third party intermediaries that are assessed at the direct account level. Some intermediaries have restored their revenue streams by charging fund transfer agents with sub-TA fees tied to the number of individual beneficial fund shareholder accounts or to fund assets under management serviced by the intermediary. However, transfer agent revenues have also fallen drastically with the decline in direct shareholder accounts maintained on their books, and transfer agents have thus pushed increasingly higher sub-TA costs down to funds. At the same time, the markets remain relatively volatile and investors are wary of funds with sales loads and high ongoing expenses that erode the returns a fund might be able to achieve. In this environment, innovative financial intermediaries have sought to bolster their income by increasing shelf space and other revenue sharing charges and also by introducing to their omnibus account customers alternative fee structures, charged at the individual beneficial shareholder account level, that minimize the most visible distribution, shareholder servicing and sub-TA costs.

To reduce distribution-related charges apparent to beneficial fund shareholders, financial intermediaries buying fund shares in bulk for their omnibus accounts now routinely demand that funds waive any sales charges applicable to the share class in which their omnibus accounts invest and that the resulting lost commissions be made up for through increased shelf space and other platform access fees. "One important element in the changing distribution structure has been a marked decline in load fees paid by mutual fund investors," the Investment Company Institute (the ICI) explains in its 2013 Factbook.[1] "Funds that normally charge front-end load fees often waive load fees … and offer volume discounts, waiving or reducing load fees for large initial or cumulative purchases," such as those made by omnibus accounts.

Similarly, third party financial intermediaries, which typically have considerable leverage in negotiations with mutual fund families seeking to grow assets, have driven the removal of ongoing shareholder service and sub-TA fees from the fund expense ratio. In response to pressure from intermediaries, many fund families have restructured their share class offerings to include institutional share classes that are designed for various types of omnibus accounts and have expense ratios composed of little more than the investment management fee. This allows intermediaries to promote to their omnibus customers those funds and share classes with no sales charges and low expense ratios and then charge one-time asset-based financial advisory and/or transaction-based service fees to individual beneficial shareholder accounts to cover costs and produce revenue. As the ICI explains in its 2013 Factbook, much of the shift of mutual fund assets away from funds and share classes with sales loads and higher expense ratios "represents sales of no-load share classes through sales channels that compensate financial professionals with asset-based fees outside of funds (for example, mutual fund supermarkets, discount brokers, fee-based advisers, full-service brokerage platforms), as well as sales of no-load funds through 401(k) plans."

In addition to the economic factors driving the reshaping of traditional mutual fund fee and expense structures, rules recently adopted by the United States Department of Labor (the DOL) have influenced the current share class offerings of many fund groups. New regulations adopted by the DOL under Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) require RPAs to provide enhanced disclosure regarding the costs of providing recordkeeping and other services to beneficial fund shareholders invested through RPAs. In order to avoid disclosing for the first time the details of these and other costs of investing in mutual funds through retirement plans, RPAs have lowered the revenue sharing payments previously charged to fund advisers and their affiliates in exchange for fund groups agreeing to offer share classes that reflect no Rule 12b-1 distribution fees and no or very low sub-TA fees. RPAs recover their lost revenue sharing payments and sub-TA fees through transaction-based fees charged to individual retirement plan participants. These types of fees are not required to be highlighted for participants in the same way that fees charged against the plan investments are under Section 408(b)(2) of ERISA.

As opposed to the traditional mutual fund share class structure, where funds offer Class A, Class B and Class C shares (each of which carry sales loads, Rule 12b-1 distribution fees, shareholder servicing fees and sub-TA fees) to retail investors and one or two lower cost classes to institutional investors, today's typical fund share class lineup might, in addition to Class A, B and C retail share classes, include, for example, institutional share classes with the following characteristics:

- no sales loads, no Rule 12b-1 distribution fees, 0.25% in shareholder service fees, and no sub-TA fees; available for investment to qualified employee benefit plans, non-profit organizations, defined contribution plans, and similar institutional investors.

- no sales loads, a 0.50% Rule 12b-1 distribution fee, no shareholder service fees and a retail-level sub-TA fee; available for investment to omnibus retirement plans and retirement accounts sponsored by third party distribution partners.

- no sales loads, no Rule 12b-1 distribution fees, no shareholder service fees, and no sub-TA fees; available for investment to omnibus retirement plans and third party fund distribution partners.

- no sales loads, no Rule 12b-1 distribution fees, no shareholder service fees and maximum sub-TA fees of 0.10%; available for investment to omnibus retirement plans.

- no sales loads, no Rule 12b-1 distribution fees, no shareholder service fees and maximum sub-TA fees of 0.05%; available for investment to third party fund distribution partners.

- no sales loads, 0.25% in combined Rule 12b-1 distribution and shareholder service fees, and no sub-TA fees; available to financial intermediaries sponsoring wrap programs.

- no sales loads, no Rule 12b-1 distribution fees, no shareholder service fees and retail-level sub-TA fees; available to the general public for investment.

The Distribution Sweep Exam

Andrew J. Bowden, Director of the SEC's Office of Compliance Inspections and Examinations (OCIE) and head of its National Examination Program (NEP) has characterized the mutual fund distribution sweep that began in March of this year as a fact-finding mission designed to give the SEC a better understanding of how mutual fund distribution methods have changed in recent years and how, and for what purpose, payments are made by mutual funds to their principal underwriters and third party distribution partners. Bowden has also said that the SEC could use the information gathered through the sweep exam to propose new or amended rules, issue additional guidance and/or engage in enforcement activity.

As discussed above and as OCIE indicated in its discussion of NEP priorities for 2013, "the wide variety" of payments related to mutual fund distribution include: Rule 12b-1 distribution fees; revenue sharing payments; access fees paid by fund advisers to financial intermediaries sponsoring industry conferences; and reimbursements made to financial intermediaries providing sub-TA and other services to beneficial fund shareholders.[2] Among other things, OCIE had explained, the distribution sweep exam will investigate the adequacy of disclosure made to fund boards about, as well as boards' oversight of, fund distribution-related payments.

Staff of the SEC's Boston office has stated that the sweep exam is also aimed at "ensuring that as broker/dealers experience declining revenue streams, they do not look to increase their sub-TA fees to compensate them for distribution expenses." This comports with OCIE's assertion in the 2013 NEP priorities release that OCIE staff will be on the lookout for "payments for distribution in guise" and in particular will be assessing whether fund shareholder servicing and sub-TA payments "are made in compliance with regulations, including… Rule 12b-1, or whether they are instead payments for distribution and preferential treatment."

The sweep exam solicits the following documentation going back as far as October 2009:

- All agreements with third party financial intermediaries regarding distribution arrangements "pursuant to which the fund pays any form of remuneration" and the purpose of compensation payable under each such agreement.

- Any analysis conducted as part of the negotiation process with third party distribution partners.

- The disclosed Rule 12b-1 fee percentage applicable to each distribution arrangement and any changes thereto; the dollar value of that percentage for each year; and a detailed accounting of the amount actually expended each year.

- All policies and procedures related to the compensation of third party distribution partners.

- The most recent risk ratings for each third party distribution partner; the most recent "Contract Analysis" and "Market Analysis" performed by the firm's finance department surrounding distributor remuneration; and any internal audit report related to distributor remuneration for the fund's principal underwriter or any of its affiliates.

- Board materials and minutes related to fund distribution.

- Revenue sharing payments made by the fund's principal underwriter, presented by sales channel in dollars and in basis points.

- Omnibus and network fees paid by the fund and its principal underwriter, presented by sales channel in dollars and in basis points.

- Expense allocations by fund and by share class for sub-TA fees, Rule 12b-1 fees, management fees and any redemption fees paid pursuant to Rule 22c-2 under the Investment Company Act.[3]

The Rule 12b-1 Backdrop

Mutual funds have not always been permitted to pay for distribution with their own assets. Section 12(b) of the Investment Company Act, which is not self-executing and required rulemaking to effectuate its purpose, provides that it is unlawful for a mutual fund to pay for marketing and other distribution activities related to the sale of its shares, except through an underwriter. Prior to the advent of Rule 12b-1 in 1980, the SEC held firm that any use of a fund's assets for distribution purposes was improper.[4] In 1980, after granting no-action and exemptive relief that allowed certain fund families to allocate their distribution-related expenses on a complex-wide basis under very specific conditions, the SEC adopted Rule 12b-1.[5] In the adopting release for Rule 12b-1, the SEC stated its view that there are circumstances under which it may be appropriate for mutual fund shareholders to bear the expenses of distributing their own fund(s), and it is up to a fund's independent directors to decide whether the fund should charge distribution fees to shareholders. Under Rule 12b-1, a fund's independent trustees are required to approve a written plan of distribution pursuant to which fees for "sales activities primarily intended to result in the sale of shares" are charged to fund shareholders.

The First Decade. In the years following the adoption of Rule 12b-1, mutual fund families developed, and their independent directors put in place, many different types of distribution plans. Some fund families began to use Rule 12b-1 to establish distribution/service plans to provide commissions to broker/dealers and other third party financial intermediaries selling fund shares; these types of plans are still prevalent in the industry today. Through a typical Rule 12b-1 distribution/service plan, (i) transaction-based brokerage commissions are funded with distribution fees and compensate intermediaries with respect to each particular sale of fund shares, and (ii) trailing commissions are funded with "service fees" and compensate intermediaries for their ongoing efforts to sell fund shares and provide services to fund shareholders.[6]

In the early 1980s, the SEC allowed funds to use contingent deferred sales charges (CDSCs) as a way of financing distribution.[7] While the front-end sales charges that had long been blessed by the SEC are deducted from a shareholder's account at the time of his investment, the CDSC distribution strategy allows a fund's adviser and/or principal underwriter to use its own resources to pay brokerage commissions to third party distribution partners and then reimburse themselves for the cost of those brokerage commissions through the ongoing collection of Rule 12b-1 distribution fees from the shareholder's account. In selling fund shares subject to a CDSC, affiliated and third party fund distributors promote the fact that a shareholder will pay a CDSC only if he or she redeems an investment prior to the full amount of the brokerage commission being collected (typically 8 years). What might be less apparent to investors, however, is that even after a CDSC ceases to apply, Rule 12b-1 distribution fees continue to be charged.

Subsequent Rulemaking. As a result of certain perceived abuses and the SEC's belief that the crucial role independent directors were intended to play with respect to fund distribution payments had been undermined, in 1988 the SEC proposed a series of amendments to Rule 12b-1 that, if successful, would have required that: (i) annual shareholder meetings be held to approve a mutual fund's Rule 12b-1 distribution plan; (ii) enhanced disclosure be added to fund sales materials describing the nature and uses of Rule 12b-1 distribution fees in the context of the widespread usage of "no load terminology"; and (iii) all payments made pursuant to a Rule 12b-1 plan be traceable to specific sales transactions or other distribution-related services involving a fund. These proposals were not ultimately adopted by the SEC, but a number of other new rules and rule amendments that were adopted significantly influenced the evolution of mutual fund distribution practices under Rule 12b-1. These include the following:

- In 1985, the SEC adopted Rule 22d-1 under the Investment Company Act, which permits mutual funds to establish scheduled variations in, or reductions of, front-end sales charges applicable at the time of investment.[8] For example, an investor might only pay a front-end sales charge if he or she redeems the investment within one year of purchase.

- Form N-1A was amended in 1988 to require the fee table included in fund prospectuses to identify the amount of all payments made pursuant to a Rule 12b-1 plan.[9]

- Rules adopted by the SEC under the Securities Exchange Act of 1934 (the Securities Exchange Act) and the NASD (now FINRA) indirectly impacted funds through their principal underwriters and third party distribution partners by limiting the rolling aggregate "asset-based fees," including sales charges and Rule 12b-1 distribution fees, that could be charged to a fund to 6.25% of a fund's average annual net assets plus interest for funds that paid service fees and 7.25% for mutual funds with no service fees.[10] Rule 2830(d) also placed a 0.25% annual cap on asset-based service fees and a 0.75% annual cap on total asset-based fees.

- Beginning in 1995, with the adoption of Rule 6c-10 under the Investment Company

Act, funds became free (without seeking exemptive relief from the SEC) to cover the costs of distributing fund shares through CDSCs as long as, among other conditions, the CDSC is calculated based on the lesser of the net asset value per share at the time of purchase or redemption and no CDSC is applied to a shareholder's reinvested dividends and/or capital gains distributions. Like front-end sales charges under Rule 22d-1, Rule 6c-10 permits funds to establish variations in, or the elimination of, a CDSC for a particular class of shareholders or type of sales transaction.[11]

- Also in 1995, the SEC adopted Rule 18f-3 under the Investment Company Act, which is largely responsible for the typical share class fee and expense structures we recognize today.[12] Rule 18f-3 permits mutual funds to offer multiple share classes with different expense structures and until it was adopted, funds were only able to create diverse share classes if they had secured exemptive relief from the SEC permitting them to do so.[13] But with Rule 18f-3, the now standard Class A, Class B, and Class C share expense structures, representative of the asset-based fee caps instituted by NASD/FINRA Rule 2830(d), became commonplace.

- Nearly a decade later in 2004, the SEC amended Rule 12b-1 to generally prohibit fund advisers from directing fund portfolio transactions as a means of compensating third party intermediaries for selling fund shares, except under certain specific conditions, including the existence of a board-approved directed brokerage policy.[14]

The 2010 Reform Attempt. While there has not been a wholesale overhaul of Rule 12b-1 as it was originally adopted in 1980, the SEC has attempted such reform. In 2007, the SEC held a formal roundtable to identify possibilities for updating Rule 12b-1 in light of emergent industry norms. Financial intermediaries participating in mutual fund distribution contended that there was no need for change, insisting that Rule 12b-1 was of benefit to both funds and shareholders and that significant changes to Rule 12b-1 could disrupt deeply embedded and systemically important distribution arrangements. Consumer protection and shareholder activist groups generally asserted that, while the services provided to investors as a result of payments made pursuant to Rule 12b-1 plans were worthwhile, greater transparency regarding the intermediary activities covered by distribution and service fees could result in more competitive pricing. These commenters also opined that Rule 12b-1 fees increased expense ratios and decreased investment returns, and should be "externalized" so as to be deducted directly from individual beneficial shareholder accounts rather than fund assets; this latter trend has materialized to a large degree, as discussed above. During the 2007 roundtable, there also appeared to be a general consensus that the importance of distribution relationships with financially influential third party intermediaries was one of the most important factors a fund's independent directors should consider in making decisions regarding the fund's Rule 12b-1 plan.

Following the 2007 roundtable, in 2010 the SEC released its Rule 12b-1 reform proposal, which attempted to revise many aspects of the fund distribution status quo.[15] In the proposing release, the SEC stated that current SEC and NASD/FINRA rules were outdated, did not reflect the realities of the current mutual fund marketplace and did not serve investors' best interests. Indeed, the stated purpose of the reform proposal was to "protect individual investors from paying disproportionate amounts of sales charges in certain share classes, promote investor understanding of fees, eliminate outdated requirements, provide a more appropriate role for fund directors and allow greater competition among funds and intermediaries in setting sales loads and distribution fees generally." It is noteworthy, particularly given today's distribution dynamics and the ongoing OCIE distribution sweep exam, that in the proposing release the SEC explicitly acknowledged that payments made pursuant to Rule 12b-1 plans are used to compensate "securities professionals" not only for "sales efforts" but also for "services provided to the fund's investors." The following identifies certain of the rule changes proposed by the SEC in 2010.

- Proposed new Rule 12b-2 would replace Rule 12b-1 in its entirety and provide that up to 0.25% of a mutual fund's assets could be used annually to pay for any distribution-related expenses in the form of a "marketing and service fee."

- Proposed amendments to Rule 6c-10 would permit asset-based payments in excess of those allowed under the 0.25% limit of proposed Rule 12b-2, in effect creating a new "ongoing sales load" category in addition to front-end sales charges and CDSCs. The cumulative amount of all sales charges paid by each shareholder (as opposed to each fund or share class under NASD/FINRA Conduct Rule 2830) would be limited to the highest front-end sales charge (i) imposed by a share class of the same mutual fund that does not impose an ongoing sales charge or (ii) 6.25%. And "ongoing sales loads" could be used to cover the costs of both distribution and non-distribution related services. The SEC stated in the proposing release that it believed these Rule 6c-10 amendments would ensure that each shareholder paid only his or her proportionate share of a mutual fund's distribution-related costs. Moreover, the SEC said, together with proposed Rule 12b-2, the proposed amendments to Rule 6c-10 would allow mutual funds to finance their own marketing and distribution strategies as well as the costs of maintaining shareholder accounts and participating in fund supermarkets and other third party distribution networks, and also provide investors with alternatives for paying sales charges.

- Proposed amendments to Form N-1A would require that: (i) funds add line items to their prospectus fee tables disclosing "marketing and service fees" paid under proposed new Rule 12b-2 fees and "ongoing sales loads" paid under amended Rule 6c-10; (ii) funds offering multiple share classes in one prospectus discuss in detail the advantages of choosing one share class/fee and expense structure over another; and (iii) fund statements of additional information include a description of any marketing and service fees and/or ongoing sales charges and the purposes for which they were used.

- Proposed amendments to Rule 10b-10 under the Securities Exchange Act would require broker/dealer confirmation statements to disclose to investors marketing and service fees, ongoing sales charges, and other charges, regardless of whether the information was duplicative of fund prospectus disclosure.

- Additional proposed amendments to Rule 6c-10 would create a new exemption from Section 22(d) under the Investment Company Act to allow funds to establish share classes designed for sale through third party financial intermediaries that would determine their own sales compensation, which could be different than that set forth in the fund prospectus. This "independent rate" aspect of the SEC's proposed Rule 12b-1 reform would be available only for funds or particular share classes that do not impose ongoing sales charges. The SEC expressed its view in the proposing release that the provision would allow for the "unbundling" or "externalization" of distribution costs and encourage competitive rates that would better reflect the specific services offered by individual fund distribution partners and the value investors place on those services.

- The duties of fund boards with respect to setting fund distribution fees would generally be greatly reduced under the 2010 reform proposal. Proposed new Rule 12b-2 would eliminate the requirement under current Rule 12b-1 that a fund's independent directors make special findings and adopt a written plan regarding asset-based distribution fees; instead, independent directors' decisions regarding asset-based distribution fees would be subject only to their fiduciary duties. Fund boards would of course still be required to monitor the use of marketing and service fees for conflicts of interest between a fund and its investment adviser and affiliated service providers. But the proposed amendments to Rule 6c-10 would require only that, as part of its annual approval of a mutual fund's underwriting contract, a board of trustees use its reasonable business judgment to determine whether ongoing sales charges were fair and reasonable and in the best interest of the mutual fund and its shareholders.

The 2010 Rule 12b-1 reform proposal was not widely embraced by the mutual fund industry. A November 2010 comment letter from the ICI provides an illustrative example of the industry's response. Arguing that the proposed rules change would inappropriately place the SEC in the role of a rate maker, the ICI urged that the proposal was far more extensive and intrusive than necessary and would, at astronomical costs to shareholders, significantly affect the lineup of share class options currently available, necessitate major systems changes and require the renegotiation of thousands of dealer agreements.

Conclusion

In late 2012, Norm Champ, Director of the SEC's Division of Investment Management stated that Rule 12b-1 reform was not on the Division's list of priorities for 2013. Accordingly, full scale Rule 12b-1 reform may not be on the immediate horizon, but the OCIE distribution sweep exam indicates that the SEC's concerns regarding the state of mutual fund distribution have not been resolved and in fact may have grown with respect to the payments made to third party fund distribution partners in the form of revenue sharing, sub-TA fees, and distribution and service fees paid under Rule 12b-1 plans. And while the SEC's Rule 12b-1 reform proposal has not been adopted and may never be adopted in its original form, the proposed rulemaking and policy positions articulated in the 2010 proposal and past regulatory actions are representative of SEC views on the appropriate future evolution of the regulation of mutual fund distribution.

Regardless of the future of Rule 12b-1 reform, mutual fund officers, directors, and counsel should pay close attention to how third party intermediaries both characterize and actually use the fees paid by funds and their beneficial shareholders. In the face of continuously evolving distribution trends and intermediaries' novel methods of financing shareholder servicing/sub-TA activities, it is important to keep in mind that any amounts used to support sales, marketing or other distribution-related efforts can only be assessed against fund assets pursuant to a Rule 12b-1 written plan of distribution.

Notes

1. The 2013 ICI Factbook is available at *http://www.icifactbook.org*.

2. The full discussion of OCIE/NEP priorities for 2013 is available at *http://www.sec.gov/news/press/2013/2013-26.htm*.

3. This information is evidenced by exam letters received by mutual fund groups from OCIE's Denver and Boston regional offices.

4. *See,* SEC Statement on the Future Structure of the Securities Markets (Feb. 1972).

5. Investment Company Act Release No. 11414 (Oct. 1980).

6. Currently, NASD (now FINRA) Conduct Rule 2830 caps service fees at 0.25% of a fund's average annual net assets. "Service fees" are generally those related to "personal service and/or the maintenance of shareholder accounts."

7. *See, e.g., E.F. Hutton Investment Series, Inc.*, Investment Company Act Release No. 12135 (Jan. 4, 1982) (first SEC exemptive order allowing mutual funds to charge CDSCs upon a shareholder's redemption of fund shares).

8. Investment Company Act Release No. 14390 (Feb. 22, 1985).

9. Investment Company Act Release No. 16244 (Feb. 1, 1988).

10. Securities Exchange Act Release No. 30897 (July 7, 1992); NASD (now FINRA) Conduct Rule 2830(d); *see also* Proposed Rule Change by NASD (now FINRA) 10–11 (Dec. 28, 1990).

11. Investment Company Act Release No. 20916 (Feb. 23, 1995); *see also* Investment Company Act Release No. 16619 (Nov. 2, 1988) (original Rule 6c-10 proposal).

12. Investment Company Act Release No. 20915 (Feb. 23, 1995).

13. *See, e.g., The Hex-Funds*, Investment Company Act Release No. 18162 (May 21, 1991); and *Federated Securities Corp.,* Investment Company Act Release No. 17715 (Aug. 30, 1990).

14. Investment Company Act Release No. 26591 (Sept. 2, 2004).

15. Investment Company Act Release No. 29367 (July 21, 2010).

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