BerkeleyLaw
UNIVERSITY OF CALIFORNIA
Berkeley Center for Law,
Business and the Economy

University of California, Berkeley
School of Law
2850 Telegraph Ave, Suite 500
Berkeley, CA 94705-7220

Ph: 510.642.0532 – Fax: 510.643.7095
E-mail: BCLBE@law.berkeley.edu
http://www.law.berkeley.edu/bclbe.htm

SEC Cracks Down on Hidden Mutual Fund Fees

By Sean Pinckney, J.D. Candidate 2018 | October 9, 2015

In what could be the tip of a legal iceberg, the Securities Exchange Commission ("SEC") filed proceedings on September 21st against First Eagle Investment Management, a $100 billion asset manager. The SEC alleged that First Eagle illicitly charged its investors nearly $25 million more in marketing fees beyond the limits allowed by the firm's 12b-1 plan. The action against First Eagle is the first case of its kind arising under the SEC's "Distribution-in-Guise Initiative," an investigation into whether mutual fund managers are improperly disguising certain expenses as those that should be borne by investors and not the funds themselves. First Eagle reached a settlement with the SEC for over $40 million without admitting or denying the findings and will be returning the unlawfully charged fees to affected investors.

Distribution fees are of particular concern to the SEC given the conflicting interests inherent to the asset management industry. Fund managers charge investors a management fee, usually a small percentage of the total assets under management. The management fee is disclosed in the fund's prospectus and is available on websites such as Morningstar. Since fund managers are paid more with larger amounts of assets under management and are the beneficiaries of fund marketing, the SEC instituted Rule 12b-1 to limit the amount of investors' money that can be used for marketing purposes and shifted the rest of the distribution expenses on to the managers.

Experts such as Barbara Roper of the Consumer Federation of America believe that this is the first of many Rule 12b-1 charges against mutual fund managers since allegations of impropriety in distribution fees are quite opaque and the SEC has a strong interest in protecting investors. Even a 0.75% distribution fee, the maximum allowed under Rule 12b-1, can weigh on investor performance when combined with already existing management fees and difficult-to-calculate trading fees.

First Eagle's improper practices allegedly began in 2008 amid a wave of investor outflows. The fund started using more investor money than legally permitted to supplement marketing expenses and to attract additional capital, generating significant inflows in the years during which the alleged Rule 12b-1 violations occurred. With some segments of the market experiencing investor outflows in recent months, asset managers may seek aggressive marketing strategies to bring in new capital. Burgeoning Rule 12b-1 enforcement by the SEC may cause mutual funds to approach future marketing outreach with additional prudence.