SEC SETTLES WITH ADVISER AND PRINCIPAL UNDERWRITER OVER IMPROPER DISTRIBUTION PAYMENTS

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Investment Management Alert

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INTRODUCTION

On May 1, 2017, the Securities and Exchange Commission ("SEC") settled an enforcement action against a fund adviser and distributor for causing the funds to pay, outside of a Rule 12b-1 plan, for activities primarily intended to result in the sale of fund shares and to pay sub-transfer agency fees in excess of limits established by the fund board.[1] The settlement order ("Settlement Order") illustrates how the SEC will apply certain principles set forth in a guidance update from the SEC Division of Investment Management issued in January 2016 ("Guidance Update"), which outlined the SEC staff's views on issues that may arise from payments to financial intermediaries that provide both distribution and nondistribution services to a fund.[2]

The settlement resulted in a civil penalty for the investment adviser and principal underwriter of the fund that was high relative to the size of the erroneous payments. Since the SEC noted that the improper payments were the result of negligence, the settlement can be read to suggest that even inadvertent errors in this area may subject advisers to the risk of enforcement actions and steep penalties.

CURRENT STATE OF THE LAW AND SEC STAFF PRONOUNCEMENTS

Rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act"), makes it unlawful to use fund assets to finance "any activity which is primarily intended to result in the sale of [fund] shares" unless such payments are made pursuant to a written plan adopted under that rule. Rule 12b-1(a)(2) provides that distribution-related activities include, among other things, compensating underwriters, dealers, and sales personnel. If there is a Rule 12b-1 plan, fund assets may be used to pay for distribution up to the limit established by the plan.[3] However, if there is no Rule 12b-1 plan, fund assets cannot be used to pay for any distribution services; the adviser or distributor must instead pay out of their own assets, or shareholders must pay through a front-end or back-end sales load. Many funds use a combination of these approaches.

Because mutual funds often make their shares available through arrangements with intermediaries (e.g., broker-dealers, banks, insurance companies, and retirement plan administrators) that provide funds with both distribution- and nondistribution-related services, issues related to the source of the funds for these payments can arise. The fund board, the adviser, and the distributor all have a role in making sure that any distribution payments come from proper sources. The Guidance Update outlined the SEC staff's positions relating to: (1) the role of the fund board and the process it undertakes in reviewing intermediary agreements and the standard by which its judgments are reviewed (i.e., a reasonable business judgment standard); (2) the requirement to have a compliance program that is reasonably designed to prevent violations of Rule 12b-1 and other federal securities laws and the potential for liability under Rule 38a-1 of the 1940 Act for an inadequate program; (3) specific arrangements that raise concerns for the SEC staff; and (4) advisers' potential conflict of interest in recommending that funds pay for certain services and advisers' potential liability under Section 36 of the 1940 Act.[4]

THE SETTLEMENT ORDER

In the recently settled administrative proceeding, the SEC found four violations that stemmed from distribution, marketing, and sub-transfer agent payments totaling $1.25 million made to several intermediaries over a four-year period. First, the SEC found that upon switching from a manual to an increasingly automated oversight system, the respondent inadvertently classified services provided under distribution and marketing agreements as sub-transfer agency services in the funds' payment systems, negligently causing the funds to pay for the distribution and marketing services outside of their Rule 12b-1 plans. Second, the SEC found that the respondent caused the funds to pay sub-transfer agency fees to a financial intermediary that were above the limits approved by the funds' board of trustees because it inadvertently paid invoices that included duplicative fees charged on the same underlying assets. Third, the agency found that the funds' registration statement failed to disclose the higher sub-transfer agency fee rates the respondent caused some of the funds to pay.

Finally, the SEC found that the respondent, acting as investment adviser, failed to disclose to the fund board the adviser's conflict of interest in recommending approval of a shareholder servicing fee to be paid by the funds. At the time the board was asked to approve the fee, the adviser said that it expected to pay the entire fee to intermediaries. As matters developed, however, the adviser performed the shareholder services and retained the fee. Although the fund board later received reports showing the amounts retained by the adviser, the SEC asserted that because the adviser failed to tell the board that it retained the entire amount of the fee, the adviser breached its duty to “fully and fairly” disclose to the board the adviser's conflict of interest in recommending the fee.

Without admitting or denying the SEC's findings, the respondent agreed to settle the SEC action, to cease and desist from committing or causing any violations of the relevant provisions of the federal securities laws, and to pay a fine of $4.5 million — more than three times the dollar amount involved in the violations. The Settlement Order notes that this case involved a measure of self-remediation by the respondent: When it learned that SEC examiners were coming as part of the “distribution-in-guise” sweep examination, the respondent undertook an independent examination of its own systems, discovered the errors, reported to the funds' board, and reimbursed the funds with interest for the amount of the improper payments. The Settlement Order does not indicate whether the respondent voluntarily reported the errors to the arriving SEC examiners.

LESSONS FROM THE SETTLEMENT

Like the 2015 *First Eagle* settlement,[5] the first case resulting from the sweep examinations, this settlement order did not use the term "distribution in guise." Indeed, there was no guise here, only negligence. In fact, the SEC's order went out of its way to emphasize that point. In many proceedings, the SEC charges respondents charged under Section 206(2) of the Investment Advisers Act of 1940, an anti-fraud provision, and adds a footnote to the settlement order pointing out that negligence is sufficient to violate that section. In the present case, the SEC order goes a step further, expressly characterizing the respondent's conduct as negligent.

While this characterization of the behavior may be preferred by respondents, fund boards and advisers should take note: Negligent misconduct brought the adviser a fine that was more than three times the size of the dollar amount of the error. The message here seems to be that the SEC expects to see good controls around these payments. Special attention might be warranted when there is a change in the payment system, as that is a point that may be especially prone to introduce errors. For its part, a fund board may want to suggest that the management company's internal auditors confirm that the system is running properly and that any changes were properly executed.

The SEC also found that the respondents violated Section 34(b) of the 1940 Act, which makes it unlawful for any person to make any untrue statement of material fact in any registration statement or other document filed or transmitted under the 1940 Act, or in any record required to be made under the Act, or "to omit to state therein any fact necessary in order to prevent the statements made therein, in light of the circumstances under which they were made, from being materially misleading." Here again, the important point to note is that the respondent's conduct was merely negligent. While there are other provisions of the securities laws that might be invoked against a registration statement that is misleading as a result of simple negligence, Section 34(b) potentially applies to a vast array of filings and records.[6]

Regarding the potential consequences of the negligent payments, one sentence in the order deserves extra attention: "The impact [of the erroneous payments] on the affected Funds was less than one penny per share." An impact of one penny per share is the level at which, under procedures widely adopted in the fund industry and informally endorsed by the SEC staff, a pricing error must be corrected. The adviser or other party responsible for the error must reimburse the fund for any shortfall (caused, for example, by net redemptions made when the net asset value per share that was too high); if the error amounts to more than one-half of one percent of the net asset value, shareholder transactions must be reprocessed and shareholders who lost more than a *de minimis* amount must be reimbursed. The process is expensive and painful for the funds involved. By invoking the penny-per-share standard here, the SEC appears to be suggesting that if the error had been large enough, it would have required the reprocessing of shareholder trades — even where the error was the result of simple negligence.

The SEC also took the respondent to task for its failure to disclose to the fund board the adviser's conflict of interest in recommending that the board approve a payment out of fund assets for certain shareholder services. As noted above, the board became aware subsequently that the adviser was retaining at least some of these fees and not paying them through to third-party intermediaries. The 2016 Guidance Update placed considerable emphasis on the need for advisers to disclose their conflicts of interest in recommending that funds pay certain intermediary expenses that the adviser would otherwise have to pay. The Guidance Update said that where the conflict cannot be eliminated, the adviser's obligation is to mitigate the conflict and provide "full and fair disclosure thereof" to the board. In the present case, where the board received information quantifying the actual payments received by the adviser under the agreements, the SEC nevertheless called out the adviser because it did not clarify that it retained all of the fees under those agreements or use the magic words “conflict of interest” in describing the situation to the board. Given that the SEC staff, as explained in the Guidance Update, views the whole field of intermediary payments as rife with potential conflicts, fund boards and advisers would seem wise to include a discussion of conflicts when considering intermediary payments and to make sure the record reflects that the discussion occurred.

Notably, the fund trustees are not named in this case, nor were they named in the 2015 *First Eagle* case. It is not clear whether any such case against fund trustees might be in the pipeline at the SEC or whether the current SEC would support such a case. The cases that have emerged so far stem from conduct that occurred before the SEC staff issued the Guidance Update in January 2016. Because the Supermarket Letter provided boards with limited guidance for how to go about the tasks they were given, any case based on conduct that occurred before early 2016 likely would have to involve a board's truly blatant disregard for its fiduciary duties to the fund — for instance, a board that failed to request any information from the adviser or service providers about the nature of the services and sources of the fee payments or a board that knowingly allowed fund assets to be used to pay for distribution outside of the approved Rule 12b-1 plan.

These cases also have not named any intermediaries as respondents. The Settlement Order noted that in at least two of the intermediary agreements, the adviser represented that the money to pay for the distribution-related services came from the adviser and not from the fund. The adviser's representation serves a double purpose: It protects the intermediary from any hint of liability if it is later determined that the payments came from an improper source, and it protects the agreement itself under Section 47(b) of the 1940 Act, which provides that contracts made in violation of that Act are unenforceable by either party, except in limited circumstances. Intermediaries sell fund shares with the expectation of receiving a stream of future payments under a 12b-1 plan, a shareholder servicing agreement, and/or a sub-transfer agency arrangement. If the agreements were found to be void, the intermediaries would face the question of whether to sell out those positions and how to compensate their representatives in the interim. From the SEC's perspective, however, the provision apparently served a third purpose: It removed any ambiguity about whether the parties to the agreement saw it as primarily involving distribution-related services. In any event, it is difficult to envision the SEC involving an intermediary in a distribution-in-guise case unless the evidence showed that the intermediary was actively misleading the fund or the adviser about the nature of the services it was providing.

CONCLUSION

In the wake of the January 2016 Guidance Update, many boards and advisers revised their procedures for board evaluation of intermediary arrangements. The Settlement Order ups the ante in two significant respects. First, it makes clear that the SEC will pursue even violations resulting from negligence, perhaps with significant penalties. Second, it emphasizes that the SEC expects advisers to take special care around payments that may involve conflicts of interest and speaks to the wisdom of documenting that the adviser discussed potential conflicts with the fund board.

NOTES:

[1] Investment Advisers Act Release No. 4695 (May 1, 2017). Although the SEC did not characterize the

respondent's conduct as involving “distribution in guise,” the case results from the SEC staff's sweep examinations around “distribution in guise,” a term used by the SEC staff to describe situations in which part of the fees paid by a fund outside of a Rule 12b-1 plan, ostensibly for sub-accounting or sub-transfer agency services, are actually used for distribution-related activity.

[2] SEC, Division of Investment Management, IM Guidance Update (January 2016), No. 2016-01, “Mutual Fund Distribution and Sub-Accounting Fees.”

[3] The amount of the Rule 12b-1 fee is also limited by Financial Industry Regulatory Authority, Inc. (“FINRA”) Rule 2830, which applies to fund distributors and effectively limits the annual amounts that can be paid under a Rule 12b-1 plan to 75 basis points for distribution and 25 basis points for shareholder servicing. In each case, the fees are calculated on the assets held through customer accounts of the intermediary receiving the payments. FINRA Rule 2830 refers to “shareholder servicing,” which is different from sub-transfer agency services. Sub-transfer agency fees are not under any specific numerical regulatory limit.

[4] For a more in-depth discussion of the Guidance Update, please see our client alert: SEC's Division of Investment Management Offers New Guidance on “Distribution in Guise” Payments, http://www.klgates.com/files/Publication/ef977ca2-d609-4ccc-bfc6-d9f6914194f9/Presentation/PublicationAttachment/06a28cc4-18a0-494f-b2e9-e7c08171074b/IM_Alert_01122016.pdf.

In 1998, the SEC staff issued a letter to the Investment Company Institute about these issues (the “Supermarket Letter”). The Supermarket Letter articulated the SEC staff's positions that the fund board should determine whether the portion of the fee that the fund pays for nondistribution-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.” While the January 2016 Guidance Update did not expressly supersede the Supermarket Letter, it did provide fund boards, advisers, and distributors with more robust guidance for evaluating payments to intermediaries.

[5] In the Matter of First Eagle Investment Management, LLC and FEF Distributors, LLC, Investment Advisers Act Release No. 4199 (September 21, 2015). In that case, the SEC settled an administrative enforcement action against First Eagle Investment Management, LLC and FEF Distributors, LLC, the investment adviser and principal underwriter to a mutual fund, respectively (“*First Eagle* settlement”). The *First Eagle* settlement centered on findings that agreements with two intermediaries described the services provided to the funds as distribution and marketing services, yet the services were paid for by the funds outside of a Rule 12b-1 plan and were inaccurately characterized in reports to the fund board as sub-transfer agency, rather than distribution, services. The respondents settled the case without admitting or denying the allegations.

For more discussion about the *First Eagle* settlement, see our client alert: SEC Announces First “Distribution in Guise” Case, http://www.klgates.com/sec-announces-first-distribution-in-guise-case-09-29-2015/.

[6] In holding the adviser responsible for misleading statements in the funds' registration statement, the order makes no mention of the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), which held that a mutual fund, and not its investment adviser, would generally be responsible under Rule 10b-5 as the maker of any misleading statements in the fund's prospectus. It is arguable that a similar interpretation should be applied to Section 34(b) because it too focuses on the "maker" of allegedly misleading statements. In the Settlement Order, however, the SEC skirted the issue by asserting that the adviser “caused”

the misleading statement in the funds' registration statement. *Janus* remains important in private actions under Rule 10b-5; there is no private right of action under Section 34(b) of the 1940 Act. *See* Bellikoff v. Eaton Vance Corp., 481 F.3d 110 (2d Cir. 2007).

