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Distribution of Mutual Fund Shares and Fund Advertising

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MUTUAL FUND DISTRIBUTION – TODAY'S AGENDA

- Multiple Distribution Channels
- Methods of Compensating for Distribution and/or Services
  - Sales Loads
  - Rule 12b-1 Fees/Service Fees
  - Revenue Sharing
  - Sub-transfer Agent Payments
- Omnibus Accounts
- Share Classes

MULTIPLE DISTRIBUTION CHANNELS

- Distribution channels:
  - Direct (No-Load) Channel
  - Broker-Dealer Channel
  - RIA Channel
  - “Supermarket” Channel
  - Retirement Plan Channel
  - Institutional Channel
  - Insurance Company Channel
- Each Distribution Channel
  - Level and types of intermediary services vary
  - Distribution costs and payment structures vary
    - Sales Loads
    - Rule 12b-1 fees current)
    - Service Fees
    - Revenue Sharing Payments
    - Sub-transfer agent-type fees from Funds
  - Multiple share classes

MULTIPLE SHARES CLASSES

- Rule 18f-3
  - Permits mutual funds to issue multiple classes of voting stock representing interests in the same portfolio
  - Classes must differ in how they distribute their securities, in the services they provide to shareholders, or both
  - Allocation of income and expenses among classes
  - Master-Feeder Structure – An alternative to multiple share classes permitted by SEC interpretations

SHARE CLASSES

- Class A
  - Front-end sales load
  - 12b-1 fee (service fee ~ 25 basis points)
  - Breakpoints may be available
- Class C
  - Level 12b-1 fees (asset-based sales charge and service fee ~ 100 basis points)
  - CDSC of 1% in the first year
- Institutional
  - No-load and no or low 12b-1 fee
  - Retirement/RIA
- Retirement
  - Different levels of fees (Class R Shares)
- Clean Shares
  - No-load
  - No 12b-1 fees

SALES LOADS

- Front-end Sales Load
  - Upfront fee that decreases amount of investment
  - Section 22(d) – fixes sales load and prevents variations
  - Rule 22d-1 permits disclosed variations in sales loads on class level (e.g., breakpoints)
- Deferred Sales Load ("CDSC" or "back-end")
  - Investor pays load, if any, at redemption pursuant to Rule 6c-10
  - Load based on lesser of offering price at purchase or specified % of NAV
- No Load
  - Adviser pays for distribution from its profits
  - Fund can be "no load," even if charges up to a 25 basis points fee from fund assets
- Amount of loads limited by FINRA Conduct Rule 2341

CAPITAL GROUP INTERPRETIVE LETTER

- On January 11, 2017, the SEC staff issued an interpretive letter clarifying the application of Section 22(d) to underwriters, dealers, and brokers of mutual funds
- The interpretive letter clarifies that the restrictions of Section 22(d) do not apply to a broker when it acts as agent on behalf of its customers and charges its customers commissions for effecting transactions in “Clean Shares”
- The interpretive letter defines Clean Shares as a class of shares of a mutual fund without any front-end load, deferred sales charge, or other asset-based fee for sales or distribution
- Certain financial intermediaries have requested that fund groups offer Clean Shares, so fund groups have responded either by restructuring existing share classes to meet the definition or launching a new share class altogether

SUITABILITY OF SHARE CLASS – FINRA CONDUCT RULE 2310

- Considerations for share class suitability include:
  - Investment amount (are load reductions available?)
  - Expected term of the investment
  - Sales loads, fees, and expenses
- These factors affect the total return on the investment
- An intermediary duty; not a mutual fund duty
- Remember also Regulation BI

RULE 12B-1 FEES

- Rule 12b-1 (adopted in 1980) permits funds to use fund assets to directly pay for distribution expenses:
  - Written plan
    - Initially approved by directors (including majority of independent directors)
    - Initially approved by shareholders (unless adopted prior to public sales of fund shares)
    - Annual approval of directors (including majority of independent directors)
  - Board approval
    - Finding that there is “reasonable likelihood that plan will benefit fund and shareholders”
  - Board quarterly review of written report of amounts spent and reasons for expenditures

RULE 12B-1 FEES *(CONTINUED)*

- Distribution and/or service expenses:
  - Compensate intermediaries for ongoing advice and/or services to current investors
  - Compensate intermediaries for administrative services to current investors (e.g., recordkeeping, account statements to investors)
  - Advertising, printing and mailing prospectuses and sales materials to prospective investors

RULE 12B-1 FEES *(CONTINUED)*

- Maximum fee limited under FINRA Conduct Rule 2341
  - 100 basis points maximum
    - 75 basis points maximum for asset-based sales charge
    - 25 basis points maximum for service charge
  - NASD Notice to Member 93-12 defines “service fees”
- Rule 2830 limits aggregate amount of sales load and/or 12b-1 fee
- Used as alternative or in addition to a sales load
  - Issues: transparency and complexity

RULE 12B-1 FEES *(CONTINUED)*

- Some 12b-1 plans are structured as so-called "reimbursement' plans
- Some 12b-1 plans are structured as so-called "compensation" plans

REVENUE SHARING

- Fund adviser or affiliate pays for fund distribution
- Adviser can pay from “legitimate” profits that are not “excessive” per SEC interpretation
  Disclosure of revenue sharing arrangements
  - Fund disclosure
  - Possible point of sale disclosure
- Permitted for Clean Shares

OMNIBUS ACCOUNTS

- The Growth in Use of Such Accounts
- Permissible Services
- Increased Fees/Source of Payments
- SEC Guidance Regarding Payments (1998)
- FINRA Guidance Regarding Payments (1993)(NTM 93-12)
- Required Findings by Mutual Fund Boards
- Developing Due Diligence Activities

DISTRIBUTION IN GUISE HISTORY

- 1980: Adoption of Rule 12b-1
- 1998: ICI Supermarket Letter
- Evolution of mutual fund marketing and sales efforts (e.g., introduction of omnibus accounts)
- 2014-2015: SEC "distribution in guise" sweep examinations
  - "These exams…highlighted the need to clarify and update our existing guidance"
  - The Staff focused on the payment of fees by funds to intermediaries characterized by funds as non-distribution-related fees, including sub-transfer agent, administrative, sub-accounting, and other shareholder servicing fees ("sub-accounting fees")

SEC STAFF GUIDANCE

- SEC has increased scrutiny of payments to intermediaries out of fund assets, both in the inspection and enforcement context, in recent years
- The Staff noted that the sweep exams raised questions as to whether part of sub-accounting fees being paid out of fund assets were actually for distribution-related activity, a practice the staff termed “distribution in guise”
- January 2016: IM Staff issues a Guidance Update titled “Mutual Fund Distribution and Sub-Accounting Fees”
- The Guidance Update notes that “[m]utual fund fees have a direct impact on investor returns. For example, because investors may evaluate funds based on the specific levels of 12b-1, management, and other fees, potential mischaracterization of fees may lead them to invest in funds that they would not otherwise have selected…in light of this possibility, as well as the potential for the inappropriate use of fund assets and the prohibition of Rule 12b-1(a) on a mutual fund directly or indirectly paying for distribution-related activities outside of a Rule 12b-1 plan, the staff [makes these recommendations]”

SEC STAFF GUIDANCE

- The Staff's guidance makes recommendations in three primary areas.
  - That a mutual fund board have a process that is "reasonably designed" to evaluate whether a portion of sub-accounting fees are being used to pay directly or indirectly for distribution
  - That advisers and other service providers provide the board with sufficient information to inform the board of an overall picture of intermediary distribution and servicing arrangements
  - That advisers and other service providers inform the board if certain activities or arrangements that are potentially distribution-related exist in connection with the payment of sub-accounting fees, and if so, the board evaluate the appropriateness and character of those payments

CLOSING STAFF OBSERVATIONS

- A board should be able to rely on the adviser and other service providers to affirmatively provide information about the existence of any of these activities and arrangements
- Advisers and service providers should also provide summary data about expenses and activities related to distribution-related activities
- A 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" [Emphasis added]
- Fund directors could receive and rely on the assistance of outside counsel, the fund's CCO, or personnel from the adviser or other service providers to assist them in making these judgments
- A board may wish to request that the information be provided in a clear concise manner with summaries and overview documents

SEC'S SHARE CLASS SELECTION DISCLOSURE INITIATIVE

- In February 2018, the SEC's Division of Enforcement announced its Share Class Selection Disclosure Initiative, resulted in settled charges against dozens of investment advisers who, according to the SEC, directly or indirectly received Rule 12b-1 fees for investments selected for their clients without adequate disclosure, including disclosures that were inconsistent with the adviser's actual practices.
- The SEC's orders found the settling investment advisers placed their clients in mutual fund share classes that charged 12b-1 fees when lower-cost share classes of the same fund were available to their clients without adequately disclosing that the higher cost share class would be selected
- According to the SEC's orders, the 12b-1 fees were routinely paid to the investment advisers in their capacity as brokers, to their broker-dealer affiliates, or to their personnel who were also registered representatives, creating a conflict of interest with their clients, as the investment advisers stood to benefit from the clients' paying higher fees

SEC MUTUAL FUND ADVERTISING

WHAT CONSTITUTES AN "OFFER"?

- Section 5 of the 1933 Act prohibits offers (broadly defined) of securities except through a Section 10 prospectus
- The following rules define what constitutes a compliant prospectus for purposes of a Section 5 offer:
  - N-1A: Must be effective or "red herring"
  - Rule 482: "Omitting prospectus"
  - Rule 134: Tombstone advertising
  - Rule 135(a): Generic advertising
  - Rule 498: Profile prospectus
  - Rule 34b-1: Supplemental sales literature
- Rules differ based on the fund's stage (*i.e.*, pre-registration, registration, post-effective)
- SEC voted to propose amendments to modernize Advisers Act advertising rules on November 4, 2019

STAGES IN THE OFFERING PROCESS

(1) Pre-Registration Period
(immediately preceding filing)

- Cannot precondition the market
- No offers, sales, sales literature or promotional activities

(2) Registration Period
(between filing and declaration as effective)

- "Red Herring" prospectuses
- Rule 482 "omitting prospectuses"

(3) Post-Effective Period
(after registration is declared effective)

- Full "statutory" prospectus may be distributed freely
- Rule 482 "omitting prospectuses" may be used in newspaper, magazine, radio, television, and web, or mailed to potential investors
- Rule 135a generic advertisements may be distributed without a prospectus
- Rule 498 profile prospectus may be used in advertisements
- "Supplemental Sales Literature" may be used if accompanied by or preceded by the statutory prospectus

RULE 482: "OMITTING PROSPECTUS"

- Rule 482 is the primary mutual fund advertising rule and permits the presentation of performance data, subject to the following requirements:
  - Must generally be consistent with Form N-1A, but is not limited to information in the fund's filed Form N-1A
  - Must disclose availability of prospectus, source of prospectus and that the investor should read the summary prospectus carefully before investing
  - Performance data must be calculated in accordance with instructions to Form N-1A, as of the most recent practicable date
  - Required performance disclosures:
    - Past performance does not guarantee future results
    - Return and principal will fluctuate
    - Contact information for current performance data
    - Whether performance reflects sales load, and that it would be lower if it did
  - Required disclosures must be presented in a font (i) of at least the same size and (ii) of a different style

RULE 135A: GENERIC ADVERTISING

- Rule 135A applies to generic communications that are not an offer to buy fund shares and do not refer to a particular fund or security
- Communications *may* contain:
  - Explanatory information as to mutual fund shares generally, or to the nature of mutual funds, or to shareholder services
  - Explanatory information as to generic types of mutual funds (*e.g.*, balanced, growth, income, stock, bond)
  - Offers of services that are not securities and do not directly relate to mutual funds (*e.g.*, bank accounts permitted, mutual fund wrap fee accounts not permitted)
  - Invitation to inquire for further information
- Communications *must* contain the name and address of the fund sponsor

SUPPLEMENTAL SALES LITERATURE

- Supplemental sales literature includes all marketing materials that must be preceded or accompanied by a prospectus
  - May contain any information that is not misleading (Rule 34b-1)
- Newsletters can contain both Rule 482 and Rule 135A material, provided that Rule 482 material is segregated and presented as a separate unit
  - Disclosure and prominence rules must be followed
- Rule 156 sets forth a general rule that no sales material (whether or not relying on another rule) can be materially misleading or omit to state a material fact

USE OF RELATED PERFORMANCE

- At times, a new fund, with no (or a short) performance track record of its own, may seek to include in its prospectus the performance record of other funds or private accounts managed by the fund's investment adviser. This is referred to as "related performance."
- The SEC staff has expressed the view in various no-action letters that a fund may include in its prospectus related performance information; provided that the information is not presented in a misleading manner and does not obscure or impede understanding of information that is required to be included in the fund's prospectus (including the fund's own performance information).
- If the fund includes related performance information, it should not exclude the performance of any separate account or other fund if the exclusion would cause the performance shown to be materially misleading or higher than would be the case if other accounts or funds were included.
- **Note**: In fund advertisements subject to FINRA regulation, related performance information generally is not permitted unless the communications are distributed solely to institutional investors.

FINRA ADVERTISING RULES

FINRA ADVERTISING RULES: OVERVIEW

- FINRA Rules 2210 and 2211 replaced with FINRA Rules 2210 and 2212-2216 (effective February 4, 2013)
- Restructures communications into 3 categories:

Retail Communication	Any written (including electronic) communication that is distributed or made available to more than 25 **retail investors** within any 30 calendar-day period
Correspondence	Any written (including electronic) communication that is distributed or made available to 25 or fewer **retail investors** within any 30 calendar-day period
Institutional Communication	Any written (including electronic) communication that is distributed or made available only to **institutional investors**, but does not include a member's internal communications

INSTITUTIONAL VS. RETAIL INVESTORS

- **Institutional Investors:**
  - Banks, savings and loan associations, insurance companies
  - Government entities, employee benefit plans and qualified plans, FINRA members
  - Individuals and entities with total assets of $50 million
    - **Note**: If talking to a potential client who is a natural person, keep the $50 million threshold in mind
- **Retail Investors:**
  - Any person other than an “institutional investor,” regardless of whether the person has an account with the firm

FINRA REGULATION AND REVIEW

- All retail communications that promote a specific registered investment company or family of registered investment companies must be filed with the SEC or, if used by a FINRA member, with FINRA
- FINRA reviews to ensure sales materials are fair, balanced, in good faith, not misleading, and compliant with FINRA rules
- Specific requirements include:
  - Disclose name (as disclosed on Form BD) of FINRA member using the material
  - If performance data is presented, disclose maximum front-end load, CDSL and annual operating expense ratio in prominent text box
  - Fund ranking guidelines
  - Investment analysis tools
  - Bond fund volatility ratings
- **Note**: Compliance with the rules does not relieve a fund of the obligation to ensure the advertisement is not false or misleading

GENERAL CONTENT STANDARDS

- **FINRA Rule 2210(d)(1)(A)**: All communications must be based on principles of fair dealing and good faith, fair and balanced, and must provide a sound basis for evaluating facts with respect to any security, industry or service
- Generally, communications may not be false or misleading. Considerations include:
  - Context of statements: Statements must be clear and not misleading within the context in which they are made
  - Nature of audience to which communication is directed: Communications must provide details and explanations appropriate to the audience
  - Clarity of communication: Unclear statements can cause a misunderstanding

GENERAL CONTENT STANDARDS *(CONT.)*

- Communications must be **fair and balanced**:
  - Discussion of rewards must provide balanced treatment of risks and potential benefits
  - Must provide sound basis for evaluating facts in regard to any particular security or type of security, industry or service
- Must not **omit any material fact** or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading
- Must be able to **substantiate all claims**
  - Retain supporting materials for all claims made in a communication
- Must have reasonable basis for any recommendations made
- **Avoid superlatives**. Cannot make false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication
  - *e.g.*, “unparalleled,” “best in class,” “world-class,” “best of breed,” etc.

GENERAL CONTENT STANDARDS *(CONT.)*

- **Footnotes**. Placement of information in footnotes permitted only if placement would not inhibit investor's understanding of the communication
- No model or hypothetical backtested performance
- **Avoid performance projections**. Cannot predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast
  - Exceptions: hypothetical illustration of mathematical principles, investment analysis tools and price targets
- If the communication includes a **price target**, it must:
  - Have a reasonable basis for the price target
  - Disclose the valuation methods used to determine the price target
  - Disclose all risks that may impede achievement of the price target

RISK DISCLOSURES

- Risk disclosures must be clear and conspicuous
- Sales material must be able to stand on its own
  - Can refer to other documents (*e.g.*, prospectus), but cannot simply incorporate by reference
- All communications with the public must provide a balanced presentation of risk and reward
  - For example, a detailed discussion of reward or a discussion of higher risk products would require a more fulsome discussion of risks
- Regulation through enforcement: No clear guidance from FINRA

USE OF RELATED PERFORMANCE

- Related performance information is defined by FINRA as:
  - The actual performance of all separate or private accounts or funds that have (i) substantially similar investment policies, objectives, and strategies; and (ii) are currently managed or were previously managed by the same adviser or sub-adviser that manages the registered fund that is the subject of the communication with institutional investors
- FINRA Interpretive Letter to Edward P. Macdonald, Hartford Funds Distributors, LLC (May 12, 2015)
  - Permitted use of related performance information in communications distributed solely to institutional investors regarding **open-end registered funds**
- FINRA Interpretive Letter to Clair Pagnano, K&L Gates LLP, on behalf of Evanston Alternative Opportunities Fund (June 9, 2017)
  - Extended the position of the *Hartford Letter* to permit use of related performance information in communications distributed solely to institutional investors regarding **continuously offered closed-end funds**

USE OF RELATED PERFORMANCE *(CONT.)*

- Related performance information may be provided only to persons who qualify as "institutional investors" (excluding institutional investors who intend to share the related performance information with persons other than institutional investors), and subject to certain additional conditions, including:
  - Includes all accounts within the definition of related performance information.
    - If there are multiple related accounts, the investment performance of such accounts will be presented in a composite or a list (in which the investment performance of each account will be displayed with equal prominence).
  - Is clearly labeled "for use with institutions only, not for use with retail investors."
  - Is net of fees and expenses of the related accounts. The composite's gross performance may be shown alongside the net performance, subject to certain disclosure requirements.
  - Is for a period of at least one year and since the inception of the investment strategy and current at least as of the most recently-ended calendar quarter.
  - Is clearly labeled as related performance and discloses the applicable dates for the performance.
  - Discloses any material differences between the funds or accounts for which related performance information is provided and the fund.

QUESTIONS?

K&L GATES