Opinion

After First Eagle, Boards Must Address Sub-TA Arrangements

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The recently settled case against **First Eagle Investment Management** appears to be the beginning of a concerted effort by the Securities and Exchange Commission to address the issue of disguised distribution fees. This case is the first to come after the SEC's multiyear sweep examination of payments being used for distribution purposes outside of 12b-1 plans.

The First Eagle case is a straightforward enforcement action that did not break any new legal ground. The agreements that the firm executed with two undisclosed broker-dealers, which called for payments to be made from fund assets for distribution and marketing services, were treated as being for sub-transfer agent services, even though the scope of the agreements was much broader. The adviser also failed to properly disclose the true purpose of these agreements to fund directors. In addition, the prospectus disclosures stated – incorrectly – that the adviser would bear any distribution expenses not covered by a Rule 12b-1 plan.

Even so, independent directors should treat this enforcement case as a warning shot and take proactive steps to evaluate more robustly the distribution arrangements of the funds they oversee. Here are three steps directors can take to confirm that their sub-TA arrangements are up to snuff.

Review Fees Paid to Broker-Dealers

The widespread use of omnibus accounts by broker-dealers is generating demands that fund assets be used to pay for shareholder servicing and recordkeeping in the form of sub-TA fees. The use of omnibus accounts – and the payment of sub-TA fees – is replacing the less expensive and more transparent networking platform that provides for automated information-sharing between intermediaries and transfer agents through the National Securities Clearing Corporation, which has been operating this networking platform since 1989.

Broker-dealers want to move their mutual fund customers onto proprietary omnibus account platforms and then charge mutual funds an average of $22 for each account annually for sub-TA services. In contrast, an account that is networked through the NSCC averages less than half of that: about $10.50 per account each year, plus minor NSCC processing costs. With more than 150 million investor accounts in omnibus form, this pricing difference results in more than $1.7 billion a year in recordkeeping overcharges that are being paid for by individual investors.

Directors should examine these high fees because inflated sub-TA payments to large broker-dealer platforms can be interpreted as payments for distribution. This practice is prohibited under Rule 12b-1, which forbids any distribution payments outside of a board-approved 12b-1 plan.

In addition, as representatives of shareholder interests, fund directors must ensure that market-based pricing is used to pay for all recordkeeping expenses. Sub-TA payments to broker-dealers are typically established by a fee schedule, and the prices are often higher than the cost of securing recordkeeping services through a competitive bidding process. Directors should insist on competitive bidding for any broker-dealer services of this type.

Review Sub-TA Services Provided by Broker-Dealers

Fund directors should also keep in mind that mutual funds remain the only issuers of securities that pay any recordkeeping fees at all to third-party financial intermediaries. For other issuers, broker-dealers are compensated directly by each customer for services rendered, through commissions, advisory fees and account maintenance charges. Broker-dealers are required by current SEC and Financial Industry Regulatory Authority rules to provide these administrative services to their customers. Therefore, the payment of sub-TA fees to broker-dealers for these services could allow them to be paid twice for the same services.

As the watchdogs of shareholder interests, fund directors should ensure they are not paying for services that are already being provided to shareholders with fund shares in brokerage accounts. If there is a specific distribution service that a fund adviser needs to have a broker-dealer perform, then that service should be paid for through a 12b-1 plan or from the adviser's own profits.

Insist on Investor-Level Transparency Within Omnibus Accounts

One of the ironies of inflated sub-TA payments is the fact that funds are paying more but getting less in return. A significant problem with omnibus accounts is the lack of transparency at the investor level in this structure. This makes it difficult and expensive for funds to apply their prospectus policies and procedures to shareholders within these broker-dealer accounts.

To protect all shareholders in a fund, directors should make sure that all broker-dealer accounts remain networked on the NSCC platform so that fund distribution activities are separate from recordkeeping. This reduces the board's compliance costs for omnibus accounts. Cumbersome surveillance and audit programs to oversee these aggregated accounts could be replaced by an automated NSCC technology platform that saves money and ensures uniform treatment of all fund investors in applying prospectus policies and procedures.

Fund directors should proactively address the problems with current sub-TA arrangements to reduce costs and better protect their shareholders. They should not wait for the other shoe to drop as the SEC continues its efforts to uncover disguised distribution payments.