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SEC Staff Denies Request for No-Action Relief Concerning Allocation of Certain Fund of Fund Operating Expenses to Underlying Funds in the Same Fund Family

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On October 26, 2017, the staff of the SEC's Division of Investment Management denied granting no-action assurances under Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 thereunder to Mutual of America Capital Management LLC (MoA) regarding the proposed allocation of certain non-advisory operating expenses among funds in the Mutual of America Life Insurance Company fund complex for which MoA serves as investment adviser. After consulting with the Division of Enforcement, the Division of Investment Management denied the request for no-action relief "as a caution" to MoA and others against establishing an arrangement similar to that described below outside the parameters and conditions of an exemptive order granted under Rule 17d-1.

Request for No-Action Relief

Section 17(d) of the 1940 Act generally provides that no affiliated person of or principal underwriter for a registered investment company, and no affiliated person of such a person, may effect a transaction in which the investment company is a joint or joint and several participant in contravention of applicable SEC rules. Rule 17d-1 under the 1940 Act generally provides that no affiliated person of or principal underwriter for a registered investment company, and no affiliated person of such a person, may participate in or effect a transaction in connection with "any joint enterprise or other joint arrangement or profit-sharing plan" in which the registered investment company is a participant without first obtaining an exemptive order from the SEC.

MoA sought assurance from the SEC staff that it would not recommend that the SEC pursue an enforcement action under Section 17(d) of the 1940 Act or Rule 17d-1 thereunder if the non-advisory operating expenses of the fundsof-funds in its complex—i.e., costs of legal and compliance services, costs of printing and distribution of fund prospectuses and shareholder reports, as well as certain licensing fees and directors, legal and auditing, and custodial fees—were allocated to underlying funds in the complex without first obtaining exemptive relief under Rule 17d-1.

In its request for no-action relief MoA emphasized that:

(1) the proposed expense allocation methodology would be subject to approval, prior to

implementation, by the funds' board, including the independent directors, and periodically monitored thereafter by the board;

(2) the allocation of expenses would be disclosed to all fund shareholders;

(3) the amounts of the expenses at issue are expected to be immaterial (i.e., not expected to exceed one half cent per share for any fund);

(4) all funds would benefit since the funds-of-funds are primarily a means of distributing the underlying funds and, by attracting new assets to the entire fund complex, the funds-of-funds would reduce the expense ratio of all funds by an amount exceeding the extra expenses to be borne by the underlying expenses under the proposed methodology; and

(5) the funds should not be considered affiliated persons with each other for purposes of the proposed expense allocations.

As to the issue of affiliation, MoA cited prior SEC guidance regarding Rule 17d-1 indicating that it does not stand for the premise that funds with common officers, directors or investment advisers are always affiliated persons: "[t]hey may or may not be, depending on the facts" (internal citations omitted). MoA also stated that "[i]n most instances in which funds are deemed to be affiliated with each other by virtue of being managed by the same adviser, the conduct at issue is directed by the adviser," such as in the case of joint trading for funds. Here, MoA contended, "there is no such control by the adviser," and "[i]f anyone "controls" the funds in this case, it is their Independent Directors." On this point, MoA added, "the role of independent directors has never been held to be sufficient to create affiliation among funds."

MoA further argued that even if the funds were deemed to be affiliated with each other, the proposed expense allocation should not be prohibited since "abuses that Section 17(d) were designed to prevent are simply not present" and decisions by independent directors about expense allocations should not constitute a "joint enterprise or other joint arrangement" within the meaning of Rule 17d-1 that would necessitate an exemptive order. MoA also asserted that "[t]here is no precedent in which the allocations of expenses among funds in a fund complex, including those between funds-of-funds and underlying funds, has been found to violate Rule 17d-1," adding that "these types of expense determinations are done by all fund complexes, and few, if any, seek exemptive orders from the SEC."

The Staff's Response

In denying MoA's request for no-action relief, the SEC staff emphasized that "some of the operating expenses proposed to be allocated to the Underlying Funds would not be incurred by, or otherwise attributable to, the Underlying Funds, but rather would be incurred by or attributable solely to the Fund of Funds." The staff stated that this "creates the potential for conflicts of interest and for participation by a Fund on a basis less advantageous than that of other participants, that is not present (or present to a much lesser degree) in the typical industry practice of allocating certain shared expenses among the relevant funds in a fund family without an order under rule 17d-1." Accordingly, the staff determined that its review under Rule 17d-1 was necessary in order to "guard against such conflicts to help ensure that each Fund's participation is consistent with the provisions, policies and purposes of the [1940] Act and no less advantageous than that of other participants."

The staff also challenged MoA's assertion that pursuing the proposed expense allocation without first

obtaining exemptive relief is consistent with industry practice and the staff's previous guidance, noting that "[t]he industry practice over the past 30 years with respect to arrangements such as the proposed expense allocation among the Fund of Funds and the Underlying Funds has been to seek Commission orders under rule 17d-1 prior to implementing the arrangements."

In addition, the staff stated that, as in prior similar instances, it "view[s] the proposed allocation of the Fund of Funds' expenses among the Underlying Funds as an arrangement effected by the Adviser in which the Fund of Funds and the Underlying Funds have a joint participation within the meaning of rule 17d-1(c) and which requires a Commission order pursuant to rule 17d-1(a) under the [1940] Act."

The SEC staff's response denying the requested relief is available here: https://www.sec.gov/divisions/investment/noaction/2017/mutualamericacapitalmanagement102617.htm

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