Will mutual funds' pay-to-play at brokerages go away?

Fund industry worries about fallout from results of SEC exam sweep on distribution fees

By Mark Schoeff Jr. *Investment News, March 20, 2015 - 1:20 pm EST*

An ongoing Securities and Exchange Commission sweep examination of payments from mutual fund companies to intermediaries such as broker-dealers has the fund industry on edge about whether the agency intends to upend the way funds get their shares into the hands of investors.

Two years ago, the SEC launched a sweep of what it calls “payments for distribution in guise.” Disbursements to finance the marketing of shares to investors, known as 12b-1 fees, are permitted under SEC rules.

In its sweep, the agency is exploring whether money paid by funds to a broker-dealer for services such as record keeping and account management are actually being used to augment marketing payments that ensure the fund has access to the broker's platform.

Results of the exam are expected to be released this spring or summer.

“A title like 'Distribution in Guise' makes you wonder if the examiners might have had a finding in mind before the exam began,” David Blass, general counsel at the Investment Company Institute, said in a speech this week at an ICI conference in Palm Desert, Calif.

The buzz at the conference was that the SEC intends to launch enforcement cases based on exam findings.

“Regulation through enforcement is far from the best way to go about regulating something,” Frank Nasta, managing director and head of JPMorgan Funds Management Legal, said at the ICI conference. “We need to have a full, open and honest discussion.”

SEC officials at the conference tried to assuage the audience.

“We don't intend to do rulemaking by enforcement,” said Andrew Ceresney, director of the SEC Division of Enforcement.

Andrew Bowden, director of the SEC Office of Compliance Inspections and Examinations, said the agency won't prevent broker-dealers from providing account services or limit payments for those services. It's also not implying that there are “hidden fees.”

“The focus of the exam isn't turning the whole system upside down,” Mr. Bowden said at the ICI conference.

Instead, the agency wants to make sure fund boards are being diligent in deciding which payments go for which services.

“When you're a fiduciary and you're confronted with a difficult determination, then what you'd expect to see is a rigorous process, controls, information flow,” Mr. Bowden said. “You would expect to see people really rolling up their sleeves, being independent, being challenging, asking the questions you would expect them to ask.”

Such scrutiny of the boards is unusual, said Mr. Blass, a former chief counsel and associate director of the SEC Division of Trading and Markets.

“Examiners seem to be questioning the business judgment of directors,” Mr. Blass said. “That's a really new concept for the SEC.”

The agency is on the right track, said Niels Holch, executive director of the Coalition of Mutual Fund Investors. He asserts that brokerages are engaged in a “pay-to-play” business model to sell access to their platforms and that the fees are ultimately being borne by investors without their knowledge.

“There are payments being made outside 12b-1 that are conflicted,” Mr. Holch said in an interview.

But parsing fees for different services is more art than science, said Michael J. Downer, senior vice president of Capital Research and Management Co.

“You can get into a metaphysical argument about what is a distribution fee,” Mr. Downer said at the ICI event.