IM Guidance Update

JANUARY 2016 | No. 2016-01

MUTUAL FUND DISTRIBUTION AND SUB-ACCOUNTING FEES

In this guidance update, the staff of the Division of Investment Management outlines its views on issues that may arise when registered open-end investment companies ("mutual funds" or "funds") make payments to financial intermediaries that provide shareholder and recordkeeping services for investors whose shares are held in omnibus and networked accounts maintained with mutual funds. In particular, the guidance addresses whether a portion of those payments are being used to finance distribution and therefore, if paid by a fund, must be paid pursuant to rule 12b-1 under the Investment Company Act (the "1940 Act").[1]

Many of the issues discussed in this guidance were brought into focus by a recent sweep examination of a number of mutual fund complexes, investment advisers, broker-dealers, and transfer agents. These exams studied, among other things, the payment of fees to financial intermediaries characterized as non-distribution related sub-transfer agent, administrative, sub-accounting, and other shareholder servicing fees (collectively "sub-accounting fees").[2] These exams, which were a joint initiative of the Office of Compliance Inspections and Examinations and a number of other offices and divisions of the Commission, highlighted the need to clarify and update our existing guidance.[3] They also raised questions as to whether, in some cases, a portion of fund-paid sub-accounting fees may have been used to pay for activities that are primarily intended to result in the sale of mutual fund shares ("distribution" or "distribution-related activity").

Mutual fund fees have a direct impact on investor returns. For example, because investors may evaluate funds based on the specific levels of 12b-1, management, and other fees, potential mischaracterization of fees may lead them to invest in funds that they would not otherwise have selected. As discussed in greater detail below, in light of this possibility, as well as the potential for the inappropriate use of fund assets and the prohibition of rule 12b-1(a) on a mutual fund directly or indirectly paying for distribution-related activities outside of a rule 12b-1 plan, the staff recommends that:

- Regardless of whether a fund has, or is considering adopting a 12b-1 plan, 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.
- As part of this process, advisers and other relevant service providers[4] provide sufficient information to inform the board of the overall picture of intermediary distribution and servicing arrangements for the mutual fund, including how the level of sub-accounting fees may affect other payment flows (such as 12b-1 fees and revenue sharing) that are intended for distribution.[5]
- 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 if they do, boards evaluate the appropriateness and character of those payments with heightened attention.

Background

The use of omnibus accounts by broker-dealers and other financial intermediaries has increased significantly in recent years.[6] Because a single omnibus account held by a mutual fund's transfer agent represents the share balance of many beneficial investors being serviced by an intermediary, these accounts may reduce the burdens of recordkeeping and other services transfer agents traditionally provide to fund investors. As a result, the financial intermediary performs many of the typical transfer agent services for fund investors whose shares are held in an omnibus account, and may offer other services to shareholders. Mutual funds or their service providers often enter into arrangements with financial intermediaries to compensate them for providing these services, which are sometimes referred to as "sub-accounting" arrangements.[7] Fee structures for the provision of these services vary and may be paid from mutual fund assets (*e.g.*, pursuant to a 12b-1 plan or through non-12b-1 shareholder service fees), or by a fund's investment adviser, by a fund's distributor or transfer agent or other service provider, or any combination thereof.

Rule 12b-1 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 a 12b-1 plan.[8] As noted in the 12b-1 Adopting Release, this prohibition applies not only to payments that are clearly identified as distribution fees, but also to payments that are ostensibly made for some other purpose, but which, based on the facts and circumstances, are used in ways that finance distribution.[9] Rule 12b-1 is designed to help control the conflicts of interest that can arise when a mutual fund

pays for distribution expenses out of its assets, where an adviser and other relevant service providers may be incentivized to encourage the fund to bear distribution-related expenses to help it grow and maximize assets under management, increasing fee revenues.[10]

Mutual fund directors generally oversee the reasonableness of fees paid out of fund assets and the relationships between funds and their service providers.[11] This oversight generally includes board approval of contracts for, among other things, adviser and principal underwriter services, as well as approval of any 12b-1 plan.[12] In addition, advisers have a fiduciary duty to either eliminate conflicts of interest, or mitigate the conflicts and provide full and fair disclosure thereof.[13]

Board Process

The staff notes that there is a potential for sub-accounting fees to be used to pay for distribution. This circumstance is most likely to arise when the recipient of the payments also distributes the mutual fund's shares. The adopting release for rule 12b-1 makes clear the Commission's view that directors bear substantial responsibility for determining whether fees paid by a mutual fund are for distribution. For example, the release noted that:

> If a fund makes payments which are ostensibly for some other purpose, and the recipient of those payments finances distribution, the question arises whether the fund's assets are being used indirectly. The Commission's position has been and continues to be that there can be no precise definition of what types of expenditures constitute indirect use of fund assets. That judgment will have to be made based on the facts and circumstances of each individual case. Under... rule 12b-1, fund directors, particularly the disinterested directors, would bear substantial responsibility for making that judgment.[14]

In the staff's view, when the *recipient of payments for services also finances distribution* (for example a mutual fund distributor[15] or an intermediary that distributes fund shares), it raises a question as to the direct or indirect use of fund assets requiring relevant input from the fund's adviser and other relevant service providers and the informed judgment of the fund's board.[16]

Given the possibility for sub-accounting fees to be used for distribution and the prohibitions in section 12(b) of the 1940 Act and rule 12b-1, the staff recommends that regardless of whether a mutual fund has, or is considering adopting a 12b-1 plan, fund

boards of directors have a process in place reasonably designed to assist them in evaluating whether a portion of fund-paid sub-accounting fees, if paid to intermediaries that distribute fund shares, is being used to pay directly or indirectly for distribution. Considering that the mutual fund's adviser and other relevant service providers are typically involved in recommending that sub-accounting fees be instituted or increased, and thus may be subject to conflicts of interest if they reduce payment obligations that the adviser or its affiliates might otherwise bear, the staff also recommends that advisers and relevant service providers provide or arrange for the provision to boards any necessary information to assist boards in this evaluation process.[17]

Many boards have already established processes designed to assist them in making such an evaluation. For example, some boards apply the framework established by the staff in the 1998 Letter on mutual fund supermarket fees.[18] In the 1998 Letter, the staff expressed the view that if a mutual fund pays a fee for participating on an intermediary-sponsored fund platform (a "supermarket fee"), then the fund's board is responsible for determining what, if any, portion of the fee is for distribution-related services and what portion of the fee is for non-distribution-related services.[19]

The staff notes that the same types of factors and analysis as described in the 1998 Letter may serve as a useful framework in establishing a process for a mutual fund board to evaluate whether a portion of fund-paid sub-accounting fees is or is not being used to pay directly or indirectly for distribution.[20] However, in adapting the 1998 Letter framework to a process for evaluating the character of sub-accounting fees, a board might generally consider also requesting information from the adviser, other relevant service providers, and intermediaries about a number of other issues. Relevant additional information would likely include, but is not limited to:

(i) information about the specific services provided under the mutual fund's sub-accounting agreements;
(ii) the amounts being paid;
(iii) if the adviser and other service providers are recommending any changes to the fee structure or if any of the services provided have materially changed;
(iv) whether any of the services could have direct or indirect distribution benefits;
(v) how the adviser and other service providers ensure that the fees are reasonable; and
(vi) how the board evaluates the quality of services being delivered to beneficial owners (to the extent of its ability to do so).[21]

As part of existing processes, some mutual fund boards also have established maximum allowable sub-accounting fees to be paid with fund assets. Such caps are often based on the level of fees the mutual fund would otherwise pay its transfer agent for the sub-accounting services performed by the intermediary, or are based on industry surveys or benchmarks obtained from third parties. These caps are often established as a result of the board's finding that any sub-accounting fees paid in excess of the limits are likely for distribution (or are otherwise too high for shareholders to bear), and thus they require that any sub-accounting fees paid in excess of that cap must be paid pursuant to a rule 12b-1 plan or from adviser-or other service provider-paid revenue sharing or other sources.[22] However, the staff cautions that fees paid to transfer agents may differ from the fees the mutual fund might pay for the same services obtained elsewhere, and boards may wish to take such information into account when evaluating such fees as a benchmark or cap for fees paid for sub-accounting services. The staff recommends that if boards use fee caps as part of their process, they should carefully evaluate any benchmark used in establishing the cap. Boards may wish to consider whether transfer agent rates used for benchmarking reflect relevant economies of scale, and whether the type and amount of services provided are comparable. In addition, rather than solely determining one maximum reasonable sub-accounting fee rate, directors may wish to consider different payment rates or fee caps to intermediaries depending on the varying kinds of services provided to the mutual fund.

Regardless of the framework or specific process used in making such an evaluation, the staff recommends that boards have a process in place reasonably designed to provide them enough information that they can make an informed judgment as to whether fund-paid fees are being used to pay directly or indirectly for distribution. We note that there are a number of reasonable approaches that a board may take in establishing such process, but in the absence of any such process, it is unclear how a board might make an informed judgment regarding the use of fund assets for distribution and the fund's compliance with rule 12b-1(a).

In a related matter, as part of the 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 violations of section 12(b) and rule 12b-1. If a mutual fund seeks to comply with the requirements of rule 38a-1 through adoption of a 12b-1 plan alone, the staff believes that the fund 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. The staff further notes that the prohibitions of section 12(b) and rule 12b-1(a) apply also to mutual funds that have not adopted a rule 12b-1 plan, and thus the staff believes that such funds should also have policies and procedures reasonably designed to prevent violations of section 12(b) and rule 12b-1 thereunder.

Providing Boards an Overall Picture of Distribution and Servicing Arrangements

As part of any process to evaluate whether any portion of fees paid by mutual funds to intermediaries that distribute fund shares are payments for distribution, the staff recommends that the adviser and relevant service providers provide sufficient information to inform the board of the overall distribution and servicing arrangements of the fund. The staff believes that if a board is not provided such information, including payment flows from relevant fund service providers, then it would be difficult to make an informed judgment as to whether certain payments by the mutual fund are for distribution, despite ostensibly being characterized otherwise, and to assess conflicts of interest.

In this regard, the staff notes the requirements of rule 12b-1(d), which require a board to request, and parties to agreements related to a 12b-1 plan to furnish, any information reasonably necessary to make an informed determination of whether such plan should be implemented or continued.[23] In addition, advisers have a fiduciary duty to either eliminate relevant conflicts of interest, or to mitigate and to provide full and fair disclosure of the conflict.[24] Thus, the staff believes that this fiduciary duty requires advisers either refrain from recommending the payment of mutual fund assets for distribution or to provide complete information to the mutual fund directors so that they can evaluate the conflict, and determine whether the payment should be made pursuant to a 12b-1 plan.[25]

The staff believes that in order for boards to understand whether the mutual fund is making payments for distribution and to assess any conflicts of interest, advisers and relevant service providers should provide to boards information about sub-accounting payments, and other intermediary payment flows made in support of the fund's distribution and servicing activities and arrangements that would be relevant to a facts and circumstances analysis of whether the payments could be for distribution. In addition, the staff recommends that advisers and other relevant service providers provide boards with information sufficient for 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. In the staff's view, this information is likely to be relevant to the board in making a judgment as to the distribution character of a sub-accounting payment, and may also be relevant to its determination of whether a 12b-1 plan should be implemented or continued.

Indicia that a Payment May be Used to Pay for Distribution

Certain activities and arrangements observed during the recent examinations may raise concerns that a payment, though ostensibly not for distribution-related activities, may in fact be (at least in part) a payment for such services. In the staff's view, the examples discussed here raise questions as to whether fund-paid fees may be for distribution outside of a 12b-1 plan, particularly when these fees flow to intermediaries that distribute fund shares. While none of these situations may demonstrate in and of itself that a non-12b-1 payment is for a distribution-related activity, the staff recommends that advisers and relevant service providers affirmatively provide the mutual fund board with information as to whether the activities or arrangements discussed below occur, and if they do, that the board closely scrutinize the appropriateness and distribution character of such payments as part of its evaluation.

- **Distribution-Related Activity Conditioned on the Payment of Sub-Accounting Fees.** Some intermediaries were observed to condition providing certain distribution-related activity (for example, access to wholesalers, distribution through mutual fund supermarkets, or placement on preferred lists) on a fund's payment or rate increase of sub-accounting fees. Such conditions may indicate that a portion of the fees paid is for distribution-related services that otherwise would be reduced or eliminated unless the mutual fund or its adviser or relevant service providers agree to the increased fee, rather than for stated recordkeeping or shareholder servicing purposes.[26]

- **Lack of a 12b-1 Plan.** In some cases, a mutual fund (or fund share class) may not have any explicit provisions for bearing distribution expenses because, for example, the adviser or fund distributor subsidizes fund distribution expenses and/or the funds had not adopted a 12b-1 plan nor imposed sales loads. If a fund does not pay distribution expenses through a 12b-1 plan, sales loads, or otherwise, boards may wish to inquire further regarding how fund distribution expenses, if they exist, are paid.

- **Tiered Payment Structures.** Some advisers have entered into agreements with intermediaries that provide for a number of services (which may include distribution-related activities) that are paid for via tiered payment structures. In these cases, an intermediary may be paid a combination of fees that are paid out of mutual fund assets and revenue sharing. The staff observed that overall payments are often structured (formally or informally) so that any payments are first made from rule 12b-1 fees, then fund-paid sub-accounting fees (generally through an affiliated entity), and finally any balance is paid by the adviser or an affiliate from revenue sharing. Such tiered structures or arrangements raise questions as to what

services the mutual fund actually is paying for, and whether the use of fund-paid fees reduces or subsidizes any fees that the adviser and other relevant service providers might otherwise be responsible for, which would be a conflict of interest.

- **Lack of Specificity or Bundling of Services.** The staff has observed that in some cases intermediaries have not provided a clear list of services provided in exchange for sub-accounting fees, or payments for both sub-accounting and distribution have been bundled into a single contract. The staff believes that such lack of specificity of services provided or bundling with distribution payments raises the question as to whether sub-accounting payments are at least in part for distribution. The staff recommends that any sub-accounting and distribution services be clearly and separately identified and handled appropriately, particularly if bundled into a single arrangement. The staff also notes that in some cases, boards have evaluated whether the *overall payment* for a bundled set of services or activities is a payment that is primarily for distribution-related services. In our view, this approach is inconsistent with the requirements of rule 12b-1, which explicitly requires that any *activity* which is primarily intended to result in the sale of mutual fund shares be paid for through a 12b-1 plan, if paid from mutual fund assets. In the staff's view, regardless of the amount of other activities or services which may be bundled together, if any specific identified activity or service in that bundle is distribution-related, any payments for such identified activities or services must be paid for through a 12b-1 plan, if paid from mutual fund assets.

- **Distribution Benefits Taken into Account.** In some cases, the staff observed that distribution and sales benefits were taken into account by the adviser and other relevant service providers when recommending, instituting, or raising sub-accounting fees. For example, employees of the adviser or relevant service providers whose primary job was to distribute the mutual fund were involved in establishing the level of sub-accounting fees, and often evaluated the overall value of the relationship with the intermediary (or the potential for new sales through that intermediary) as part of the determination whether to recommend instituting or increasing a sub-accounting fee. When such employees negotiate sub-accounting fees, it heightens the risk that distribution benefits or services are in part driving the arrangement. We recognize that mutual fund boards are likely not to be aware of which specific employees are involved in the day-to-day negotiations of particular agreements, but recommend that advisers and relevant service providers furnish information to boards generally about who is negotiating such fees, the process for their approval, and the considerations taken into account, with the aim of informing the board's fee approval evaluation process.

- **Large Disparities in Sub-Accounting Fees Paid to Intermediaries.** Certain mutual funds pay, either directly or through the adviser or other relevant service providers, disparate sub-accounting payment rates to intermediaries that may be providing substantially the same set of services to the fund. While this may be a result of competitive pressures, depending on the facts and circumstances, such disparities in payments for the same services may also indicate that they are payments for distribution-related activities. An indication that such payments may be for distribution is if the higher payments for the services are being paid to the mutual fund's newest, largest, or fastest-growing distribution partners in light of the possibility that the fees may incorporate distribution payments as part of the higher payments. Directors may also wish to consider if the services being provided are in fact substantially the same, and if there are differences between the services provided that support different payment rates.
- **Sales Data.** Intermediaries may offer to sell additional "strategic sales data" to mutual funds, their adviser or other relevant service providers, providing information about the demographics of fund investors and other information about top sales partners and channels to obtain better understanding of them. The staff recommends that boards carefully consider the extent to which any payments for such sales data are distribution-related, and thus should be paid pursuant to a 12b-1 plan or from adviser or relevant service provider revenue sharing.

The staff recognizes that mutual fund boards are typically not involved in the day-to-day negotiation of agreements with intermediaries. Thus, the staff believes that mutual fund boards should be able to rely on the adviser and other relevant service providers to affirmatively provide information about the existence of any of these activities or arrangements, as well as summary data about expenses and activities 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 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, to assist them in making these judgments. As part of this assistance, it is the staff's view that the board may wish to request that relevant information be provided in a clear and concise manner, with summaries or overview documents being included to assist them in their review as appropriate. Given that some mutual funds have selling/distribution agreements and service agreements with hundreds of intermediaries, and in many instances, multiple

agreements with the same intermediary, 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.

The staff has also observed that in some cases, affiliates of the adviser (but not the adviser) have been the entities actually making payments in support of distribution out of their profits. We note that section 36(b) of the 1940 Act applies not just to payments to the adviser, but also to payments to any affiliated person of the adviser. In cases of mutual funds paying fees to affiliated entities that then make distribution payments, the staff believes that the same analysis applies as boards would use when they evaluate potential distribution aspects of compensation and payments to an adviser as part of the section 15(c) process. As noted, this is a facts and circumstances evaluation to be made by the board of directors in their reasonable business judgment based on information provided by mutual fund advisers and other relevant service providers.

Conclusion

Given the growth in omnibus relationships and the various payments to intermediaries, the staff reminds interested parties of the possibility that a portion of sub-accounting and other mutual fund-paid fees may be direct or indirect payments for distribution, which if not paid through a 12b-1 plan, would violate section 12(b) of the 1940 Act and rule 12b-1. To address this risk, the staff recommends that boards have a process in place to evaluate such payments, and that as part of that process, advisers and other service providers provide sufficient information for the board to understand the overall picture of the distribution and non-distribution intermediary arrangements of the mutual fund. The staff recommends that directors pay particular attention to fees paid to financial intermediaries for the servicing of mutual fund shareholder accounts, especially if those intermediaries provide distribution-related activities to the mutual fund. As discussed throughout this guidance, although none of the considerations identified above may be dispositive as to the value of services rendered by, and the appropriateness of fees paid to, financial intermediaries, or their proper characterization, the issues discussed above may be relevant to a board's evaluation process.

(Endnotes)

1 Rule 12b-1 permits an open-end fund to bear its own distribution expenses under certain conditions, including that distribution expenses be paid pursuant to a "12b-1 plan." *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980) [45 FR 73898 (Nov. 7, 1980)] ("12b-1 Adopting Release").

2 These fees are referred to in various ways by different fund complexes and may cover a variety of services. For ease of reference, throughout this update we generally refer to them as "sub-accounting" fees.

3 The staff also notes that, as a result of the sweep, the Commission recently brought an enforcement action against an adviser which caused a fund to pay for certain specific distribution-related activities outside of a 12b-1 plan. *See In the matter of First Eagle Investment Management, et al.,* Investment Company Act Release No. 4199 (Sep. 21, 2015).

4 Other fund service providers may include fund transfer agents, distributors, and administrators, to the extent they have relevant information or obligations.

5 Revenue sharing generally refers to payments made by advisers or other affiliated entities out of their "legitimate" profits to intermediaries to compensate them for their distribution efforts. *See* Payments of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431 [53 FR 23258] (June 21, 1988) (proposing release) ("1988 Proposal"). *See also* revenue sharing requirements set forth in the 12b-1 Adopting Release and discussed at n. 16.

6 *See generally* Deloitte, *The Omnibus Revolution; Managing risk across an increasingly complex service model* (2012). *See generally* Deloitte, *The Omnibus Revolution; Managing risk across an increasingly complex service model* (2012), *available at* http://www.deloitte.com/view/en_US/us/Industries/Private-Equity-Hedge-Funds-Mutual-Funds-Financial-Services/e89659d4db516310VgnVCM3000001c56f00aRCRD.htm.

7 Examples of these services include communicating with their customers about their fund holdings; maintaining their financial records; processing changes in customer accounts and trade orders; recordkeeping for customers; answering customer inquiries regarding account status and the procedures for the purchase

and redemption of fund shares; providing account balances and providing account statements, tax documents, and confirmations of transactions in a customer's account; transmitting proxy statements, annual reports and other communications from a fund; and receiving, tabulating and transmitting proxies executed by customers.

8 *See* rule 12b-1(a)(2); 12b-1 Adopting Release.

9 *See* 12b-1 Adopting Release.

10 *Id.*

11 *See* Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 112 (1940) at 109; *Burks v. Lasker,* 441 U.S. 471 (1979); *see generally,* Independent Directors Council, *Board Oversight of Certain Service Providers* (June 2007) ("IDC Report"), *available at* http://www.idc.org/pdf/21229.pdf, at 2 (discussing the standard of care for board actions relating to the oversight of service providers). Fund directors typically are not involved in the day-to-day management of a fund and its service providers, which is primarily the responsibility of the fund's adviser. *See* Federal Regulation of Securities Committee, American Bar Association, Fund Director's Guidebook (4th ed. 2015).

12 *See* 12b-1 Adopting Release and sections 15(c) and 36(b) of the 1940 Act.

13 When possible conflicts are present, fund management is under a duty to fully and effectively disclose information sufficient for the independent directors to exercise informed discretion on the matters put before them. *See, e.g., SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963). *See also* Mutual Fund Distribution Fees; Confirmations, Investment Company Act Release No. 29367 (July 21, 2010) discussion in n.157 [75 FR 47064 (Aug. 4, 2010)] (providing a summary of the relevant case law regarding fiduciary obligations of fund directors).

14 *See* 12b-1 Adopting Release.

15 As part of this process, the Commission in the 12b-1 Adopting Release stated that "directors of mutual funds would have to give careful scrutiny to any past, present, or planned expenditures by the investment adviser for distribution" and determine whether such expenditures violate section 36(b) or rule 12b-1. In addition, the Commission stated that "an indirect use of fund assets results if any allowance is

made in the adviser's fee to provide money to finance distribution." Finally, boards must make a "judgment" based on the "facts and circumstances of each individual case" of whether "fund assets are being used indirectly" for distribution. *See* 12b-1 Adopting Release.

16 The Commission's concern about financing of distribution by such persons is reflected in one of the factors that the Commission provided in the 12b-1 Adopting Release as guidance for directors to consider in their deliberations regarding whether to adopt a 12b-1 plan. The sixth factor in the list recommended that directors "consider the interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company's shares, including whether any payments by the company to such other person are made in such a manner as to constitute the indirect financing of distribution by the company."

17 The Commission has settled enforcement actions against advisers and service providers for improperly using service fees for fund distribution and not providing adequate information on such use to fund boards. *See, e.g., In re AmSouth Bank, N.A., et al.,* Investment Company Act Release No. 28387A (Sept. 23, 2008); *In re BISYS Fund Servs., Inc.,* Investment Company Act Release No. 27500 (Sept. 26, 2006).

18 In particular, the letter articulated the staff's view that if a board determines that a portion of a fee paid by a fund is for distribution-related services and a portion is for non-distribution-related services, then the board should determine whether the portion of the fee that the fund pays for non-distribution-related services "is reasonable in relation to (a) the value of those services and the benefits received by the fund and its shareholders and (b) the payments that the fund would be required to make to another entity to perform the same services" and should assess certain factors in making the determination. The factors involved in this determination as outlined in the 1998 Letter include: (1) the nature of the services provided; (2) whether the services provide any distribution-related benefits; (3) whether the services provide non-distribution-related benefits and are typically provided by fund service providers; (4) the costs that the fund could reasonably be expected to incur for comparable services if provided by another party, relative to the total amount of the fee; and (5) the characterization of the services by the intermediary. *See* Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, Securities and Exchange Commission, to Craig S. Tyle, General Counsel, Investment Company Institute (Oct. 30, 1998), at 10 ("1998 Letter").

19 *See* 1998 Letter.

20 The 1998 Letter provided a number of factors for a board to consider, and noted that the board would need to be "able to satisfy itself that its determination was supported by all factors relevant to its characterization of the purpose of the service." We note that not all of the factors listed in the 1998 Letter may be "relevant" to an evaluation of the character of sub-accounting fees, and therefore a board need not consider every factor stated in the 1998 Letter if not relevant to an evaluation of the character of sub-accounting fees. On the other hand, other factors may be more relevant to an evaluation of sub-accounting fees, and thus the staff believes that a board should satisfy itself that its determination is supported by the relevant factors discussed above as well as any other relevant factors.

21 While this information may usually be provided at the time that a 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 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.

22 *See, e.g.,* IDC Report at 7 ("To the extent these [sub-accounting] fees may exceed the reasonable compensation for the services to be rendered, a board may wish to inquire whether a portion of the fees should be covered by a Rule 12b-1 plan or paid by the adviser. As another example, if a fund's sub-transfer agent fees exceed the per account charge for the fund's transfer agent, the board may wish to examine whether the services for such fees are demonstrably different and justifiable.").

23 In fulfilling this duty, the directors must consider and give appropriate weight to all pertinent factors, and minutes describing the factors considered and the basis for the decision to use fund assets for distribution must be made and preserved. *See* rule 12b-1(d). The 12b-1 Adopting Release noted a variety of factors that boards may find pertinent in this evaluation. We note that since 1980 when the 12b-1 Adopting Release was issued, fund's distribution structures and the purpose and use of 12b-1 fees has evolved significantly. As a consequence, certain of the factors noted in the 12b-1 Adopting Release may no longer be pertinent to a fund board's current evaluation of whether a 12b-1 plan should be implemented or continued, while other factors not included in that release may be. Accordingly, in the staff's view, it would not be necessary for boards to make a finding about *each* of the factors laid out in the 12b-1 adopting release if such factors are not pertinent to boards' evaluation of whether a 12b-1 plan should be implemented or continued in the current

environment. On the other hand, the staff believes that boards should consider, and keep appropriate records of their consideration, other pertinent factors, even those not noted in the 12b-1 Adopting Release, if they form the basis for their decision to use fund assets for distribution.

24 *See supra* n. 10 and accompanying text; s*ee also* n. 13.

25 The Commission has brought enforcement actions against advisers who breached their fiduciary duty in violation of section 206 of the Advisers Act, for example, when, without full and fair disclosure to fund boards, they used fund brokerage to reduce the sponsors' revenue sharing obligations. *See, e.g., In re Massachusetts Fin. Services Co.*, Advisers Act Release No. 2224 (Mar. 31, 2004); *In re PA Fund Management LLC, PEA Capital LLC, and PA Distributors LLC,* Exchange Act Release No. 50384, 2004 WL 2060484 (Sept. 15, 2004).

26 Such intermediary conditions may also indicate that the intermediary attributes at least a portion of the sub-accounting fee to distribution-related services, a factor discussed as relevant in the 1998 Letter.

The Investment Management Division works to:

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