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CLIENT ALERT

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The SEC Releases the First Distribution-In-Guise Enforcement Action Concerning Fund Assets Used to Pay For Marketing and Distribution Fees

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THE SEC'S ORDER PROVIDES SIGNIFICANT GUIDANCE ON HOW THE SEC STAFF WILL SCRUTINIZE THE PROPRIETY OF PAYMENTS MADE PURSUANT TO COMMONLY OCCURRING AGREEMENTS BETWEEN MUTUAL FUNDS AND THEIR SERVICE PROVIDERS AND WITH RESPECT TO AGREEMENTS PURSUANT TO DEALER ARRANGEMENTS.

On September 21, 2015, the Securities and Exchange Commission (the Commission) announced that it had settled charges an investment adviser improperly used mutual fund assets to pay for the distribution and marketing of fund shares. In its announcement of the *In the Matter of First Eagle Investment Management, LLC and FEF Distributors, LLC* settlement, the Commission termed the case to be the "first" to be brought under the Commission staff's (the Staff) previously announced "Distribution-In-Guise Initiative."

The Distribution-In-Guise Initiative was introduced in 2013 to address the Staff's concerns over payments made by advisers and funds to distributors and intermediaries, disclosures made to fund boards about these payments, and board oversight of the same. Section 12(b) of the Investment Company Act of 1940 and Rule 12b-1 thereunder make it unlawful for a registered open-end investment company to engage "directly or indirectly in financing any activity which is primarily intended to result in the sale of shares issued by such company." A fund's assets may not be used to pay for such financing unless the payment is made pursuant to the requirements of Rule 12b-1. The fund's adviser, however, may make these payments out of its own resources.

In *First Eagle*, the Staff investigated whether payments made to financial intermediaries were improperly characterized as being made for account recordkeeping and sub-transfer agency (sub-TA) services while actually being used to pay for the distribution and marketing of fund shares outside of a Rule 12b-1 Plan. According to the Order, First Eagle Investment Management, LLC (First Eagle) served as the adviser to a number of mutual funds. First Eagle's affiliate, FEF Distributors, LLC (FEF) served as principal underwriter and distributor. First Eagle and FEF entered into agreements with two unidentified financial intermediaries under which the financial intermediaries would provide a variety of sub-TA and other services that are typically paid for out of fund assets, and for distribution and shareholder services to the mutual funds pursuant to 12b-1 plans. However, the agreements also described services related to the distribution and marketing of fund shares, which were paid from fund assets and in addition to or from outside of Rule 12b-1 plan fees. According to the Order, First Eagle treated these payments as being for sub-TA services, caused the mutual funds to pay for them, and incorrectly characterized them as such to the funds' board. Additionally, the mutual funds' prospectuses contained inaccurate disclosure concerning the funds' payments for distribution-related services.

First Eagle and FEF reached a $40 million settlement with the Commission, including the obligation to disgorge approximately $25 million for services paid for by the funds which were "generally for marketing and distribution and not sub-TA services." (The Adviser was

not required to disgorge for payments made for sub-TA services under the contacts or payments made pursuant to permissible plans.) The Adviser was found to have violated Section 206(2) of the Investment Advisers Act of 1940, "…operat[ing] as a fraud or deceit upon any client…" and Section 34(b) of the Investment Company Act, "…mak[ing] any untrue statement of a material fact in any registration statement…" Both the Adviser and the Underwriter were found to have caused the mutual funds to have violated Section 12(b) and Rule 12(b)-1 of the Investment Company Act. The parties agreed to cease and desist from committing or causing any future violations and FEF must additionally retain an independent compliance consultant.

Pepper Points

- The Order identified a presumably non-exclusive list of sub-TA services it characterized as "typically paid for out of fund assets," including: (i) maintaining separate records for each customer in the omnibus account for each fund; (ii) transmitting purchase and redemption orders to the Funds; (iii) preparing and transmitting account statements for each customer; (iv) transmitting proxy statements, periodic reports, and other communications to customers; (v) providing periodic reports to the Funds to enable each fund to comply with state Blue Sky requirements; and (vi) providing standard monthly contingent deferred sales charge reports.

- In bringing this action, the Staff has thus far held true to its previous public statements that it would not use the enforcement process arising from its Distribution-In-Guise Initiative as an avenue for revising the guidance previously put forth by the Staff in the area of fund payments to intermediaries. The payments for the services as described in the order were of a nature that required them to be paid from 12b-1 fee or non-fund assets, consistent with long-standing Staff guidance.

- While the Staff in *First Eagle* focused on the manner in which intermediary services were characterized in the relevant agreement, funds should remain equally attentive to the substantive nature of the services provided by an intermediary as the Commission's Distribution-In-Guise Initiatives continue.