Viewpoints

Four areas of focus when overseeing distribution fees, practices

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The Securities and Exchange Commission has been focused for some time now on mutual fund distribution fees and practices. The SEC conducted a number of sweep examinations over the past several years to evaluate “disguised” distribution payments, and the Investment Management staff issued new guidance last January, after finding regulatory deficiencies at a number of fund complexes.

The industry regulator of broker-dealers—the Financial Industry Regulatory Authority (FINRA)—is similarly focused on the proper application of sales load discounts and waivers within intermediary accounts. More than 90 enforcement actions have been brought against broker-dealers on this issue over the past 13 years, resulting in more than $100 million in penalties and more than $220 million in restitution payments to aggrieved investors.

Independent fund directors need to get ahead of these regulatory challenges and re-examine the processes they use to oversee the distribution of fund shares by large broker-dealers and other intermediaries. For many fund complexes, most of the board’s attention to this issue should be focused on four problem areas:

Avoid Disguised Distribution Payments.
Fund boards should examine all intermediary payments to ensure that fund distribution arrangements are within an approved Rule 12b-1 plan. Payments for services outside of a 12b-1 plan are permitted by existing SEC regulations, but only if they are not primarily intended to result in the sale of fund shares.

Fund directors need to inquire more deeply into the purposes of such payments and draw a hard line on any that have even an indirect distribution purpose and are not within the scope of a 12b-1 plan. What passed muster previously may not anymore, as the SEC looks for disguised distribution payments.

Require Account-Level Transparency.
A continuing regulatory problem for funds and their boards is the lack of transparency within intermediary-controlled omnibus accounts. It is next to impossible for funds to ensure the proper application of their prospectus policies and procedures within these consolidated accounts, including (1) frequent trading restrictions, (2) sales load discounts and waivers, and (3) other shareholder privileges. Boards that look the other way regarding their omnibus arrangements are taking a significant compliance risk under SEC Rule 38a-1, especially for those funds that have a substantial majority of their shares within these consolidated intermediary accounts.

Transparency within third-party accounts was never a problem when broker-dealers and other intermediaries used the networking service of the National Securities Clearing Corporation (NSCC) to share account-level information with funds. This NSCC service—which dates back to 1989—

standardizes the information-sharing process between funds and their intermediaries and is completely automated.

Fund boards should take a page from the pre-omnibus days and demand that all intermediaries provide account-level transparency to funds on a same-day basis. This would not disrupt distribution activities and would ensure a more cost-effective process for fund compliance with prospectus policies and procedures. SEC Rule 22c-2 already permits funds to request this information from their intermediaries. Fund boards have the authority to require the incorporation of account-level information sharing into the daily order flow from intermediaries.

Promote Competitive Pricing.
Too many mutual fund fees are set by relying on price lists provided by intermediaries, or by a cursory examination of "what everyone else is doing." Fund boards must demand more competitive pricing from intermediaries for services that are readily available in the open market. And fund directors also should avoid paying for services by broker-dealers and other intermediaries that are already required to be performed under existing SEC and FINRA rules.

One example is recordkeeping. The average annual payment for recordkeeping and standard shareholder servicing activities to an internal transfer agent or a broker-dealer is $20 to $25 per account or position, according to reviews of public disclosures and SEC filings. However, annual charges for these services by third-party recordkeepers—established through a competitive bidding process—are much lower, typically $10 to $13 per account or position. Fund boards should require competitive pricing for these services, including the use of competitive bidding whenever possible. Board approval of inflated payments for intermediary services is nothing other than a payment for distribution, whether disguised or not.

Demand Reasonable Fees.
Whether inside or outside a 12b-1 plan, fund directors should take a harder look at intermediary fee arrangements to ensure they are in the best interests of shareholders. Fund advisers always will push to grow assets under management. And advisers will continue to tell directors that distribution payments are the price of admission to certain broker-dealer and intermediary platforms. But fund boards have a solemn responsibility to be "independent watchdogs" of shareholder interests and need to be more aggressive in declining to approve excessive fee structures. A number of these fees to intermediaries are not paid by issuers of equities, bonds, exchange-traded funds, or other securities. Why should mutual funds be the only issuer required to pay fees for distribution?

Independent directors are expected to represent the interests of individual fund shareholders. The manner in which directors handle intermediary fees and business practices will determine which funds avoid regulatory and enforcement problems.

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