How Mutual Funds Use 12b-1 Fees

The overwhelming majority of mutual fund investors seek professional advice when they buy mutual fund shares outside of retirement plans at work. In a recent Investment Company Institute (ICI) survey, more than 80 percent of investors who own funds outside these plans reported that they invest in funds through a financial adviser.¹

Until about 25 years ago, fund shareholders could only compensate financial advisers for their assistance through a front-end sales load, i.e., a one-time, upfront payment made to financial advisers for both current and future services. After 1980, when the Securities and Exchange Commission (SEC) adopted Rule 12b-1 under the Investment Company Act of 1940, funds and their shareholders have had greater flexibility in compensating financial advisers. The SEC’s adoption of this rule and its subsequent regulatory actions established a framework under which mutual funds pay for some or all of the services that financial advisers provide to their shareholders through so-called 12b-1 fees. This framework also allows mutual funds to use 12b-1 fees to compensate other financial intermediaries such as retirement plan recordkeepers and discount brokerage firms for providing services to fund shareholders, and to pay for advertising, marketing, and other sales promotion activities.

ICI surveyed mutual fund companies in late 2004 about how they use 12b-1 fees. The survey found that funds use most of these fees to compensate financial advisers and other financial intermediaries for assisting fund investors before and after they purchase fund shares. Funds use only a small fraction of the 12b-1 fees that they collect for advertising and promotion (Figure 1).

This issue of Fundamentals presents the findings from ICI’s survey. The survey results reflect responses from fund complexes that manage three-quarters of the assets of mutual funds with 12b-1 fees. Because 12b-1 fees are computed as a

percentage of assets, the high asset coverage in the sample ensures that the survey respondents account for the majority of 12b-1 fees.

**Trends in the Use of 12b-1 Fees**

The amount of 12b-1 fees that shareholders pay through mutual funds has risen from a few million dollars in the early 1980s to more than $10 billion in 2004 (Figure 2). In part, the increase reflects the 60-fold growth in mutual fund assets and the 12-fold increase in the number of households owning funds since 1980.

The increase in total 12b-1 fees also reflects a shift by mutual funds and their investors from front-end sales loads to 12b-1 fees as a mechanism to compensate financial advisers. As funds have added 12b-1 fees, the typical front-end sales load has declined from 8 percent in 1980 to 5 percent in 2004. Most load funds now also offer classes of their shares that have 12b-1 fees but no front-end loads. These changes are an important reason why the 12b-1 fees that load funds collect have risen since 1980.

The 2004 ICI survey provides additional evidence that mutual funds primarily use 12b-1 fees as an alternative to front-end sales loads. It found that funds use 40 percent of 12b-1 fees to compensate financial advisers for assistance when investors purchase shares and 52 percent for the ongoing assistance and service that financial advisers and others provide to shareholders after the purchase (Figure 1). Mutual fund underwriters receive 6 percent of 12b-1 fees to cover some of their costs. Underwriters act as representatives between mutual funds and third parties selling funds. Only 2 percent of 12b-1 fees are used for promotion, advertising, and other miscellaneous purposes.

These survey results are similar to those from a survey that ICI conducted in 2000. The 2000 survey likewise found that mutual funds used almost all of their 12b-1 fees to compensate financial advisers, reimburse fund underwriters for their costs, or to pay for ongoing services to shareholders. Funds reported that they used only 5 percent of 12b-1 fees for promotion and advertising.

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**Figure 2**

**Total 12b-1 Fees, 1980–2004**

(billions of dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>No-Load Funds</th>
<th>Load Funds</th>
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<tbody>
<tr>
<td>1980</td>
<td>0</td>
<td>0.01</td>
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<tr>
<td>1982</td>
<td>0.08</td>
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<tr>
<td>1992</td>
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</tbody>
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*Based on preliminary data.

**Sources:** Investment Company Institute, Lipper, Strategic Insight Mutual Fund Research and Consulting, LLC, and CRSP University of Chicago, used with permission, all rights reserved (773.702.7467/www.crsp.com).
How 12b-1 Fees Compensate Financial Advisers for Initial Assistance

Financial advisers typically devote professional time and attention to prospective mutual fund shareholders before they make an initial purchase. The adviser generally meets with the investor, identifies financial goals, analyzes his or her other investments, determines an appropriate asset allocation, and selects and recommends a fund or funds to meet these goals.

Financial advisers receive compensation for these services through mutual fund underwriters. If the shareholder pays a front-end sales load, the underwriter passes all or part of the sales load through to the financial adviser and firm. If there is no front-end sales load, the underwriter may use 12b-1 fees to compensate financial advisers and their firms.

One method involves the underwriter paying financial advisers upfront when the shareholder makes the purchase. The fund then reimburses the underwriter each year with 12b-1 fees until the upfront payment is repaid. Some underwriters finance these upfront payments to financial advisers through loans, and the 12b-1 fees they receive from the fund facilitate repayment of the loan. Sixty-six percent of the 12b-1 fees that mutual funds use to compensate financial advisers are actually payments to reimburse underwriters or lenders for these upfront payments (Figure 3).

A second method involves the underwriter making an annual payment to the financial adviser for as long as the shareholder owns shares in the fund. Rather than receiving a single upfront payment when the shareholder purchases the fund shares, the financial adviser receives compensation over time for his or her initial advice and assistance. These annual payments amount to about 34 percent of all 12b-1 fees used for commissions.

How 12b-1 Fees Pay for Ongoing Shareholder Services

The National Association of Securities Dealers (NASD) permits mutual funds annually to pay up to 0.25 percent of fund assets for shareholder services in the form of 12b-1 fees. These payments compensate financial advisers for ongoing services, such as responding to customer inquiries and providing information on investments. The ICI survey found that mutual funds use

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**Figure 3**

12b-1 Fees Used to Compensate Financial Advisers (percent)

- Compensation to Financial Advisers for Initial Assistance: 40%
- Reimbursement for Advance Compensation: 66%
- Annual Payments to Financial Advisers: 34%

*Source: Investment Company Institute*
52 percent of 12b-1 fees for this purpose, with bank trust departments and broker-dealers being the primary recipients (Figure 4).

Discount brokers, mutual fund supermarkets, and 401(k) recordkeepers receive 7 percent of all 12b-1 fees that mutual funds paid for ongoing shareholder services. Many shareholders use discount brokers and mutual fund supermarkets to purchase no-load funds, which can charge 12b-1 fees of up to 0.25 percent of assets. No-load funds often use 12b-1 fees to pay financial intermediaries for the ongoing service and support that they provide to these funds’ shareholders.

Mutual funds do not have to pay for shareholder services through a 12b-1 plan. Some mutual funds choose to pay for them outside such a plan and to report these fees separately. Out of the total of shareholder service fees paid, 82 percent are paid through a 12b-1 plan and 18 percent are paid outside such a plan (Figure 5). Most of the non-12b-1 shareholder service fees were paid to bank trust departments and broker dealers.

**Conclusion**

The 2004 survey that ICI conducted on 12b-1 fees found that mutual funds use most of the fees to compensate financial advisers and financial intermediaries for services provided to fund shareholders. Funds use only a tiny fraction to promote and advertise funds to attract new shareholders.