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Sub-TA Sweep Gives Fund Shops a Bargaining Chip

By Peter Ortiz October 15, 2015

The first enforcement case to come from the Securities and Exchange Commission's longstanding investigation into fees paid by fund shops to intermediaries did little to clarify the murky line between what the regulator might consider to be shareholder servicing and what qualifies as marketing activities.

But it may provide fund shops with new leverage in pressing distribution partners for cleaner, more transparent revenue-sharing and pricing contracts.

"They need to take these issues out of the hands of salesmen and put it back to a governance committee," says Jason Rosenberg, senior principal consultant at ACA Compliance Group.

Last month's settlement with First Eagle Investment Management outlined a cut-and-dried example of a firm that flouted practices laid out in agreements with distributors about which fees were to be paid using fund assets and which were to come from the fund firm's pocket.

But the bigger question vexing fund shops is tracking to which services intermediaries apply the sub–transfer agency and shareholder service fees gleaned from fund assets, and for which services they use revenue sharing dollars paid out of fund company profits.

One problem facing fund companies is that often, they don't know.

Diana McCarthy

"There are no rules that require [intermediaries] to distinguish service between distribution and non-distribution and what the fees are," says Diana McCarthy, partner at Drinker Biddle. "Sometimes it's very difficult [for asset managers] to untangle the appropriate fees for the appropriate services."

Yet that is the very issue the SEC sweep hinges on. The regulator's big concern is that some fund firms are masking payments for marketing and sales efforts by labeling them shareholding servicing and sub-TA costs.

The only fund assets allowed to be used for sales and marketing are those broken out in a fund's 12b-1 plan. All other marketing and sales support paid by fund companies to broker-dealer and other distributors must come from the asset manager's own pocket. The so-called distribution-in-guise investigation also coincides with greater adoption by advisors of share classes without 12b-1 fees for use in fee-based advisory programs and other retail accounts.

“Intermediaries hold the distribution strings,” says ACA’s Rosenberg. “[Intermediaries] have no incentive to do it and will not do it, and that puts the mutual fund complex in a bad situation.”

Lori Schneider

Typically, fund companies focus most on hammering out the terms of agreements with the distributors that control the greatest proportion of their assets, says Lori Schneider, partner at K&L Gates. The First Eagle case suggests that approach may not be sufficient, she says.

“It really highlights the need to examine every agreement,” she says.

Whether intermediaries would be open to sharing the specifics of the services they provide is a different question, says Drinker Biddle’s McCarthy.“You probably need another case about confusion over the services being provided under the agreements,” she says.

Still others see a compelling business case for distributors to provide better reporting.

“If they stay opaque, the SEC will go in and force their hand, and no one wants that,” says Whitfield Athey, CEO and president of **Delta Data**, a Columbus, Ga.-based distribution consulting and software provider. “It’s easier to give fund companies what they need than to wait for the ax to fall.”

When approaching intermediaries, fund shops need to ask the right questions, he says. That includes the number of investors who are represented by omnibus accounts that distributors maintain, so that the fund can determine the effective rate in dollars that is being charged for each service, he notes.

In some cases, fund shops have begun demanding separate contracts for the distribution and shareholder servicing components of the intermediary relationship, says Nicholas D’Angelo, director, risk and regulatory, PwC, in an e-mail response to questions.

“As part of this exercise they are demanding more clarity regarding the services performed,” he says.

One leading industry practice is to create a list of intermediary services and fee ranges that funds are willing to pay, he notes.

“Funds sometimes have an outside source benchmark the cost of each service to determine that those ranges are reasonable,” D’Angelo writes.

Fund firms should also establish clear compliance policies that prohibit senior sales or account executives who negotiate revenue-sharing arrangements from talking about sub-TA and shareholder servicing, Rosenberg says. Some firms, for example, refer all sub-TA discussions to someone in the fund complex’s operations department.

Some firms tackle the issue by tightening language in fund prospectuses and other shareholder documents. Franklin Templeton, AB and Deutsche Asset Management, for example, each lay out ranges of payments made to distributors and, in some cases, the source of those monies. (See table below.)

First Eagle declined to comment on changes to its policies since the recent enforcement. But another firm reported to have been ensnared in the sweep has tightened certain disclosures.

In May, *Ignites*'s sister publication *BoardIQ* first reported that the SEC had referred OppenheimerFunds to enforcement as part of its distribution-in-guise probe. OppenheimerFunds has stated that the firm does "not confirm or deny the existence of nonpublic regulatory inquiries."

But since March, the New York–based shop has amended the statements of additional information on half of its nearly 90 mutual funds as part of annual prospectus updates.

The old disclosure noted that payments to financial intermediaries could include fund assets "to reimburse the sub-adviser or the distributor for the fund expense they incur for providing omnibus accounting, recordkeeping, networking, sub-transfer agency or other administrative or shareholder services."

The new language says that although the firm does pay intermediaries for those services, the payments do not come out of fund assets. While OppenheimerFund's disclosure language is new, the practice there has been the same for the past 15 years, says Kim Weinrick, a spokeswoman for the firm.

"The funds' advisor pays for those services out of its own resources. We believe this is a sound and transparent practice," she writes.

Distribution Payment Disclosures: A Closer Look

While most fund complexes disclose that they at times pay distributors for different services, few spell out the range of those payments or the specific services provided in exchange. Below is a sampling of a few that do.

Firm	Disclosure language
Deutsche	"Financial Intermediary Support Payments...Advisor, the Distributor and/or their affiliates currently make revenue sharing payments from their own assets in connection with the sale and/or distribution of Deutsche fund shares, or the retention and/or servicing of investors, to financial advisors in amounts that generally range from 0.01% up to 0.52% of assets of a fund serviced and maintained by the financial advisor, 0.05% to 0.25% of sales of a fund attributable to the financial advisor, a flat fee of up to $120,000, or any combination thereof."
AB	"Other Payments For Distribution Services and Education Support...In 2014 additional payments to these firms for distribution and education support related to the AllianceBernstein Mutual Funds are expected to be approximately 0.05% of the average monthly assets of the AllianceBernstein funds, or approximately $21 million."
Franklin Templeton	"Marketing support payment...In the case of any one dealer, marketing support payments will generally not exceed 0.05% of the total assets of Franklin Templeton mutual funds attributable to that dealer, on an annual basis. For a dealer exceeding $50 billion in total assets of Franklin Templeton mutual funds, Distributors may agree to marketing support payments of up to 0.06% of such assets, on an annual basis."

Source: SEC Filings