Appendix II
History of Rule 12b-1

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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.