



May 10, 2004

Mr. Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Re: Prohibition on the Use of Brokerage Commissions to Finance  
Distribution (File No. S7-09-04)

Dear Mr. Katz:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to express its views on the Securities and Exchange Commission's proposal to amend Rule 12b-1 under the Investment Company Act of 1940 to prohibit mutual funds from paying for the distribution of their shares with brokerage commissions.<sup>2</sup> The Institute generally supports the Commission's proposal, which is consistent with a recommendation made by the Institute in a December 2003 letter to Chairman Donaldson.<sup>3</sup> A critical difference between the two proposals, however, is that the Institute coupled its recommended ban on directed brokerage with a safe harbor so that a mutual fund's legitimate brokerage allocations would not be second-guessed. We continue to believe that a safe harbor is needed.

The Institute also welcomes the opportunity to respond to the Commission's request for comment on whether it should propose additional changes to Rule 12b-1 to address other issues that have arisen under the rule, or propose to rescind the rule. We agree with the conclusion of the Commission's Division of Investment Management in its 2000 study of mutual fund fees and expenses that the Commission should consider certain modifications to Rule 12b-1 to reflect the many developments in fund distribution practices since the rule's adoption in 1980 and the experience gained from observing how the rule has operated.<sup>4</sup> In particular, the Institute recommends that the Commission: (1) update its guidance to fund directors concerning the factors that directors may wish to consider in approving a 12b-1 plan; and (2) eliminate the

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<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,595 open-end investment companies ("mutual funds"), 612 closed-end investment companies, 124 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members have assets of about \$7.554 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

<sup>2</sup> SEC Release No. IC-26356 (Feb. 24, 2004); 69 Fed. Reg. 9726 (Mar. 1, 2004) ("Proposing Release").

<sup>3</sup> See Letter from Matthew P. Fink, President, Investment Company Institute, to the Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, dated Dec. 16, 2003.

<sup>4</sup> See Division of Investment Management, Securities and Exchange Commission, "Report on Mutual Fund Fees and Expenses" (Dec. 2000) ("SEC Staff Fee Study") at 39. Citations in this letter to the SEC Staff Fee Study are to the version available on the Commission's website.

quarterly reporting requirement. We believe that these changes would appropriately modernize Rule 12b-1 without compromising investor protection.

## **I. Directed Brokerage Arrangements**

### **A. Proposed Ban on Directed Brokerage**

Under the proposal, Rule 12b-1 would be amended to prohibit a mutual fund from compensating a broker-dealer for promoting or selling the fund's shares by directing portfolio securities transactions to that broker-dealer. The amended rule also would prohibit a mutual fund from engaging in step-out and similar arrangements that compensate broker-dealers for selling the fund's shares.

The Institute supports the proposed prohibition. Under current law, a mutual fund adviser may consider sales of fund shares in allocating brokerage subject to various conditions, including that the adviser does so only on an "after the fact" basis and the broker-dealer is providing best execution.<sup>5</sup> Despite these restrictions, the Institute has concluded that prohibiting the allocation of brokerage based on sales considerations is warranted because the practice of directed brokerage can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts, given the fact-specific nature of the best execution determination.

### **B. Policies and Procedures**

Under the proposal, Rule 12b-1 would be amended to provide that a mutual fund may not direct portfolio transactions to a broker-dealer unless it (or its adviser) has implemented policies and procedures reasonably designed to prevent: (1) the persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities from taking broker-dealers' promotional or sales efforts into account in making those decisions; and (2) the fund, its adviser, or its principal underwriter from entering into any arrangement or understanding under which the fund directs brokerage transactions, or revenue generated by those transactions, to a broker-dealer to pay for distribution of the fund's shares. The fund's board, including a majority of the independent directors, would have to approve the policies and procedures. The Institute supports the proposed requirement. Implementation of the types of policies and procedures described above would facilitate a mutual fund's compliance with the proposed ban on directed brokerage arrangements, while at the same time preserving the fund's ability, in each instance, to select a broker-dealer able to provide best execution for a particular portfolio transaction.<sup>6</sup>

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<sup>5</sup> NASD Conduct Rule 2830(k). NASD has filed with the SEC a proposal to amend that rule to prohibit broker-dealers from selling the shares of any mutual fund that considers fund sales in making its brokerage allocation decisions. *See Proposed Amendment to Rule Relating to Execution of Investment Company Portfolio Transactions*, File No. SR-NASD-2004-027 (Feb. 10, 2004). We urge that the Commission take prompt action on the NASD's proposal so that the effective dates of the prohibitions on directed brokerage under Rule 12b-1 and NASD Conduct Rule 2830(k) would coincide.

<sup>6</sup> Such policies and procedures could include, for example: (1) placing brokerage allocation determinations under the control of trading and investment personnel; (2) affirmatively prohibiting marketing considerations from playing any role in brokerage allocation; and (3) periodic review by fund boards.

### **C. Safe Harbor**

The Proposing Release requests comment on whether the Commission should include a safe harbor in the rule for mutual funds that execute portfolio securities transactions with broker-dealers that sell their shares.<sup>7</sup> The Institute believes that adoption of a safe harbor is critical. As we explained in our December letter to Chairman Donaldson, a ban on the allocation of brokerage based on sales could have the potential to improperly discourage a fund from directing portfolio transactions to broker-dealers that sell the fund's shares, for fear of being second-guessed. This could result, in some cases, in funds not using the brokerage firm that would be best suited for executing a trade. Moreover, in today's world of integrated financial services firms, most of the major broker-dealers that funds typically use for execution services are also major distributors of fund shares. It is also the case that mutual funds often have selling agreements with hundreds of broker-dealer firms. Consequently, it might be almost impossible for funds to avoid directing portfolio transactions to broker-dealers that sell their shares. In the absence of a safe harbor, a mutual fund could run the risk of being challenged by regulators or class-action attorneys each time it directed a portfolio transaction to a major broker-dealer firm.

To address this concern, the Institute recommends that the Commission adopt a safe harbor stating that no mutual fund would be deemed to have violated the ban on directed brokerage arrangements solely by reason of having directed portfolio transactions to a broker-dealer that also sells the fund's shares, if the fund has implemented, and its board of directors (including a majority of its independent directors) has approved, policies and procedures as outlined in Section B above. The safe harbor should relate to both Rule 12b-1 and Section 17(e)(1) of the Investment Company Act.<sup>8</sup> The adoption of a safe harbor along these lines would ensure that selection of a broker-dealer that sells a fund's shares to execute portfolio transactions for that fund would not, in and of itself, subject the fund to potential liability. Further, we believe that such a safe harbor would not compromise investor protection, because implementation of the types of policies and procedures contemplated by the Commission's proposal should provide adequate assurances that a fund's brokerage allocations would not be influenced by sales considerations.

### **D. Other Measures**

The Proposing Release requests comment on whether the Commission, in addition to requiring funds to implement policies and procedures, should adopt other measures to help funds monitor the use of fund brokerage, such as requiring: (1) fund directors to approve the allocation of brokerage; or (2) an official of the fund or its adviser to certify periodically that the fund's brokerage allocation decisions were made without considering a broker-dealer's promotion or sale of fund shares.<sup>9</sup> In the Institute's view, these sorts of additional requirements

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<sup>7</sup> Proposing Release at 9731.

<sup>8</sup> See Proposing Release at 9729 n.45 (stating that the use of fund brokerage commissions to finance distribution for the economic benefit of the fund's adviser raises questions under Section 17(e)(1)).

<sup>9</sup> Proposing Release at 9731.

are unnecessary in light of the protections that would be afforded by a fund's adoption of the proposed policies and procedures.<sup>10</sup> As the Proposing Release notes, the proposed policies and procedures are "designed to ensure the active monitoring of brokerage allocation decisions when executing brokers also distribute the fund's shares."<sup>11</sup> This monitoring by fund management and the fund's chief compliance officer ("CCO"),<sup>12</sup> coupled with board oversight, should provide sufficient assurances that, on a going forward basis, brokerage allocation decisions will not be influenced by broker-dealers' distribution efforts.

## **E. Transition Period**

The Institute recommends that the proposed ban on directed brokerage arrangements, if adopted by the Commission, become effective 120 days after the date that the Commission approves final amendments implementing the ban. A transition period of this length should provide sufficient time for mutual funds to implement, and their boards of directors to approve, the policies and procedures described above.<sup>13</sup>

## **II. Comment on Further Amendments to Rule 12b-1**

### **A. Introduction**

The Proposing Release requests comment on whether the Commission should propose additional changes to Rule 12b-1 to address other issues that have arisen under the rule, or even propose to rescind the rule.<sup>14</sup> The Institute believes that a reevaluation of the rule and how it operates today is timely and prudent. Given the significance of the rule and its widespread use, the Institute commends the Commission for soliciting the views of all interested parties before determining what other specific changes to the rule, if any, it should propose.

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<sup>10</sup> More specifically, the Institute believes that requiring a fund board to approve the adviser's brokerage allocation decisions would involve fund directors in operational issues to an extent that is inconsistent with their oversight function. With respect to certification, we believe that it would place fund management officials in the difficult position of having to prove a negative (*i.e.*, that brokerage allocation decisions did not involve sales considerations). Further, a certification requirement could inappropriately suggest that a fund's compliance with a prohibition on directed brokerage is more important than a host of other regulatory requirements to which mutual funds are subject.

<sup>11</sup> Proposing Release at 9731.

<sup>12</sup> Pursuant to Rule 38a-1 under the Investment Company Act, a fund's CCO will be responsible for administering the fund's policies and procedures. At least annually, the fund will have to review the adequacy of its policies and procedures, and the CCO will have to provide a written report to the board addressing, among other things, the operation of the policies and procedures and any material changes made (or recommended to be made) to them since the date of the last report.

<sup>13</sup> The Institute requests that the Commission clarify that funds would not be required to make any conforming changes to their registration statements until the time of their next regularly scheduled update. Under current law, a fund that may consider sales of its shares as a factor in selecting broker-dealers to execute portfolio transactions is effectively required to disclose this policy in its prospectus. *See* NASD Conduct Rule 2830(k)(7)(B). If the Commission adopts the proposed ban on directed brokerage arrangements, funds would need to delete this language from their prospectuses. We believe that there would be no harm in permitting funds to retain this language in their prospectuses until their next regularly scheduled update.

<sup>14</sup> Proposing Release at 9731.

Over the past 25 years, there have been dramatic changes in how mutual funds are sold to the investing public. Before 1980, all funds had a single share class, and shares of a given fund were offered to all investors. Most funds were sold through broker-dealers, who provided advice, assistance, and ongoing service to the investor. Brokers were compensated for their services exclusively by a front-end sales load. Other funds sold shares directly to investors without a sales load. Investors in these funds either did not receive advice and assistance or obtained and paid for these services separately.

Today, as a result of innovations in the mutual fund industry, investors have significantly greater choice about how and where they purchase mutual fund shares. This choice has largely been made possible by the use of asset-based fees, charged in accordance with Rule 12b-1, to compensate broker-dealers and other investment professionals for providing advice and other investment-related services to fund investors. In the case of “level load” shares, for example, Rule 12b-1 has provided a method for tying the payment stream to the length of the advisory relationship, thus aligning the interests of the investment professional and the fund investor. At the same time, the range of distribution channels through which investors may purchase fund shares has broadened, and many funds have responded by fashioning share classes that impose costs reflecting the different services investors receive through a particular channel. As the Commission staff has recognized, Rule 12b-1 payments are integral to these arrangements.<sup>15</sup>

It should be noted that, along with these changes in fund distribution practices, distribution costs have declined significantly over the last 25 years. An Institute study of mutual fund distribution channels and trends in distribution costs found that the average annual distribution cost incurred by investors in equity funds decreased from 1.49 percent (or 149 basis points) of their initial investment in 1980 to 40 basis points in 2001 – a 73 percent decrease. Similarly, distribution costs of bond funds fell 60 percent, from 82 basis points in 1980 to 33 basis points in 2001. According to the study, approximately two-thirds of the decrease in overall distribution costs can be attributed to a decline in distribution costs for load share classes, while the remaining one-third of the decrease resulted from a relative shift in new sales from share classes with loads to those with no load.<sup>16</sup>

## **B. Uses of 12b-1 Fees**

When the Commission adopted Rule 12b-1 in 1980, it “presupposed” that 12b-1 plans would be used for relatively short periods of time in order to solve particular distribution problems or respond to specific circumstances.<sup>17</sup> Most of the early adopters of 12b-1 plans were

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<sup>15</sup> See SEC Staff Fee Study, *supra* note 4, at 39.

<sup>16</sup> See Brian K. Reid and John D. Rea, “Mutual Fund Distribution Channels and Distribution Costs,” *Perspective*, Vol. 9, No. 3, July 2003, Investment Company Institute, at 15-18, available at <http://www.ici.org/stats/res/per09-03.pdf>. For purposes of the study, distribution costs were defined as charges incurred by mutual fund investors directly through the payment of sales loads or indirectly through 12b-1 fees. The two forms of distribution charges were made comparable by annuitizing the sales load into an equal series of annual payments. This process spreads the load over the entire holding period, allowing the annuitized load to be added to the 12b-1 fee to form an estimate of distribution cost.

<sup>17</sup> See SEC Staff Fee Study, *supra* note 4, at 39.

no-load funds, which generally used 12b-1 fees of 25 basis points or less to subsidize the expenses that their advisers and distributors incurred for advertising, the printing and mailing of prospectuses to prospective investors, and the printing and mailing of sales literature. This level of 12b-1 fees and the way in which the fees were used were consistent with the Commission's original expectation.<sup>18</sup>

For most of their history, however, 12b-1 plans have been most widely used on a continuing basis to serve two other very different purposes – first, as a substitute for front-end sales loads, and second, to pay for administrative and shareholder services that benefit existing fund shareholders.<sup>19</sup> In 1999, for example, 95 percent of the 12b-1 fees paid by mutual funds was used for these two purposes.<sup>20</sup> Only in very limited instances are 12b-1 plans used today to subsidize the costs incurred by a fund's distributor in promoting the sale of fund shares.<sup>21</sup>

These uses of 12b-1 fees, although not anticipated when Rule 12b-1 was first adopted, are nevertheless consistent with the rule's administrative history. The adopting release stated that Rule 12b-1 was intended to be flexible enough to cover new distribution financing arrangements that the industry might develop, and that the Commission and its staff would monitor the rule's operation closely and be prepared to make adjustments in light of experience to make the restrictions on the use of fund assets for distribution more or less strict.<sup>22</sup> In fact, through several regulatory actions over the past two decades, the Commission and the staff

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<sup>18</sup> See, e.g., Joel H. Goldberg and Gregory N. Bressler, *Revisiting Rule 12b-1 Under the Investment Company Act*, 31 Rev. Sec. and Commodities Reg., 147, 150 (1998).

<sup>19</sup> We note that several academic papers have examined the extent to which 12b-1 fees produce lower overall expense ratios through asset growth and economies of scale. See, e.g., R. McLeod and D.K. Malhotra, "A Re-examination of the Effect of 12b-1 Plans on Mutual Fund Expense Ratios," *Journal of Financial Research*, Vol. 20, No. 2, 1997, 231-240; L. Walsh, "The Costs and Benefits to Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns," Office of Economic Analysis, Securities and Exchange Commission, 2004. The premise of these studies is not related to the current use of 12b-1 fees as an alternative to front-end sales loads or as payment for fund administrative services. Consequently, from the standpoint of the current use of 12b-1 fees, these papers have little bearing on whether investors benefit from 12b-1 plans. For analyses that take into account the role of 12b-1 fees as an alternative to front-end sales loads, see J.L. Davis, "A New Look at SEC Rule 12b-1," *Securities Regulation Law Journal*, 1995, 23, 184-210; E.S. O'Neal, "Mutual Fund Share Classes and Broker Incentives," *Financial Analysts Journal*, Sep/Oct 1999, 55(5), 76-86; and S. Collins, "The Effect of 12b-1 Plans on Mutual Funds, Revisited," Investment Company Institute, March 2004, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=522442](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=522442).

<sup>20</sup> According to a survey conducted by the Institute, 63 percent of the 12b-1 fees collected in 1999 was used to compensate broker-dealers and other third-party sales professionals. This compensation included payments made to broker-dealers for the sale of fund shares, reimbursements to the fund distributor for financing charges arising from advances to broker-dealers for the sale of fund shares, and compensation of in-house marketing personnel. Thirty-two percent of the 12b-1 fees paid in that year was used for expenses associated with providing ongoing administrative services to fund shareholders. See "Use of Rule 12b-1 Fees by Mutual Funds in 1999," *Fundamentals*, Vol. 9, No. 1, April 2000, Investment Company Institute, available at [www.ici.org/pdf/fm-v9n1.pdf](http://www.ici.org/pdf/fm-v9n1.pdf). The survey included 95 mutual fund organizations having at least one fund with a 12b-1 plan. Survey respondents accounted for nearly 70 percent of the assets of mutual funds with 12b-1 fees, and for 52 percent of the share classes and 69 percent of the assets of all share classes with 12b-1 plans.

<sup>21</sup> In 1999, only 5% of the 12b-1 fees paid by fund shareholders was used for advertising and other sales promotion activities, including expenses for printing and mailing prospectuses to prospective investors. *Id.*

<sup>22</sup> See *Bearing of Distribution Expenses by Mutual Funds*, SEC Rel. No. IC-11414 (Oct. 28, 1980) ("Rule 12b-1 Adopting Release").

have helped to create the infrastructure to support these uses of 12b-1 fees. These actions include: granting exemptive relief to permit the use of spread load arrangements and multiple class structures; extending the NASD sales charge rule to cover asset-based sales charges imposed in accordance with Rule 12b-1; and issuing written guidance relating to participation in fund supermarkets.

### 1. Substitute for Front-End Sales Loads

This use of 12b-1 fees provides mutual fund investors who rely on the advice and assistance of third-party intermediaries (*e.g.*, full-service brokers, independent financial planners, insurance agents) in making their investment decision with the option of paying for those services over time. Thus, 12b-1 fees substitute for the front-end sales load that traditionally had been the sole means of compensating intermediaries for sales of fund shares.<sup>23</sup>

This development dates back to 1982, when the Commission issued the first of nearly 300 exemptive orders permitting mutual funds to impose a “spread load” consisting of a 12b-1 fee in combination with a contingent deferred sales load (“CDSL”). The advent of spread load arrangements allowed investors to have all of their purchase price invested in a fund and, at the same time, enabled fund distributors to advance commission payments to salespersons with the expectation that they would be repaid over time.<sup>24</sup> The Commission helped to facilitate the growth in spread load arrangements by also permitting mutual funds to issue multiple classes of securities representing interests in the same investment portfolio.<sup>25</sup> By using a multiple class structure, funds could more efficiently introduce shares with a spread load, instead of having to create “clone” funds or seek shareholder approval to change a fund’s existing sales load structure.<sup>26</sup>

Today, mutual funds sold through intermediaries generally are organized into a number of different share classes, each of which uses a different combination of front-end and/or

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<sup>23</sup> Unlike front-end loads, 12b-1 fees are paid to the fund’s distributor from fund assets rather than from an investor’s account. As with front-end loads, however, the distributor typically pays (or “reallows”) by far the major portion of the fees to the intermediary. Only a small portion of the 12b-1 fee usually is retained by the distributor to help defray distribution-related expenses such as advertising, providing sales materials to investors, printing and mailing prospectuses, and supporting the distributor’s own marketing operation.

<sup>24</sup> See Division of Investment Management, Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992) (“Protecting Investors Report”) at 323. In 1995, the Commission adopted Rule 6c-10 under the Investment Company Act, which essentially codified the conditions in the exemptive orders.

<sup>25</sup> Beginning in 1985, the Commission issued nearly 200 exemptive orders permitting mutual funds to adopt multiple class structures. In 1995, concurrently with the adoption of Rule 6c-10, the Commission adopted Rule 18f-3 under the Investment Company Act, which streamlined the conditions required to be met by a fund implementing a multiple class structure. See *Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans*, SEC Rel. Nos. 33-7143, IC-20915 (Feb. 23, 1995) (“Rule 18f-3 Adopting Release”).

<sup>26</sup> See, *e.g.*, Philip L. Kirstein, “New and Improved Rule 12b-1 for the New Millennium,” SEC Roundtable on the Role of Independent Investment Company Directors, Feb. 23-24, 1999. The Commission has recognized that multiple class funds “may increase investor choice, result in efficiencies in the distribution of fund shares, and allow fund sponsors to tailor products more closely to different investor markets.” See Rule 18f-3 Adopting Release, *supra* note 25.

CDSLs and 12b-1 fees.<sup>27</sup> The fees for each share class are disclosed in the fund's prospectus. On the basis of this information, investors, by purchasing a particular class of shares, choose the particular method for paying their intermediary.<sup>28</sup>

The use of 12b-1 fees as a substitute for front-end sales loads has been a critical development in mutual fund investing. Notwithstanding the availability of no-load investment options and greater investor awareness of the costs associated with investing in mutual funds, the simple fact is that many investors prefer to purchase fund shares with the help of an intermediary. That was true before the adoption of Rule 12b-1, and it remains true today.<sup>29</sup> The critical difference is that fund shareholders now have greater flexibility in paying for the investment advice and assistance they have chosen to obtain.

## 2. Payments for shareholder servicing

This use of 12b-1 fees allows mutual funds to pay for administrative and shareholder services that benefit existing fund shareholders. These services include processing shareholder transactions, maintaining shareholder records, and mailing account statements, fund communications, and reports to shareholders. Providers of these services also may be the investor's "point of contact" with the fund, including: (1) the broker-dealer or other intermediary that assisted the investor in determining to purchase shares of the fund; (2) the fund supermarket through which the investor purchased the fund's shares; and (3) the plan recordkeeper of a retirement plan offered by the investor's employer.<sup>30</sup> A fund may adopt a

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<sup>27</sup> In a typical arrangement, the fund offers three classes of shares: Class A, which charge a front-end sales load and often a small 12b-1 fee; Class B, which charge an annual 12b-1 fee and a CDSL that declines in each year the investment is held, and which typically convert to Class A shares after a period of six to eight years; and Class C, which typically charge an annual 12b-1 fee as well as a CDSL of 1% for the first year of the investment. See Reid and Rea, *supra* note 16, at 8-11. Rule 18f-3(a)(1)(i) under the Investment Company Act requires that each class offered by a multiple class fund must have a different arrangement for distribution, shareholder servicing or both, and that each class must bear all of the expenses of that arrangement.

<sup>28</sup> An investor's choice of share classes may be influenced by several factors. Long-term investors will generally be indifferent between Class A and Class B shares because their performance is quite similar over long holding-periods. Those who have large balances to invest, however, may be entitled to discounts on front-end sales loads ("breakpoints"), in which case Class A shares normally would offer superior performance. On the other hand, those who have relatively moderate amounts to invest and who are uncertain as to how long they might hold their shares may find Class B shares to be preferable. For investors who have a short- to medium-term investment horizon and who do not qualify for breakpoints, Class C shares would be a likely choice. In addition, investors who employ the services of registered investment advisers to help manage their investments often purchase Class C shares. See, e.g., Reid and Rea, *supra* note 16, at 11-13.

<sup>29</sup> For example, in 1975, 81 percent of all long-term fund sales were made through financial advisers. As of 2001, more than 70 percent of all shareholders who primarily buy funds outside a 401(k) or other employer-sponsored pension plan used a financial adviser as their main source for purchasing fund shares. See "The Cost of Buying and Owning Mutual Funds," Fundamentals, Vol 13, No. 1, Investment Company Institute, Feb. 2004, available at <http://www.ici.org/statements/res/fm-v13n1.pdf>.

<sup>30</sup> Retirement plan service providers also may meet the needs of employee-investors by providing educational materials and seminars that explain the retirement plan and investment principles, answering investors' questions through telephone call centers and automated voice-response systems, and maintaining websites with information specific to the retirement plan. While some employers may choose to pay for these services as a benefit to their employees, in other cases the costs are covered through a combination of employer subsidies, direct charges to employees, and/or fees included in mutual fund expenses, such as 12b-1 fees and service fees. See, e.g., Reid and Rea, *supra* note 16, at 5-6.



multiple class structure in part to reflect different servicing arrangements for different groups of its shareholders.<sup>31</sup>

Adoption of a 12b-1 plan gives a fund and its sponsor enhanced regulatory assurance that the payment of fees to third parties who provide administrative and shareholder services that benefit the fund's shareholders will not be considered an impermissible use of fund assets for distribution.<sup>32</sup> The Commission staff has recognized that it can be difficult to determine how Rule 12b-1 applies when a fund is paying for a mix of distribution and non-distribution services.<sup>33</sup> In the fund supermarket context, for example, the staff has issued written guidance to assist funds in determining when payments for supermarket services must be made pursuant to a 12b-1 plan and the role of fund directors in making this determination.<sup>34</sup>

### 3. Closed funds and 12b-1 fees

Some have questioned the propriety of funds that are closed to new investors continuing to pay 12b-1 fees. In fact, there is nothing inappropriate about such payments.<sup>35</sup> The two principal uses of 12b-1 fees – to compensate intermediaries for advice previously provided to fund investors and to compensate third parties for providing ongoing administrative and shareholder services that benefit existing fund shareholders – are not affected by the fact that a fund has stopped accepting *new* investors.<sup>36</sup> Moreover, as discussed in Section C below, the NASD rule governing mutual fund sales charges imposes cumulative limits on 12b-1 fees that are tied to a fund's overall sales of shares.<sup>37</sup> A fund that stops selling shares will eventually reach its "cap" and, at that point, would be precluded from imposing asset-based sales charges under Rule 12b-1.

### C. Regulation and Disclosure of 12b-1 Fees

In the Institute's view, possible modifications to Rule 12b-1 should be evaluated not only in light of the ways that mutual funds use 12b-1 fees, as discussed above, but also in light of the

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<sup>31</sup> See *supra* note 27 (stating requirements of Rule 18f-3(a)(1)(i)).

<sup>32</sup> We note that a few funds have adopted so-called "defensive" 12b-1 plans, which do not impose a separate fee and are primarily intended to permit fund directors to take into account the distribution expenses of the investment adviser and its affiliated distributor in the board's annual review of investment advisory contracts under Section 15(c) of the Investment Company Act.

<sup>33</sup> See, e.g., Memorandum from Paul F. Roye, Director, Division of Investment Management, to Chairman William H. Donaldson, regarding Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, dated June 9, 2003 ("2003 Roye Memorandum"), at 74.

<sup>34</sup> Investment Company Institute (Oct. 30, 1998) ("Fund Supermarkets Letter"), at n. 18.

<sup>35</sup> Even a prominent industry critic has acknowledged that there are "good reasons" for closed funds to charge 12b-1 fees. See "12b-1 Fees: Politics and Policy," Fund Democracy Insights, Vol. 1, Issue 4 (Sept. 2001) ("Fund Democracy Insights"), at 3.

<sup>36</sup> The staff has acknowledged, for example, that a mutual fund that has discontinued sales through a fund supermarket may nevertheless be required to continue paying supermarket fees to cover the administrative services provided to customers of the supermarket who purchased shares of the fund. See Fund Supermarkets Letter, *supra* note 34, at n.18.

<sup>37</sup> NASD Conduct Rule 2830(d).

substantial investor protections afforded by the regulatory and disclosure requirements that must be satisfied by funds imposing 12b-1 fees. In this section, we discuss those requirements.

## 1. Rule 12b-1

Under Rule 12b-1, any payments by a fund in connection with the distribution of its shares must be made in accordance with a written plan approved by the fund's board of directors, including a majority of the independent directors.<sup>38</sup> Rule 12b-1 also imposes considerable oversight duties on fund directors,<sup>39</sup> including: (1) annual approval of a fund's 12b-1 plan by the board, including a majority of the independent directors; and (2) periodic review of amounts spent under the 12b-1 plan and the reasons for the expenditures. In determining whether to implement or continue a 12b-1 plan, fund directors are held to the fiduciary standards of Section 36 of the Investment Company Act and of applicable state law.<sup>40</sup>

A 12b-1 plan must provide, among other things, that it may be terminated at any time by vote of a majority of the independent directors or a majority of the fund's outstanding voting securities.<sup>41</sup> Rule 12b-1 further requires that fund shareholders must approve any material increase in a fund's 12b-1 fee.<sup>42</sup> Thus, funds cannot unilaterally raise 12b-1 fees, nor may the board alone approve a fee increase.

## 2. NASD regulation

NASD Conduct Rule 2830(d) identifies 12b-1 fees as "asset-based sales charges" and imposes annual and cumulative limits that are designed to approximate the rule's limits on front-end sales charges.<sup>43</sup> In this way, the rule seeks to achieve "approximate economic equivalency" between 12b-1 fees and sales loads in setting the maximum permissible sales charges for mutual fund shares.<sup>44</sup> The rule also prohibits a fund that has a front-end or deferred sales charge, or a 12b-1 fee higher than 25 basis points, from being referred to as a "no load" fund.<sup>45</sup>

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<sup>38</sup> Rule 12b-1(b). This section of the rule further requires that an independent director have no direct or indirect financial interest in the 12b-1 plan or any agreements under that plan. Rule 12b-1(b)(2).

<sup>39</sup> Pursuant to Rule 12b-1(c), a fund may impose a 12b-1 fee only if: (1) independent directors constitute a majority of the fund's board; (2) the independent directors select and nominate other independent directors; and (3) any person acting as legal counsel to the independent directors is an independent legal counsel.

<sup>40</sup> Rule 12b-1(e).

<sup>41</sup> Rule 12b-1(b)(3)(iii).

<sup>42</sup> Rule 12b-1(b)(4).

<sup>43</sup> Among other things, the rule limits 12b-1 fees to a maximum of 1.0 percent of a fund's average net assets per year, which may include a service fee of up to 0.25 percent to compensate intermediaries for providing services or maintaining shareholder accounts, and imposes a lifetime cap on 12b-1 fees (other than service fees) that is based upon a percentage of fund sales.

<sup>44</sup> See *Self-Regulatory Organizations; Nat'l Ass'n of Sec. Dealers, Inc.; Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies*, SEC Rel. No. 34-30897 (July 7, 1992).

<sup>45</sup> This requirement recognizes that the expenses of funds with low 12b-1 fees tend to more closely resemble those of funds with no sales loads or 12b-1 fees. *Id.*

In addition to limiting sales charges on sales of fund shares, the NASD Conduct Rules impose general suitability requirements on broker-dealers with respect to their recommendations of mutual fund shares. NASD has issued specific guidance concerning the application of suitability principles to sales of mutual funds that offer multiple classes.<sup>46</sup>

### 3. Disclosure of 12b-1 fees

All mutual fund fees and expenses are set forth in a standardized fee table that is required to be at the front of a fund's prospectus. If a fund charges a 12b-1 fee, that fee will be clearly identified as a separate line item in the fee table as part of the fund's annual operating expenses. The 12b-1 fee also will be reflected in the fund's total annual operating expenses shown in the fee table and in the hypothetical example of fund expenses that accompanies the fee table.<sup>47</sup>

Mutual funds charging a 12b-1 fee are required to include disclosure in their prospectuses concerning the impact of this ongoing fee. Specifically, the prospectus must disclose that over time, 12b-1 fees will increase the cost of an investment in the fund and may cost the investor more than paying other types of sales charges.<sup>48</sup> More detailed disclosure about a fund's 12b-1 fee is required in the Statement of Additional Information, which is available to fund shareholders free of charge upon request and also may be posted on a website maintained by the fund's adviser. Such disclosure includes, among other things, a breakdown of the dollar amount of 12b-1 payments made for various activities, such as compensating broker-dealers and sales personnel.<sup>49</sup>

The requirements summarized above ensure that investors receive clear disclosure of 12b-1 fees paid by mutual funds. Still, more can be done to try to enhance investor awareness and understanding of 12b-1 fees and the impact they may have on the overall costs of investing in a mutual fund. A recent Commission proposal would require broker-dealers to make additional disclosures to investors concerning 12b-1 fees and other distribution-related expenses and payments.<sup>50</sup> Broker-dealers would have to disclose to their customers, before a purchase of mutual fund shares, the estimated amount of 12b-1 fees to be paid in the year following purchase, based on the assumption that the fund's net asset value would remain constant. The proposal also would require quantitative disclosure of 12b-1 fees on mutual fund confirmations. The Institute supports these proposed disclosures.<sup>51</sup>

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<sup>46</sup> See, e.g., NASD Regulation, Inc., "Suitability Issues for Multi-Class Mutual Funds," Regulatory & Compliance Alert, Summer 2000, available at [http://www.nasdr.com/rca\\_summer00\\_reg.htm#suitability](http://www.nasdr.com/rca_summer00_reg.htm#suitability).

<sup>47</sup> Item 3 of Form N-1A.

<sup>48</sup> Item 8(b) of Form N-1A.

<sup>49</sup> Item 15(g) of Form N-1A. In addition, the 12b-1 plan and any agreements relating to the plan's implementation must be filed as exhibits to the fund's registration statement. Item 23(m) of Form N-1A.

<sup>50</sup> See *Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds*, SEC Release No. IC-26341 (Jan. 29, 2004).

<sup>51</sup> See Letter from Amy B.R. Lancellotta, Acting General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated April 12, 2004.

## **E. Specific Recommendations for Reform of Rule 12b-1**

In 2000, the Division of Investment Management issued a comprehensive report presenting its findings regarding trends in mutual fund fees and expenses – including 12b-1 fees – over the previous twenty years.<sup>52</sup> The staff made several recommendations for regulatory enhancements relating to fees and expenses, including with respect to Rule 12b-1. It is important to note that the staff did *not* recommend wholesale reform of Rule 12b-1, much less the total repeal of the rule. Rather, the staff concluded that modifications may be needed to reflect changes in the manner in which funds are marketed and distributed and the experience gained from observing how Rule 12b-1 has operated since it was adopted in 1980.<sup>53</sup> In particular, the staff stated that the Commission should consider: (1) whether to give additional or different guidance to fund directors, including whether the factors suggested in the Commission’s Rule 12b-1 adopting release to guide directors’ review of 12b-1 plans are still valid; and (2) whether the procedural requirements of Rule 12b-1 need to be modified to reflect changes in fund distribution practices that have developed since the rule’s adoption or that may be developed in the future.<sup>54</sup>

The Institute concurs with the staff’s conclusions. Given the tremendous changes in the mutual fund industry since 1980, particularly with respect to fund distribution practices, we believe that the Commission should consider certain modifications that would better reflect current fund distribution practices without compromising investor protection. In particular, the Institute recommends that the Commission: (1) update its guidance to fund directors with respect to the factors that directors may wish to consider in approving a 12b-1 plan; and (2) eliminate the rule’s quarterly reporting requirement.

### **1. Guidance to fund directors**

Rule 12b-1 states that fund directors should consider and give weight to “all pertinent factors” in determining whether to approve a 12b-1 plan. In its release adopting Rule 12b-1, the Commission explained that it had decided not to require directors to consider any particular factors in making their determination.<sup>55</sup> Instead, the Commission included in its adopting release a list of nine factors “that would normally be relevant to a determination of whether to use fund assets for distribution.”<sup>56</sup>

According to the staff, many of the factors identified by the Commission in 1980 “presupposed that funds would typically adopt 12b-1 plans for relatively short periods in order to solve a particular distribution problem or to respond to specific circumstances, such as net redemptions.”<sup>57</sup> The staff also has acknowledged arguments that many of the factors have

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<sup>52</sup> SEC Staff Fee Study, *supra* note 4.

<sup>53</sup> *Id.* at 39.

<sup>54</sup> *Id.* at 40.

<sup>55</sup> See Rule 12b-1 Adopting Release, *supra* note 22.

<sup>56</sup> *Id.*

<sup>57</sup> See SEC Staff Fee Study, *supra* note 4, at 39; 2003 Royce Memorandum, *supra* note 33, at 73.

become obsolete because, today, many funds adopt a 12b-1 plan as a substitute for or supplement to sales charges or as an ongoing method of paying for marketing and distribution arrangements.<sup>58</sup>

In the Institute's view, fund directors would benefit from updated guidance, based on current fund distribution practices, as to the factors that may be relevant to a fund board's decision whether or not to approve a 12b-1 plan. As the Commission aptly determined in 1980, the rule itself should not require fund directors to consider certain specified factors but instead should preserve the necessary flexibility for directors to consider "all pertinent factors" that may be relevant to their decision. The precise factors considered should be tailored to reflect, for example, the intended purpose(s) of the payments to be made under the 12b-1 plan (*e.g.*, compensation to brokers and other investment professionals for sales of fund shares, administrative and shareholder services). The Institute further recommends that, in issuing such guidance, the Commission state explicitly that the factors are intended as suggestions only and that fund directors have the responsibility to identify, in the exercise of their business judgment, those factors that are relevant to their determination.

Based on the industry's experience with Rule 12b-1, the Institute offers the following possible factors for the Commission's consideration:

- If the fund intends to pay for shareholder and administrative services under its 12b-1 plan: (1) the nature of the services to be rendered; and (2) whether the fee for these services is reasonable in relation to (a) the value of those services and the benefits received by the fund and its shareholders and (b) the costs that would otherwise be incurred by the fund or payments that the fund would be required to make to another entity to perform the same services.<sup>59</sup>
- If the fund intends to use its 12b-1 plan to compensate intermediaries for services that they provide to their customers at the time of sale, competitive conditions in the intermediary marketplace, including comparative 12b-1 fees of other funds.<sup>60</sup>
- The cost of a 12b-1 plan to the fund and its shareholders, including the effect of 12b-1 payments on the expense ratio and investment performance of the fund.<sup>61</sup>
- Whether the intended use of fund assets for distribution and/or to pay for administrative and shareholder services is generally fair to the shareholders who bear

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<sup>58</sup> *Id.*

<sup>59</sup> See Fund Supermarkets Letter, *supra* note 34.

<sup>60</sup> See 2003 Roye Memorandum, *supra* note 33, at 9 ("As a practical matter . . . when a fund sponsor establishes the . . . level of Rule 12b-1 fees for a fund, it takes into account the expectations that broker-dealers may have concerning the compensation that they will receive for selling the fund's shares.")

<sup>61</sup> See Mark Perlow, *Mutual Fund Directors' Oversight of Distribution Relationships: Emerging Best Practices*, Investment Lawyer, Vol. 11, No. 1, 1, 9 (Jan. 2004).

those costs. In the case of a multiple class fund, one relevant consideration might be whether the fund offers a conversion feature.<sup>62</sup>

## 2. Quarterly Reports

Rule 12b-1 currently requires a fund's board to receive, and to review, quarterly reports concerning amounts expended under a 12b-1 plan and the purposes of those expenditures. Such frequent reporting is unnecessary, especially given that the nature of most 12b-1 payments does not vary quarter by quarter but rather remains relatively constant over time. In the Institute's view, it would be more appropriate for fund directors to receive this type of information annually, so that they could consider it in determining whether to approve the continuation of a 12b-1 plan.<sup>63</sup> For these reasons, the Institute recommends that the Commission eliminate the rule's quarterly reporting requirement.

### F. Deducting Distribution Costs from Shareholder Accounts

The Proposing Release requests comment on whether the Commission should "refashion" Rule 12b-1 so that funds would deduct distribution-related costs directly from shareholder accounts rather than from fund assets.<sup>64</sup> The Institute agrees that this alternative would seem to offer a "cleaner" way of paying for distribution. There are, however, significant disadvantages to imposing distribution costs at the shareholder account level that would outweigh this potential benefit. For this reason, the Institute believes that the assessment of 12b-1 fees at the fund level remains the best way to give fund investors the choice of paying for distribution costs over time.

Most importantly, deducting distribution costs at the shareholder account level would have negative tax consequences for fund shareholders and would increase their recordkeeping burdens. The Division of Investment Management has expressed similar concerns with respect to replacing spread load arrangements with installment loads. Specifically, the Division stated in its Protecting Investors Report:

We recognize that the tax laws are a significant impediment to implementing non-contingent deferred loads and installment loads. The tax laws may prohibit payments of installment loads in certain tax-privileged situations, such as Individual Retirement Accounts or pension accounts. In addition, the collection of installment loads is likely to occur through redemptions of fund shares, which is a taxable event. Investors either would incur tax liabilities for gains when not actually receiving any distributions or would realize losses. Investors also would bear added recordkeeping burdens, because

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<sup>62</sup> A conversion feature helps to ensure that investors holding Class B shares generally would not pay more than investors holding Class A shares (assuming no breakpoint was received by the Class A investor).

<sup>63</sup> Rule 12b-1(d) already provides, among other things, that fund directors have a duty to request and evaluate, and any person who is party to an agreement with the fund relating to its 12b-1 plan has a duty to furnish, such information as may reasonably be necessary to an informed determination of whether the plan should be continued.

<sup>64</sup> Proposing Release at 9731.

each installment of a deferred load would be treated as an increase in the shareholder's basis.<sup>65</sup>

More specifically, the report pointed out that payments from pension plans and individual retirement accounts ("IRAs") and annuities that are not considered rollovers would likely be taxed to the investor as a distribution.<sup>66</sup> The report further noted that, in addition to the shareholder recognition problems mentioned above, tax-related issues would involve imputed interest (and investment interest expense) and withholding.<sup>67</sup>

The Division concluded that "tax law complications would make the [implementation of installment loads] *essentially impossible*. Unless and until the tax laws change, we think spread loads generally should be permitted."<sup>68</sup> The Institute notes that the relevant tax laws have not changed since the Division's report was issued in 1992 and, further, that the tax and recordkeeping implications would be the same if an asset-based 12b-1 fee (rather than an installment load) were assessed at the shareholder account level. Therefore, the tax laws continue to present a formidable, if not insurmountable, obstacle to the successful implementation of a system in which distribution costs are deducted on a shareholder account basis.

The Institute also has reservations about the serious operational difficulties that would be involved in switching from fund-level to shareholder-level deductions of distribution costs. These difficulties would include: (1) substantial transfer agent and accounting costs for administering and monitoring individual shareholder accounts; (2) the costs, in dollars and in time, associated with developing and implementing the systems necessary to support these functions; (3) significant bookkeeping burdens and accounting problems for fund distributors; and (4) increased recordkeeping complexity with respect to shares held through intermediaries (e.g., omnibus accounts, retirement plans).<sup>69</sup> Fund complexes also would have to bear the costs associated with substantial marketing campaigns to educate investors about, and encourage financial intermediaries to sell, fund shares with this type of load arrangement.<sup>70</sup>

It is worth noting that mutual funds already have the flexibility they need under both Commission and NASD rules to impose installment loads.<sup>71</sup> The Institute is not aware, however, of any fund that has chosen to do so. We presume that this can be attributed, at least in large part, to the difficult tax and operational issues outlined above.

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<sup>65</sup> Protecting Investors Report, *supra* note 24, at 329.

<sup>66</sup> *Id.* at n.165.

<sup>67</sup> *Id.* at n.167.

<sup>68</sup> *Id.* at 327 (emphasis added). The report further stated that the staff recognized that installment loads likely would not be used without tax reform. *Id.* at 329.

<sup>69</sup> Of course, because neither the industry nor its regulators have experience in this area, there may be other practical problems that would become apparent if a fund complex tried to deduct distribution costs at the shareholder account level.

<sup>70</sup> See Rochelle Kauffman Plesset and Diane E. Ambler, "The Financing of Mutual Fund 'B' Shares," *Business Lawyer*, Vol. 52, No. 4, 1385, 1428 (Aug. 1997).

<sup>71</sup> Rule 6c-10 under the Investment Company Act; NASD Conduct Rule 2830(d).

The Institute believes that Rule 12b-1, while perhaps imperfect, offers fund shareholders many, if not most, of the potential benefits of periodically deducting distribution costs at the shareholder account level while avoiding the problems that such a system would involve for funds and shareholders alike. Most significantly, 12b-1 fees provide investors with the option of paying distribution costs over time, so that all of their initial investment “goes to work” for them right away. In some cases, the fees allow funds to participate in a particular distribution channel. Shareholders who choose to invest in a fund through that channel arguably would not otherwise have the opportunity to invest in that fund.<sup>72</sup> These advantages are coupled with a host of regulatory requirements – limitations on 12b-1 fee levels under the NASD sales charge rule, board approval and oversight, and clear disclosure – that provide significant protection to fund shareholders against excessive distribution costs.

The Institute believes that, on balance, fund shareholders would be worse off if the Commission prohibited the assessment of 12b-1 fees at the fund level and instead required that distribution costs be deducted from each shareholder account. We therefore recommend that the Commission refrain from pursuing such an approach at this time.

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We appreciate the Commission’s consideration of our comments. If you have any questions or need additional information, please contact me at (202) 326-5824, Frances M. Stadler at (202) 326-5822, or Rachel H. Graham at (202) 326-5819.

Sincerely,

Amy B.R. Lancellotta  
Acting General Counsel

cc: The Honorable William H. Donaldson  
The Honorable Cynthia A. Glassman  
The Honorable Harvey J. Goldschmid  
The Honorable Paul S. Atkins  
The Honorable Roel C. Campos

Paul F. Roye, Director  
Susan Nash, Associate Director

Division of Investment Management

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<sup>72</sup> See, e.g., Fund Democracy Insights, *supra* note 35, at 7.