



Crucial Element Lacking in SEC Distribution Fee Guidance

By Peter Ortiz January 14, 2016

While the SEC's new guidance on mutual fund distribution and sub-accounting fees goes a long way toward helping fund directors and advisors deal with a murky area, it falls short in one crucial way, according to industry attorneys and consultants.

The Division of Investment Management's guidance does not deal with the challenges boards and shops face in obtaining necessary information from a principal player: fund distributors.

"The guidance does not address one key fundamental problem — financial intermediaries," says Jason Rosenberg, senior principal consultant at ACA Compliance Group. "They control distribution and have no fiduciary duty [to provide information], so [fund] advisors are in a tough situation, because how will they get transparency if financial intermediaries push back and don't provide this information?"

The guidance acknowledges the difficulty some firms have encountered in getting information regarding fees and services from intermediaries, citing Securities and Exchange Commission examiners' observations from a sweep of fund complexes, investment advisors, broker-dealers and transfer agents.

"[I]n 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 guidance notes. "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 guidance also calls attention to what appear to be quid pro quo arrangements.

"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 of increase of sub-accounting fees," the guidance notes.

But the Investment Management's guidance does not direct intermediaries to provide information. The difficulty is that it is up to the SEC's Division of Trading and Markets to address intermediaries, Rosenberg says.

"The SEC failed on that point," he says. "Trading and Markets is supposed to be integral to this, and I don't know why they have not issued guidance and why they can't do something."

The SEC declined to comment for this article.

Despite clear directives, intermediaries will feel pressure to deliver better information indirectly, says Whitfield Athey, CEO and president of **Delta Data**, a Columbus, Ga.-based distribution consulting and software provider.

The guidance suggests that intermediaries should cooperate in providing information to fund firms and boards, and intermediaries may now have a greater interest in doing so, says Lori Schneider, partner at K&L Gates. Indeed, the SEC could feel "compelled" to address the issue through a new rule, the threat of which may increase intermediaries' willingness to provide requested information.

But there is no regulatory requirement at this time for intermediaries to turn over information, she adds.

The guidance "does not ... require they do anything and the practical challenge we always hear from clients is that they can't get specific information on the quality of the services or specifics of services they are providing," she says. And "it is really the intermediaries that have the leverage here."

Diana McCarthy, partner at Drinker Biddle, agrees with others in the industry that the new guidance provides specific direction for boards, advisors and service providers that they lacked in the past, but still does not put enough pressure on intermediaries.

"The force of the guidance will probably cause more conversations to happen between advisors and intermediaries, and it does provide them with a little more ammunition to get what they need," McCarthy says. "But what is really needed is a corresponding obligation on intermediaries to provide information."

Delta Data's Athey suggests that if a fund board "were to call one of these big wirehouses and ask for the data, it will be tough for that wirehouse to say no."

Getting more information on fees and services could also present new burdens for small and midsize fund shops. Those firms, unlike large fund complexes, are unlikely to have the sophisticated tools and analytics to break down the data from distributors, Athey notes.

"Where do they put that information?" Athey asks. "They have 400 agreements and get hit with 40 gigabytes of data from a single firm. What do you do with it?"

Separate from the issue of gaining information from intermediaries, the guidance is noteworthy for specifically referencing Rule 38a-1, also known as the chief compliance officer rule, says K&L Gates's Schneider.

"I think it clarifies for fund CCOs and everybody involved that the SEC views this as something that should be part of a 38a-1 program," Schneider says. "So to the extent policies addressing these issues are not already part of the compliance program, the fund CCO should make sure something is developed."

The examples cited by the guidance of what examiners found during their sweep also "put this all in practical terms and gives a board, fund's advisor and everyone involved specific insight on what to look for," she notes.

SEC Tips For Boards to Ferret Out Distribution-in-Guise

The new guidance goes a long way in spelling out what data about distribution and subaccounting fees directors should ask for from advisors and other service providers, industry attorneys and consultants say. Here are the six areas the SEC recommends fund directors scrutinize when evaluating fees.

- Information on specific services entailed in the fund's sub-accounting agreements.
- Amounts paid for such services.
- Any recommendations from the advisor or other service providers to change the fee structure or information about whether the services provided have "materially changed."
- Whether services provided could provide direct or indirect benefits for distribution.
- How advisors and service providers ensure fees are reasonable.
- How boards evaluate the quality of services.

Source: SEC