Report of the Working Group on Rule 12b-1

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Investment Company Institute
Board of Governors
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Formation of the Working Group

In January 2005, the Investment Company Institute formed a Working Group comprised of members of its Board of Governors to analyze mutual fund distribution issues, including the role of Rule 12b-1 under the Investment Company Act of 1940. As part of this analysis, the Working Group considered a broad range of distribution issues, including possible changes to Rule 12b-1.

This Report reflects the results of the Working Group's analysis and findings and the recommendations of the majority of its members. While not all of the members of the Working Group agree with each finding or recommendation in the Report, all of the members agreed that it was important to issue the Report at this time.

Historical Overview

Section 12(b) of the Investment Company Act provides that in general it is unlawful for a mutual fund to act as a distributor of its securities in contravention of any rules the Securities and Exchange Commission may prescribe. In 1980, the SEC adopted Rule 12b-1 permitting funds, subject to largely procedural conditions, to pay directly distribution-related costs.

In the first few years following Rule 12b-1's adoption, most funds adopting 12b-1 plans used 12b-1 fees to pay advisers and distributors for costs associated with advertising, the printing and mailing of prospectuses to prospective investors, and the printing and mailing of sales literature. Notwithstanding this early experience, for most of their history, 12b-1 fees have been widely used on a continuing basis as a substitute for front-end sales loads and to pay for ongoing advice and services provided to fund shareholders. While some investors prefer to buy mutual funds directly from the company sponsoring them, the vast majority of investors today seek professional help and advice from financial intermediaries in making investment decisions. These financial intermediaries provide investors initial and ongoing advice to help them achieve their financial goals. Intermediaries also perform various administrative, recordkeeping, and transfer agent services on behalf of funds. Rule 12b-1 has enabled funds to let investors decide how and when to pay for advice and services. Today's uses of 12b-1 fees are consistent with the SEC's intent that the rule be flexible enough to cover new distribution financing arrangements that the industry might develop.

Analysis and Recommendations

Although most funds rely on 12b-1 fees to finance at least some portion of their distribution efforts, recent media coverage and regulatory commentary have questioned whether Rule 12b-1 continues to serve the purpose for which it was originally intended, whether it benefits investors, and, therefore, whether it should be amended or repealed. Some commentators have proposed improving disclosure about the amount of fees charged and how they are spent. Others have recommended modernizing the guidance provided to boards regarding the factors they may consider in approving and continuing 12b-1 plans. Operational changes also

have been suggested, such as eliminating Rule 12b-1 or deducting12b-1 fees at the account level rather than the fund level. The Working Group's analysis included consideration of each of these possible courses of action.

Fund Disclosure

The evolution of the mutual fund industry since 1980 has presented investors with a wide range of choices of how to pay for the advice and services they receive in connection with fund investments. At the same time, the variety and complexity of these choices present certain disclosure challenges.

To improve investor awareness and understanding of 12b-1 fees and other fund fees and expenses, the information provided to investors should be improved. For instance, 12b-1 fees should be identified in a manner that describes their general purpose and should be listed in the prospectus fee table using tailored, straightforward, descriptive terms to accurately describe the main purpose of a fund's 12b-1 fee. To aid investors' understanding of these and other fees associated with a fund purchase, a glossary of the terms used in the fee table should be included in the fund prospectus.

These steps should be coupled with broader efforts to improve fund disclosure. In particular, the SEC should allow funds to offer their shares using a short-form disclosure document that provides key information about a fund, including the fund's fee table. A simplified disclosure document is likely to significantly enhance the transparency of 12b-1 fees and, indeed, all fund fees and expenses.

Requiring brokers to provide investors with information about 12b-1 fees and other fund distribution costs at the point of sale also would be useful, so long as any point-of-sale disclosure requirements do not operate to discourage brokers from selling mutual funds. First, any point-of-sale disclosure requirements should be consistent with the manner in which brokers typically sell funds (*i.e.,* by phone rather than in face-to-face meetings with customers). Second, point-of-sale requirements should not create competitive disadvantages by imposing regulatory obligations on funds without regard to the other investment products that brokers sell. Point-of-sale disclosure would help investors better understand the costs of, and evaluate broker recommendations to invest in, the full range of investment products that brokers sell, and therefore should be extended beyond mutual funds.

Board Oversight Under Rule 12b-1

Board involvement in fund distribution arrangements should stem from regulatory responsibilities that are consistent with marketplace realities. This is not the case currently under Rule 12b-1; regulatory guidance concerning the board's responsibilities under this rule (in the form of suggested factors) has long been outdated as a result of market developments. The Working Group's suggestions for reform include:

- *Renewed Emphasis on Board Oversight*. The board has an appropriate oversight role in approving and annually renewing 12b-1 plans. A board can fulfill this role, in light of the current uses of 12b-1 fees, by focusing on the full range of activities financed under a fund's 12b-1 plan and the options and other benefits those activities provide to the fund's shareholders. How each board

makes its determination under the rule should be left to that board and will vary depending on the intended purpose(s) of its fund's 12b-1 plan.

- *Eliminating Board Factors.* Given the range of different circumstances that boards may face, the SEC should not specify the factors that a board should consider in deciding whether or not to approve or continue a 12b-1 plan. In fact, the SEC should eliminate the factors that were listed in 1980. By identifying specific factors, the SEC creates the risk that a board will focus too much attention on enumerated factors, and too little on other relevant, non-enumerated factors.

- *Eliminating the Rule's Quarterly Reporting Requirement*. Rule 12b-1 requires a fund's board to receive, and to review, quarterly reports on amounts expended under a 12b-1 plan and the purposes of those expenditures. Quarterly board consideration does not provide any meaningful additional protection to investors and should be eliminated. Many directors believe the time spent on reviewing these quarterly reports is a diversion away from more substantive matters. Instead, it would be a more productive use of their time, if, similar to their consideration of advisory agreements, fund directors reviewed and considered this type of information as part of the annual renewal process. To continue to provide periodic oversight, a fund's chief compliance officer ("CCO") could review quarterly reports of distribution expenditures and advise the board of any irregularities or material changes in a particular quarter.

Operational Changes to 12b-1 Fees and Other Distribution Practices

Repealing the authority provided under Rule 12b-1 for funds to pay distribution costs out of their assets would dramatically change the regulatory and business landscape and jeopardize the existence of current distribution systems and shareholder service arrangements. Industry experience indicates that Rule 12b-1 allows investors the option of paying distribution costs over time, gives investors access to funds that otherwise might not be available to them, and, when used to pay for ongoing advice and services to shareholders, acts as an incentive for financial professionals to continue to provide these services, on which so many fund investors depend.

One possible change to 12b-1 fees that has been suggested by various commentators is requiring funds to deduct distribution costs from shareholder accounts rather than from fund assets. Proponents contend that this approach could provide greater transparency of amounts paid in 12b-1 fees by funds and their shareholders. Even if so, such an approach would have adverse tax consequences for fund investors and pose significant operational difficulties. A better way to make the costs of distribution more transparent is through the disclosure improvements discussed above.

Commentators also have proposed eliminating 12b-1 fees charged by funds that have stopped accepting new investors. This proposal seems inconsistent with current uses of 12b-1 fees. These include providing ongoing advice and shareholder servicing to existing shareholders, irrespective of whether they are shareholders in open or closed funds, and allowing the fund's underwriter to recoup advanced sales commissions.

Sales of Class B shares have been the subject of widespread criticism, regulatory scrutiny, and enforcement proceedings. Unlike Class A shares, which have front-end sales loads and often small 12b-1 fees, Class B shares typically have higher annual 12b-1 fees and contingent deferred sales loads ("CDSLs") that decline in each year the investment is held. Class B shares also convert to Class A shares after a given number of years (*e.g.*, six to eight years). Some have expressed concerns that investors may purchase Class B fund shares when it would be more suitable for those investors to purchase a different class of shares. In addition, investors who purchase Class B shares cannot take advantage of breakpoint discounts available on large purchases of Class A shares. Despite these concerns, studies have shown that Class B shares outperform Class A shares over certain periods and in certain market conditions. There also are regulatory actions, such as limiting the length of time before Class B shares convert to Class A shares and the size of cumulative Class B share investments, that can be taken to address the common concerns regarding the sale of Class B shares.

Report of the Working Group on Rule 12b-1

I. Formation of the Working Group

In January 2005, the Institute formed a Working Group comprised of members of its Board of Governors[1] to evaluate current law, regulation, and industry practices relating to mutual fund distribution and to consider the need to revise Rule 12b-1 under the Investment Company Act. In addition to drawing upon the experience of its members, the Working Group conducted an analysis of Rule 12b-1, including its history, the evolution of fund distribution practices since the rule's adoption, and various regulatory actions over the past 27 years that have influenced the ways in which 12b-1 fees are used today. As part of its analysis, the Working Group considered a broad range of distribution issues, including possible changes to Rule 12b-1. This Report reflects the results of the Working Group's analysis and findings and the recommendations of the majority of its members.

II. Historical Overview[2]

Section 12(b) of the Investment Company Act provides that in general it is unlawful for a mutual fund to act as a distributor of its securities in contravention of any rules the SEC may prescribe. Under this section, Congress did not prohibit funds from underwriting their own securities, but rather only from doing so in contravention of SEC rules. Although the statutory language of Section 12(b) does not prohibit funds from imposing asset-based charges to pay for the distribution of their shares, the SEC and its staff generally took the position that it was improper for mutual funds to finance distribution of their shares.[3] This position was based on concerns about conflicts of interest that may exist between a fund and its investment adviser when fund assets are used to finance distribution and about whether a fund and its existing shareholders could benefit from this use of fund assets.[4]

As a result of the SEC's position, before 1980, funds sold through investment professionals compensated those professionals for providing advice, assistance, and ongoing services to shareholders through "front-end" sales loads.[5] 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.

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[1] A list of the members of the Working Group is included on the inside front cover of this report.

[2] A chronology of significant Rule 12b-1 events and a more complete history of Rule 12b-1 are included in Appendices I and II, respectively.

[3] *See e.g.,* Securities and Exchange Commission, Statement on the Future Structure of Securities Markets (Feb. 2, 1972), 37 FR 5286 (Mar. 14, 1972) ("1972 Statement"); Bearing of Distribution Expenses by Mutual Funds, SEC Release No. IC-9915 (Aug. 31, 1977) ("1977 Statutory Interpretation") (citing 1972 Statement as continuing to represent the SEC's position); Bearing of Distribution Expenses by Mutual Funds, SEC Release No. IC-10862 (Sept. 7, 1979) ("Rule 12b-1 Proposing Release") (citing the 1977 Statutory Interpretation as representing the SEC's position).

[4] *See* Exemptions for Certain Registered Open-End Management Investment Companies to Impose Deferred Sales Loads, SEC Release No. IC-16619 (Nov. 2, 1988) ("1988 Release").

[5] A front-end sales load is a sales fee charged at the time of an investor's initial purchase of his/her investment.

A. Proposal and Adoption of Rule 12b-1

In the 1970s, the SEC began to reexamine its position with respect to the distribution of fund shares. Following public hearings in 1976 and solicitations of written comments by the SEC with respect to whether permitting fund assets to finance distribution could benefit investors, the SEC issued a release proposing Rule 12b-1 in 1979.[6]

In 1980, the SEC adopted Rule 12b-1 permitting funds, subject to largely procedural conditions, to pay directly distribution-related costs.[7] The rule, as adopted, prohibited an open-end fund from using its own assets to pay for any distribution costs unless it had adopted a written plan approved by the fund's board and its shareholders and the fund's distribution payments were made pursuant to the plan. When the SEC adopted the rule, it first contemplated that 12b-1 plans would be used to solve particular distribution problems or respond to specific circumstances, such as helping funds through periods of net redemptions. It did not include in the rule, however, any restrictions on the types of distribution activities that funds could finance under the rule. Instead, the SEC specifically noted that Rule 12b-1 does not restrict the kinds or amounts of payments that a fund may make and was intended to be flexible enough to allow funds to develop new distribution practices.[8] The SEC generally provided that, within the framework of the rule, discretion would lie with fund boards, and particularly independent directors, regarding the fund's distribution-related activities. The rule's adopting release also stated that the SEC 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.[9]

B. Early Uses of 12b-1 Fees

Initially, funds used 12b-1 plans to pay advisers and distributors for costs associated with advertising, the printing and mailing of prospectuses to prospective investors, and the printing and mailing of sales literature.[10] As distribution practices continued to evolve in the years following Rule 12b-1's adoption, the

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[6] *See* Rule 12b-1 Proposing Release, *supra* note 3.

[7] *See* Bearing of Distribution Expenses by Mutual Funds, SEC Release No. IC-11414 (Nov. 7, 1980) ("Rule 12b-1 Adopting Release").

[8] *See id*. In providing an overview of the meaning of distribution expenses, a 1999 administrative law judge stated that, in adopting Rule 12b-1, the SEC recognized "that new distribution activities may continuously evolve in the future." *See In re Terrence Michael Coxon, et al.*, Initial Decision Release No. 140 (April 1, 1999). The decision went on to say that an "expansive, aggressive and even atypical approach to what is included in a fund's 12b-1 plan does not necessarily violate section 12(b) and rule 12b-1." *Id.*

[9] *See* Rule 12b-1 Adopting Release, *supra* note 7.

[10] *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). By 2004, however, only 2 percent of the 12b-1 fees paid by fund shareholders was used for advertising and other sales promotion activities. *See* "How Mutual Funds Use 12b-1 Fees," *Fundamentals*, Vol. 14, No. 2, Investment Company Institute, February 2005 ("February 2005 Fundamentals"), available at http://www.ici.org/pdf/fm-v14n2.pdf. Survey respondents accounted for three-quarters of the assets of mutual funds with 12b-1 fees.

SEC took steps to address investor protection concerns, including by requiring new prospectus disclosure concerning fund distribution costs and other material expenses.[11]

During this same period, increased competition from no-load funds and negative attitudes among mutual fund investors toward products that charge front-end sales loads prompted load funds to develop alternative methods of distribution financing.[12] The SEC helped to foster these innovations in fund distribution by creating the infrastructure to support the fund industry's development of a wide variety of methods for compensating broker-dealers and other intermediaries that sell fund shares. Specifically, in 1982, the SEC issued the first of nearly 300 exemptive orders permitting mutual funds to adopt a "spread load"[13] consisting of an asset-based fee, charged in accordance with Rule 12b-1, in combination with a CDSL.[14] The advent of spread load arrangements provided mutual fund investors who rely on the advice and assistance of third-party intermediaries in making their investment decisions (*e.g.*, full-service brokers, independent financial planners, or insurance agents) the option of paying for those services over time. At the same time, fund distributors under a spread load arrangement could advance commission payments to salespersons with the expectation that the advances would be recouped in the future.[15] Thus, spread loads became a substitute for the front-end sales load that traditionally had been the sole means of compensating intermediaries for sales of fund shares.

The SEC also helped to facilitate the growth in spread load arrangements by permitting mutual funds to issue multiple classes of securities representing interests in the same investment portfolio, with each class subject to a different distribution arrangement.[16] By using a multiple class structure, funds could more efficiently introduce shares with a spread load, instead of having to create, for instance, "clone" funds consisting of the same portfolio of investments that require duplication of portfolio and fund management

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[11] *See generally* Consolidated Disclosure of Mutual Fund Expenses, SEC Release No. IC-16244 (Feb. 1, 1988).

[12] *See* 1988 Release, *supra* note 4.

[13] A spread load is a plan under which a fund uses annual 12b-1 fees in place of, rather than as a supplement to, a traditional front-end sales load to cover the cost of distribution efforts.

[14] A CDSL is a sales charge that is imposed only if an investor redeems his shares within a specified period of time following purchase. The rate of the CDSL, typically starting between 2 percent and 6 percent, declines over time, usually at a rate of 1 percent per year. Although CDSLs had been used in connection with variable insurance products before the adoption of Rule 12b-1, they had not been used in connection with mutual funds. *See* 1988 Release, *supra* note 4; Nationwide Life Insurance Company and MFS Variable Account, SEC Release Nos. 10557 (Jan. 15, 1979) (notice) and 10590 (Feb. 12, 1979) (order).

[15] *See* Division of Investment Management, Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992) ("Protecting Investors Report") at 322. In 1995, the SEC adopted Rule 6c-10 under the Investment Company Act, which essentially codified the conditions in the exemptive orders permitting funds to implement spread load arrangements.

[16] Beginning in 1985, the SEC issued nearly 200 exemptive orders permitting mutual funds to adopt multiple class structures. In 1995, concurrently with the adoption of Rule 6c-10, the SEC adopted Rule 18f-3 under the Investment Company Act, which streamlined the conditions applicable to funds 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 Release Nos. 33-7143, IC-20915 (Feb. 23, 1995) ("Rule 18f-3 Adopting Release").

costs. These multiple share class arrangements enable investors to choose among pricing options for a particular fund and to select the distribution arrangement that best suits their needs. [17]

C. Today's Uses of 12b-1 Fees

Today, as a result of these innovations, investors have significantly greater choice about how and where they purchase mutual fund shares. While some investors prefer to buy mutual funds directly from the company sponsoring them, most investors seek professional help and advice from financial intermediaries in making investment decisions.[18] Many funds sold through intermediaries offer investors alternative sales charge arrangements combining different structures (multi-class and/or master-feeder),[19] sales charge methodologies (front-end and CDSL), and utilizing different combinations of service fees and distribution fees.[20] In fact, nearly 70 percent of all funds today have 12b-1 plans.[21] The primary purpose of these fees is to compensate financial advisers for advice and other services to their clients. These services include not only assistance with mutual fund selection and monitoring, but also "big picture" planning assistance with, for example, asset allocation strategies, education costs, life and long-term care insurance coverage, retirement needs, and estate planning. The fees for each share class are disclosed in the fee table at the front of the fund's prospectus. On the basis of this information, investors, by purchasing a particular class of shares or arrangement, may choose the particular method for paying their intermediary. Many funds, including no-load funds, money market funds, and front-end sales load funds, also have established 12b-1

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[17] The SEC 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 16.

[18] As of 2003, more than 80 percent of all shareholders owning fund shares outside a 401(k) or other employer-sponsored pension plan owned fund shares through financial advisers. *See* "Ownership of Mutual Funds Through Professional Financial Advisers," *Fundamentals*, Vol. 14, No. 3, Investment Company Institute, April 2005, available at http://www.ici.org/pdf/fm-v14n3.pdf.

[19] An alternative to the single (or one-tier) fund with multiple classes is the master-feeder structure in which one or more funds (the feeder funds) invest in the securities of another fund (the master fund). All portfolio management services are performed, and related costs incurred, at the master fund level, with distribution and shareholder servicing costs borne at the feeder fund level.

[20] In a typical arrangement, the fund offers three classes of shares: Class A, which have front-end sales loads and often small 12b-1 fees; Class B, which have annual 12b-1 fees and CDSLs that decline in each year the investment is held, and which convert to Class A shares after a period of time (*e.g.*, six to eight years); and Class C, which typically have annual 12b-1 fees as well as CDSLs of 1 percent for the first year of the investment. *See* Brian K. Reid and John D. Rea, "Mutual Fund Distribution Channels and Distribution Costs," *Perspective*, Vol. 9, No. 3, Investment Company Institute, July 2003, at 8–11 ("July 2003 Perspective"), available at http://www.ici.org/pdf/per09-03.pdf.

[21] According to the Institute's research, as of 2006, 3,885 funds (out of 5,536), or 70 percent of all mutual funds, (excluding variable annuity funds) have 12b-1 plans.

plans to pay "trail commissions" or "service fees" to compensate sales personnel and others for providing ongoing advice, administrative, recordkeeping, and transfer agent services to investors. [22]

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 incur fees that reflect the different services investors receive through a particular distribution channel.[23] Investors, seeking advice and assistance, purchase and redeem shares through financial advisers at securities firms, banks, insurance agencies, and financial planning firms. Investors also can buy and redeem shares of many funds through "fund supermarkets"[24] or retirement plan platforms[25] sponsored by third-party broker-dealers, retirement plan administrators and other institutions. In those fund supermarkets or retirement plan platforms, the supermarket or platform sponsor offers administrative and/or distribution services to its customers who purchase shares of a fund participating in the supermarket or platform program. The ability of funds to assess asset-based distribution fees has allowed many small fund groups to remain competitive by allowing them to gain access to a wider array of distribution channels, such as fund supermarkets, than they otherwise would have through traditional front-end sales load structures.[26]

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[22] In 2004, for example, virtually all (98 percent) of the 12b-1 fees paid by mutual funds were used as a substitute for front-end sales loads and/or to pay for ongoing advice, administrative and shareholder services. According to a survey conducted by the Institute, 40 percent of the 12b-1 fees collected in 2004 were used to compensate financial advisers and other financial intermediaries for assisting fund investors before they make an initial fund purchase. Another 6 percent of the 12b-1 fees collected in 2004 were used to compensate mutual fund underwriters to cover some of their costs. Fifty-two percent of the 12b-1 fees paid in that year were used to compensate financial advisers for ongoing services, such as responding to customer inquiries and providing information on fund investments. *See* February 2005 Fundamentals, *supra* note 10.

[23] The SEC staff has recognized that 12b-1 fees are integral to these arrangements. *See* Division of Investment Management, Securities and Exchange Commission, *Report on Mutual Fund Fees and Expenses* (December 2000) at 39 ("SEC Staff Fee Study"), available on the SEC's website at http://www.sec.gov/news/studies/feestudy.htm.

[24] Fund supermarkets are programs sponsored by financial institutions through which their customers may purchase and redeem a variety of funds, with or without paying transaction fees. Many funds that offer shares through fund supermarkets adopt 12b-1 plans to finance the payment of fees that are charged by the sponsors of the fund supermarkets. *See* SEC Staff Fee Study, *supra* note 23, at 39.

[25] Retirement plan service providers may meet the needs of plan participants by providing educational materials and seminars that explain the retirement plan and investment options, answering investors' questions through telephone call centers and automated voice-response systems, and maintaining websites with information specific to the retirement plan. Employers may choose a variety of ways to pay for these services to plan participants. The costs may be 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* July 2003 Perspective, *supra* note 20, at 5–6. *See also* "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses," *Fundamentals*, Vol. 15, No. 7, Investment Company Institute, November 2006, available at http://www.ici.org/pdf/fm-v15n7.pdf.

[26] *See* Statements of Mellody Hobson, President, Ariel Capital Management, LLC/Ariel Mutual Funds, and Thomas O. Putnam, Founder and Chairman, Fenimore Asset Management, Inc./FAM Funds, on "Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Costs and Distribution Practices," Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 26, 2004 and March 31, 2004; respectively (discussing the importance of 12b-1 fees to small fund complexes).

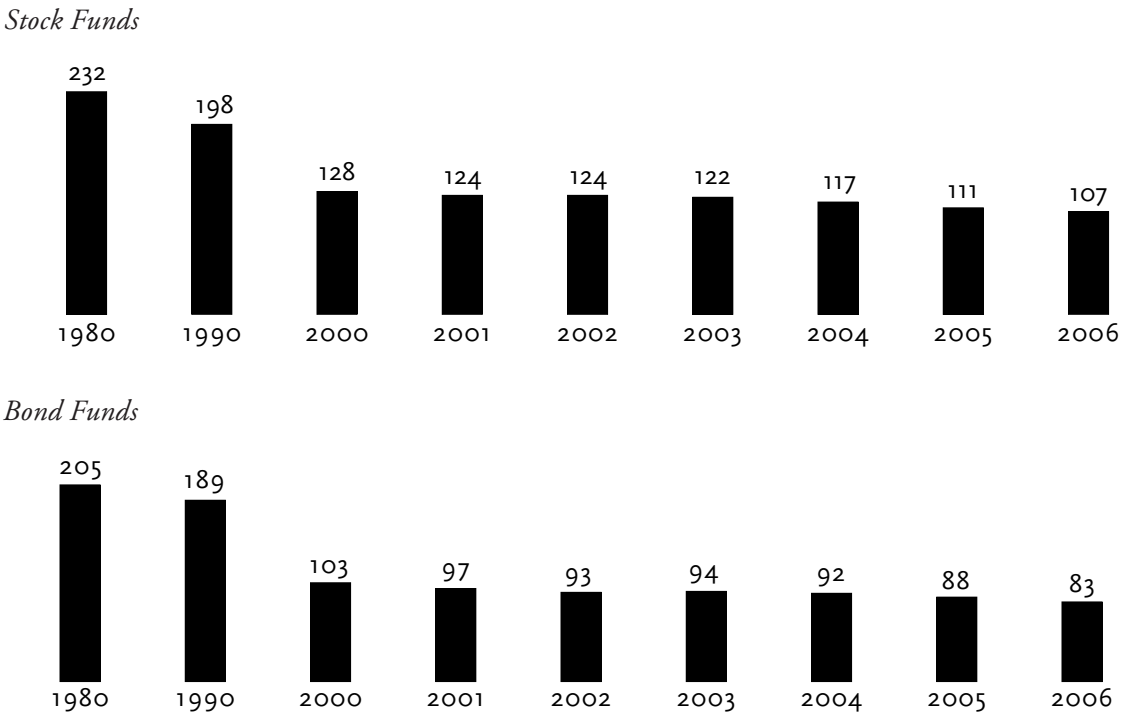
D. Mutual Fund Fees and Expenses

Not only have there been dramatic changes in how mutual funds are sold to the investing public since 1980, there also have been changes in the fees and expenses of stock and bond mutual funds. Mutual fund fees and expenses that investors pay have trended downward since 1980. In 1980, investors in stock funds, on average, paid fees and expenses of 2.32 percent (or 232 basis points) of fund assets. By 2006, that figure had fallen by more than half to 1.07 percent (or 107 basis points) of fund assets. Fees and expenses paid on bond funds have declined by a similar amount.

There are several reasons for the dramatic drop in the fees and expenses incurred by mutual fund investors. These include the growth in sales of no-load funds, the downward pressure on fund fees caused by intense competition within the mutual fund industry, economies of scale resulting from the growth in fund assets, and a decline in distribution costs for load share classes.

Total Fees and Expenses Incurred by Mutual Fund Investors*

Basis points, 1980–2006, selected years



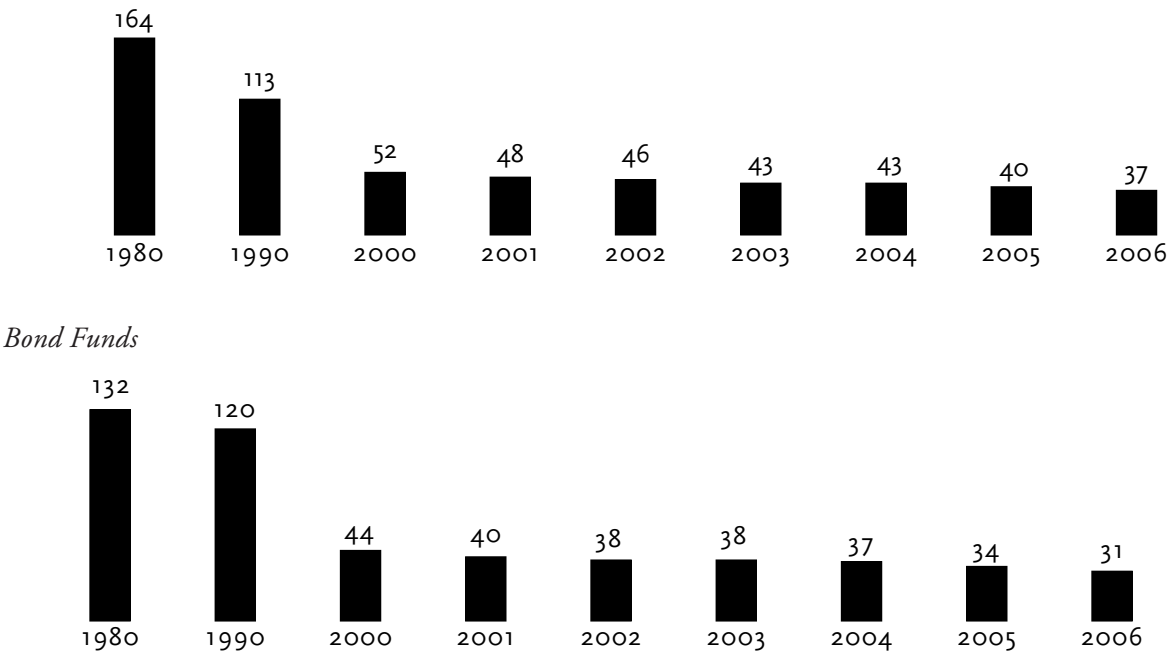
* Total fees and expenses are calculated as an asset-weighted average of annual expense ratios and annualized loads for individual funds. The annualized load is the conversion of the one-time load payment into annual payments made over the life of the investment.

Sources: Investment Company Institute; Lipper; ValueLine Publishing, Inc; CDA/Wiesenberger Investment Companies Services; © CRSP University of Chicago, used with permission, all rights reserved; and Strategic Insight Simfund

A significant reason for the decrease in overall mutual fees and expenses, as discussed above, is a decrease in distribution costs since 1980. As the chart below illustrates, average annual distribution costs incurred by investors in stock funds decreased from 1.64 percent (or 164 basis points) of the investors' initial investment in 1980 to 37 basis points in 2006, a 77 percent decrease. Similarly, distribution costs of bond funds fell 76 percent, from 132 basis points in 1980 to 31 basis points in 2006. Sixty percent of the decrease in overall distribution costs resulted from a decline in distribution costs for load share classes, while the remaining 40 percent of the decrease resulted from a relative shift in new sales from share classes with loads to those with no loads.

Distribution Costs of Mutual Funds*

Basis points, 1980–2006, selected years



*The distribution costs of stock and bond funds are the sum of the asset-weighted average 12b-1 fees and the asset-weighted average total annualized loads for each group. The annualized load is the conversion of the one-time load payment into annual payments made over the life of the investment.

Sources: Investment Company Institute; Lipper; ValueLine Publishing, Inc; CDA/Wiesenberger Investment Companies Services; © CRSP University of Chicago, used with permission, all rights reserved; and Strategic Insight Simfund

III. Analysis and Recommendations

Today, most funds rely on 12b-1 fees to finance at least some portion of their distribution costs. Notwithstanding the widespread use and acceptance of these fees, however, recent media coverage and regulatory commentary have questioned whether Rule 12b-1 continues to serve the purpose for which it was originally intended, whether it benefits investors and, therefore, whether it should be amended or repealed.[27] Proposals have ranged from improving disclosure of the fees charged and how they are spent to eliminating Rule 12b-1 or deducting 12b-1 fees at the account level rather than the fund level.

In 2004, the NASD formed a Mutual Fund Task Force, which issued a report on fund distribution arrangements in early 2005.[28] The report stated that many developments in distribution payments since the adoption of Rule 12b-1 have benefited investors by allowing them to choose how to pay distribution costs (*i.e.*, up-front, over time, or upon redeeming fund shares). Among other things, the report recommended that the SEC review the rule's requirements, particularly those that are procedural in nature, with a view toward modernizing them. More recently, the Chairman of the SEC and the Director of the SEC's Division of Investment Management have announced plans to reconsider Rule 12b-1 this year.[29]

A. Fund Disclosure

With the evolution of 12b-1 fees, the advent of multiple class funds, and the variety of distribution channels, investors have a wide range of choices in how to pay for the advice and shareholder services they receive in connection with the distribution of fund shares. While this range of choices is beneficial to investors, the variety and complexity of these choices presents certain disclosure challenges.

1. Use of the "12b-1" Term

If a fund charges a 12b-1 fee, that fee must be identified as a separate line item in the fee table as "Distribution [and/or Service] (Rule 12b-1) fees." The term "12b-1 fees" is legalese that does not convey the nature and purpose of these fees. Identifying 12b-1 fees solely in a manner that describes their purpose,

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[27] *See* Speech by SEC Chairman: Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference by Chairman Christopher Cox, Securities and Exchange Commission, Washington, DC (April 13, 2007) at 2–4 ("Chairman Speech"); Speech by SEC Staff: Keynote Address at 2007 Mutual Funds and Investment Management Conference by Andrew J. Donohue, Director, Division of Investment Management, Securities and Exchange Commission, Washington, DC (March 26, 2007) at 6–7 ("Donohue Speech").

In 2004, in response to current practices under the rule, the SEC issued a release seeking public comment on whether Rule 12b-1 should be amended or rescinded. See Prohibition on the Use of Brokerage Commissions to Finance Distribution, SEC Release No. IC-26356 (Feb. 24, 2004) ("2004 SEC Proposal"). In 2000, the SEC staff noted some of the staff's concerns with Rule 12b-1. *See* SEC Staff Fee Study, *supra* note 23. The study recommended that the SEC consider whether it would be appropriate to review the requirements of Rule 12b-1. The report noted 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. *Id.* at 39.

[28] *See Report of the Mutual Fund Task Force: Mutual Fund Distribution*, NASD (April 2005) at 18–19, ("NASD Task Force Report"), available at http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_013690.pdf.

[29] *See* Chairman Speech, *supra* note 27, at 4; Donohue Speech, *supra* note 27, at 7.

without reference to a rule number, could demystify the term for investors.[30] Specifically, 12b-1 fees should be listed in the prospectus fee table using tailored, straightforward, descriptive terms such as "third-party investment advice" or "sales and service charges." This approach would accurately describe the primary purpose(s) of a fund's 12b-1 fee, as reflected in the fund's 12b-1 plan and its actual expenditures.[31]

An additional step to enhance investors' understanding of all fees associated with a fund purchase would be to include a glossary of the terms used in the prospectus fee table (*e.g.*, various types of sales loads, management, transfer agent, custody, and service fees). The glossary, a sample of which is included in Appendix III, should cover fees associated with buying, maintaining, and redeeming fund shares in an easy-to-understand format that would provide investors with a better context in which to evaluate fund expenses.

These disclosure improvements should be coupled with broader efforts to improve mutual fund disclosure. Institute research indicates that most investors find fund prospectuses difficult to understand and too long.[32] Investors prefer a concise summary of key information about a fund.[33] The use of a short-form disclosure document that provides this key information, including the fund's fee table, would significantly enhance the transparency of fund fees and expenses, including 12b-1 fees. This format would make fee information more readily accessible to investors. The SEC staff currently is considering recommending such an approach.[34]

The SEC has proposed to require broker-dealers to provide, at the time of sale, information about distribution costs and potential conflicts of interest on the part of brokers in selling particular mutual funds.[35] Point-of-sale disclosure requirements could offer an effective way to further improve investor awareness and understanding of 12b-1 fees and other fund distribution costs, if carefully crafted so as not to dissuade brokers from selling fund shares. Given that brokers typically sell mutual funds by phone rather

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[30] The NASD Mutual Fund Task Force recommended this same change to the SEC. *See* NASD Task Force Report, *supra* note 28, at 17.

[31] An industry critic has advocated that the SEC develop 12b-1 fee disclosure that "describes the fees as what they represent: the added cost of servicing non-self-directed investors." *See* "12b-1 Fees: Politics and Policy," *Fund Democracy Insights*, Vol. 1, Issue 4 (September 2001) at 8.

[32] *See* Investment Company Institute, *Understanding Preferences for Mutual Fund Information,* 2006, at 5–6, 29–30.

[33] *Id.*

[34] *See* Speech by SEC Staff: Remarks before the American Bar Association Section of Business Law Spring Meeting, by Andrew J. Donohue, Director, Division of Investment Management, Securities and Exchange Commission, Washington, DC (March 16, 2007), at 2–3("the [Division] is considering whether to recommend that the SEC permit funds to offer securities pursuant to a streamlined disclosure document that … could include key information necessary for an investor to make an investment decision, such as fees and expenses, risks, investment objectives and strategies, and historical returns.").

[35] *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 (January 29, 2004). *See also* Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds, SEC Release No. IC-26778 (February 28, 2005).

than in face-to-face meetings, point-of-sale disclosure should not have to be delivered in paper form, nor should lengthy narrative be required.[36]

In addition, if point-of-sale disclosure requirements apply to mutual funds but do not apply to the other investment products that brokers sell, brokers predictably will steer customers to alternative investments that do not offer the same level of regulatory protection and other benefits (*e.g.,* diversification and liquidity) that mutual funds do. Properly crafted point-of-sale disclosure requirements would help investors better understand the costs of, and evaluate broker recommendations to invest in, the full range of investment products that brokers sell, and therefore should be extended beyond mutual funds. When appropriate point-of-sale disclosure requirements covering funds and other types of investments are devised, they should include 12b-1 fees and other distribution costs.

2. Use of the "No-Load" Term

NASD rules prohibit any fund with a front-end load, CDSL, or a 12b-1 fee from being referred to as "no-load," except for a fund with a 12b-1 fee that does not exceed 25 basis points.[37] This approach 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.[38] In adopting the exception, the SEC and NASD determined that, without the exception, it would be difficult for investors to distinguish between funds that use relatively low 12b-1 fees to finance advertising and other sales promotion activities and funds that use higher 12b-1 fees as an alternative to front-end sales charges.[39] The SEC and NASD reasoned that any potential investor confusion could be addressed in the fund's fee table.[40]

The original premise upon which the exception is based is still relevant today. For example, "no-load" funds often use 12b-1 fees to pay fund supermarkets and retirement plan sponsors for providing a platform through which investors can research funds, obtain fund literature, and purchase fund shares. For these funds, there are no sales loads to compensate financial advisers for sales assistance. A "no-load" exception, therefore, should be retained.

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[36] *See* Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 4, 2005.

[37] *See* NASD Conduct Rule 2830(d).

[38] *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 Release No. 34-30897 (July 7, 1992).

[39] *Id.*

[40] *Id.*

B. Board Oversight Under Rule 12b-1

1. Board Guidance

Rule 12b-1 makes it the duty of a fund's directors to "request and evaluate" and the duty of any person who is a party to any agreement with the fund relating to the fund's 12b-1 plan to furnish "such information" as may reasonably be necessary to an "informed determination" of whether the 12b-1 plan should be implemented or continued. To approve or renew a plan, Rule 12b-1 requires that fund directors conclude, in the exercise of "reasonable business judgment and in light of their fiduciary duties" under state law and under Sections 36(a) and (b) of the Investment Company Act, that there is "a reasonable likelihood that the plan will benefit the [fund] and its shareholders." In the release proposing Rule 12b-1, the SEC stated that what constitutes reasonable business judgment in a given case would depend on all the pertinent facts and circumstances of that case.[41]

Rule 12b-1 requires fund directors in making this judgment to consider and give weight to "all pertinent factors." In its release adopting Rule 12b-1, the SEC explained that it had decided not to require directors to consider any particular factors in making this determination.[42] Instead, the SEC 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."[43] Many of the factors identified by the SEC in 1980 presupposed that funds would typically adopt 12b-1 plans for relatively short periods to solve a particular distribution problem or to respond to specific circumstances, such as net redemptions.[44]

Developments since 1980 have made the factors obsolete. The industry has not needed to use 12b-1 plans to solve short-term distribution problems or to address prolonged periods of net redemptions. Rather, as discussed above, 12b-1 fees are used to give investors significantly greater choice about how and when they pay for advice and service in connection with the purchase of mutual fund shares. In addition, there

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[41] *See* Rule 12b-1 Proposing Release, *supra* note 3.

[42] *See* Rule 12b-1 Adopting Release, *supra* note 7.

[43] The SEC suggested that fund directors consider the following factors: (1) the need for independent counsel or experts to assist the directors in reaching a determination; (2) the nature of the problems or circumstances which purportedly make implementation or continuation of such a plan necessary or appropriate; (3) the causes of such problems or circumstances; (4) the ways in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including the nature and approximate amount of the expenditures, the relationship of such expenditures to the overall cost structure of the fund, the nature of the anticipated benefits, and the time it would take for those benefits to be achieved; (5) the merits of possible alternative plans; (6) the interrelationship between the plan and the activities of any other person who finances or has financed distribution of the fund's shares, including whether any payments by the fund to such other person are made in such a manner as to constitute the indirect financing of distribution by the fund; (7) the possible benefits of the plan to any person relative to those expected to inure to the fund; (8) the effect of the plan on existing shareholders; and (9) in the case of the decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the fund and its shareholders. *See* Rule 12b-1 Adopting Release, *supra* note 7.

[44] *See e.g.,* SEC Staff Fee Study, *supra* note 23, at 39; 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 73.

are now annual and cumulative limits on 12b-1 fees under NASD rules.[45] These limits are designed to achieve "approximate economic equivalency" in the amounts that may be charged in 12b-1 fees and sales loads. The limits, which were not in place when Rule 12b-1 was adopted, protect shareholders against excessive payments.[46]

These developments do not necessarily warrant revisions to Rule 12b-1, although they do suggest that the SEC should revisit the role of the board under the rule. We believe the board has an appropriate oversight role in approving and annually renewing 12b-1 plans. Rule 12b-1 provides a strong framework for this responsibility based upon a standard that fund directors make a "reasonable business judgment" that the plan will likely benefit the fund and its shareholders. A board can reach this conclusion, in light of the current uses of 12b-1 fees, by focusing on the full range of activities financed under a fund's 12b-1 plan and the options and other benefits those activities provide to the fund's shareholders. More importantly, the standard provides directors with the flexibility to exercise oversight of 12b-1 plans consistent with marketplace realities and their duties of care and loyalty as fiduciaries.

How each board makes its determination under the rule should be left to that board and will vary depending on the intended purpose(s) of its fund's 12b-1 plan. For example, directors for a fund that uses its 12b-1 plan to compensate intermediaries for initial and ongoing advice in connection with the sale of fund shares may want to review the need for such services and the competitive conditions in the intermediary marketplace, including 12b-1 fees of comparable funds. Directors for a fund that uses its 12b-1 plan to pay for ongoing shareholder and administrative services may want to focus on the nature of the services that shareholders would receive and the payments that the fund would be required to make to another entity to perform the same services. Other boards will take other factors into consideration.

Given the range of different circumstances that boards may face, the SEC should not specify the factors that a board should consider in deciding whether or not to approve or continue a 12b-1 plan. In fact, the SEC should eliminate the factors that were listed in 1980. By identifying specific factors, the SEC creates the risk that a board will focus too much attention on enumerated factors, and too little on other relevant, non-enumerated factors. For example, although the Rule 12b-1 Adopting Release states that the factors are "suggested" and not "required," many fund boards and fund counsel have found it difficult to ignore these

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[45] Unlike other fund fees, the NASD imposes two types of limits on 12b-1 fees. One is an annual limit on asset-based sales charges of 0.75 percent of a fund's assets. (An additional 0.25 percent "service fee" may be paid to brokers or other sales professionals for providing ongoing information and assistance.) The other is an overall cap on 12b-1 fees that is based on a percentage of fund sales. The cap is calculated at 6.25 percent of new sales (plus interest) for funds that pay a service fee, and 7.25 percent plus interest for funds that do not pay a service fee. *See* NASD Conduct Rule 2830(d).

[46] In 1988, the SEC proposed to disallow the use of fund assets as a continuing substitute for front-end sales loads but was persuaded instead to subject 12b-1 fees to maximum limits of the NASD deemed to be the economic equivalent of the NASD limits on front-end sales loads. *See* Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, 1940 Act Release No. 16431 (June 13, 1988) at notes 105–23 and accompanying text. *See also* Protecting Investors Report, *supra* note 15, at 297, 325–28.

In addition to limiting sales charges and 12b-1 fees, the NASD rules impose general liability requirements on broker-dealers with respect to their recommendations to customers regarding the purchase, sale, or exchange of any security, including fund shares. *See* NASD Conduct Rule 2310.

factors, and some funds have viewed the factors as a mandatory checklist rather than a form of guidance.[47] In addition, factors that may appear relevant to a board's deliberations today may become outdated (as they have since 1980) and thus may need to be updated to avoid, among other things, the risk of inappropriately exposing boards to liability.

2. Quarterly Reports

Rule 12b-1 currently requires a fund's board to receive, and to review, quarterly reports on amounts expended under a 12b-1 plan and the purposes of those expenditures. Such frequent reporting to the board may no longer be necessary, particularly when the 12b-1 fees are used to fund trail commissions and up-front brokerage commissions on CDSL shares that do not vary quarter by quarter. The amounts charged under the plan typically are formulaic and thus quarterly board consideration does not provide any meaningful additional protection to investors. Many directors believe that the time spent on reviewing these quarterly reports is a diversion away from more substantive matters. Instead, it would be a more productive use of their time, if, similar to their consideration of advisory agreements, fund directors reviewed and considered this type of information as part of the annual renewal process.

We therefore recommend that the requirement that a fund's board review quarterly reports under Rule 12b-1 be eliminated. To ensure continued periodic oversight of distribution expenditures, a fund's CCO could review 12b-1 quarterly reports. As part of this evaluation, the CCO could flag for discussion with the board any irregularities or material changes in a particular quarter that may warrant the board's consideration.

C. Operational Changes to 12b-1 Fees and Other Distribution Practices

Other proposals to reform 12b-1 plans have focused on operational changes, such as eliminating Rule 12b-1 or deducting 12b-1 fees at the account level rather than the fund level.

1. Continued Effectiveness of Rule 12b-1

Repealing the authority provided under Rule 12b-1 for funds to pay distribution costs out of their assets would change significantly the regulatory and business landscape and jeopardize the existence of current distribution systems and shareholder service requirements. Industry experience indicates that developments in mutual fund distribution practices allow investors the option of paying for advice and assistance over time. Such developments also give those who choose to own funds through a particular distribution channel access to funds that otherwise might not be available to them and, when used to pay for ongoing services to shareholders, act as an incentive for financial professionals to continue to provide these services.

We conclude that repeal of the rule would *not* benefit shareholders. In connection with purchasing and redeeming fund shares, most investors seek advice and other assistance from a financial intermediary, who reasonably expects to be compensated for its assistance. Many of those who commented on the SEC's

[47] Not all funds view the factors as a mandatory checklist. Other boards have decided to supplement or replace some or all of the factors with factors that more accurately reflect today's distribution practices.

proposal concerning Rule 12b-1 included individual brokers, financial planners, and other intermediaries. These commenters argued that 12b-1 fees properly compensate salespersons for advice provided to and services performed for investors. They indicated that if 12b-1 fees were eliminated: intermediaries would be forced to shift to a different and possibly more expensive compensation model for ongoing investment planning assistance for fund clients; investor choices of funds and services would be limited; account transactions might increase to generate front-end sales loads as a replacement for income lost from the elimination of 12b-1 fees (*i.e.*, churning);[48] and small investors likely would receive less ongoing attention and service following their purchase of mutual fund shares.[49]

Repealing Rule 12b-1 likely would limit investors' choices of funds, leaving many investors with fewer investment options. For instance, alternative fee-based products, such as separately managed accounts"[50] or "mutual fund advisory programs,"[51] offered by broker-dealers and other investment professionals typically are not available to investors with more modest amounts to invest.[52] In addition, in contrast to separately managed accounts, funds offer protection to shareholders such as board oversight, standardized fee disclosure, asset diversification, and regulatory safeguards relating to, for instance, securities valuation, custody of assets, and investment leverage.

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[48] Asset-based fees have been recognized as better aligning the interests of broker-dealers and their clients than traditional commission-based products by allowing registered representatives to focus on their most important role—providing investment advice to individual clients, not generating transaction revenues. *See* Report of the Committee on Compensation Practices (April 10, 1995), available at http://www.sec.gov/news/studies/bkrcomp.txt. The SEC's endorsement of this report, known as the Tully Report, is reflected in the SEC's original proposal in 1999 of Rule 202(a)(11)-1 under the Investment Advisers Act of 1940. *See* Certain Broker-Dealers Deemed Not to be Investment Advisers, SEC Release No. 34-42099 (November 4, 1999).

[49] *See, e.g.,* Letters to Jonathan G. Katz from National Association of Insurance and Financial Advisors, dated May 7, 2004; The Financial Planning Association, dated May 10, 2004; The Financial Services Roundtable, dated May 11, 2004. The SEC also received letters from individuals and other entities arguing that Rule 12b-1 should be drastically amended or eliminated. Some of these commenters argued that sales charges for the services of broker-dealers or other intermediaries should be paid directly by investors who choose to utilize their services and not paid through a 12b-1 fee. *See, e.g.,* Letters to Jonathan G. Katz from Marvin L. Mann, Chairman of the Independent Trustees, The Fidelity Funds, dated May 10, 2004; Fund Democracy, Inc., Consumer Federation of America, Consumers Union, and Consumer Action, dated May 10, 2004. The SEC received over 1,600 comment letters in response to its 2004 proposal requesting comment on whether it should propose changes to Rule 12b-1 or rescind the rule. *See* 2004 SEC Proposal, *supra* note 27.

[50] Separately managed accounts allow an investor to employ the services of a professional money manager for an account that is separate and distinct from the accounts of other investors.

[51] Mutual fund advisory programs systematically allocate investors' assets across a wide range of mutual funds.

[52] In general, achieving diversification through separate accounts requires opening multiple $100,000 accounts. *See* "Trends in Separate Account Consultant Programs," *Strategic Insight Overview*, Issue 6 (2004) at 4. For mutual fund advisory programs, although investment minimums can be as low as $5,000 and $10,000 at some firms, the average account size is greater than $100,000. *See* "In the Comfort Zone: Shining While Remaining Out of the Spotlight," Managed Accounts Edition, *The Cerulli Edge*, Cerulli Associates, First Quarter 2005 at 6. In contrast, account-level data collected by the Institute indicate that the typical balance in a long-term retail mutual fund, as indicated by the median account balance, may be less than $10,000. *See* "Mutual Funds and Institutional Accounts: A Comparison," Investment Company Institute (2006). In addition, fund investment minimums can be as low as $50 per month for investors participating in automatic investment plans.

2. Account-Level Distribution Charges

One change that has been suggested by various commentators and mentioned by the SEC and its staff is refashioning Rule 12b-1 so that funds would deduct distribution-related costs directly from shareholder accounts rather than from fund assets. These commentators suggested that this alternative would offer a "cleaner" or more "transparent" way of paying for advice and other services. As previously discussed, we agree that more can and should be done to inform investors about amounts paid in 12b-1 fees.[53] There are, however, disadvantages to imposing distribution costs at the shareholder level that likely would outweigh the benefits of this approach. Specifically, payment of distribution charges at the account level has significant tax and operational disadvantages that other disclosure modifications designed to enhance investors' understanding of fees associated with a fund purchase do not. In light of these significant disadvantages, we strongly recommend that the SEC conduct an in-depth analysis if the SEC determines that deducting distribution-related costs at the account level should be pursued.

a) Tax Considerations[54]

Deducting distribution costs at the shareholder account level would have adverse tax consequences for fund shareholders and increase their recordkeeping burdens. In general, account-level distribution charges most likely would reduce two tax benefits that fund shareholders receive when 12b-1 fees are paid by the fund. The first benefit involves timing: 12b-1 fees paid at the fund level reduce shareholders' taxable distributions currently. By contrast, account level charges would cause shareholders to receive this benefit later (when fund shares are sold). The second benefit involves tax-rate differences: 12b-1 fees paid by the fund reduce income taxed at regular "marginal" rates (of up to 35 percent), which are the highest tax rates imposed on income. Shareholder account level charges would offset income taxed at more favorable capital gains rates (generally 15 percent).

Shareholder-level deductions of distribution costs presumably would be in the form of installment loads. The SEC's Division of Investment Management has pointed to tax laws as creating roadblocks for 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 each installment of a deferred load would be treated as an increase in the shareholder's basis.[55]

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[53] *See supra* Section III.A.

[54] An example demonstrating the tax consequences of charging 12b-1 fees at the account level is included in Appendix IV.

[55] Protecting Investors Report, *supra* note 15, at 329.

The report pointed out that payments from pension plans and individual retirement accounts and annuities that are not considered rollovers likely would be taxed to the investor as a distribution.[56] 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.[57]

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."[58] Relevant tax laws have not changed since the Division's report was issued in 1992. As noted above, 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. Clearly, the tax laws continue to present a formidable obstacle to the successful implementation of a system in which ongoing distribution fees are deducted on a shareholder account basis.

b) Operational Issues[59]

Switching from fund-level to shareholder-level deductions of ongoing distribution fees also has very significant operational implications. Shareholder-level deductions of distribution costs would be a departure from current practice and would require costly systems changes at all distribution levels by fund distributors, transfer agents, and other intermediaries. Specifically, to track and assess accrued 12b-1 fees daily against individual accounts, new transfer agent, bookkeeping, and accounting systems would need to be created. Because mutual fund investor recordkeeping typically is conducted at multiple levels—by funds' primary transfer agents as well as broker-dealers, banks, trust companies, and retirement plan recordkeepers operating sub-accounting systems (*e.g.*, omnibus accounts such as retirement plans)—the new systems and required programming would need to be implemented and replicated at each level.

As discussed above, shareholder-level deductions of distribution costs likely would be in the form of installment loads. Funds that wish to offer shares with an installment load option would need to determine how to structure the fee. Regardless of their structure, installment loads most likely would be collected through periodic redemptions of fund shares. For this, systems would need to address how to ensure that account balances are not reduced (by redemptions, exchanges, and/or market related reductions) to levels below which collection of the installment loads would be at risk. The redemption of shares to pay installment loads (which could often involve relatively small amounts) also would result in higher transfer agent fees.

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[56] *Id.* at n.165.

[57] *Id.* at n.167.

[58] *Id.* at 327 (emphasis added). The report stated that the staff recognized that installment loads likely would not be used without tax reform. *Id.* at 329.

[59] For a detailed discussion of the operational implications associated with charging 12b-1 fees at the shareholder account level, see Appendix V.

Mutual funds already have the flexibility they need under both SEC and NASD rules to impose installment loads.[60] Funds, however, have not utilized installment loads, which presumably can be attributed, in large part, to the tax and operational issues outlined above.

3. 12b-1 Fees on Closed Funds

Given the investment capacity constraints of certain funds, such as those that invest in small market capitalization stocks or have specialized strategies, advisers may deem it appropriate to close a fund to new investors. Funds also close to new investors for other reasons, including an inability to find new investments priced within the fund's valuation model and organizational stress due to "hyper-growth" throughout a management company, not just in one of its funds.[61] Some commentators have proposed eliminating 12b-1 fees charged by funds that are "closed" to new investors on the basis that a fund not currently offered to the general public has no need to pay distribution fees. This logic misunderstands contemporary uses of 12b-1 fees in two respects.

First, shareholders receive ongoing advice and shareholder services from their financial intermediaries, irrespective of whether they are shareholders in open or closed funds.[62] If closed funds are precluded from collecting 12b-1 fees, financial intermediaries will lose an important incentive to continue serving the investors in those funds.

Second, when brokers sell Class B shares of a fund (*i.e.*, share classes charging a 12b-1 fee and a CDSL), the fund's underwriter typically advances an upfront commission to the selling broker when an investor buys shares, allowing the investor to pay sales commissions over time. The fund then, from ongoing 12b-1 fees, reimburses the underwriter for the cost of the commissions already advanced to the selling broker. If closed funds are not able to charge 12b-1 fees, underwriters might be unable to fully recoup the costs of commissions already advanced to brokers. In fact, some underwriters finance the payment of upfront commissions by borrowing from banks, finance companies, or other financial intermediaries, using the expected stream of 12b-1 fee payments as collateral.[63] The fund's underwriter must continue to repay such loans when the fund closes. Thus, it is appropriate to allow a closed fund to continue paying, and the

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[60] *See* Rule 6c-10 under the Investment Company Act; NASD Conduct Rule 2830(d).

[61] *See* "The Use of 12b-1 Fees Among Funds 'Closed' to New Investors," *Mutual Funds Insight: Perspectives & Insights*, No. 17 (2005) at 3 ("2005 Mutual Funds Insight"). Although some funds exercise a "hard" close, permitting no additional investments, most closed funds remain open for many of their existing shareholders or other types of investors (sometimes referred to as a "soft" close). *Id.* at 4. Other funds, instead of closing to new investors, may slow down new sales by drastically increasing the minimum size of new investments. *Id.*

[62] A fund that exercises a "soft" close, for example, continues to require some ongoing marketing and sales efforts. *Id.*

[63] *See* SEC Staff Fee Study, *supra* note 23, at 39.

underwriter of the fund to continue collecting, 12b-1 fees until any previously advanced sales commissions have been fully recouped.[64]

A fund's board also should consider the consequences to the fund and its shareholders of eliminating a 12b-1 plan. For example, if a fund is closed to new investors and 12b-1 fees are eliminated, services for existing shareholders may be adversely affected if, as noted above, financial intermediaries lose an important incentive to continue serving those shareholders. In turn, a loss of services may cause a potential loss of assets (and a resulting increase in expenses) if shareholders leave the fund.

The SEC has recognized the appropriateness of funds that are closed to new investors continuing to charge 12b-1 fees.[65] Moreover, 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.[66] A fund that stops selling shares will eventually reach its "cap" and, at that point, will be precluded from imposing asset-based sales charges under Rule 12b-1.

4. Distribution Fees v. Service Fees

Another change to Rule 12b-1 that has been suggested is prohibiting payments for administrative (as opposed to distribution) purposes.[67] One difficulty with this approach is that there is no single industry convention (nor any explicit regulatory standard) about how funds classify or label their services, nor is there a bright line that differentiates various kinds of services under 12b-1 plans. Different funds often use different labels for similar shareholder servicing fees they pay and/or use common labels to refer to different

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[64] A federal district court has recognized that funds properly may pay compensation for past distribution services under Rule 12b-1. *See ING Principal Protection Funds Derivative Litigation,* 369 F. Supp. 2d 163 (Dist. Mass. May 9, 2005) (dismissing a claim that a closed fund paid excessive 12b-1 fees). For the year ended April 30, 2005, based on public filings with the SEC, 191 funds closed to new investors. Of these funds, 16 reduced their 12b-1 fees. With each of these funds, 12b-1 fees for class A shares were reduced, rather than eliminated, from 0.30 or 0.35 percent to 0.25 percent (a common level for service fees of class A shares that have a 12b-1 fee and are open to new investors). The 12b-1 fees for other share classes (*e.g.*, class B and C shares), typically used to pay financial advisers or to amortize previously advanced upfront distribution costs, were not changed. (Not all of the 191 closed funds had 12b-1 fees before closing.) *See* 2005 Mutual Funds Insight, *supra* note 61, at 4.

[65] In 1993, then SEC Chairman Arthur Levitt sent to John D. Dingell, Chairman of the House Committee on Energy and Commerce, a memorandum authored by the SEC staff, addressing the propriety of continuing 12b-1 payments by closed funds. The staff memorandum noted that "even if a fund closes to new investors, it may continue to pay 12b-1 fees in order to compensate the distributor for past distribution efforts" because "Rule 12b-1 permits a fund to spread its distribution expenses over several years and allows payment of fees for past distribution services." Similarly, the SEC staff has recognized that a mutual fund that has discontinued sales through a fund supermarket may still 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* Investment Company Institute, SEC No-Action Letter (pub. avail. October 30, 1998) at n.18 ("Fund Supermarkets Letter"). The NASD Mutual Fund Task Force noted that it is appropriate for a mutual fund closed to new investors to continue to charge 12b-1 fees to recoup its up-front distribution costs, to support the continued bank financing of those costs, or to assist existing fund shareholders when the fees are charged for shareholder servicing or ongoing advice. *See* NASD Task Force Report, *supra* note 28, at 18–19.

[66] *See* NASD Conduct Rule 2830(d), *supra* note 45.

[67] Fees that are distribution-related must be paid by a fund only through a 12b-1 plan, whereas fees for administrative services may be paid outside of a 12b-1 plan.

things. Moreover, in prospectus fee tables, some funds combine 12b-1 fees and service fees together and others list service fees separately from 12b-1 fees under "Other Expenses."[68]

The SEC 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.[69] In the fund supermarket context, the staff has issued 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.[70]

Because of difficulties in drawing meaningful distinctions between distribution and servicing fees, requiring differentiation may subject the judgment calls made by fund directors about the nature of particular payments to second-guessing and potential liability. Adoption of a 12b-1 plan gives a fund, its directors, 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.[71]

5. Sales of Class B Shares

Sales of Class B shares have been the subject of widespread criticism, regulatory scrutiny, and enforcement proceedings.[72] Unlike Class A shares, which have front-end sales loads and often small 12b-1 fees, Class B shares typically have higher annual 12b-1 fees and CDSLs that decline in each year the investment is held. Class B shares convert to Class A shares after a given number of years (*e.g.*, six to eight years). Concerns have been raised that investors may purchase Class B shares when it would be more suitable for those investors to purchase a different class of shares.[73] Investors who purchase Class B shares, for example, cannot take advantage of breakpoint discounts available on large purchases of Class A shares.[74] These concerns relate to the suitability of Class B shares for certain investors, rather than the inherent nature of

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[68] Out of the total of shareholder service fees paid in 2004, 82 percent were paid through a 12b-1 plan and 18 percent were paid outside such a plan. *See* February 2005 Fundamentals, *supra* note 10.

[69] *See, e.g.,* 2003 Roye Memorandum, *supra* note 44, at 74; SEC Staff Fee Study, *supra* note 23, at 39.

[70] *See* Fund Supermarkets Letter, *supra* note 65.

[71] In order to avoid potential liability regarding a board's determination about the nature of particular payments, some funds adopt so-called "defensive 12b-1 plans" to cover both distribution and administrative fees. These plans do not impose separate payments from the fund's assets to a distributor; rather, they stipulate that the adviser to finance the distribution of fund shares may use a portion of the fund's advisory fee.

[72] *See, e.g.,* "Class B Mutual Fund Shares: Do They Make the Grade?," *NASD Investor Alert*, June 25, 2003 ("NASD Investor Alert"). The SEC and NASD have settled enforcement actions against broker-dealers relating to improper sales of Class B shares. *See, e.g.*, *In the Matter of Citigroup Global Markets, Inc.*, SEC Release Nos. 33-8557 and 34-51415, Admin. Proc. File No. 3-11869 (March 23, 2005); *In re Citigroup Global Markets, Inc.*, NASD Letter of Acceptance, Waiver and Consent (March 23, 2005); *In re American Express Financial Advisors Inc.*, NASD Letter of Acceptance, Waiver and Consent (March 23, 2005); *In re Chase Investment Services Corporation*, NASD Letter of Acceptance, Waiver and Consent (March 23, 2005).

[73] *See, e.g.,* NASD Investor Alert, *supra* note 72.

[74] *Id.*

Class B shares themselves. While some commentators have recommended the elimination of Class B shares and some fund groups have discontinued them based on such concerns, studies have shown that Class B shares can outperform Class A shares over certain periods and in certain market conditions.[75] As with a fund, the suitability of a share class depends upon specific circumstances.

Some fund companies have taken steps to address sales practice concerns regarding Class B shares, such as limiting the size of any single B-share purchase. The NASD Mutual Fund Task Force also has identified actions that we believe regulators should consider. These include (i) limiting the length of time before Class B shares convert to Class A shares to avoid charging investors the higher 12b-1 fee after the fund has recouped its up-front distribution costs and (ii) limiting the size of cumulative Class B share investments and providing guidance concerning the mutual fund sponsor's responsibility to police these limitations.[76] These actions could help address concerns regarding the sale of Class B shares without unduly limiting the class share options available to investors.

IV. Conclusion

The Working Group is pleased to have had the opportunity to review mutual fund distribution practices and, in particular, the requirements of Rule 12b-1. The Working Group's Report is intended to assist the Institute's members and Board of Governors as they consider what modifications, if any, may be appropriate in this area. The Working Group also hopes that the Report will prove useful to the SEC as it continues to consider possible modifications to Rule 12b-1.

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[75] *See* Edward O'Neal, *Mutual Fund Share Classes and Broker Incentives*, Financial Analysts Journal, 76–87 (September/October 1999). *See also* July 2003 Perspective, *supra* note 20, at 12–13.

[76] NASD Task Force Report, *supra* note 28, at 18–19.

Appendix I
Rule 12b-1: Chronology of Events

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Rule 12b-1 was adopted in 1980 after an extended and intensive administrative process, which included public hearings, several rounds of public comment, and four years of study by the SEC and its staff. While it initially anticipated that 12b-1 plans would be used for relatively short periods of time for specific distribution purposes, the SEC also intended that Rule 12b-1 be flexible enough to accommodate new distribution practices that might be developed in the future. Since 1980, there have been dramatic changes in mutual fund distribution, which have given investors significantly greater choice in purchasing fund shares (*e.g.*, investors may choose whether to pay up front or over time for the services they receive from investment professionals). These changes, which occurred under the oversight of the SEC and its staff, are consistent with the original intent of Rule 12b-1.

The following summarizes the SEC's development of Rule 12b-1, its monitoring of the rule's operation, and various regulatory actions over the past two decades to permit the ways in which 12b-1 fees are used today.

Oct. 1976 The SEC announces that it will hold public hearings on the use of fund assets to pay for distribution expenses. The announcement outlines the legal and public policy issues to be considered and states that the hearings will assist the SEC in re-examining its past positions with respect to whether funds may bear distribution expenses.

Nov. 1976 The SEC holds four days of public hearings and receives written statements concerning the legal and public policy implications of arrangements permitting funds, directly or indirectly, to bear expenses related to the distribution of their shares.

Aug. 1977 The SEC announces that there has been no change in its previous position that it is generally improper for funds to use their assets to finance distribution. The announcement also states that the SEC "has not yet completed its consideration of the relevant issues and is not yet prepared to suggest whether, and if so under what circumstances, mutual funds should be permitted to bear distribution expenses."

May 1978 The SEC issues a release outlining a range of possible conditions under which funds might be permitted to use their assets to pay for distribution expenses. The release requests public comment on those conditions and states that the SEC will determine whether to propose a rule after reviewing the comments it receives.

Sept. 1979 The SEC proposes Rule 12b-1 and seeks public comment. The SEC's release states that the conditions in the proposed rule are significantly different from those outlined in the May 1978 release because the SEC found "a number of practical and technical difficulties with some of those conditions."

Oct. 1980 The SEC adopts Rule 12b-1. The rule emphasizes the role of a fund's independent directors in overseeing the use of fund assets to pay for distribution expenses. The SEC says it will closely monitor the operation of Rule 12b-1 and be ready to adjust the rule in light of experience.

The SEC later commented on the flexibility that it had built into the rule: "The Commission did not include in Rule 12b-1 a recitation of all the distribution activities that funds could finance under the rule. Additionally, the Commission specifically noted [in its 1980 adopting release] that the rule does not restrict the kinds or amounts of payments that could be made by a fund. *The rule was intended to be flexible enough to cover new distribution financing arrangements that might be developed by the mutual fund industry*."[*]

Jan. 1982 The SEC issues the first of nearly 300 exemptive orders permitting funds to impose "spread loads" consisting of 12b-1 fees in combination with contingent deferred sales loads. A spread load is essentially a financing of a front-end sales load. Spread loads allow investors to have their entire purchase price invested in fund shares and, at the same time, enable fund distributors to advance commission payments to salespersons that are repaid over time through 12b-1 fees.

Nov. 1984 The SEC proposes to consolidate all expense-related disclosure in fund prospectuses and to require a new standardized table setting forth the fund's major expenses by category. The SEC's release states that "mutual funds today are using a variety of distribution techniques and fee arrangements" and that "the variety and complexity of these arrangements" prompted the SEC "to explore ways to improve the quality of prospectus disclosure so that investors may more easily and more clearly understand mutual fund fee and expense arrangements." The distribution techniques discussed in the release include using a 12b-1 plan as part of a spread load arrangement or to compensate banks for providing services (*e.g.*, account maintenance, order processing, responding to inquiries) to bank customers who purchase fund shares.

1985 The SEC issues the first of nearly 200 exemptive orders permitting funds to issue multiple classes of shares that have different distribution arrangements and related fees. These classes allow investors to select the method of financing distribution that best fits their investment horizon and the size of their investment.

Aug. 1987 Responding to industry concerns, the SEC revises its November 1984 proposal on expense disclosures. The new proposal includes an "extensively revised" fee table that contains a separate line item identifying the fund's 12b-1 fees.

1988 In February, the SEC adopts its revised proposal on expense disclosures, with minor changes. In June, following an SEC staff review of fund distribution practices developed since the adoption of Rule 12b-1, the SEC proposes to amend the rule to prohibit the use of spread

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[*] *Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies*, Investment Company Act Rel. No. 16431 (June 13, 1988), at text accompanying n.45 (emphasis added).

loads as alternatives to front-end sales loads. The SEC proposal notes that NASD rules limit other forms of fund sales charges but not 12b-1 fees.

Dec. 1990 In response to the SEC proposal, the NASD proposes to expand its fund sales charge rule to cover 12b-1 fees. The change would create "approximate economic equivalency" between the amount of sales charges paid up front, which is limited to 8.5 percent, and 12b-1 fees paid over time.

1992 In May, the SEC staff issues a comprehensive report entitled *Protecting Investors: A Half Century of Investment Company Regulation*. The report endorses the NASD proposal and recommends that the SEC not make any changes to Rule 12b-1 that would prevent the use of spread loads. In July, the SEC approves the NASD proposal.

1995 The SEC approves new rules that permit funds to impose spread loads and to issue multiple classes of shares without first having to obtain exemptive orders from the SEC.

1998 The SEC staff reviews fund supermarkets in response to the dramatic growth in both the number of funds participating in, and the amount of assets invested through, fund supermarkets organized by discount brokers. The staff issues industry guidance as to when payments for supermarket services must be made pursuant to a 12b-1 plan and the role of fund directors in making this determination.

Dec. 2000 The SEC staff issues a comprehensive report regarding trends in fund fees and expenses since 1980. The report notes that Rule 12b-1 "essentially requires fund directors to view a fund's 12b-1 plan as a temporary measure." The report concludes that Rule 12b-1 may need to be updated to reflect changes in how funds are marketed and distributed.

June 2003 The SEC staff sets forth its views on various fund issues in response to an inquiry from Congressman Richard Baker (R-LA). The staff's memorandum largely repeats the discussion of Rule 12b-1 in the staff's December 2000 fee report. It also addresses the question of when revenue sharing payments must be made pursuant to a 12b-1 plan.

Feb. 2004 The SEC proposes to amend Rule 12b-1 to prohibit directed brokerage arrangements, whereby a fund compensates a broker for selling the fund's shares by directing portfolio securities transactions to that broker. The SEC also requests public comment on whether it should propose other changes to Rule 12b-1.

Aug. 2004 The SEC prohibits directed brokerage arrangements. The SEC announces no other changes to Rule 12b-1 but says that the SEC staff will continue to review the public comments the SEC received on possible reforms to the rule.

Mar. 2005 The Mutual Fund Task Force, formed by NASD after discussions between the SEC and NASD staffs, issues a report on fund distribution arrangements. The report states that many developments in distribution payments since the adoption of Rule 12b-1 have benefited investors by allowing them to choose how to pay distribution costs (*i.e.*, up-front, over time, or upon redeeming fund shares). Among other things, the report recommends that the SEC review the rule's requirements, particularly those that are procedural in nature, with a view toward modernizing them.

Spring 2007 The Chairman of the SEC and the Director of the SEC's Division of Investment Management announce plans to reconsider Rule 12b-1 by the end of the year.

Appendix II
History of Rule 12b-1

prepared by Shearman & Sterling LLP

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Appendix II
History of Rule 12b-1

Introduction

Section 12(b) of the Investment Company Act of 1940 provides that it is unlawful for a mutual fund to distribute its own shares, except through an underwriter, in contravention of rules and regulations prescribed by the SEC. No such rules or regulations, however, were promulgated by the SEC until 1980. Notwithstanding the express terms of Section 12(b), which suggest that a fund could lawfully distribute its own shares in the absence of any rules to the contrary, the SEC and its staff historically took the view, with some exceptions, that it would be improper for a mutual fund to finance, directly or indirectly, the distribution of its own shares. In 1980, the SEC reversed its position and adopted Rule 12b-1, which permits a mutual fund to pay distribution-related costs out of fund assets, subject to certain conditions contained in the rule. This paper explores the regulatory events and fund industry developments leading up to, and following, the adoption of Rule 12b-1.

Historical Overview of Fund Distribution to 1970

Legislative History of the Investment Company Act

In connection with the enactment of the Investment Company Act, the Senate acknowledged that, because of the redeemability of their shares, most open-end investment companies would shrink if they did not continuously sell new securities to investors.[1] At the same time, the SEC "was particularly fearful of the possibility that open-end investment companies in their formative stages might be made to shoulder the unprofitable burden of selling and distributing their shares during this period of heavy expenses and small return, building up the investment company for the benefit of some controlling person."[2] With regard to this concern, SEC spokesman David Schenker portrayed the purpose of Section 12(b) as to protect funds "against excessive sales, promotion expenses, and so forth."[3] Congress did not, however, prohibit funds from underwriting their own securities. Section 12(b) instead has prohibited funds only from doing so in contravention of SEC rules.

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[1] Investment Company Act of 1940 and Investment Advisers Act of 1940, S. Rep. No. 76-1775 (1940), *reprinted in* Thomas Lemke and Gerald Lins, 2 Regulation of Investment Companies D-5 (2004).

[2] Alfred Jaretzki, *The Investment Company Act of 1940*, 26 Wash. U.L.Q. 303, 324-325 (1941).

[3] H.R. 76-10065, Investment Trusts and Investment Companies: Hearings Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce (1940) (testimony).

SEC Interpretation of Section 12(b)

In 1953, the SEC informed an applicant for exemptive relief that an exemption from the provisions of Section 12(b) was not required for the fund to finance the distribution of its shares because the SEC had not yet adopted rules or regulations under Section 12(b).[4]

Early Case Law Relating to Mutual Fund Distribution

Toward the end of the 1950s, a number of lawsuits alleged excessive investment advisory fees, including in relation to distribution expenses, although only a few were fully litigated. In one case,[5] the court implicitly raised the issue of the propriety of including distribution expenses in an adviser's presentation to shareholders of its profitability,[6] but the SEC in a subsequent discussion of this case concluded that the parties "did not raise and the court did not consider the propriety of justifying advisory fees on the basis of a management decision to subsidize sales of fund shares."[7]

Wharton Report

Around the time that these cases were being litigated, the SEC commissioned the Wharton School of Finance and Commerce to prepare a report (the "Wharton Report")[8] that discussed, in various contexts, the effect of the distribution of fund shares on the operations and expenses of funds. Recognizing that a number of investment advisory firms also provided distribution services, the report provided information on "the extent to which, if at all, the advisory function of certain firms is subsidizing the underwriting function, or vice versa."[9] The report concluded that, "[i]n sum, the selling of shares of open-end companies is a major concern of the control groups that supervise these companies."[10] The report found that the sale of fund shares was "the principal means by which increases in assets managed are achieved, and such increases automatically bring with them higher management fees," as well as significant revenue directly from acting as the distributor of fund shares.[11]

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[4] In the Matter of Institutional Investors Mutual Fund, Inc., 35 S.E.C. 72, at n.6 (Apr. 14, 1953) (Opinion), Investment Company Act Release No. 1856 (Apr. 14, 1953) (Order) ("Institutional Investors Mutual Fund"). *See also* First Safe Fund, SEC No-Action Letter (pub. avail. Jan. 9, 1972) ("First Safe Fund") (commenting that, absent the promulgation of rules or regulations under Section 12(b), no-action relief from Section 12(b) was unnecessary).

[5] *Saxe v. Brady*, 184 A.2d 602 (Del. Ch. 1962) (finding in favor of defendants). *See also Acampora v. Birkland,* 220 F. Supp. 527 (D. Colo. 1963) (finding that "[t]he servicing and processing of … accounts is so closely tied to the sale and distribution of the shares as to be inescapably incident thereto").

[6] *Saxe*, 184 A.2d at 609.

[7] Securities and Exchange Commission, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 89-2337, at 135 n.152 (1966) ("PPI Report").

[8] Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. 2274 (1962). This report did not purport to reflect the views of the SEC.

[9] *Id*. at 514.

[10] *Id.* at 473.

[11] *Id.*

Special Study

In 1963, the SEC submitted to Congress the results of a study (the "Special Study")[12] that noted that:

> Mutual fund shares, alone among securities offered to the public, are constantly redeemable and continuously offered by their issuers. Their statutorily required redeemability has been taken by most funds and their sponsors to justify if not require the creation of retail sales forces to facilitate the constant offering of shares.[13]

The Special Study remarked that "the entire cost of selling fund shares is generally borne exclusively by the purchaser of new shares and not by the fund itself."[14] The Study noted that, although the SEC had never promulgated rules under Section 12(b), "it is the universal practice that all mutual funds other than no-load funds are sold through a principal underwriter."[15] The Special Study noted that, because a fund's principal underwriter is typically connected in some way with the fund's investment adviser, which receives an asset-based advisory fee, the underwriter has an interest, which it otherwise would not have, in increasing the fund's size.[16]

PPI Report

In 1966, the SEC issued a report titled "Report on the Public Policy Implications of Investment Company Growth" (the "PPI Report").[17] The report discussed, among other developments, the analyses contained in the Wharton Report and the Special Study, and discussed various issues relating to the distribution of mutual fund shares. The SEC Chairman's transmittal letter accompanying the report cited, as a conflict of interest inherent in the structure of registered funds, that, "[s]ince mutual fund managers are usually compensated upon the basis of a percentage of the net assets of the fund, there is a powerful incentive for growth through the sale of new shares."[18]

The PPI Report generally found that underwriting activities were unprofitable and "the difference in profitability between the advisory and distribution functions is striking."[19] The report found that the data reviewed "supports the Wharton Report's findings that to a significant extent mutual fund advisers use the

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[12] Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Rep. 88-95 (1963).

[13] *Id.*, pt. 4, at 204.

[14] *Id.*, pt. 4, at 96-97.

[15] *Id.*, pt. 4, at 97 n.9.

[16] *Id.*

[17] PPI Report, *supra* note 7.

[18] Transmittal Letter dated Dec. 2, 1966, from Manuel F. Cohen, Chairman, SEC, to U.S. Congress, at viii.

[19] PPI Report, *supra* note 7, at 123.

profits from advisory fees paid by the funds to subsidize underwriting activities in the hope of increasing the size of the funds under their management and generating greater advisory fees."[20]

Legislative and Regulatory Developments in the Early 1970s

The 1970 Amendments

In 1970, Congress enacted the Investment Company Amendments Act of 1970 (the "1970 Amendments"),[21] which included the enactment of Sections 15(c) and 36(b) of the Investment Company Act. The Senate Report relating to the 1970 Amendments[22] indicated that the Amendments represented an "effort . . . to deal with the problems described in" the Wharton Report, the Special Study, and the PPI Report.[23] The Senate Report concluded that "the adviser and underwriter are usually the same or related entities" and noted that the fiduciary duty established under new Section 36(b) would apply with respect to compensation for services paid by the fund or its shareholders to the fund's investment adviser or affiliated persons of the adviser, and that the section would provide a mechanism for court enforcement of that duty.[24]

The Senate Report noted that sales competition was "operat[ing] in reverse in the sale of mutual funds"– that is, competition raised sales loads rather than lowering them, because "mutual funds compete for the favor of dealers and salesmen by offering higher sales compensation."[25] The report noted that, historically, only unconscionable or grossly excessive sales loads were prohibited. It found that "[t]he real financial return to the underwriter or the affiliated investment adviser … is the management fee which increases automatically as the fund grows in size."[26]

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[20] *Id.* at 125. The report expressed the Commission's view that, as a result, larger companies had a substantial advantage over smaller ones in the competition for sales of mutual fund shares. *Id.*

[21] Pub. L. 91-547 (Dec. 14, 1970).

[22] Investment Company Amendments Act of 1970, S. Rep. No. 91-184 (1970), *reprinted in* Thomas Lemke and Gerald Lins, 2 Regulation of Investment Companies D-35 (2004).

[23] *Id.* at D-36.

[24] *Id.* at D-41 to D-45.

[25] *Id.* at D-44.

[26] *Id.* at D-43 to D-45.

1972 Statement

In 1972, the SEC issued an interpretive statement[27] that concluded, without citing particular provisions of the Investment Company Act, that:

> [W]e believe that the cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment, and not, even in part, by the existing investors of the fund who often derive little or no benefit from the sale of new shares. To impose a portion of the selling cost upon the existing shareholders of the fund may violate principles of fairness which are at least implicit in the Investment Company Act.[28]

Although this statement was made in the context of the SEC's analysis of reciprocal portfolio brokerage for sales of fund shares, the statement was later cited by the SEC as representing its general position on the distribution of mutual fund shares.[29]

Over the next few years, the SEC and its staff provided guidance that, in several instances, reached conclusions that were consistent with the 1972 Statement,[30] as well as other guidance[31] that some have viewed as contrary to the policy set out in the 1972 Statement.[32]

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[27] Securities and Exchange Commission, Statement on the Future Structure of Securities Markets (Feb. 2, 1972), 37 FR 5286 (Mar. 14, 1972) ("1972 Statement").

[28] *Id.* at 37 FR 5291.

[29] *See, e.g.,* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 9915 (Aug. 31, 1977) ("1977 Statutory Interpretation") (citing 1972 Statement, *supra* note 27, as continuing to represent the SEC's position); Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10862, 1979 LEXIS 735, at *5-*6 (Sept. 7, 1979) ("Rule 12b-1 Proposing Release") (citing the 1977 Statutory Interpretation as representing the SEC's position).

[30] *See* Axe-Houghton, SEC No-Action Letter (pub. avail. Nov. 15, 1973) (a fund's financing of the distribution of its shares would constitute a hidden sales load under Section 22(d) of the Act). *See also* Terry & Saxton, Inc., SEC No-Action Letter (pub. avail. Sept. 7, 1973) (expressing the staff's view that assigning a portion of the fund management fee to sales personnel may be deemed to result in the assignment of the fund's advisory agreement under the Act each time a salesperson is replaced).

[31] *See* In the Matter of Broad Street Investing Corporation, et al., Investment Company Act Release No. 7114 (Apr. 4, 1972) (allowing a fund to own its distributor); In the Matter of Broad Street Investing Corporation, et al., Investment Company Act Release No. 9513 (Nov. 8, 1976) (allowing the addition of a new fund to the arrangement); Pegasus Fund, Inc., SEC No-Action Letter (pub. avail. May 21, 1975) (permitting the internalization of management and distribution by a group of funds) ("Pegasus Fund"); Armstrong Associates, SEC No-Action Letter (pub. avail. Aug. 19, 1975) (allowing the manager to pay a set portion of a fund's management fee as continuing sales compensation to broker-dealers); Mutual Liquid Assets, Inc., SEC No-Action Letter (pub. avail. July 15, 1976) (permitting a start-up fund's adviser to reallocate one-half of the fund's advisory fee to dealers selling the fund's shares subject to disclosure about the "uncertain legal status" of the practices).

[32] *See* John P. Freeman, *The Use of Mutual Fund Assets to Pay Marketing Costs*, 9 Loy. U. Chi. L.J. 533, 539-540 (1978).

1974 Mutual Fund Distribution Report

In 1974, the SEC's Division of Investment Management issued a report on mutual fund distribution.[33] That report found that "[f]und distribution, seldom profitable in and of itself in the best of times, seems to have become even less profitable (or more unprofitable) lately, thus requiring greater subsidization of distribution from advisory profits."[34] The report further stated that "[t]he notion of a distribution system which is, in itself, not profitable seems to have become accepted as a fact of life by the mutual fund industry, and more and more complexes have been forced to finance essential wholesaling services and the sale of fund shares out of the profits generated from investment advisory fees."[35] The staff also expressed concern that "the fund industry seems to be unable to assure proper follow-up service to shareholders."[36] The report proposed that a mutual fund be permitted to impose "a reasonable flat service fee" that might "include an amount to compensate the underwriter, at least in part, for the absence of any underwriter's spread on the sale."[37]

1976 Hearings

In November 1976, four days of hearings were held before the Commission (the "1976 Hearings")[38] on "the appropriateness of arrangements whereby mutual funds would, directly or indirectly, bear expenses related to the distribution of their shares, such as the costs of advertising and providing compensation for dealers."[39] The release announcing the hearings said that, "[i]n the past, the Commission and its staff generally have questioned the propriety of arrangements under which open-end investment companies would bear the costs of distribution,"[40] but it also noted that, "in certain unusual circumstances, the Commission or its staff has not objected to such arrangements."[41]

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[33] SEC Division of Investment Management Regulation, Mutual Fund Distribution and Section 22(d) of the Investment Company Act of 1940 (Nov. 4, 1974) (report submitted to the Senate Committee on Banking, Housing and Urban Affairs).

[34] *Id.* at 20.

[35] *Id.* at 31. *See also id.* at 31-33; 43.

[36] *Id*. at 43.

[37] *Id.* at 106.

[38] *See* Official Transcript of Proceedings Before the Securities and Exchange Commission: The Bearing of Distribution Expenses by Mutual Funds, Washington, DC (Nov. 17, Nov. 18, Nov. 22, Nov. 23, 1976) ("1976 Hearings").

[39] Announcement of Public Hearings, Investment Company Act Release No. 9470, 1976 SEC LEXIS 691, at *1 (Oct. 4, 1976) ("1976 Announcement of Public Hearings").

[40] *Id.* at *2.

[41] *Id.* at *1-*2 (citing Broad Street Order, *supra* note 31 (allowing a fund to own its distributor), and Pegasus Fund, *supra* note 31 (permitting the internalization of management and distribution by a group of funds)). As noted above, the staff in less "unusual circumstances" had taken a similarly permissive position. *See, e.g.*, Institutional Investors Mutual Fund, *supra* note 4; First Safe Fund, *supra* note 4.

The 1976 Hearings frequently focused on the viability of open-end investment companies and the benefits to the investing public of the existence of those funds. During the hearings, industry representatives generally supported the use, in some way, of fund assets, or at least of a manager's own resources, for the distribution of fund shares. Some industry representatives noted that companies in other industries were not restricted as to the resources from which promotional expenses could be paid. One Commissioner stated that the SEC's past positions restricting the use of fund assets to finance distribution "were based upon a conclusion based upon the evidence available that in most instances funds were in fact controlled by their advisers."[42]

1977 SEC Statutory Interpretation

In 1977, the SEC issued a statutory interpretation announcing that it was still studying the question of the use of fund assets to finance distribution.[43] In that announcement, the SEC said that it had not changed the position, as set out in the 1972 Statement, that it is generally improper for a fund to finance distribution, and further expressed its view that, absent an SEC order, "one or more sections" of the Act (the announcement did not identify which sections) would prohibit the use of fund assets to finance distribution.

Vanguard Exemptive Application

During this time period, The Vanguard Group was in the process of internalizing the management of the Vanguard funds, which effectively would result in the funds owning their manager. If an internalized fund was a no-load fund, the fund's assets would be the only potential source of the payment of the fund's distribution costs. In a 1978 hearing on a Vanguard exemptive application, an administrative law judge described the question of the use of fund assets for distribution as "still under consideration"[44] and "under re-examination."[45]

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[42] 1976 Hearings, *supra* note 38 at 410.

[43] 1977 Statutory Interpretation, *supra* note 29.

[44] In the Matter of The Vanguard Group, et al., Initial Decision, 1978 SEC LEXIS 2550 (Nov. 29, 1978), at *26.

[45] *Id*. at *57.

1978 SEC Advance Notice of Rulemaking

In 1978, in an SEC notice[46] announcing its consideration of rulemaking in the area of fund distribution expenses, the SEC said it was

> explor[ing] whether the use of mutual fund assets to pay distribution expenses could benefit shareholders under some circumstances, and, if so, what conditions could be designed to protect the interests of investors. The Commission has not decided whether this should be done. . . .[47]

The notice reiterated that "the Commission and its staff have taken the position, with certain exceptions, that any use of mutual fund assets for the purpose of financing the distribution of mutual fund shares would be improper."[48]

Proposal and Adoption of Rule 12b-1

Rule 12b-1 Proposal

In 1979, the SEC proposed the adoption of Rule 12b-1.[49] The SEC stated in the accompanying release (the "Proposing Release") that:

> The Commission is taking these actions because it believes that directors and shareholders of open-end management investment companies should be able to make business judgments to use their assets for distribution in appropriate cases but that, in view of the investment adviser's conflict of interest with respect to any recommendation to bear distribution expenses, any such exercise of business judgment should be subject to conditions designed to ensure that it is made by persons who are free of undue management influence and have carefully considered all relevant factors.[50]

The Proposing Release remarked that the SEC and its staff had traditionally viewed funds' financing of share sales as improper, but had been "reviewing the issue in light of public interest in and comment on the legal and policy implications of use of fund assets for distribution."[51] The release also concluded that "it clearly would constitute an indirect use of fund assets for distribution if the advisory fee was inflated in order to provide the adviser with funds for that purpose."[52]

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[46] Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10252 (May 23, 1978) ("Notice of Rulemaking").

[47] *Id.*

[48] *Id.*

[49] Rule 12b-1 Proposing Release, *supra* note 29.

[50] *Id.* at *2.

[51] *Id.* at *6.

[52] *Id.* at *25.

Rule 12b-1 Adoption

In 1980, the SEC adopted Rule 12b-1.[53] The release accompanying the rule adoption (the "Adopting Release"), as with the Proposing Release, referred to the SEC's "traditional view that it is generally improper under the Act for mutual funds to bear direct or indirect expenses related to the distribution of their shares."[54] The Adopting Release also described "the Commission's longstanding position that an adviser may use its 'legitimate' or 'not excessive' profits to finance distribution."[55] Although adopting the rule, the SEC expressed its general concern about conflicts of interest between a fund and its adviser, the likelihood that funds will benefit, and the fairness to existing shareholders, from a fund's financing the expenses of the sale of its shares.[56] The rule, as proposed, would have required that directors consider and give appropriate weight to particular, enumerated factors.[57] The Adopting Release characterized those factors as "helpful guidance" rather than mandated considerations.[58]

The Adopting Release emphasized that that "there can be no precise definition of what types of expenditures constitute indirect use of fund assets," and placed the burden of that judgment primarily on directors, and particularly on disinterested directors.[59] The release also stated that "[i]t is the Commission's view that, an indirect use of fund assets results if any allowance is made in the adviser's fee to provide money to finance distribution," and fund directors "must satisfy themselves either that the management fee is not a conduit for the indirect use of the fund's assets for distribution or that the rule has been complied with."[60]

The SEC made clear that it intended to allow for flexibility and the evolution of the scope of activities that would be permissible under the rule. The SEC noted that it would monitor the operation of Rule 12b-1 and intended to adjust the rule from time to time in light of experience and that, within the framework of the rule, discretion would lie with fund boards, and particularly with independent board members, regarding the fund's marketing, promotional and other distribution-related activities.

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[53] Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414, 1980 LEXIS 444, at *26 n.49 (Oct. 28, 1980) ("Rule 12b-1 Adopting Release").

[54] *Id.* at *5 (citing 1977 Statutory Interpretation, *supra* note 29). The Adopting Release also said, without citation, that "[t]he Commission has historically been concerned with whether funds are paying for distribution in substance and not with the form of particular arrangements." Rule 12b-1 Adopting Release, *supra* note 53, at *28.

[55] Rule 12b-1 Adopting Release, *supra* note 53, at *14.

[56] *Id.* at *22.

[57] *See id.* at *49-*50 (text of proposed Rule 12b-1(d)).

[58] *Id.* at *37-*39.

[59] *Id.* at *29.

[60] *Id.* at *30.

Evolution of Rule 12b-1 in the 1980s and 1990s

Spread-Load Plans

Within a couple of years of Rule 12b-1's adoption, the use of 12b-1 plans became common in the industry and continued to grow in popularity throughout the 1980s and 1990s.[61] One of the most significant innovations that followed the adoption of Rule 12b-1 was the development of "spread-load plans," under which funds have used 12b-1 fees in place of, rather than as a supplement to, traditional front-end sales loads to cover the cost of distribution efforts.[62] Such plans effectively spread the sales charge that would otherwise be assessed at the time of purchase over an extended time period, allowing the entire purchase price paid by a shareholder to be fully invested from the start.[63] In connection with spread-load plans, many funds imposed contingent deferred sales loads ("CDSLs," also called contingent deferred sales charges, or "CDSCs"), pursuant to exemptive orders granted by the SEC,[64] to recoup distribution costs from investors who did not remain in the fund long enough to cover those costs through the annual payment of 12b-1 fees.[65] Spread-load plans often also provided for payment of trail commissions, ongoing payments to selling brokers that are intended to encourage brokers to continue providing services to shareholders after the time of purchase.[66]

In the mid-1980s, the SEC staff distinguished between two types of spread-load plans: (1) "reimbursement plans," under which 12b-1 fees paid to a fund's distributor in any given year may be used to both cover the distribution expenses actually incurred during the current year and reimburse the distributor for costs

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[61] *See, e.g.,* Lee B. Burgunder & Karl O. Hartmann, *The Mutual Fund Industry and Rule 12b-1 Plans: An Assessment*, 15 Sec. Reg. L.J. 364, 364 n.1 (1988) (citing a study by Lipper Analytical Services, Inc. in which 24 percent of the funds surveyed had 12b-1 plans at the end of 1983, 30 percent had plans at the end of 1984, 38 percent had plans at the end of 1985, and 48 percent had plans at the end of 1986).

[62] *See, e.g.,* Arthur Z. Gardiner, *Distribution of Investment Company Shares under Rule 12b-1*, 548 PLI/Corp 91, 121 (1987) (describing spread-load plans favorably as "innovative developments"). *But see* Burgunder & Hartmann, *supra* note 61, at 406 (describing the plans as "increasingly popular" but existing on "a legal tight-rope").

[63] Statement of the Investment Company Institute Regarding the Operation of Rule 12b-1 Plans, at 8 (submitted Aug. 8, 1986) ("ICI Statement"); Gardiner, *supra* note 62, at 123.

[64] Until 1995, when the SEC adopted Rule 6c-10, a mutual fund could not impose a CDSL absent exemptive relief from various provisions of the Investment Company Act. Exemption for Certain Open-End Management Investment Companies to Impose Contingent Deferred Sales Loads, Investment Company Act Release No. 20916 (Feb. 23, 1995) (adopting Rule 6c-10). Approximately 300 exemptive orders were granted during the period between 1981 and 1995. J. Julie Jason, *Mutual Fund Share Classes: Uses and Abuses*, 1327 PLI/Corp 27, 37 (2002).

[65] A CDSL is a sales load that is charged to an investor only if the investor redeems his or her shares within a specified period of time following purchase. The initial sales load on the investor's purchase is advanced by the fund's principal underwriter, with the expectation that the amount advanced will be recouped from the investor over time either through the underwriter's receipt of 12b-1 fees, or, in the case of an investor that withdraws from the fund within a specified period, through the receipt of the CDSL. *See* Joel H. Goldberg and Gregory N. Bressler, *Revisiting Rule 12b-1 Under the Investment Company Act*, 31 Sec. & Comm. Reg. 147, 150 (1998).

[66] ICI Statement, *supra* note 63, at 2.

it incurred in previous years when the distributor's costs exceeded the 12b-1 plan's annual cap,[67] and (2) "compensation plans," under which a fund's distributor receives a fixed percentage of a fund's daily average net assets or aggregate sales, without specific reference to the amount of distribution expenses borne by the distributor.[68]

Early Use of "No Load" Terminology

In 1978 the SEC stated that until it considered the matter further, the term "no load" and other similar terminology should not be used to characterize a fund whose shares were sold without a front-end sales load but whose assets would be used to pay distribution expenses.[69] In 1981, the SEC revisited that position, announcing its view that no load funds electing to use 12b-1 plans could use the term "no load," pending further review by the SEC and its staff.[70] The SEC clarified, on multiple occasions in the 1980s, that the term could not be used to describe a fund imposing a CDSL or any other type of deferred sales charge. Some industry commentators and regulators expressed concern that the use of the term "no load" to describe funds with 12b-1 fees could be confusing or misleading.[71]

Disclosure and Investor Understanding

Clear disclosure of 12b-1 fees, sales loads and other expenses has long been a focus of regulators and the industry. The lack of uniform fee disclosure in fund prospectuses was identified as an obstacle to investor understanding about mutual fund fees.[72]

In 1984, the SEC proposed to amend Form N-1A to require consolidated prospectus disclosure of all expense-related information, citing "changing patterns in the ways mutual funds distribute their shares

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[67] *See* Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431, 1988 SEC LEXIS 1206, at *40 (Jun. 13, 1988) ("1988 Proposing Release").

[68] *Id.* at 12.

[69] *See* In the Matter of The Vanguard Group, Inc., et al., Investment Company Act Release No. 11645, 1981 SEC LEXIS 1981, 47 S.E.C. 450, at *44 (Feb. 25, 1981) (citing Notice of Rulemaking, *supra* note 46).

[70] *Id.*

[71] *See, e.g.,* Pamela Sebastian, *Mutual Funds That Dip Into Assets to Pay Marketing Costs Face Greater Disclosure*, Wall St. J. (May 27, 1986); Anise C. Wallace, *Fund Fees: A Baffling Array*, 12 N.Y. Times at 46 (Nov. 17, 1985); Memorandum: *Response to Letter from Chairman Dingell Concerning Rule 12b-1 Under the Investment Company Act of 1940*, from Kathryn B. McGrath, Director, SEC Division of Investment Management, to Chairman John Shad, U.S. Securities and Exchange Commission, 1986 SEC No-Act. LEXIS 2866, at *11 n.12 ("McGrath/Shad Memorandum"); 1988 Proposing Release, *supra* note 67, at *59; NASD Notice to Members 89-35: Misuse of "No Load" Terminology in the Offer of Mutual Funds that Have Contingent Deferred Sales Loads (1989).

[72] *See, e.g., Wallace*, *supra* note 71; Consolidated Disclosure of Mutual Fund Expenses, Investment Company Act Release No. 15932, 1987 SEC LEXIS 3933 (Aug. 18, 1987); Memorandum for Staff Use in Responding to Public Inquiries Regarding Disclosure and Other Issues Raised By Certain Types of 12b-1 Plans, from Thomas P. Lemke, Chief Counsel, to Mary Joan Hoene, Associate Director, (May 21, 1986) ("Lemke/Hoene Memorandum").

and pay distribution expenses" as the primary catalyst for change.[73] The proposal called for a narrative explanation of all material fund expenses, including any distribution expenses, as well as a fee table setting out a fund's major expense items.[74] The SEC proposed a requirement that all expense-related disclosures appear in one location in the prospectus.[75] Some parts of the mutual fund industry opposed the SEC's fee disclosure proposal because the proposed requirements were inflexible and would not accommodate the wide variety of distribution financing arrangements employed by funds,[76] the level of detail required would run counter to the SEC's objectives of simplicity and clarity in prospectus disclosure, and the proposed fee table would lead investors to overestimate the degree of meaningful comparison among funds the fee tables would provide.[77] In 1987, the SEC reproposed, and ultimately adopted, amendments to Form N-1A, including a modified version of the original fee table concept.[78]

Accounting Practices

In the early years of Rule 12b-1, the SEC and its staff, from time to time, questioned the accounting practices employed by some funds that had adopted "reimbursement" plans.[79] The staff initially took the position that funds using such plans should account for the entire amount of a distributor's expenses as a liability accruing at the time the expenses were incurred, regardless of the extent to which a distributor's costs exceeded the fund's annual 12b-1 cap, and thus were not actually reimbursed by the fund in the year incurred.[80] The fund industry generally took the view that it was appropriate to treat only the amount actually expended for distribution, within the annual 12b-1 cap, as a liability for the fund accruing in a given year[81] because, under the requirements of the rule, a 12b-1 plan is terminable at any time by the fund "without penalty" upon 60 days notice, and thus a fund has no "present duty or responsibility" to make payments under the plan for future years.[82] Ultimately, a mutual fund has been required to treat

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[73] Expense-Related Disclosure Requirements; Form Revision, Investment Company Act Release No. 14230, 1984 SEC LEXIS 363, *3 (Nov. 8, 1984).

[74] *Id.*

[75] *Id.* at *7.

[76] *See* McGrath/Shad Memorandum, *supra* note 71, at *18; Investment Company Act Release No. 15932, *supra* note 72, at *5.

[77] *See id.*

[78] *See generally* Consolidated Disclosure of Mutual Fund Expenses, Investment Company Act Release No. 16244, 1988 SEC LEXIS 157 (Feb. 1, 1988).

[79] *See* Accounting for Distribution Expenses, Investment Company Act Release No. 14623, 1985 SEC LEXIS 1130 (Jul. 10, 1985); 1988 Proposing Release, *supra* note 67, at *53; ICI Statement, *supra* note 63.

[80] *See* 1988 Proposing Release, *supra* note 67, at *53.

[81] *See* ICI Statement, *supra* note 63, at 84.

[82] Gardiner, *supra* note 62, at 133 (citing ICI Statement, *supra* note 63, and Paragraph 36 of Financial Accounting Concepts No. 6 (December 1985)).

expenses exceeding its annual 12b-1 cap as a liability if, but only if, the fund is legally obligated to continue compensating a distributor under a 12b-1 plan after the plan is terminated.[83]

Defensive Plans

At the same time that many mutual funds were using 12b-1 plans as a substitute for traditional sales loads, other funds were adopting 12b-1 plans with an eye to avoiding liability in the event a regulator or shareholder alleged that a fund's assets were being used indirectly to finance distribution. These plans, referred to as "defensive plans," do not authorize separate payments from the fund's assets to a distributor; rather, they stipulate that a portion of the fund's advisory fee may be used by the adviser to finance the distribution of fund shares.[84] Defensive 12b-1 plans arguably permit directors to consider distribution expenses paid by advisers when assessing the reasonableness of the fund's advisory fee.[85] With regard to these types of plans, the SEC reiterated its position that an adviser is not indirectly using a fund's assets to pay for distribution expenses so long as those costs are paid out of the adviser's own resources.[86] The SEC emphasized that the adoption of a defensive plan was unnecessary if a fund's directors reasonably concluded that the advisory contract was "not a conduit" for the payment of costs associated with the sale of fund shares.[87]

Meyer v. Oppenheimer Management Corp.

In a private action brought in the early 1980s under Section 36(b), *Meyer v. Oppenheimer Management Corp.*,[88] an investor alleged that a fund's 12b-1 fees were excessive or, alternatively, violated Rule 12b-1 because payments were not made "primarily" for the sale of new fund shares, but rather "to maintain old, existing accounts." The U.S. Court of Appeals for the Second Circuit observed that it could "see nothing in [Rule 12b-1] or in section 36(b) that prevents a mutual fund from deciding to pay distribution expenses to dealers in order to retain the interest of those dealers in selling the fund's shares to their customers."[89] After a trial on remand, the district court held that the 12b-1 fees at issue in *Meyer* did not violate Section

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[83] In 1988, the SEC took the position that a fund should treat any amount of distribution expenses that would be carried forward and could be reasonably estimated as a liability if the fund is legally required to pay expenses upon termination of the fund's 12b-1 plan. *See* 1988 Proposing Release, *supra* note 67, at *55. In 1995, the American Institute of Certified Public Accountants ("AICPA") adopted a Statement of Position requiring a fund to recognize on its balance sheet as a liability the promise to pay distribution expenses if the fund has adopted a 12b-1 plan that requires the fund to continue making payments until a distributor is fully compensated for expenses it advance on behalf of the fund. AICPA, Statement of Position No. 95-3.

[84] *See* 1988 Proposing Release, *supra* note 67, at *70. If payments are made from fund assets, or where a specified portion of advisory fee is earmarked for distribution, the 12b-1 plan is not a "defensive plan." *Id.* at n.127.

[85] *See* ICI Statement, *supra* note 63, at 23. *But see* 1988 Proposing Release, *supra* note 67, at *70 (indicating SEC was reluctance to accept this argument).

[86] 1988 Proposing Release, *supra* note 67, at *70.

[87] *Id.*

[88] 764 F.2d 76 (2d. Cir. 1985).

[89] *Id.* at 84.

36(b).[90] The appeals court affirmed the district court's decision,[91] holding, among other things, that investment advisory fees and 12b-1 fees should not be aggregated for purposes of determining whether compensation is excessive under Section 36(b), because, "[i]f the fee for each service viewed separately is not excessive in relation to the service rendered, then the sum of the two is also permissible."[92] In several other cases litigated in the 1980s, plaintiffs were likewise unsuccessful in actions brought under Section 36(b) challenging the propriety of fee payments in the context of Rule 12b-1.[93]

Multiple Share Classes

Beginning in 1985, the SEC began granting exemptive orders to mutual funds permitting the issuance of multiple classes of securities, with each class representing interests in the same portfolio of investments, but carrying different types of distribution financing arrangements.[94] These multiple share class arrangements enabled a fund investor, for the first time, to choose among different pricing options for an investment in the same portfolio of securities.

1986 Staff Memoranda

In 1986, the SEC staff issued two memoranda communicating its concerns about the use of spread-load plans and CDSLs as substitutes for front-end sales loads, the use of the term "no load," and 12b-1-related disclosure practices.

The first memorandum[95] announced that the staff had initiated an informal inquiry to evaluate certain practices that had emerged since Rule 12b-1's adoption. The staff particularly questioned the propriety of reimbursement plans under the rule. Citing "the rule's requirements, that, among other things, directors review the plan annually and find an ongoing benefit to shareholders in order to continue a plan," the staff suggested that because reimbursement plans contemplate payments to distributors in future years, a fund board's ability to undertake a meaningful annual review of such plans may be compromised and such

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[90] *Meyer v. Oppenheimer Mgmt. Corp.*, 707 F. Supp. 1394, 1405-06 (S.D.N.Y.1988). The history of this decision is complicated by the fact that the district court filed an amendment to this decision because the parties had stipulated that the issue of the fairness of the fund's fees under Section 36(b) would be reserved for later resolution. The district court's final decision, which dismissed the plaintiff's complaint and held that the 12b-1 fees were not excessive, was issued a year later. *See Meyer v. Oppenheimer Management Corp.,* 715 F. Supp. 574 (S.D.N.Y 1989).

[91] *Meyer v. Oppenheimer Mgmt. Corp.*, 895 F.2d 861 (1990).

[92] *Id.*

[93] *See, e.g., Krinsk v. Fund Asset Management*, 715 F. Supp. 472 (S.D.N.Y. 1988), *aff'd* 875 F.2d 404 (2d Cir. 1989); *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962, 987 (S.D.N.Y.), *aff'd*, 835 F.2d 45 (2d Cir. 1987), *cert. denied*, 485 U.S. 1034 (1988).

[94] *See* U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation, at 330 (May 1992) ("1992 Report"). These exemptive orders were ultimately codified in Rule 18f-3 in 1995. *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, Investment Company Act Release No. 20915, 1995 SEC LEXIS 3638, at *4 (Feb. 23, 1995) (adopting release).

[95] Lemke/Hoene Memorandum, *supra* note 72.

plans may not be terminable without penalty.[96] The staff also took issue with compensation plans, arguing that Rule 12b-1 "was designed to permit funds to use assets to pay only for actual distribution expenses incurred."[97] The staff also included the use of "no load" terminology within the scope of its inquiry.[98]

The second memorandum released by the SEC staff in 1986 was prepared in response to a request for information about 12b-1 practices and regulatory actions.[99] The SEC staff's memorandum stated that the staff was considering making several recommendations to the Commission to amend rules related to 12b-1 plans, primarily in the area of disclosure requirements.[100] It noted that the staff had been conducting inspections of a number of funds to determine whether those funds' 12b-1 plans were in compliance with the rule.[101] The SEC staff also provided the Committee with a Statement that had been submitted to the SEC by the ICI.[102] The ICI Statement emphasized that 12b-1 plans were in the early stages of development and that any major reforms to the rule would be premature.[103] The ICI statement further noted that the new distribution arrangements developed under the rule were consistent with the SEC's expectation that methods of distribution financing would evolve over time.[104] One of the central positions expressed in the ICI Statement was that spread-load plans are beneficial to, and popular with, investors, because they allow 100 percent of the investor's capital to be invested up front.[105]

1988 Proposal to Amend Rule 12b-1

In 1988, the SEC proposed to make sweeping changes to Rule 12b-1. The proposed amendments would, among other things, specify items directors must consider in approving and continuing distribution plans; require that payments under a 12b-1 plan be made on a current basis, traceable to specific distribution services actually provided to the fund; prohibit funds that assess 12b-1 fees from being held out to the public as "no-load" funds; and require annual approval by shareholders in order to continue a 12b-1 plan.[106] In response to the SEC's proposals, the ICI submitted a comment letter reflecting the mutual fund

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[96] *Id.* at 12.

[97] *Id.*

[98] *Id.*

[99] McGrath/Shad Memorandum, *supra* note 71.

[100] *Id.* The Memorandum stated that the staff was considering recommending (1) codifying the guidelines in the Lemke/Hoene Memorandum in Form N-1A; (2) codifying different disclosure requirements; and/or (3) amending both Rule 12b-1 itself and Form N-1A to address the staff's concerns about compensation and reimbursement plans. *Id.* at *15-*16.

[101] *Id.* at *20-*21.

[102] ICI Statement, *supra* note 63, at 7-10.

[103] *Id.*

[104] *Id.* at 6.

[105] *See id.* at 26-28.

[106] 1988 Proposing Release, supra note 67, at *1.

industry's opposition to most of the proposed changes.[107] The ICI observed that the proposal to prohibit payment of 12b-1 fees to cover distribution expenses incurred in previous years would virtually eliminate spread-load plans. The comment letter also noted that the requirement that shareholders annually approve 12b-1 plans would be even more stringent than the requirements imposed by Congress with respect to advisory and underwriting contracts, and was particularly critical of the proposal to define more specifically what information fund directors must consider in approving 12b-1 plans. Although the ICI had previously argued that NASD regulation of 12b-1 rates was inappropriate, it departed from that view in its comment letter, advocating the delegation to the NASD of the SEC's authority to regulate maximum charges under 12b-1 plans, as a compromise position that would be preferable to the alternative proposed by the SEC.

NASD Action

In 1990, the NASD issued a proposal to amend its maximum sales charge rule to cover asset-based sales charges, specifically including 12b-1 fees.[108] Two years later, the proposal was adopted.[109] NASD Conduct Rule 2830(d) (then classified as Section 26(d) of the Rules of Fair Practice), imposes certain limits on a mutual fund's front-end sales load or CDSL depending on the level of any "asset-based sales charge" imposed by the fund.

1992 Staff Report

In 1992, the SEC Division of Investment Management issued a report entitled *Protecting Investors: A Half Century of Investment Company Regulation* (the "1992 Report"), in which the Division observed that "tremendous changes" had taken place in the area of mutual fund distribution since the passage of the Investment Company Act.[110] The report identified three "factors that are critical to the dynamics of distribution and the interplay of regulation and competition on distribution pricing:" (1) fund companies are under "tremendous" ongoing pressure to sell new shares to offset redemption orders; (2) the structure of investment companies, as externally managed entities, entails some inherent conflicts of interest with regard to advisory fees, other service fees, and the use of fund assets to promote distribution; and (3) because a variety of methods are available to finance distribution expenses, regulation of one method necessarily affects each other method.[111] The Division recommended that, "in light of the NASD's proposal" to amend its maximum sales charge rule to cover asset-based sales charges, only limited changes be made to Rule 12b-1 itself. The Division, rather than supporting the changes that the SEC had proposed in 1988, acknowledged that investors may prefer spread load arrangements.[112]

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[107] *See, e.g.*, Comments of the Investment Company Institute On Amendments to Rule 12b-1 Proposed by Investment Company Act Release No. 16431 (Sept. 19, 1988).

[108] NASD Notice to Members 90-26: Proposed Amendments to Subsections (b)(4) and (d) of Article III, Section 26 of the NASD Rules of Fair Practice Re: Regulation of Asset-Based Sales Charges by the NASD (1990).

[109] NASD Notice to Members 92-41: SEC Approval of Amendments to Article II, Section 26 of the NASD Rules of Fair Practice Regarding Limitations on Mutual Fund Asset-Based Sales Charges (1992).

[110] *See* 1992 Report, *supra* note 94, at 291.

[111] *Id.* at 296-97.

[112] *Id.* at 297, 325-28.

Rulemakings: Multiple Share Classes, CDSLs, and Prospectus Disclosure

In the 1992 Report, the Division recommended that the SEC adopt a rule that would permit mutual funds to issue multiple classes of shares without first obtaining an exemptive order.[113] Shortly thereafter, in 1993, the Commission proposed Rule 18f-3, which would allow multiple classes, and an amendment to Rule 12b-1 that would govern how certain distribution arrangements would apply to multi-class funds.[114] The SEC adopted Rule 18f-3 in 1995.[115] In 1995, concurrently with the adoption of Rule 18f-3, the SEC adopted Rule 6c-10, permitting mutual funds to impose CDSLs without obtaining an exemptive order.[116] In a companion release, the SEC simultaneously proposed amendments to Rule 6c-10 that would allow funds to offer other types of deferred sales loads, as well as eliminate certain requirements of the rule.[117] Those amendments were adopted the next year.[118]

In 1997, the SEC again proposed major changes to Form N-1A.[119] The proposal called for disclosure that, among other things, redesignated the "12b-1 Fees" caption as "Marketing (12b-1) Fees" in the fee table, placed information about distribution arrangements in one place, and, for funds charging 12b-1 fees, stated that over time 12b-1 fees increase investment costs and may cost more than other types of sale loads.[120] The release accompanying these proposals explained that the complexity of existing 12b-1 related disclosures did not appear to be helpful to investors, and noted that investors were also protected by the substantive requirements of Rule 12b-1, by the board of directors' review and approval of 12b-1 plans, and by the NASD's sales charge limits.[121] The bulk of these amendments were adopted, as proposed, in 1998.[122] The fee table caption, in its final form, became "Distribution [and/or Service] (12b-1) Fees."[123]

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[113] *Id*. at 332.

[114] *See* Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds, Investment Company Act Release No. 19955 (Dec. 15, 1993) (proposing release).

[115] *See* Investment Company Act Release No. 20915, *supra* note 94.

[116] *See* Investment Company Act Release No. 20916, *supra* note 64. The SEC first proposed Rule 6c-10 in November 1988.

[117] *See* Exemption for Certain Open-End Management Investment Companies to Impose Deferred Sales Loads, Investment Company Act Release No. 20917 (Feb. 23, 1995) (proposing release).

[118] *See* Exemption for Certain Open-End Management Companies to Impose Deferred Sales Loads, Investment Company Act Release No. 22202 (Sept. 9, 1996) (adopting release).

[119] Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 22528 (Feb. 27, 1997).

[120] *Id*. The proposing release noted that this disclosure requirement was somewhat duplicative of current NASD requirements. In 1999, the NASD eliminated its disclosure requirement.

[121] *Id.* at nn. 198-200 and accompanying text.

[122] Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 23064 (Mar. 13, 1998).

[123] *Id.*

Fund Supermarkets

During the 1990s, participation increased dramatically in "fund supermarkets" that allow investors to purchase and redeem shares of a variety of mutual funds. In 1998, the SEC staff published a letter to the ICI outlining the staff's view that if a fund pays a fee to participate in a fund supermarket, and the fund participates with the primary purpose of selling its shares, "at least part of the fee must be considered to be compensation paid to the sponsor for providing distribution services."[124] The letter also clarified that a fund that has not adopted a 12b-1 plan would be prohibited from paying a fund supermarket fee out of fund assets, except to the extent that the fund's board of directors has determined that the fee is for non-distribution, or administrative, services.[125]

Coxon Decision

In 1999, an administrative law judge found a violation of Rule 12b-1 in a case in which a fund paid expenses, under a 12b-1 plan, that the applicable investment advisory agreement and fund prospectus provided would be paid by the fund's adviser.[126] In providing an overview of the meaning of "distribution" expenses, the decision stated that, in adopting Rule 12b-1, the SEC recognized "that new distribution activities may continuously evolve in the future," and the decision went on to say that an "expansive, aggressive and even atypical approach to what is included in a fund's 12b-1 plan does not necessarily violate section 12(b) and rule 12b-1."[127]

2000 to Present

2000 Report on Mutual Fund Fees and Expenses

In December 2000, the SEC's Division of Investment Management issued a study titled *Report on Mutual Fund Fees and Expenses* (the "Staff Fee Study").[128] The study concluded that the "current statutory framework's primary reliance on disclosure and procedural safeguards to determine mutual fund fees and expenses, rather than on fee caps or other regulatory intervention, is sound and operates in the manner contemplated by Congress."[129] The Staff Fee Study recommended certain measures to "enhance" the current regulatory framework, including that the SEC consider adjusting Rule 12b-1's requirements "to

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[124] Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, 1998 SEC No-Act. LEXIS 976, at *13 (Oct. 30, 1998).

[125] *Id.* at *15.

[126] In re Terrence Michael Coxon, et al., Initial Decisions Release No. 140 (April 1, 1999).

[127] *Id.*

[128] Division of Investment Management, Report on Mutual Fund Fees and Expenses (Dec. 2000) *available at* http://www.sec.gov/news/studies/feestudy.htm ("Staff Fee Study"). Earlier that year, the U.S. General Accounting Office ("GAO") had issued a report to Congressional requesters on mutual fund fees, but did not discuss in detail fees imposed pursuant to Rule 12b-1. GAO, Mutual Fund Fees (June 2000) *available at* http://www.gao.gov/new.items/d03763.pdf.

[129] Staff Fee Study, *supra* note 128.

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."[130] The Division recommended that the SEC consider providing new or additional guidance on appropriate factors for a board to consider in adopting or renewing a 12b-1 plan.[131]

Mahaffy No-Action Letter

In 2003, the SEC staff found that 12b-1 fee rebates by a broker-dealer to its customers would not violate Section 15(a) of the Securities Exchange Act of 1934 but warned that "any waiver or rebate of an investor's pro rata portion of the expenses incurred under a 12b-1 plan would raise serious concerns" under both Section 36 of the Investment Company Act and "general fiduciary principles."[132] The staff "question[ed] whether a 12b-1 plan under which broker-dealers rebate 12b-1 fees to their customers would benefit the fund and its shareholders."[133]

In a subsequent letter,[134] the SEC staff clarified that it did not intend for *Mahaffy* to mean that a fund's board could never approve a fund's 12b-1 plan if a broker-dealer rebates 12b-1 fees to its customers. Rather, the appropriateness of a board's determination would depend upon all of the relevant facts and circumstances. As an example, the staff explained that if all or almost all of the 12b-1 fees that a fund paid to broker-dealers under its 12b-1 plan were being rebated, the fund's board might reasonably conclude, in the exercise of its business judgment, that the continuation of the plan at the current level was no longer reasonably likely to benefit the fund and its shareholders. In that event, the board might reasonably determine to discontinue the plan or reduce the amount of the 12b-1 fees paid by the fund.

Baker Report

In June 2003, the SEC submitted to Congress a report sometimes referred to as the "Baker Report," discussing a number of issues related to mutual funds.[135] The Baker Report noted that the requirements imposed by Rule 12b-1 "are intended, in part, to address the potential conflicts of interest between a fund and its investment adviser that are created when a fund bears its own distribution expenses," because the adviser is relieved from making those payments and also benefits from increased advisory fees in the event of fund asset growth.[136] The Baker Report said that, when it adopted Rule 12b-1, the SEC enumerated

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[130] *Id.* at n.126 and accompanying text.

[131] *Id.*

[132] Edward Mahaffy, SEC No-Section Letter, 2003 SEC No-Act. LEXIS 358 (pub. avail. Mar. 6, 2003) ("Mahaffy") at *4 (citing Southeastern Growth Fund, SEC No-Action Letter (pub. avail. May 22, 1986).

[133] Mahaffy, *supra* note 132, at *5.

[134] E*Trade Securities, LLC, SEC No-Action Letter, 2005 SEC No-Act LEXIS 805 (pub. Avail. Nov. 30, 2005).

[135] Memorandum from Paul F. Roye, Director, Division of Investment Management, SEC, to William H. Donaldson, Chairman, SEC, on Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (June 9, 2003) ("Baker Report").

[136] *Id.* at 70-71.

certain factors "that it believed, at the time, would normally be relevant" to a board determination with respect to whether to use fund assets to pay for distribution.[137] The Baker Report cited the Staff Fee Study's recommendations that the SEC consider amending the requirements of Rule 12b-1 and stated that the SEC staff "will continue to assess the issues raised by rule 12b-1 and discuss with the Commission the current status of the rule in light of [the Staff Fee Study] recommendation and the changes in fund distribution practices that have developed since the rule was adopted over twenty years ago."[138]

Legislative Developments

Throughout 2003 and 2004, Congress considered a variety of bills to amend the Investment Company Act, including with respect to a fund's financing of the distribution of its shares. None of these legislative reforms was enacted.[139]

2004 Release

Effective December 2004, the SEC adopted Rule 12b-1(h), to prohibit funds from paying for the distribution of their shares with brokerage commissions.[140] In proposing the rule, the SEC also asked for public comment on whether Rule 12b-1 should be further amended or even rescinded.[141] The SEC noted that it has responded in many ways to the evolution of industry practices under Rule 12b-1 and continued to assess issues raised by Rule 12b-1.[142]

NASD Task Force

In March 2005, the NASD's Mutual Fund Task Force, which was formed in 2004 to provide guidance to the SEC on, among other things, distribution arrangements, issued a report (the "Task Force Report") that included a discussion on updating the requirements of Rule 12b-1.[143] The Task Force Report suggested that certain factors "no longer provide helpful guidance to independent directors in determining whether to adopt or continue a Rule 12b-1 plan."[144] The report recommended that boards annually focus on specific

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[137] *Id.* at 71.

[138] *Id.* at 76.

[139] H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act, introduced by Rep. Richard H. Baker (to whom the Baker Report had been submitted), was passed by a vote in the U.S. House of Representatives in 2003, and a number of Senate bills were subsequently introduced and considered, but legislative mutual fund reform did not issue from the full Congress.

[140] Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26591 (Sept. 2, 2004) ("2004 Release").

[141] Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26356 (Feb. 24, 2004).

[142] 2004 Release, *supra* note 140, at nn.60-62 and accompanying text.

[143] NASD, Report of the Mutual Fund Task Force: Mutual Fund Distribution (Mar. 24, 2005).

[144] *Id.* at 16.

concerns, such as whether to continue a 12b-1 plan with respect to a fund that is closed to new investors.[145] Overall, the Task Force Report urged the SEC to review the provisions of the rule "with a view to whether the requirements should be modernized."[146]

[145] *Id.* at 17.

[146] *Id.* at 16.

Appendix III
Sample Mutual Fund Fee and Expense Glossary

Sample Mutual Fund Fee and Expense Glossary

A mutual fund's prospectus contains a Fee Table that summarizes the fees and expenses relating to an investment in the fund. The following glossary is intended to help you understand the fees and expenses set out in the Fee Table. This glossary is split into expenses that shareholders pay directly (shareholder level expenses) and those deducted from the fund (fund level expenses). The glossary definitions appear in roughly the order in which fees and expenses commonly appear in a Fee Table.

Shareholder level expenses: You pay shareholder level expenses out of your pocket or out of your investment account. Sales charges and account fees are examples of shareholder level expenses.

Fund level expenses: Every fund shareholder incurs fund level expenses on a pro rata basis, that is, in proportion to the amount of his or her investment. Management fees and distribution fees are examples of these expenses. These fees and expenses are deducted from the fund.

Shareholder level expenses

Maximum Sales Charge (Maximum Sales Load)	When you purchase shares of a mutual fund that imposes a sales charge, also called a sales load, a portion of your investment typically is used to compensate the broker or dealer who placed you in the fund. A sales charge that applies at the time you invest is often referred to as a front-end sales charge. On your purchase of fund shares, the value of your investment is reduced by the amount of this charge. The Fee Table describes the maximum sales charge, and may contain information about any exceptions that allow for a reduced sales charge.
Maximum Deferred Sales Charge (Maximum Deferred Sales Load)	A deferred sales charge is a sales charge that, rather than applying at the time of your investment as with a front-end sales charge, applies at a later time and reduces the amount you receive when you sell your shares. Some funds impose a form of deferred sales charge that is sometimes called a back-end load, which can be at a fixed rate that you would pay upon selling a share rather than upon purchasing it. The shares of some other funds are subject to a contingent deferred sales charge or CDSC—the amount of the back-end sales charge depends (is contingent) on a factor such as how long you held the shares. The deferred sales charge typically decreases over time according to a schedule until, after a certain number of years, you may owe no sales charge upon redeeming your shares.

Maximum Sales Charge Imposed on Reinvested Dividends [and Other Distributions] (Maximum Sales Load Imposed on Reinvested Dividends [and Other Distributions])	A fund that imposes a sales charge on your reinvestment of the fund's dividends or distributions back into the fund would describe the maximum sales charge it imposes on those reinvestments.
Redemption Fee	Some mutual funds charge a fee if the shareholder redeems (sells) shares of the fund within a certain time period (*e.g.*, 30 days) after buying them. A redemption fee reduces the amount you receive upon redeeming your shares. The redemption fee is paid to the fund to compensate remaining shareholders for costs that may be associated with your redemption.
Exchange Fee	A fund that imposes an exchange fee charges a shareholder for exchanging his or her mutual fund shares for those of another fund in the same mutual fund complex.
Account Fee	A mutual fund may impose an account fee on a shareholder under certain circumstances. An example of an account fee is one that some mutual funds charge when the value of a shareholder's investment in a fund falls below a specified amount.

Fund level expenses

Management Fee, Advisory Fee	A mutual fund pays a management or advisory fee to its investment adviser for managing the fund's investment portfolio and providing other services under the fund's management or advisory agreement. Some management fees also include components that pay for administrative and other costs; other funds charge separately for those expenses, which would be reflected under "Other Expenses" described below.
Distribution and/or Service (12b-1) Fees [Suggested new terminology: "Third-Party Investment Advice" or "Sales and Service Charges," for example]	A mutual fund that pays distribution and service fees to brokers or dealers who sell the fund's shares generally does so pursuant to Rule 12b-1 under the Investment Company Act. These payments, sometimes called 12b-1 fees, may be intended to facilitate the selling of fund shares or the providing of services to you over time.
Other Expenses	A mutual fund can be subject to a variety of "other expenses." A mutual fund generally must pay board members' compensation, auditing fees, legal fees and expenses, proxy statement expenses in connection with shareholder votes, postage, and other expenses arising from the operation of the fund's business. Other expenses that also are common include administrative, transfer agency, and custodian fees, which are described below.
• Administrative Fee	A mutual fund may enter into an agreement with a fund administrator, which provides services to the fund such as recordkeeping, portfolio transaction processing, coordinating board meetings, and conducting shareholder mailings. The particular services provided in exchange for an administrative fee vary depending on the fund's agreement with its administrator. In some cases, a mutual fund whose manager is also its administrator arranges to pay for administrative services out of its management fee, rather than out of a separate administrative fee.
• Transfer Agency Fee	As a shareholder buys and sells shares of a mutual fund, and receives dividends and distributions from the fund, the fund's transfer agent processes those transactions and updates the shareholder's account. In exchange for providing this service to the fund, the fund's transfer agent receives payment of a transfer agency fee.
• Custodian Fee	A mutual fund's custodian is an institution that holds the fund's securities and other assets in safekeeping. The fund pays the institution a custodian fee for providing this service to the fund.

Waiver and/or Reimbursement	A mutual fund's manager may determine to waive a portion of its fees, place a cap on the overall level of expenses the fund must pay, or reimburse some amount to the fund. The fund's expense ratio effectively is reduced by the amount waived or reimbursed. Waivers and reimbursements sometimes are described in a footnote accompanying the Fee Table.
Total Annual Fund Operating Expenses, Expense Ratio	The fund's expense ratio is the bottom line number that tells you the level of the fund's total annual operating expenses. This figure is the sum of all of the fund level expenses, minus any waiver or reimbursement that a fund's adviser makes to the fund.

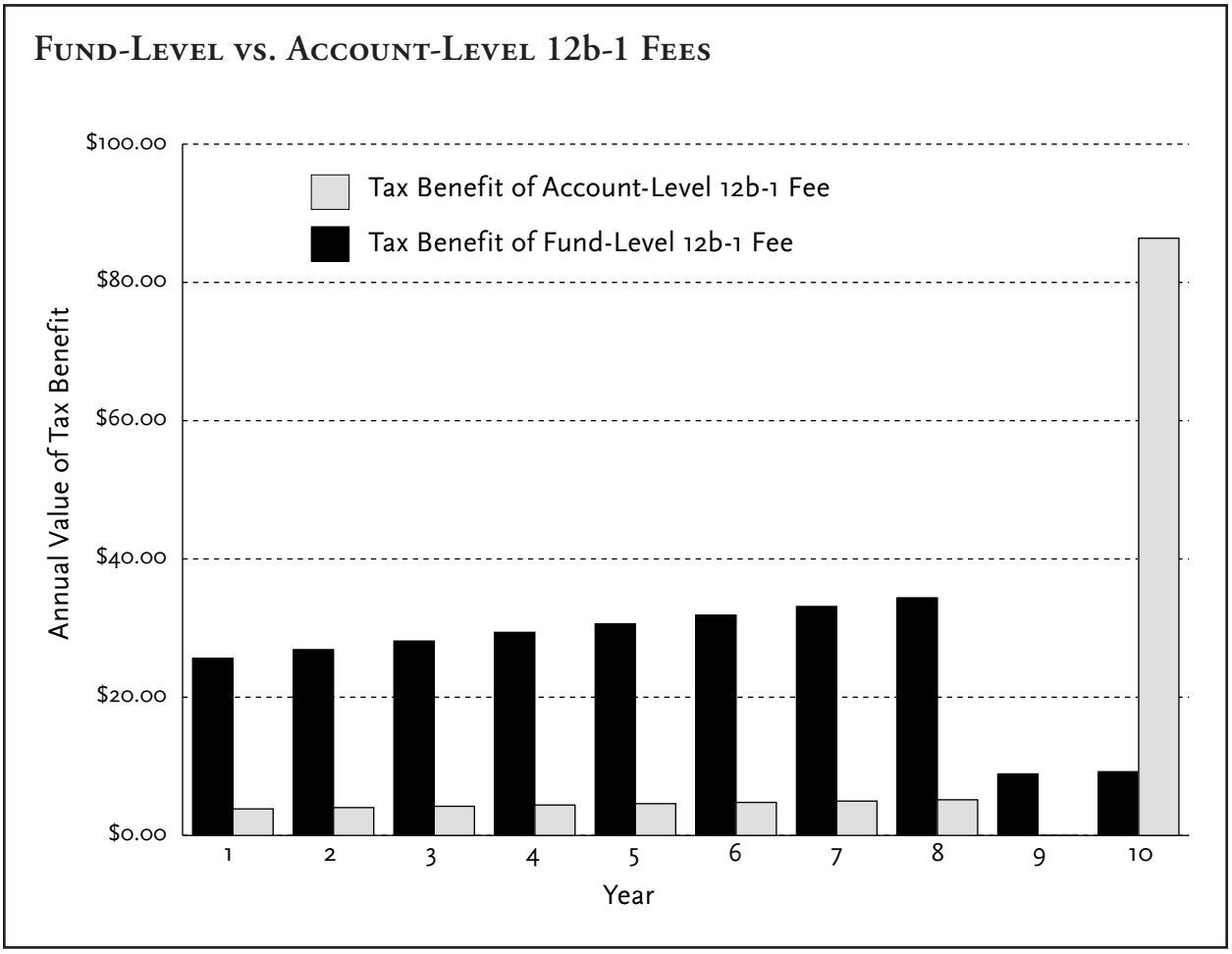
Appendix IV
Example: Tax Consequences of Charging 12b-1 Fees at the Account Level

Example: Tax Consequences of Charging 12b-1 Fees at the Account Level

This example illustrates the tax effect of charging 12b-1 fees at the account level on a long-term investor in a moderate tax bracket.

Summary of Relative Tax Benefits:

The cumulative reduction in tax liability from 12b-1 fees being charged at the ***fund level*** is **$258.12**. This benefit is received, in part, each year over the ten-year period. In contrast, the cumulative reduction in tax liability from 12b-1 fees being charged at the ***account level*** is only **$122.40**—less than half of the tax savings from 12b-1 fees being charged at the fund level. In addition, for account-level fees, over 70 percent of the diminished benefit would not be received until the fund shares are redeemed. Graphically, the annual tax benefits are as follows:



Factual Assumptions

- An investor who is in the 25 percent tax bracket purchases $10,000 of a fund's shares.
- The investor purchases Class B shares, which have a 75 basis-point distribution fee and a 25 basis-point service fee; these shares convert after eight years to A shares, which have an ongoing 25 basis-point service fee.
- The fund pays dividends taxable at marginal rates every year.
- The investor's shares increase in value each year by $500; the shares purchased for $10,000 are worth $15,000 at the end of 10 years.
- The investor redeems the shares at the end of 10 years and realizes a $5,000 gain; a capital gains tax of 15 percent (or $750) is paid on the realized gain.
- Account-level 12b-1 fees are collected from fund distributions rather than from periodic (*e.g.*, monthly) redemptions of fund shares.[1]

Discussion

Fund-Level 12b-1 Fees

Over a 10-year period, the investor's taxable distributions are reduced by $1,032.50 (which is the amount of fund-level 12b-1 fees attributable to the investor's shares).[2] Thus, the investor's tax liability is reduced over the 10-year period by $258.12 ($1,032 *x* 0.25). When the shares are redeemed at the end of 10 years, the full gain ($5,000) is taxable (at a 15 percent rate—or $750). This is because the investor's cost basis in the shares was not increased by the fund-level 12b-1 payments.

Account-Level 12b-1 Fees

If the investor paid the 12b-1 fees directly, the investor would pay the same $1,032.50. The 25 basis-point service fee, paid directly over 10 years, would total $312.50. The 75 basis-point distribution fee, paid directly over eight years until the B shares converted to A shares, would total $720.

Under current law, any distribution fee paid directly by the investor likely would be treated as having two components—a commission payment and an interest charge on the deferred payment amount. For simplicity, the example assumes that 80 percent of each distribution fee payment is treated as the payment

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[1] Redemptions to generate cash to pay account-level charges would create additional taxable events every time they occurred. The example's assumption that fees are collected from distributions likely *understates* the negative tax impact of charging 12b-1 fees at the account level, as the periodic redemptions would accelerate tax liability (in a generally rising market).

[2] The investor pays a 100 basis-point 12b-1 fee for the first eight years. After eight years, the shares are converted to A shares and the investor incurs a 25 basis-point 12b-1 fee for years nine and ten.

of a commission and 20 percent is treated as the payment of interest; this assumption results in an interest rate of approximately 5 percent. Over eight years, the investor would treat $576 (80 percent of the $720 distribution fee) as commission payments and $144 (20 percent of the $720 distribution fee) as investment interest.

The tax effect of paying 12b-1 fees at the account level would be as follows:

- The service fee of $312.50 is treated as payment for investment services and, under current law, is deductible only to the extent that the payment exceeds 2 percent of an individual's adjusted gross income. Because investors typically do not incur such expenses in excess of this threshold, the payment generally would not be deductible.

- The $144 portion of the distribution fee treated as interest could be deducted, under current law, against investment income, reducing taxable income by $144 over eight years and providing a tax savings of $36 (25 percent of $144). The tax benefit of this component of the payment would be comparable to that of a payment made at the fund level—reducing distributions otherwise taxed at the investor's tax rate (*e.g.*, 25 percent).

- The commission payment of $576 would be added, under current law, to the investor's initial cost basis of $10,000 (resulting in a basis of $10,576). The taxable gain at redemption would be only $4,424. The tax benefit of the $576 increase in cost basis (and corresponding reduction in redemption gains) would be $86.40 (15 percent of $576) less in tax payments; this benefit would be realized only at the end of 10 years, when the shares are redeemed. Compared to fund-level expense treatment, the tax benefit is both delayed (realized only when shares are sold) and less valuable (as increases in cost basis reduce capital gains; long-term gains are taxed at lower maximum rates—typically 15 percent).

- The cumulative tax benefit of charging 12b-1 fees at the account level would be $122.40. Of this amount, $36 would be received over the 10-year period and the remainder, $86.40, would be received only when the shares are redeemed.

Appendix V
Operational Issues with Converting 12b-1 Fees to a Shareholder Account Expense

Operational Issues with Converting 12b-1 Fees to a Shareholder Account Expense

Converting 12b-1 fees to a shareholder level expense likely would take the form of a deferred, or installment, load. The costs of building new systems to accommodate this type of deferred load would be substantial. In addition, the ongoing costs would be significant, as transaction volumes would rise considerably in the form of periodic redemptions to collect the load payments and associated transaction confirmations. Training costs would rise to prepare industry service groups to support the new product. The change would necessitate new education efforts both for intermediaries that sell fund shares and for fund investors.

Structure of the Deferred Load

Funds that wish to offer shares with an installment load option would need to determine how to structure the deferred load (unless the load structure is prescribed by SEC and/or NASD rule). One approach would be to assess a periodic charge against the shareholder's account until the amount of the deferred load is paid. Choices would need to be made about how to assess the periodic charge. For example, the amount assessed could be a flat dollar amount, such as $100 annually (plus a carrying charge). Alternatively, funds could assess a basis points charge, such as .75 percent (which would likely include an interest component), against the account until the deferred load is paid. In this situation, funds would need to determine the amount against which to assess the basis points charge. Potential options would include the initial value of the purchased shares, the average value of the account over the relevant period, or the ending value, among others.

Payment via Share Redemptions

Regardless of the structure of the deferred load, the assessments against the account most likely would take the form of periodic redemptions. It would be necessary to include on the shareholder record the amount of the deferred load and reduce that amount by the dollar amount of each periodic redemption until the deferred load reaches zero. Assuming the amounts assessed include a financing charge, only the principal portion of the payments would reduce the deferred load that is owed. Another option may be to reduce the amount of any dividends by the amount of an investor's deferred load to produce a more favorable tax result, but that approach would add considerable complexity to any systems changes.

Fund underwriters likely would continue to advance commissions to selling intermediaries and then obtain reimbursement by collecting from each shareholder account the proceeds of the periodic redemptions (rather than the current practice of collecting a monthly 12b-1 fee from the fund). The redemptions would need to take place on a regular schedule, such as annually, quarterly, or monthly. Monthly redemptions would enable underwriters to obtain reimbursement on a basis similar to the current system, but at a greater administrative cost to the fund than quarterly or annual redemptions.

Operational Issues

While the operational issues and costs associated with adopting an account-level 12b-1 system would not be insubstantial, a system could be designed. Since the 1980s, the industry has built capabilities to track each share purchase separately for contingent deferred sales loads, 12b-1, and cost basis reporting purposes. The important questions relate to feasibility. In assessing feasibility, the operational issues must be considered along with certain transition issues, including possible grandfathering of, or merging with, current arrangements. Investor and intermediary education regarding the changes also would need to occur.

Creating New Systems

It would be necessary to build a new system to assess deferred sales charges at the account level, albeit using some of the share tracking technology that is currently in wide use. Given that mutual fund investor recordkeeping is currently conducted not only by funds' primary transfer agents but also by other intermediaries, programming the necessary systems changes would need to be completed by each recordkeeper. Thus, all of the various mutual fund sub-accounting agents—including retirement plan recordkeepers and broker/dealers using omnibus accounts—would need to replicate the systems development effort initiated at the primary transfer agent level. Finally, the more flexible the SEC makes the rules, the more variable the deferred load arrangements would likely be across the industry and thus the more difficult and costly it would be to accommodate a large number of different funds on any single processing platform.

Creating a New Share Class

A new share class may need to be created for funds that elect to offer a deferred load option. One way to avoid the creation of a new class would be to convert B share investors from paying for distribution through fund level 12b-1 payments to paying individually at the account level. This could be accomplished by estimating the amount of 12b-1 payments attributable to them up through the date of conversion as a rough measure of economic equivalency and then charging those accounts the new deferred load less the amount already paid indirectly. This approach likely would raise legal and tax issues that would need to be explored. It also would raise business issues to the extent it resulted in a loss of 12b-1 revenue expected to be collected.

Tracking Deferred Loads and Payments

Regardless of whether a fund charges a dollar-based fee or a basis point charge against some measure of the account's value, to amortize a deferred load, the new system or systems would need to track separately the deferred load associated with each purchase of fund shares. While the deferred load associated with each share purchase could be paid with a single periodic redemption, the amount realized from each redemption would need to be allocated across all share purchases in a way that amortizes each deferred load in accordance with its own amortization period.

Early Redemptions, Exchanges, and Account Transfers

For shareholders who redeem their accounts without a simultaneous exchange into another fund in the same fund family, the redemption proceeds presumably would need to be reduced by the amount of any remaining unpaid deferred loads, which would introduce a contingent dimension to the deferred load system. Systems would need to address how to ensure that account balances are not reduced (by redemptions, exchanges, and/or market forces) to a level below which collection of the deferred loads is at risk. This could possibly involve escrowing shares or adjusting the periodic redemption amounts to take account of such effects. Exchanges within a fund family would likely necessitate the movement of the unpaid deferred load data along with the other account registration data to the successor account. Perhaps different treatments would be appropriate for partial versus full redemptions. A similar but more difficult problem would exist where accounts are transferred from one recordkeeping system to another, for example, in connection with a transfer of an account from broker A to broker B or from fund transfer agent to dealer omnibus account or vice versa.