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# 2016 Year in Review: Division of Investment Management Guidance Updates

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## Introduction

In 2016, the Staff (Staff) of the Division of Investment Management of the US Securities and Exchange Commission (Commission or SEC) continued to provide informal guidance and interpretations regarding issues of relevance to the investment management industry through a guidance update initiative. Although the number of guidance updates issued by the Staff in 2016 was relatively low when compared to the number from several years ago, the Staff articulated its views with respect to a number of high profile issues, including mutual fund distribution and sub-accounting fees, business continuity planning for funds registered under the Investment Company Act of 1940 (1940 Act), and mutual fund fee structures. Overall, these guidance updates clarify and offer insight into the Staff's view of certain discrete interpretive questions. However, the guidance updates leave certain other related interpretive questions unresolved.

It is important to note that the guidance updates are not rules, regulations, or statements of the Commission, and the Commission itself, has neither approved nor disapproved the statements and policies set forth in the guidance updates. However, the investment management industry should continue to be mindful and consider the potential implications of the Staff's guidance updates to existing and future policies and procedures, disclosures to investors, filings with the SEC, and other legal and regulatory matters.

This article provides a summary of the guidance updates published by the Staff in 2016 as well as certain practical considerations that industry participants may wish to take into account in connection with their review of the guidance updates.

## Guidance Update No. 2016-01 – "Mutual Fund Distribution and Sub-Accounting Fees" (January 2016)

### Overview

In a guidance update published on January 6, 2016, the Staff outlined its views regarding potential issues implicated by mutual funds making payments to financial intermediaries for furnishing shareholder and recordkeeping services to omnibus and networked shareholder accounts (Sub-Accounting Guidance).[1] The Sub-Accounting Guidance acknowledged that Staff observations during the so-called "distribution-in-guise" sweep examinations had highlighted the need to clarify and update its existing guidance, especially in connection with the prevalence of omnibus account and sub-accounting service arrangements through which intermediaries currently perform many traditional transfer agency services for fund investors whose shares are held in an omnibus account.[2]

The Sub-Accounting Guidance provided several Staff recommendations with respect to the oversight responsibilities of a fund's board of directors/trustees (board) as well as related information to be provided periodically to the board by fund service providers in connection with the board's consideration of whether a portion of sub-accounting fees[3] are for services primarily intended to result in the sale of fund shares (distribution or distribution-related activity).[4]

The Staff's focus on these board oversight and reporting matters stems from the prohibition under the 1940 Act, pursuant to Section 12(b) and Rule 12b-1 thereunder, against the use of a fund's assets to directly or indirectly finance distribution-related expenses other than in accordance with a plan of distribution meeting the requirements of Rule 12b-1 (a 12b-1 Plan). The Staff explained that there is a potential for sub-accounting fees to be used to finance distribution, which is most likely to arise when the sub-accounting fees compensate intermediaries that are also involved in the distribution of fund shares.

*Staff Recommendations:* In the Sub-Accounting Guidance, the Staff expressed its belief that "the board's role should focus on understanding the overall distribution process as a whole to inform its reasonable business judgment about whether sub-accounting and other mutual fund-paid fees represent payments for distribution, in whole or in part."[5] In light of the Staff's concerns regarding the potential mischaracterization of such fund-paid fees as well as the potential for the inappropriate use of fund assets to finance distribution outside of a 12b-1 Plan, the Sub-Accounting Guidance set forth the following recommendations, which are discussed in more detail below:

- Boards should have a process in place that is "reasonably designed to evaluate whether a portion of sub-accounting fees is being used to pay directly or indirectly for distribution"—regardless of whether a fund has, or is considering adopting, a 12b-1 Plan.
- This process should include the provision of "sufficient information to inform the board of the overall picture of intermediary distribution and servicing arrangements for the [fund]" by advisers and other relevant service providers, including information as to the possible impact of sub-accounting fees on other distribution-related payment flows (such as 12b-1 fees and distribution-related revenue sharing).
- Boards should be informed by advisers and other relevant service providers whether certain activities or arrangements that are potentially distribution-related exist in connection with the payment of sub-accounting fees and, if such activities or arrangements exist, "boards [should] evaluate the appropriateness and character of those payments with heightened attention."[6]

In the Sub-Accounting Guidance, the Staff stated that funds should develop and implement "adequate policies and procedures for reviewing and identifying any payments that may be for distribution-related services that are not paid through [a 12b-1 Plan,]" and even funds that have not adopted a 12b-1 Plan should have policies and procedures reasonably designed to prevent violations of Rule 12b-1.[7]

*Board Process and Oversight – Staff Recommendations for Oversight and Reporting Framework:* In the Sub-Accounting Guidance, the Staff articulated its view that "when the *recipient of payments for services also finances distribution* … it raises a question as to the direct or indirect use of fund assets [to pay for distribution activities] requiring relevant input from the fund's adviser and other relevant service providers and the informed judgment of the fund's board."[8] On this basis, the Staff recommended that boards receive "any necessary information" to assist them in this evaluation process, noting that relevant information would likely include, but is not limited to: information about the specific services provided under the mutual fund's sub-accounting agreements and the amounts being paid.[9]

The Sub-Accounting Guidance noted that fund directors/trustees have substantial oversight responsibilities, including overseeing the reasonableness of fees paid out of fund assets and the relationships between funds and their service providers, approving various fund contracts, and addressing potential conflicts of interest. The Sub-Accounting Guidance also noted that many boards already have established processes intended to assist them in making a determination as to whether sub-accounting fees are being used to pay for the distribution of fund shares but, regardless of the framework or specific process, the Staff recommended that boards receive adequate information to support an informed judgment as to whether fund assets are being used to directly or indirectly finance distribution outside of a 12b-1 Plan.[10] Although the Staff recognized that there are "a number of reasonable approaches that a board may take in establishing such process," the Staff stated that, without any such process, "it is unclear how a board might make an informed judgment regarding the use of fund assets for distribution and the fund's compliance with Rule 12b-1(a)."[11]

*Providing Boards an Overall Picture of Distribution and Servicing Arrangements:* Rule 12b-1 requires that a board request, and certain parties furnish, any information reasonably necessary to make an informed determination of whether to implement or continue a 12b-1 Plan. As part of the board understanding the overall distribution and servicing arrangements of a fund, the Staff recommended that the adviser and other relevant service providers furnish sufficient information to support this understanding. The Staff stated its belief that "if a board is not provided such information, including payment flows from relevant fund service providers, then it would be difficult to make an informed judgment as to whether certain payments by the mutual fund are for distribution, despite ostensibly being characterized otherwise, and to assess conflicts of interest."[12]

*Indicia that Payment May be Used to Pay for Distribution:* In the Sub-Accounting Guidance, the Staff provided examples that, in its view, raise questions as to whether sub-accounting fees may be used for distribution. Although the Staff acknowledged that none of the examples may, by themselves, demonstrate that a payment made from fund assets outside of a 12b-1 Plan is for a distribution-related activity, these examples included, among others: (i) distribution-related activity that is conditioned on the payment of sub-accounting fees; (ii) the financing of distribution in the absence of a 12b-1 Plan; (iii) the adviser and other relevant service providers taking distribution and sales benefits into account when recommending, instituting, or raising sub-accounting fees; and (iv) a lack of specificity of services or bundling of services into a single contract.[13] The Staff made clear that boards should be able to rely on the adviser and other relevant service providers to furnish relevant information and summarize data about distribution-related activities and corresponding expenses, preferably in a clear and concise manner, as well as receive and rely on the assistance of outside counsel and a fund's chief compliance officer in making these judgments.

The Staff explained its belief that, when the adviser or its affiliates make payments for distribution out of their own resources, boards should apply the same analysis that they would use when evaluating potential distribution aspects of compensation and payments to an adviser as part of the contract review process consistent with Section 15(c) of the 1940 Act.[14] The Staff noted that this evaluation should be made by the board in its reasonable business judgment based on the facts and circumstances and the information provided by the adviser and other relevant service providers.

## Practical Considerations

As funds and boards continue to evaluate the Sub-Accounting Guidance, there are several considerations that they may wish to take into account. Below is an overview of certain considerations that may be applicable to funds and board oversight processes.

- Although the Staff noted that the considerations set forth in the Sub-Accounting Guidance are not dispositive as to the value or appropriateness of fees paid to intermediaries or their proper characterization, boards and advisers should consider incorporating the Staff's recommendations into their evaluation and reporting processes, to the extent applicable.

- Fund management and service providers may wish to review board reporting practices and materials with respect to fees paid under a 12b-1 Plan and sub-accounting payments, including possible adjustments to make such materials clearer and more concise to further support the board's understanding of key information.
- In connection with reviewing these board materials, fund management and service providers may consider discussing with boards and independent trustee counsel the preferred format and scope of such materials (for example, the use of summary "dashboard" style materials supported by more detailed information).
- Boards may consider whether additional educational sessions are appropriate to continue to further develop their understanding of their responsibilities and legal and regulatory considerations with respect to the payments and services contemplated by the Sub-Accounting Guidance.
- Fund management and service providers may wish to review existing arrangements with respect to the payment of sub-accounting fees, focusing on the types and level of services, the amount of compensation and whether the agreements provide for distribution and non-distribution services.
- Fund management and service providers may also wish to review their processes with respect to entering into new sub-accounting arrangements, including the involvement of several groups to review and monitor these agreements and arrangements, as well as review existing policies and procedures in this context and consider whether any enhancements are appropriate.

## Guidance Update No. 2016-02 – "Fund Disclosure Reflecting Risks Related to Current Market Conditions" (March 2016)

### Overview

In March 2016, the Staff published a guidance update on fund disclosure regarding risks related to current market conditions—reminding the fund industry that full and accurate risk disclosures are important, particularly disclosures of risks that arise during periods of changing market conditions (Risk Disclosure Guidance).[15] The Risk Disclosure Guidance emphasized the need for funds to monitor current market conditions, as well as their related risk disclosures, on an ongoing basis.

The Staff discussed two examples of situations for when updated disclosures "highlight current conditions in a manner that [it believes] can make risk disclosure more timely, more meaningful, and more complete" — (i) disclosures by fixed income funds with respect to interest rate, liquidity and duration risks and (ii) disclosures as to fund exposure to Puerto Rican debt securities.[16]

To provide risk disclosure that remains current and relevant, the Staff suggested that funds take the following steps on an ongoing basis:

- As an initial matter, a fund should monitor market conditions and their impact on fund risks to determine whether changing conditions will affect the fund and the fund's investment risks. The Staff indicated that this type of monitoring is implicit in "prudent portfolio management" and is "a normal part of day-to-day operations."
- Following any determination that there has been such a risk impact, a fund should assess whether fund risks have been adequately communicated to investors in light of current market conditions. If so, the fund should then consider the significance and materiality of the change for

investors, as well as whether the fund's current disclosures remain sufficient.

- If a fund determines that its risk disclosures are no longer adequate given current market conditions, the fund should update communications to investors, as needed. The Staff indicated that such updated communication should be delivered in accordance with federal securities laws, but the Staff otherwise provided leeway as to the appropriate manner of such communication.[17]

Further, the Staff stated that it "believes that a fund's adviser should consider providing information to the fund board on the steps taken by the adviser to evaluate fund risk disclosures and consider whether changes are appropriate."[18]

### Practical Considerations

As funds and boards evaluate the Risk Disclosure Guidance, there are several considerations that they may wish to take into account, including the following:

- Fund management, in particular legal, compliance, and investment personnel, should consider reviewing current fund disclosure documents to determine that they continue to appropriately reflect investment strategies and associated risks in light of changes to existing market conditions, such as interest rate increases. These personnel may wish to implement or enhance ongoing formal or informal processes to assess changing market conditions, portfolio holdings and investment exposure and review the adequacy and accuracy of corresponding investment risk and strategy disclosures—including fund prospectuses and shareholder reports.
- This ongoing process may supplement any similar processes developed and implemented in connection with annual reviews of fund disclosure documents or the preparation of shareholder reports on a semi-annual basis, which often include collaboration among legal, compliance and investment (advisory and subadvisory) personnel.
- If disclosure refinements or enhancements are considered necessary or appropriate, funds should consider the manner in which such changes are communicated and ensure that updated disclosure is available to current and prospective shareholders on a timely basis and in an appropriate manner.
- Boards may consider periodically inquiring into management's evaluation and assessment of fund disclosure documents, which may be reflected in a written policy and communicated on an annual or other regular basis in a memorandum or other materials that inform the board as to material changes to fund disclosures and the basis for such changes.

## Guidance Update No. 2016-03 – "FAST Act Changes Affecting Investment Advisers to Small Business Investment Companies" (March 2016)

### Overview

In a March 2016 guidance update, the Staff clarified its views regarding the impact of the Fixing America's Surface Transportation Act (FAST Act), which was signed into law on December 4, 2015, on certain investment adviser registration matters (SBIC Guidance).[19] The FAST Act amended two provisions of the Investment Advisers Act of 1940 (Advisers Act) relating to the registration of investment advisers by revising the exemption from registration in (i) Section 203(l) of the Advisers Act (the venture capital fund adviser exemption) to treat small business investment companies (SBICs) as venture capital funds and (ii) Section 203(m) of the Advisers Act (the private fund adviser exemption) to exclude SBIC assets from applying to the $150 million threshold.

As a result, investment advisers can now rely on the venture capital fund adviser exemption if their only clients are venture capital funds (pursuant to Rule 203(I)-1 under the Advisers Act) and/or SBICs.

In addition, investment advisers to private funds and SBICs may rely on the private fund adviser exemption, regardless of the assets under management in the United States attributable to their SBIC clients, if assets under management in the United States attributable to their non-SBIC private fund clients are below the $150 million threshold. Thus, investment advisers relying on these exemptions from registration may begin advising SBIC clients consistent with the revised exemptions.

The Staff noted its view that an adviser advising only SBICs may choose to rely upon either (i) the venture capital fund adviser exemption when advising both SBICs and Rule 203(l)-1 venture capital funds or (ii) the private fund adviser exemption when advising both SBICs and non-SBIC private funds that account for less than $150 million in assets under management. However, the Staff explained that, under either exemption, it believes the adviser would be required to submit reports to the Commission as an exempt reporting adviser—unlike if the adviser relies on an exemption under Section 203(b)(7) for advisers to SBICs (SBIC exemption), which would not subject them to these annual reporting requirements. In the SBIC Guidance, the Staff stated that certain registered advisers to SBICs may obtain permission to withdraw their registration and begin reporting to the Commission as exempt reporting advisers under these revised exemptions.

In the SBIC Guidance, the Staff also stated that it is in the process of developing a recommendation for the Commission to amend Rules 203(l)-1 and 203(m)-1 under the Advisers Act to reflect the FAST Act amendments to the Advisers Act. The Staff explained that it would not object to an adviser relying on the amended venture capital fund adviser or private fund adviser statutory exemptions until these rules are amended, if the adviser files the reports required of an exempt reporting adviser on Form ADV.

### Practical Considerations

As investment advisers consider the scope of their advisory activities and advisory clients, they may wish to take the SBIC Guidance into account. In addition, advisers relying on the SBIC exemption that choose to rely on the venture capital fund adviser exemption or the private fund adviser exemption should be mindful of the associated Commission filing requirements and the timing of such filings as an exempt reporting adviser. Also, any registered advisers of SBICs that wish to withdraw their registration and rely on the venture capital fund adviser exemption or the private fund adviser exemption to be treated as an exempt reporting adviser should be aware of the filing requirements necessary to switch such registration.

## Guidance Update No. 2016-04—"Business Continuity Planning for Registered Investment Companies" (June 2016)

### Overview

On June 28, 2016, the Staff issued a guidance update regarding business continuity planning for funds, reminding funds of the compliance program requirements pursuant to Rule 38a-1 under the 1940 Act and emphasizing the importance of mitigating operational risks for funds and investors relating to significant business disruptions (BCP Guidance).[20] In the BCP Guidance, the Staff articulated its view that "fund complexes should consider their respective compliance obligations under the federal securities laws when assessing their ability to continue operations during a business continuity event."[21] As fund activities and operations as well as the nature and scope of their businesses vary, the Staff acknowledged that proper fund business continuity plans generally should be tailored to the particular fund complex but suggested that these plans include due diligence of their service providers' business continuity and disaster recovery plans, particularly those service providers that perform functions considered critical to fund operations (such as the adviser, principal underwriter, administrator, transfer agent, custodian, and pricing agent).[22]

The Staff took into account continued efforts of the fund industry to improve resiliencies to mitigate the consequences of significant business disruptions, but highlighted in the BCP Guidance certain business disruptions that have affected the fund industry over the last several years, including an August 2015 systems malfunction that prevented a third-party service provider from calculating certain funds' net asset values for several days. The BCP Guidance stated that, following such disruption, Staff "outreach revealed that some funds could have been better prepared for the possibility that one of their critical service providers would suffer an extended outage."[23]

*Notable Practices*. The Staff noted that most funds generally rely on fund complex or enterprise-wide business continuity and disaster recovery plans that incorporate critical functions performed on behalf of the funds. The BCP Guidance described certain "notable practices" identified by the Staff following its outreach to fund complexes and their advisers regarding business continuity planning, which include: (i) plans typically cover the facilities, technology/systems, employees and activities of the adviser, its affiliates and critical third-party service providers and involve a broad cross-section of employees from key functional areas; (ii) CCO (fund and/or third-party) participation in third-party service provider oversight and due diligence; (iii) annual business continuity planning testing and reporting to the fund's board with the CCO's participation; and (iv) incident monitoring and board reporting by the fund's CCO and other pertinent staff.

*Lessons Learned – Additional Considerations Regarding Critical Service Providers.* The BCP Guidance also highlighted the Staff's view that fund complexes' business continuity planning should address reliance on affiliates and third parties to perform critical business functions and related activities. Additionally, the Staff stated its belief that appropriate board oversight generally should involve discussions with the fund's adviser and other critical service providers regarding: (i) the steps being taken to mitigate the risks associated with business disruptions; (ii) the robustness of their business continuity planning; and (iii) how the fund complex's business continuity plan addresses the risks of business disruptions to critical third-party service providers.

The Staff encouraged fund complexes to consider a number of measures as they evaluate the robustness of their business continuity plans and develop and review these plans as they relate to critical service providers, including the following (characterized by the Staff as "lessons learned"):

- *Back-Up Processes and Contingency Plans*. Funds should consider critical service providers' business continuity plans, including back-up processes and redundancies and the service providers' reliance on other critical service providers. Overall, boards may wish to understand how the funds' service providers intend to maintain operations during a significant business disruption, how the funds' business continuity plan addresses the risk of such a disruption and how the funds and their service providers might respond.
- *Monitoring Incidents and Communications Protocols*. Fund complexes should consider how to monitor critical service providers for disruptions and the potential impacts and appropriate communication protocols for navigating such disruptions. The Staff encouraged the implementation of policies and procedures for internal communications within the fund complex (including with the fund complex's board(s)) and external communications with the affected service provider, other service providers, investors, regulators, and others.
- *Understanding the Interrelationship of Critical Service Provider Business Continuity Plans*. The Staff stated that fund complexes should consider how critical service providers' plans relate to each other, including redundancies and back-up procedures at the service provider and fund level to mitigate the potential risks to impacted funds and investors.

- *Contemplating Various Scenarios*. The Staff explained that it believes that fund complexes should consider how a critical service provider disruption could impact fund operations and investors, and have a plan to manage various scenarios involving these types of disruptions.

## Practical Considerations

In addition to the Staff recommendations, fund management and boards may wish to take into account the following considerations, among others, as they review the BCP Guidance:

- Fund management may wish to conduct an evaluation of the business continuity concerns relevant to fund operations and activities, including identification of critical service providers, investment and compliance functions, and personnel and incorporate this evaluation into the development or enhancement of business continuity plans.
- Fund management may also wish to consider enhancing existing plans or associated policies and procedures to reflect initial and ongoing due diligence activities, which may include periodic or unannounced on-site visits or business disruption exercises, whether the result of information technology, weather or other events.
- In addition, fund management may consider periodically reporting to boards with respect to enhancements to business continuity plans (of the fund or service providers), possibly in connection with CCO reports.
- Boards may wish to invite critical service providers to present during meetings from time to time and discuss their business continuity and disaster recovery plans as they relate to operations relevant to the funds, including business continuity disruptions or exercises and the reactions to these circumstances, as well as any enhancements implemented over time that are designed to further mitigate risks and support efficient recovery from such disruptions.

# Guidance Update No. 2016-05 – "Staff Guidance Concerning Investment Adviser Reliance on Predecessor Registration" (November 2016)

## Overview

In November 2016, the Staff clarified the situations when an investment adviser may be able to avail itself of special registration provisions for "successors" to SEC-registered advisers that may elect to rely on a predecessor's registration by application or by amendment to a registration (Adviser Registration Guidance).[24]

*Change in Business Organization.* An adviser may file as a successor by amending its Form ADV within 30 days after it changes its form of organization, legal status, or the composition of its partnership without changing the control of the organization. The Staff noted that the dissolution of an entity under state law, and subsequent creation of another entity, presents some uncertainties. In this context, the Staff believes that, when a dissolution is deemed to occur under state law, a new registration by the new legal entity is required within 30 days and this requirement may be fulfilled by *succession by amendment* or, if there has been a practical change in control or management, by *succession by application*.

*Change in Control and Change in Ownership.* In the Adviser Registration Guidance, the Staff discussed the circumstances in which a succession concern is raised during changes in control and changes in ownership. For example, the Staff stated that "if the new controlling party or parties (i) cause an unregistered separate or new legal entity to acquire or assume substantially all of the registered adviser's assets and liabilities and to continue the business of the registered adviser (and that acquired adviser ceases its advisory activities), or (ii) change the registered adviser's form of legal entity, the acquiring or resulting adviser must register and may do so by filing a *succession by application*."[25] The Staff clarified that the "change in ownership of an adviser, *by itself*, does not implicate successor concerns, even if the change in ownership results in a change in control of the adviser."[26]

*Purchase of a Portion of Registered Adviser's Business and Internal Reorganizations.* When an unregistered entity purchases a portion of a registered adviser's business without acquiring or assuming substantially all of the assets and liabilities, the Staff noted that the purchaser is not entitled to rely on the special registration provisions for successors and must wait until its own registration becomes effective before conducting business as an investment adviser. In contrast, when an unregistered entity acquires substantially all of the assets and liabilities of the registered adviser owned by the same parent corporation (internal reorganization or restructuring), the unregistered entity may rely on succession by amendment if the unregistered entity continues to be wholly owned by the same parent corporation. However, the unregistered entity cannot rely on succession by amendment if there is a change of control of the unregistered entity and, in this instance, the unregistered entity must file its own registration application and may rely on succession by application.

### Practical Considerations

The Adviser Registration Guidance conveniently gathers various SEC and Staff statements over the last 25 years relating to predecessor investment adviser registrations and clarifies the Staff's views with respect to certain instances in which an investment adviser may be able to rely on special successor registration provisions and the process by which to do so. Investment advisers that are involved in (or anticipating) relocations, organizational changes, changes in control or ownership, or reorganizations should carefully review the circumstances addressed by the Adviser Registration Guidance and the common questions to which the Staff responds in the Adviser Registration Guidance, which may streamline the adviser's registration process.

## Guidance Update No. 2016-06 – "Mutual Fund Fee Structures" (December 2016)

### Overview

In a guidance update published on December 15, 2016, the Staff articulated its views as to certain issues that many fund companies may find helpful in connection with ongoing developments relating to the sale of mutual fund shares by intermediaries (Fee Structure Guidance).[27] The Fee Structure Guidance clarified the Staff's positions with respect to certain disclosure and regulatory filing matters implicated by intermediary proposals for new share classes and share class structures.

*Background.* In response to various regulatory considerations, including the adoption of the US Department of Labor's "investment advice" regulation, fund intermediaries have been re-evaluating mutual fund sales loads and share class structures.[28] Requests from intermediaries, based on these re-evaluations, raise a variety of issues for fund companies, including the potential for intermediary-specific disclosures in fund prospectuses and/or statements of additional information (SAIs) with respect to variations in sales loads as well as the possible creation of new share classes.

Rule 22d-1 under the 1940 Act furnishes an exemption from the provisions of Section 22(d) of the 1940 Act, which generally prohibits mutual funds, or principal underwriters or dealers, from selling fund shares at a price other than the current offering price described in fund prospectuses (that is, net asset value plus any applicable initial sales load).[29] Pursuant to Rule 22d-1 under the 1940 Act, variations in, or eliminations of, sales loads for "particular classes of investors or transactions" are permissible, provided that, among other things, they are disclosed in accordance with applicable registration statement requirements (such as Item 12(a)(2) of Form N-1A) and uniformly applied.

*Disclosure Requirements.* The Fee Structure Guidance clarified the Staff's belief that intermediary-specific sales load variations are permissible, provided that the variations are disclosed properly in the prospectus (and the summary prospectus, as applicable) and administered uniformly.

The Fee Structure Guidance stated that a fund's prospectus should specifically identify any intermediary to which a particular sales load variation applies (investors who purchase fund shares through the intermediary would be a "class" for purposes of Item 12(a)(2)). Nonetheless, acknowledging industry concerns about lengthy prospectus disclosure regarding sales load variations that may be difficult to understand, the Fee Structure Guidance indicated that the Staff will not object to the use of an appendix to the statutory prospectus as a means for funds to disclose sales load variations, provided that the fund:

- Prominently states, in the appropriate portion of its prospectus, that different intermediaries may impose different sales loads, which are described in an appendix to the prospectus (with such appendix specified by name);
- Includes a cross-reference to the appendix in the narrative introduction to the fee table; and
- Specifically identifies the relevant intermediary by name in the appendix and includes sufficient information to allow an investor to determine which scheduled variation applies to the investor's investment (including any variations based on account type).

In addition, the Fee Structure Guidance provided that the appendix can be in the form of a stand-alone document, so long as the fund:

- Incorporates the appendix into the prospectus by reference and files it with the prospectus;
- States on the front cover of the appendix that it is part of, and incorporated in, the prospectus;
- States on the outside back cover of the prospectus that information about the different sales loads variations is provided in a separate document that is incorporated by reference into the prospectus;
- Delivers the appendix with the prospectus; and
- Posts the appendix on its website (if the fund uses a summary prospectus).

The Staff stated that funds must update their prospectuses or appendices on an ongoing basis to reflect any new or modified sales load variations. However, in many cases, information regarding the sales load structure (or waivers or discounts of sales loads) available through a particular financial intermediary may be updated only upon the receipt of new information from the intermediary.

The Fee Structure Guidance explained that, to "add disclosure about sales load variations, a [f]und will need to file the amendment to its registration statement under rule 485(a) under the Securities Act of 1933" to permit Staff review (which, in this case, would be subject to a 60-80 day review period under the rule).[30]

*Procedural Requirements.* The Staff encouraged registrants to *seek* selective review of a filing that contains disclosure not "substantially different" from previous disclosures made by the fund or fund complex, including when a fund is the first in its complex to implement the new share class or sales load variation.[31] Alternatively, the Staff noted that, if a registrant is making "substantially identical" changes to multiple funds, the registrant can *request* relief under Rule 485(b)(1)(vii) under the Securities Act of 1933 (Template Filing Relief), to eliminate the need for multiple Rule 485(a) filings containing the same changes (referred to as replicate filings).

The Fee Structure Guidance set forth specific procedural requirements for selective review requests and seeking Template Filing Relief, including statements and other information that must be provided in cover letters to the template and replicate filings. In addition, the Staff stated that, to rely on Rule 485(b)(1)(vii), funds must represent that, among other things, the replicate filings "will incorporate changes made to the disclosure included in the Template filing to *resolve any staff comments thereon*."[31] In the Fee Structure Guidance, the Staff also stated that these requests will be considered "as expeditiously as possible."[32]

### Practical Considerations

Although the Fee Structure Guidance clarified the Staff's views on certain matters implicated by intermediary proposals requesting that funds establish new share classes and share class structures, it leaves certain questions unresolved and may not offer sufficient flexibility for funds to react in a timely manner to intermediary proposals (which may continue to evolve). As funds and boards continue to evaluate the Fee Structure Guidance, there are several key considerations that they may wish to take into account, including the following:

- Funds may wish to consider the representations required to request Template Filing Relief consistent with the Fee Structure Guidance, in particular the representation to "resolve any staff comments" to the filing, which might be viewed in light of the Staff's statement in the Fee Structure Guidance that "[n]otwithstanding any request for selective review, we may comment on any portion of a filing."
- Fund management may also wish to consider the timing requirements associated with these filings and requests for effectiveness from intermediaries, particularly whether the time allows for requesting to take advantage of these procedural options.
- When developing disclosure that is responsive to intermediary-specific sales loads and evaluating the appropriate filing process, funds should carefully consider the disclosure surrounding these variations.
- Funds may wish to develop a process to obtain confirmation from intermediaries with respect to the accuracy of the disclosure on a periodic basis.
- Fund management and boards may consider the appropriate level of board involvement in the initial implementation of intermediary-specific variations in sales loads (and future changes to these variations or implementation of additional variations).

## Conclusion

The six guidance updates published by the Staff during 2016 offer insight into the Staff's views and interpretations of discrete issues of interest to the industry. Accordingly, the investment management industry should continue to be mindful and consider the potential implications of the Staff's guidance updates.

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**NOTES**

1 IM Guidance Update 2016-01, "Mutual Fund Distribution and Sub-Accounting Fees" (Jan. 2016), available at *https://www.sec.gov/investment/im-guidance-2016-01.pdf*. As noted in the Sub-Accounting Guidance, examples of these services include maintaining customer financial records, communicating with customers about fund holdings and providing account statements and other similar documentation.

2 In September 2015, the Commission settled an enforcement action resulting from one of these examinations. Investment Company Act Rel. No. 31832 (Sept. 21, 2015) (stating that fund assets were used to pay for distribution and marketing services outside of a plan adopted pursuant to Rule 12b-1, and that the respondents therefore did not bear the additional distribution and marketing expenses not covered by the plan, as had been disclosed).

3 As noted in the Sub-Accounting Guidance, these are referred to in different ways and may cover a range of services, but generally include sub-transfer agent, administrative, sub-accounting and other shareholder servicing fees.

4 The Sub-Accounting Guidance emphasized that this prohibition "applies not only to payments that are clearly identified as distribution fees, but also to payments that are ostensibly made for some other purpose, but which, based on the facts and circumstances, are used in ways that finance distribution." *See* Sub-Accounting Guidance (citing *Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Rel. No. 11414 (Oct. 28, 1980)) (hereinafter Adopting Release).

5 *See* Sub-Accounting Guidance.

6 *Id.*

7 *Id.*

8 *Id.*

9 The Sub-Accounting Guidance set forth several other categories of information that may be relevant to boards in this context, noting that these are in addition to the factors and analysis described in a 1998 letter by the Staff regarding mutual fund supermarket fees, which may also serve as a useful framework in developing this process. *See* Letter from Douglas Scheidt, associate director and chief counsel, Division of Investment Management, Securities and Exchange Commission, to Craig S. Tyle, General Counsel, Investment Company Institute (Oct. 30, 1998). In this letter, the Staff articulated its view that boards are responsible for determining what, if any, portion of fund-paid supermarket fees are for distribution purposes and the portion that finances non-distribution services.

10 The SEC has previously acknowledged that there "has been and continues to be … no precise definition of what types of expenditures constitute an indirect use of fund assets." *See* Adopting Release.

11 *See* Sub-Accounting Guidance.

12 *Id.* In adopting Rule 12b-1, the SEC recognized the conflict of interest that can arise in this context as advisers and other service providers may be incentivized to encourage funds to bear distribution expenses. *See* Adopting Release. In the Sub-Accounting Guidance, the Staff stated that it believes advisers' fiduciary duty to funds "requires advisers either refrain from recommending the payment of mutual fund assets for distribution or to provide complete information to the mutual fund directors so that they can evaluate the conflict, and determine whether the payment should be made pursuant to a 12b-1 plan."

13 The Staff recommended that any sub-accounting and distribution services be "clearly and separately identified and handled appropriately," particularly if the services are provided under a single arrangement. In addition, the Staff articulated its view that it is inconsistent with the requirements of Rule 12b-1 for a board to evaluate "whether the *overall payment* for a bundled set of services or activities is a payment that is primarily for distribution-related services," because the use of fund assets to pay for any activity that is primarily intended to result in the sale of fund shares must be paid inside a 12b-1 Plan (*i.e.,* any specified distribution-related activity must be paid under a 12b-1 Plan, if paid from fund assets). *Id.*

14 The Staff noted in the Sub-Accounting Guidance that Section 36(b) of the 1940 Act deems advisers *and their affiliates* to have a fiduciary duty with respect to the receipt of compensation from funds.

15 IM Guidance Update 2016-02, "Fund Disclosure Reflecting Risks Related to Current Market Conditions" (Mar. 2016), available at *https://www.sec.gov/investment/im-guidance-2016-02.pdf*. Indicating that "[d]egree of risk is dynamic in nature rather than static," the Risk Disclosure Guidance provided the Staff's view that "undertaking [designated] steps on an ongoing basis should help [mutual funds, exchange-traded funds and other registered investment companies] in providing risk disclosures to investors that remain robust in changing market conditions."

16 *Id.* The Risk Disclosure Guidance noted that, with respect to liquidity risks, some funds are disclosing the risks associated with increased redemptions (such as disposing fund holdings during unfavorable conditions, which may reduce returns) and, with respect to Puerto Rico risk, the existence of heightened investment risk under current conditions. *See also* Risk Management in Changing Fixed Income Market Conditions, IM Guidance Update 2014-01

(Jan. 2014) available at *https://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf* (suggesting steps that fund advisers may consider with respect to risk management and disclosure matters relating to changing conditions in fixed income markets).

17 In the Risk Disclosure Guidance, the Staff noted possible options for communicating changes in risk disclosures with investors include formal communications (*e.g.,* in fund prospectuses or shareholder reports) and less formal means (*e.g.,* website disclosure or letters to shareholders).

18 *Id.* The Staff noted its understanding that many boards request reports from advisers regarding the disclosure preparation process.

19 IM Guidance Update 2016-03, FAST Act Changes Affecting Investment Advisers to Small Business Investment Companies (Mar. 2016), available at *https://www.sec.gov/investment/im-guidance-2016-03.pdf*.

20 IM Guidance Update 2016-04, "Business Continuity Planning for Registered Investment Companies" (June 2016), available at *https://www.sec.gov/investment/im-guidance-2016-04.pdf*. On the same day, the Commission proposed new Rule 206(4)-4 under the Advisers Act, which would require every investment adviser registered with the Commission to adopt, implement and annually review a written business continuity and transition plan with certain enumerated components reasonably designed to address the risks of a significant disruption in the adviser's operations. *See Adviser Business Continuity and Transition Plans*, Investment Advisers Act Rel. No. 4439 (June 28, 2016) (Proposing Release).

21 *See* BCP Guidance.

22 The BCP Guidance also noted that the business continuity plans of any "turnkey" service provider or third-party administrator that serves as fund "sponsor" should also be considered for this purpose.

23 *See* BCP Guidance.

24 IM Guidance Update 2016-05, Staff Guidance Concerning Investment Adviser Reliance on Predecessor Registration (Nov. 2016), available at *https://www.sec.gov/investment/im-guidance-2016-05.pdf* (noting the SEC recognized that facilitating the legitimate transfer of business between entities and minimizing the interruption of business support a policy rationale to allow successors to rely on their predecessors' registration).

25 *Id.*

26 *Id.*

27 IM Guidance Update 2016-06, "Mutual Fund Fee Structures" (Dec. 2016), available at *https://www.sec.gov/investment/im-guidance-2016-06.pdf*.

28 President Donald Trump, on February 3, 2017, issued a memorandum directing the US Department of Labor to conduct an economic and legal analysis of the fiduciary rule and to propose rescinding the rule if, among other things, it is determined to be inconsistent with the administration's priorities. Presidential Memorandum on Fiduciary Duty Rule (Feb. 3, 2017), available at *https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule*.

29 The Staff published an interpretive letter on January 11, 2017, which articulated the Staff's position that, under the circumstances described in the letter, "the restrictions of section 22(d) of the 1940 Act do not apply to a broker, when the broker acts as agent on behalf of its customers and charges its customers commissions for effecting transactions" in a class of shares that does not impose any front-end load, deferred sales charge, or other asset-based fee for sales or distribution. The letter expressly did "not address the effect under section 22(d) of a broker receiving revenue sharing payments from the fund's adviser." *See* "Interpretive Letter from Rachel Loko, senior counsel, Division of Investment Management, Securities and Exchange Commission, to The Capital Group Companies" (Jan. 11, 2017).

30 *See* Fee Structure Guidance. The Fee Structure Guidance did not specify whether a fund that has already incorporated sales load variation disclosure into its registration statement through the Rule 485(a) process could include additional intermediary-specific sales load disclosure without the need for another Rule 485(a) filing. When the Staff has had the opportunity to review the structure and content of a fund's sales load

variation disclosure, the addition of new intermediary-specific variations may not automatically trigger the need for a Rule 485(a) filing; funds may wish to consider whether a Rule 485(a) filing is necessary based on the perceived materiality of the changes necessary to add such intermediary-specific disclosure.

31 *See id*. (emphasis added).

32 *Id*.