

Chapman Client Alert

January 15, 2016

Current Issues Relevant to Our Clients

SEC Issues Guidance on Evaluation of Mutual Fund Sub-Accounting Fees

On January 6, 2016, the staff of the Securities and Exchange Commission's Division of Investment Management released guidance regarding registered open-end investment company ("mutual funds") payments to certain financial intermediaries that provide shareholder and recordkeeping services for investors. Concerns arise when fees characterized as non-distribution related sub-transfer agent, administrative, sub-accounting, and other shareholder servicing fees (collectively "sub-accounting fees") are used, in whole or in part, to pay for activities that are primarily intended to result in the sale of mutual fund shares (*i.e.* distribution in guise). Rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act") prohibits mutual funds from engaging, directly or indirectly, in the financing of any activity which is primarily intended to result in the sale of fund shares except pursuant to 12b-1 plans. The staff's guidance is designed to help fund boards oversee and evaluate whether sub-accounting fees are for distribution or non-distribution services. The staff recommends that:

- Mutual fund boards have a process in place reasonably designed to evaluate whether a portion of sub-accounting fees is being used to pay directly or indirectly for distribution;
- Advisers and other relevant service providers provide information to inform mutual fund boards of the overall picture of intermediary distribution and servicing arrangements for a mutual fund; and
- Advisers and other relevant service providers inform mutual fund boards if certain activities or arrangements that are potentially distribution-related exist in connection with the payment of sub-accounting fees and, if they do, boards evaluate the appropriateness and character of those payments with heightened attention.

The full text of the guidance update is available [here](#).

Background

The guidance follows recent sweep examinations that studied, among other things, the payment of sub-accounting fees. Rule 12b-1 under the 1940 Act prohibits mutual funds from engaging, directly or indirectly, in the financing of any activity which is primarily intended to result in the sale of fund shares except pursuant to 12b-1 plans. The Rule 12b-1 adopting release noted that this prohibition applies to payments that may not be clearly identified as distribution fees and are ostensibly made for some other purpose, but which, based on the facts and circumstances, are used in ways that finance distribution.

Staff Recommendations

The staff recommends that:

- Mutual fund boards of directors have a process in place reasonably designed to evaluate whether a portion of sub-accounting fees is being used to pay directly or indirectly for distribution (whether or not a fund has or is considering adopting a 12b-1 plan);
- Advisers and other relevant service providers provide sufficient information to inform a fund's board of the overall picture of intermediary distribution and servicing arrangements for a mutual fund including how the level of sub-accounting fees may affect other payment flows that are intended for distribution (such as 12b-1 fees and revenue sharing); and

- Advisers and other relevant service providers inform boards if certain activities or arrangements that are potentially distribution-related exist in connection with the payment of sub-accounting fees (and where they do, that mutual fund boards evaluate the appropriateness and character of those payments with heightened attention).

Evaluation of Sub-Accounting Fees by Mutual Fund Boards

The staff notes that there are a number of reasonable approaches that a board may take in establishing a process to evaluate whether a portion of sub-accounting fees is being used to pay directly or indirectly for distribution. The staff observed that many mutual funds did not have in place explicit compliance policies and procedures designed to prevent violations of Section 12(b) and Rule 12b-1. The staff indicated that whether or not a fund has a 12b-1 plan, the staff believes funds should have policies and procedures that are reasonably designed to prevent violations of those provisions.

One approach for evaluating sub-accounting fees that the staff observed from some fund boards was the application of the framework established by the staff in the October 30, 1998 letter from Douglas Scheidt, Associate Director and Chief Counsel of the Division of Investment Management of the Securities and Exchange Commission to Craig S. Tyle, General Counsel of the Investment Company Institute (the "1998 Letter") regarding mutual fund supermarket fees. The 1998 Letter summarized various factors that funds' boards may consider in determining the distribution-related portion and the non-distribution-related portion of fund supermarket fees including:

- the nature of services provided,
- whether services provide any distribution-related benefits,
- whether services provide non-distribution related benefits and are typically provided by fund service providers,
- the costs that a fund could reasonably be expected to incur for comparable services if provided by another party relative to the total amount of the fee, and
- the characterization of the services by the intermediary.

When using these factors from the 1998 Letter in the evaluation of sub-accounting fees, the staff recommends that boards also consider requesting additional information from the mutual fund adviser, other relevant service providers and

intermediaries such as information about the specific services provided under a mutual fund's sub-accounting agreements and the amounts being paid.

Another approach the staff observed from certain boards for dealing with the distribution in guise concerns connected to the payment of sub-accounting fees was the establishment of maximum allowable sub-accounting fees payable from fund assets. Under this approach any excess fees are typically paid pursuant to a 12b-1 plan or from the adviser or other service provider-paid revenue sharing or other sources. The staff cautioned that a cap alone may not satisfy the board's responsibilities in connection with reviewing these fees. The staff recommends that boards that use fee caps as part of their process for determining whether fund-paid fees are for distribution should carefully evaluate any benchmark used in establishing the cap and should consider using different fee caps for intermediaries depending on the varying kinds of services provided to a mutual fund.

The staff also notes that regardless of the specific framework or process for an evaluation, boards should have in place processes reasonably designed to provide them with sufficient information to make an informed judgment as to whether fund-paid fees are being used to pay directly or indirectly for distribution. The staff notes that there are a number of reasonable approaches that a board may take in establishing such processes but the absence of such a process could make it difficult for a fund's board to make an informed judgment.

Red Flags for Distribution in Guise

The staff provides examples of certain activities and arrangements that may raise concerns that the funds may be paying the fees, at least in part, for distribution-related activities outside of a 12b-1 plan. Examples include:

- Distribution-related activity conditioned on the payment of sub-accounting fees;
- Lack of a 12b-1 plan for a mutual fund;
- Tiered payment structures (e.g. where payments are first made pursuant to a 12b-1 plan, then fund-paid sub-accounting fees and then from revenue sharing);
- Lack of specificity by intermediaries in specifying services;
- Bundling of services for sub-accounting and distribution;
- Distribution benefits taken into account by advisers or other service providers when recommending, instituting, or raising sub-accounting fees;

- Large disparities in sub-accounting fees for different intermediaries; and
- Providing sales data to advisers.

The staff notes that none of these arrangements necessarily indicate that a payment is being made for a distribution-related activity outside of a 12b-1 plan. However, the staff does recommend that advisers and relevant service providers affirmatively provide the board with information as to whether the arrangements listed above occur or have occurred. Further, if these arrangements are present, the staff recommends that the fund board closely scrutinize the appropriateness and distribution character of such payments.

Responsibility of Advisers and Service Providers to Provide Boards with Information

To aid the board in determining whether any fund-paid fees are for distribution, the staff recommends that advisers and other relevant service providers provide sufficient information to inform the board of the overall distribution and servicing arrangements of the fund. Advisers and other relevant service providers should also provide the board with information allowing them to 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. The staff notes particular concern with the potential for mischaracterization of fees when the intermediaries receiving those fees also distribute the fund's shares. When the recipient of payments for services also finances distribution (for example a mutual fund distributor or an intermediary that distributes fund

shares), the staff notes that this raises a question as to the direct or indirect use of fund assets requiring relevant input by the adviser or other relevant service provider and the informed judgment of the fund's board.

Recognizing that mutual fund boards often are not involved in the negotiation of the agreements with intermediaries, the staff notes that boards should be able to rely on information provided by the adviser or other relevant service provider as well as summary data about expenses and arrangements related to distribution-related activities. The staff believes 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. The staff also notes that boards should also watch for payments to affiliated persons of an adviser which could require the same analysis to determine potential distribution aspects of compensation and payments to an adviser as part of the 1940 Act Section 15(c) agreement review process.

What Now?

Mutual funds, their boards and their advisers should review existing policies and procedures and fee arrangements in light of the staff's guidance.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

Chapman and Cutler LLP

Attorneys at Law • Focused on Finance®

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

To the extent that any part of this summary is interpreted to provide tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors. © 2016 Chapman and Cutler LLP. All rights reserved. Attorney Advertising Material.