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November 5, 2010

Ms. Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Mutual Fund Distribution Fees; Confirmations (File Number S7-15-10)

Dear Ms. Murphy:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposed new rule and rule amendments that would replace Rule 12b-1 under the Investment Company Act of 1940.[2]

Mutual funds currently have more than $11 trillion in assets on behalf of more than 90 million shareholders with more than 285 million accounts.[3] They play an important role in helping investors participate in the financial markets, particularly for those millions of Americans attempting to prepare for a financially secure retirement.

Rule 12b-1 is an integral part of the structure and strength of the mutual fund industry. The rule and its associated fees allow investors to pay distribution costs over time, to access funds that otherwise might not be available to them, and to compensate financial intermediaries, on whom so

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.05 trillion and serve over 90 million shareholders.

[2] *Mutual Fund Distribution Fees; Confirmations*, SEC Release Nos. 33-9128; 34-62544; IC-29367 (July 21, 2010), 75 FR 47064 (August 4, 2010) (the "Release").

[3] For asset information, *see* Investment Company Institute, *Trends in Mutual Fund Investing September 2010*, available at www.ici.org/research/stats/trends/trends_09_10. For number of mutual fund investors, see "Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010," *Investment Company Institute Fundamentals*, Vol. 19, No. 6 (September 2010), available at www.ici.org/pdf/fm-v19n6.pdf. The number of accounts is from Investment Company Institute, *Supplementary Data for the Quarter Ending June 30, 2010*.

many fund investors depend. Accordingly, this rulemaking is of critical importance to the fund industry and its millions of investors.

This letter provides our views on the rulemaking in general, as well as a number of specific comments, concerns, and recommendations on five major elements of the proposal: ongoing sales charges; marketing and service fees; board oversight; new disclosures; and the proposed exemption from Section 22(d) that would allow for a new distribution option.

Executive Summary

The SEC has a number of legitimate concerns with 12b-1 fees. Rule 12b-1 was adopted in 1980 and is in need of an update. Investors may not have sufficient understanding of what 12b-1 fees are, other than a line in the fund's fee table, or what they pay for. Boards currently feel compelled to make findings pursuant to outdated guidance that is impractical and largely unnecessary.

We share many of these concerns[4] and commend the SEC for its attempt to address these issues. Ultimately, however, we believe that the proposal places the agency in the inappropriate role of a ratemaker, and is far more extensive and intrusive than necessary. If adopted as proposed, the revisions could fundamentally alter the way intermediaries use funds in various distribution channels, significantly affect the lineup of share class options currently available to investors, necessitate major systems changes, and require the renegotiation of thousands of dealer agreements. All of this would be done at a great cost that would be reflected in higher expenses borne by shareholders. And the benefits are uncertain and quite possibly illusory. As a result, the significant operational and transitional costs on funds, intermediaries, and investors are simply not warranted.

Our comments, concerns, and recommendations, as described fully below, include the following:

<u>General Comments</u>

- *Timing of the proposal.* This proposal comes at a time when the SEC is also actively considering the harmonization of standards of care for investment advisers and broker-dealers and contemplating new point of sale disclosure rules. In order most thoughtfully to address the entire range of distribution-related issues facing it, the SEC ought to first resolve the debate over the appropriate standard of care applicable to

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[4] For the past several years we have advocated changes to Rule 12b-1 that would refine or enhance the rule, such as changes that would clarify the role of the board under the rule and provide better disclosure of 12b-1 fees. *See, e.g.*, letter from Mary S. Podesta, Acting General Counsel, ICI, to Nancy M. Morris, Secretary, SEC (June 19, 2007) ("2007 ICI Roundtable Submission"). The 2007 ICI Roundtable Submission and other materials related to past ICI positions on Rule12b-1 are available at www.ici.org/rule12b1fees.

broker-dealers, and then address point of sale disclosure, confirm disclosure, and Rule 12b-1.

- *The SEC's economic analysis.* As required by statute, the SEC must weigh the anticipated benefits of a rulemaking against any resulting costs and burdens for investment companies generally and small funds in particular. We question whether the proposal has met the statutory requirements, and urge the SEC to take a further and more careful look at its analysis before proceeding. To assist in this regard, we are conducting our own economic analysis, which we expect to file by the end of the month as a supplement to this letter.

Ongoing Sales Charges

- *The concept of "functional equivalence."* The proposal would allow funds to impose "ongoing sales charges" up to a reference load. The central concept underlying much of this part of the proposal is that a portion of what is currently paid for with 12b-1 fees is the functional equivalent, paid over time, of a front-end sales load. We strongly disagree that in *every* context, a 12b-1 fee that exceeds 25 basis points is the functional equivalent of a front-end sales charge. In many instances a hard cap on aggregate compensation is not warranted. The services in those instances continue; the compensation must as well.

- *C shares.* For many investors, particularly those with relatively smaller amounts to invest, C shares have proven to be the best way available to obtain the benefits of a flexible asset allocation account and the ongoing services of a financial professional. We are concerned that, while the SEC did not propose to eliminate C shares, the proposal would have a significant impact on these shares as we know them and disadvantage many small investors. To the extent that, despite our concerns, the SEC moves forward with this part of the proposal, it should distinguish the C share context from other uses of 12b-1 fees, such as for retirement shares and money market funds, where the use of 12b-1 fees is far different from the use of a front-end sales charge.

- *The "reference load" used to cap ongoing sales charges.* We recommend that the SEC treat the FINRA sales charge limit of 6.25 percent as the reference load for purposes of determining the maximum amount of ongoing sales charge in all cases.

- *Retirement plans.* The current use of 12b-1 fees in the retirement plan context is clearly not the functional equivalent of a front-end sales charge; the SEC should take steps to permit funds to provide ongoing compensation for ongoing services rendered in the retirement plan context, without having to treat that compensation as a form of

ongoing sales charge. It could do this in either or both of two ways: by providing guidance to the effect that certain ongoing services provided to plans and their participants are not "primarily intended to result in the sale" of fund shares and therefore not "distribution activities" and/or by directing FINRA to craft a separate cap for retirement shares that would reflect the unique nature of the ongoing services provided by brokers in that context. In essence, this latter recommendation would allow for a higher marketing and service fee for classes of fund shares used exclusively for retirement plans.

- *Money market funds.* The use of 12b-1 fees in the money market fund context is clearly not the functional equivalent of a front-end sales charge; money market funds are not sold with a front-end sales charge. The Release does not appear to contemplate the use of 12b-1 fees by money market funds, either with respect to marketing and service fees or ongoing sales charges. Before the SEC goes forward with this rulemaking, it should carefully consider the application of the rules in this context, and in doing so should reject the notion that 12b-1 fees in excess of 25 basis points must in this case be treated as an ongoing sales charge subject to conversion. Requiring systems to be built for money market funds to track and age their shares, including, for example, the daily investment of overnight balances in a sweep account, would be costly and pointless.

- *Reinvested dividends and distributions.* The proposal would permit the reinvestment of dividends and distributions in a share class with an ongoing sales charge, subject to the same conversion schedule as the shares on which the dividend or distribution was declared. This would be highly problematic for operational reasons, and we recommend instead that the final rule permit funds to convert dividend and distribution reinvestments proportionately, based on the total shares held in an account at the next scheduled periodic conversion date.

- *The five year "grandfathering" period.* We recommend that the SEC consider alternatives that would eliminate or at least mitigate disparities between the length of the grandfathering period and the length of conversion schedules for funds with smaller ongoing sales charges. More specifically, the SEC may wish to consider providing longer grandfathering periods for fund shares with 12b-1 fees in one or more defined bands (*e.g.*, a grandfathering period of fifteen years for fund shares with 12b-1 fees between 25 and 50 basis points). Or, it might consider allowing funds to overlay their conversion schedule on existing share classes, provided that the fund gives credit to existing shareholders for their holding periods.

Marketing and Service Fees

- We appreciate the SEC's recognition that funds bear ongoing distribution-related expenses that benefit the fund and existing fund shareholders in a variety of ways, and we appreciate the recognition that, at a certain level, there is no need for a written plan to be approved annually by the fund's board. We are concerned, however, that with a cap of 25 basis points, funds and their advisers will be under a great deal of pressure to carefully define what constitutes "distribution activities" for purposes of Rule 12b-2. Accordingly, we request that the SEC provide unequivocal statements in any final rulemaking that, at a minimum, administrative services, non-distribution service fees, and non-distribution payments to retirement plan recordkeepers are outside the scope of Rule 12b-2.

Board Guidance

- We appreciate the SEC's efforts to modernize and streamline the role of fund boards in overseeing distribution fees. We strongly support the SEC's proposal to eliminate board requirements like annual approvals of 12b-1 plans and quarterly reviews of 12b-1 fees. We are opposed, however, to the SEC's proposed guidance for directors. We see it as inaccurate, inappropriate, and unnecessary.

Confirmation Statement Disclosure

- The proposal includes a number of new disclosure requirements in investor confirmation statements ("confirms"). While we strongly support changes that would improve investor understanding of distribution-related fees and expenses, we believe that some of the proposed confirm disclosure is better suited for point of sale disclosure and therefore unnecessary in a confirm. We are also concerned about the potential that complicated, fund-specific confirms may have the unintended consequence of incenting brokers to sell other products not subject to the same requirements.

Account-level Sales Charges; the 22(d) Exemption

- Our members have expressed mixed, and often uncertain, views on the concept of account-level sales charges. Given this reaction, we strongly recommend that the SEC conduct further study on the range of views and likely outcomes from account-level sales charges before proceeding on this aspect of the proposal.

I. General Comments

a. Timing of Proposal

This proposal is the proverbial cart before the horse. The SEC is currently in the midst of a major study on the effectiveness of existing legal and regulatory standards of care for brokers, dealers, investment advisers, and their respective associated persons.[5] The SEC is undertaking that review in the context of personalized investment advice and recommendations about securities to investors, and evaluating whether there are gaps, shortcomings, or overlaps in the current legal or regulatory standards of care applicable to these intermediaries.

A thoughtful and deliberate approach to rationalizing the IA-BD regulatory regime would lay the foundation for appropriate reforms to Rule 12b-l. As we have repeatedly said, it would seem the core regulatory requirements applied to advisers and brokers ought to be resolved first, with the labels and limitations on their compensation then tailored accordingly. Consider, for example, the fiduciary duty in Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the exact contours of which are the subject of the SEC's IA-BD study and subsequent rulemaking.[6] Although it is impossible to predict exactly how this duty will affect the sale of fund shares, it is fair to suggest that broker-dealers will adjust their business models to suit the new standard, and in so doing may render parts of this proposal unnecessary or outdated. It makes little sense to fundamentally alter Rule 12b-1 with the virtual certainty that its successors, Rules 12b-2 and 6c-10(b), would need to be revisited once the new IA-BD regulatory regime is adopted.

Certain elements of the confirmation statement disclosure proposed as part of this 12b-1 rulemaking also appear to be misplaced and premature, as they would clearly be more appropriate for a point of sale disclosure document.[7] Confirms should serve as a record of a transaction and allow the investor to verify that the transaction was processed correctly and that whatever fees are associated with the transaction were properly assessed. Point of sale disclosure, in contrast, is meant to provide the investor with certain key information that highlights potential conflicts that he or she should consider *before* making the investment decision. As the SEC itself recognizes, confirms cannot do this – "[i]n making this proposal, we are mindful that…customers do not receive confirmations until after completing their purchases of mutual funds."[8] The SEC has legitimate concerns over the potential conflicts of interest a broker may have in recommending a particular investment or share class to an

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[5] *See Study Regarding Obligations of Brokers, Dealers, and Investment Advisers*, SEC Release Nos. 34-62577 and IA-3058 (July 27, 2010), available on the SEC's website at www.sec.gov/rules/other/2010/34-62577.pdf (the "IA-BD Study"). In response to a request for comments on the IA-BD Study, the SEC received over three thousand comment letters.

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

[7] Our specific comments on the proposed confirm disclosure are below, at pp. 28-30.

[8] Release at 68.

investor, but these conflicts are best addressed through the combination of point of sale disclosure and a fiduciary standard. The confirm simply is a belated and inappropriate means to convey this important information.

We also are concerned that the SEC looks to a fund-specific confirm to address potential conflicts that exist with respect to all investments – not just funds. We have repeatedly said that point of sale disclosure must be product-neutral to be effective.[9] Congress appears to have agreed. Section 919 of the Dodd-Frank Act is notable not only as it recognizes that there is a need for effective and concise point of sale disclosure by brokers, but also because it is specifically designed to be product-neutral.[10] We are understandably concerned, therefore, that the confirm disclosure requirements proposed by the SEC run the risk of establishing unique disclosure requirements applicable solely to the sale of mutual funds, and not other products. As such, not only are they misplaced, they run counter to the mandate in the Dodd-Frank Act.

b. Importance of a Robust Economic Analysis

A careful, comprehensive economic analysis is especially critical given the fundamental role that 12b-1 fees play in paying for fund distribution and certain shareholder services. We are concerned that the SEC has not given sufficient consideration to the potential impacts of its proposal. As required by statute, the SEC must weigh the anticipated benefits of a rulemaking against any resulting costs and burdens for investment companies generally and small funds in particular.[11] The United States Court of Appeals for the District of Columbia Circuit has repeatedly emphasized the importance of the SEC's

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[9] The Institute has consistently supported enhanced point of sale disclosure to help investors assess and evaluate a broker's recommendations and services, provided that any point of sale disclosure obligation is product-neutral. We also believe any point of sale disclosure requirement should be fully consistent with the industry's existing customer service model and should seek to find the best way to provide investors with timely and convenient access to the required information without imposing inappropriate costs and burdens on brokers. *See*, *e.g.,* Letter from Elizabeth R. Krentzman, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated April 4, 2005, available at www.sec.gov/rules/proposed/s70604/ekrentzman040405.pdf (the "2005 ICI Point of Sale Letter"); letter from Karrie McMillan, General Counsel, Investment Company Institute to Marcia E. Asquith, Senior Vice President and Corporate Secretary, FINRA, dated August 3, 2009, available at www.finra.org/Industry/Regulation/Notices/Comments/P119756.

[10] Section 15(n)(1) of the Securities Exchange Act of 1934, as added by Section 919 of the Dodd-Frank Act, states that the SEC "may issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor."

[11] As the Release indicates at 241, the SEC is required to consider the impact that a proposal would have on competition, and is prohibited from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Securities Exchange Act. *See* Section 23(a)(2) of the Securities Exchange Act. The SEC also must consider, "in addition to the protection of investors, whether [the rule proposal] will promote efficiency, competition, and capital formation." *See* Section 3(f) of the Securities Exchange Act and Section 2(c) of the Investment Company Act.

consideration of the costs regulated entities would incur in order to comply with a rule.[12] The Institute is preparing a detailed report that responds to the SEC's requests for comment on the cost benefit analysis in the proposal.

As part of the Institute's forthcoming report, we surveyed our members who would be most affected by the costs of the proposal (*i.e.*, those with share classes that have a 12b-1 fee of greater than 25 basis points). We received responses from 19 complexes with a total of $533 billion in total net assets of share classes with a 12b-1 fee of greater than 25 basis points as of year-end 2009. These complexes comprise 64 percent of the $838 billion in total net assets in share classes with a 12b-1 fee of greater than 25 basis points. We are in the process of compiling the surveys and performing data verification as needed. We expect the submission to be filed with the SEC by the end of the month. We believe this analysis will be informative to the SEC in evaluating its own estimates of fund costs.

We will note now, however, that the SEC analysis overlooked certain costs. For example, the SEC assumes that brokers and clearing firms will be the only parties to incur costs of modifying confirmations and quarterly statements under the proposed changes to Rule 10b-10. This is not true; mutual fund transfer agents voluntarily provide confirms for accounts held directly at mutual funds. Moreover, the proposed changes would seem to affect all funds that send out confirms, not just those with ongoing sales charges. These additional costs, which we are seeking to assess, would be passed onto funds and their shareholders.[13] The SEC also ignored the difficulties and costs associated with adapting money market fund share classes that have a 12b-1 fee greater than 25 basis points to the new rule.[14] In addition, we believe that the SEC does not fully consider the impact of the proposal on smaller retirement plans and their participants, given the costs associated with retirement plan recordkeepers putting in place systems that are capable of aging and converting share lots at a participant level.[15]

In addition, we believe the SEC has significantly overstated the proposal's benefits. Our forthcoming analysis will examine the methodology and assumptions used by the staff to derive their estimate of $1.1 billion in annual benefits from the proposal. In the meantime, we note that the SEC's

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[12] *See Chamber of Commerce v. Securities and Exchange Commission*, 412 F.3d 133, 144 (June 21, 2005) ("Uncertainty…does not excuse the Commission from its statutory obligation to do what it can to apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation before it decides whether to adopt the measure."); *American Equity Investment Life Insurance Company v. Securities and Exchange Commission*, Case No. 09-1021 (July 21, 2009) (finding that the SEC's analysis of effects on efficiency, competition, and capital formation in adoption of rules related to indexed annuities was arbitrary and capricious, and remanding the matter to the SEC for reconsideration). Another SEC rule is currently being challenged as arbitrary and capricious. *See Business Roundtable et al. v. Securities and Exchange Commission*, United States Court of Appeals for the District of Columbia Circuit, Docket # 10-1305 (filed Sept. 29, 2010).

[13] For our discussion of confirms, *see* pp. 28-30 below.

[14] For our discussion of money market funds, *see* pp. 19-20 below.

[15] For our discussion of retirement plans, *see* pp. 15-19 below.

putative monetary benefits arise primarily ($857 million annually) from the assumption that investors will pay less to invest in mutual funds if level loads on C shares are capped. The SEC also posits that monetary benefits arise ($170 million to $340 million annually) from assuming that increased disclosure and improved investor understanding of distribution fees will lead C share investors to shift from C shares to A shares (or perhaps to no-load funds or no-load share classes).

These estimated benefits are highly speculative and, in our opinion, inconsistent with the SEC's own analysis of likely costs.[16] Moreover, these benefits arise from assumptions that are incompatible with the principles of competitive and contestable markets. At root, the SEC has assumed that it can cap distribution fees paid by investors through funds with no deterioration in the service that intermediaries provide to investors or that intermediaries will be unable to make up the difference in lost revenue via other avenues (*e.g.*, wrap account fees). We dispute this assumption.

Market forces suggest two other outcomes that are far more likely. One possibility is that because investors will pay less in distribution fees, they will receive fewer and lower quality ongoing services from intermediaries. Alternatively, investors will pay fees outside of mutual funds for the ongoing services they demand, such as they do now by paying wrap fees. Either way, when one factors in potential increases in distribution costs elsewhere and potential reductions in the quality and amount of services provided by intermediaries, the logic of market forces suggests that the benefits to investors will be much closer to zero than the $1.1 billion estimated by the SEC.

Thus, even if the cost estimates from our survey were to line up with those estimated by the SEC, the net benefit from the proposal would be substantially smaller and could well be negative. As such, we question whether the proposal has met the statutory requirements for a robust cost-benefit analysis, and we urge the SEC to take a further and more careful look at the economic impact of this rulemaking before proceeding.

Specific Comments

The proposal has five major elements: ongoing sales charges; the marketing and service fee; board oversight; new disclosures; and the proposed exemption from Section 22(d) that would allow for a new distribution option. We have significant questions and concerns about each of these elements, as described below.

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[16] For example, they are predicated on the assumption that C shares have long holding periods; whereas, the proposal elsewhere implies that C share investors have short holding periods.

c. Ongoing Sales Charges and the "Functional Equivalence" of 12b-1 Fees to Up-Front Sales Charges; Conversions

The proposal would allow funds to impose "ongoing sales charges" up to a reference load. The central concept underlying much of this part of the proposal is that a portion of what is currently paid for with 12b-1 fees is the functional equivalent, paid over time, of a front-end sales load, and thus should be subject to the requirements and limitations that apply to traditional front-end sales loads.[17]

In the following section, we discuss the concept of functional equivalence. We then discuss C shares, retirement shares, and money market funds. In these contexts, the comparison between an up-front sales charge and an ongoing stream of compensation is inapt and the imposition of a cap on ongoing sales charges tied to a front-end "reference load" is highly problematic. Finally, we address several other issues with ongoing sales charges, including reinvested dividends and distributions, exchanges, variable insurance products, and the SEC's proposed transition period.

1. The Concept of Functional Equivalence

Given the ongoing nature of 12b-1 fees, it is possible that a shareholder would pay more in 12b-1 fees over time than he or she would have paid in an up-front sales commission. It is therefore appropriate for the SEC to explore whether brokers may have a conflict of interest, to the extent that they may receive greater compensation, for providing essentially the same transaction-based services, through the sale of fund shares with 12b-1 fees than they otherwise would receive.[18] The SEC's focus, correctly, is on "that portion of asset-based distribution fees (today's 12b-1 fees) that operates as a substitute for a sales load," *i.e.*, its functional equivalent.[19]

Although the theory underlying the ongoing sales charge part of the proposal rests on the functional equivalence of a portion of 12b-1 fees to up-front sales charges, the proposal itself is far broader. It would apply to *any* context in which a current 12b-1 fee exceeds 25 basis points, including in many contexts where the use of the fee is quite clearly not an alternative to a front-end sales charge. In addition to providing a way to create a substitute for a front-end sales charge, Rule 12b-1 has allowed funds to tailor various classes to reflect the economics and pricing necessary in different contexts. This has broadened the payment options available to investors for distribution and shareholder services, as

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[17] Release at 37 ("[O]ur proposal would explicitly recognize that a portion of asset-based distribution fees…functions like a sales load that is paid over time, and thus should be subject to the requirements and limitations that apply to traditional sales loads.").

[18] There are ways to mitigate this potential conflict. As stated above, we believe the SEC should address these potential conflicts through point of sale disclosure and the imposition of a fiduciary standard. Even absent those measures, however, the conflicts are mitigated in a variety of ways, including the suitability standards imposed on brokers and enforced by FINRA and conversions on B shares.

[19] Release at 37.

funds have created share classes with fees that reflect the different services investors receive through a particular distribution channel.[20] In those instances, three of which are discussed in the following sections, a hard cap on aggregate compensation is not warranted. The services in those instances continue; the compensation must as well.

2. C Shares

Clearly, C shares with 100 basis point 12b-1 fees were one of the central considerations in developing the SEC's proposal.[21] Since their inception, C shares have grown to an estimated $411 billion in assets.[22] For many investors, particularly those with relatively smaller amounts to invest, C shares have proven to be the best available option to obtain the benefits of a flexible asset allocation account and the ongoing services of a financial professional. These investors often do not qualify for fee-based accounts.[23] Even if they do qualify, they stand to pay substantially more by virtue of a minimum fee.[24] And they may not want to buy class A shares because they do not qualify for breakpoints on front-end sales commissions or may have a short or uncertain investment time

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[20] For a description of the benefits that Rule 12b-1 has provided, *see* 2007 ICI Roundtable Submission.

[21] *See*, *e.g.*, Speech by Commissioner Luis A. Aguilar, *Statement at SEC Open Meeting—12b-1 Fees*, July 21, 2010 ("Class C shares are the shares that impose a sales load for as long as the shareholder owns the shares. Accordingly, long-term shareholders in C shares are paying distribution expenses or sales loads for the entire time they hold the shares, making it entirely possible that they may be paying more than if those investors had paid a traditional front-end sales load.... I want to particularly highlight the proposal that would automatically convert, within five years, existing C class shareholders into a share class that does not deduct an ongoing sales charge.").

[22] The estimated $411 billion is comprised of share classes in which the front-end load is greater than or equal to zero percent, any contingent deferred sales load is greater than or equal to two percent, and the 12b-1 fee is greater than 25 basis points. This definition primarily includes C shares.

[23] Fee-based products offered by broker-dealers and other investment professionals, such as separately managed accounts ("SMAs") or mutual fund advisory "wrap" programs ("wrap accounts"), are generally not available to investors with more modest amounts to invest. As of the first quarter of 2007, the average SMA size is $336,000. *See* "Rule 12b-1: Looking Back, Looking Forward, in the Context of a $12 Trillion Mutual Fund Industry," *Strategic Insight Overview*, Issue 4 (2007) at 2 ("2007 SIO Issue"). For wrap accounts, investment minimums can be as low as $5,000 and $10,000 at some firms. *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. The current average account size, however, is $143,000. 2007 SIO Issue at 2. In contrast, account-level data collected by the Institute indicate that the typical balance in a long-term mutual fund, as indicated by the median account balance, is about $5,000. *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.

[24] *See* comment by David A. Madsen, Financial Advisor, Bank of America-Merrill Lynch, available at www.sec.gov/comments/s7-15-10/s71510-214.htm ("Eliminating 'C' shares forces the Advisor to abandon these smaller accounts as not cost effective to service, unless they increase their asset size by four times or transition into a much higher fee-based wrap account with base annual fees of $500.00 per year or 2.5% on a small $20,000 sized account. This cost would be prohibitive to the small investor, so the result would be abandonment by the Advisor. The small investor would now be on their own because of the implementation of this new rule.").

horizon.[25] The C share model provides investors with a viable alternative and a way to compensate their broker or adviser through an ongoing fee for the ongoing services rendered.[26]

We recognize that the SEC did not propose to eliminate classes, such as C shares, that use 12b-1 fees to pay for ongoing services. Nevertheless, the proposal would have a significant impact on C shares as we know them, and many believe that the proposal ultimately will disadvantage small investors – many of whom own funds through this channel.[27] We question how the SEC, with its mandate to "protect investors," could adopt a rule that has such potential to harm smaller investors. As the SEC reconsiders its economic analysis of this rulemaking, it should pay particular attention to the possible disenfranchisement of smaller investors who currently own C shares.

Despite our concern that the proposal could harm small investors, we understand that mandating an aggregate cap on ongoing sales charges in the C share context is one of the lynchpin concepts in the SEC's proposal. To the extent that the SEC moves forward with this part of the proposal, it should, at a minimum, distinguish the C share context from other contexts, such as those discussed below with respect to retirement shares and money market funds, where the use of 12b-1 fees is plainly far different from the use of a front-end sales charge. The SEC also should address certain elements of the proposal that add significantly to the complexity and operational difficulty of

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[25] *See*, *e.g.*, John Hancock Funds, "Choose the Share Class That's Right for You," available at www.jhfunds.com/Article.aspx?ArticleID=%7B91F8B258-9726-4AFF-98E5-CC2D905DEB8F%7D ("Class C shares may be best for investors who have a short or uncertain time horizon, want the flexibility of free redemptions after one year and prefer the simple 'pay-as-I-go' pricing structure.").

[26] *See* comment by John Grady, Certified Financial Planner, available at www.sec.gov/comments/s7-15-10/s71510-202.htm ("This ongoing [12b-1] revenue allows me to focus on servicing my existing client base and management of their assets, big or small. I charge nothing more for my time on the phone or in meetings with my clients. Were it not for the ongoing revenue provided me from these 12b-1 fees, I would not be able to focus on my existing clients, but rather would constantly need to solicit new business in order to make a living. Alternatively, I would have to charge my existing clients an hourly fee for my services to them, resulting in the vast majority of my clients paying more than they do now via the 12b-1 fees. Many would likely choose not to pay me, I would have to drop their accounts, and they would be on their own to manage their investments and financial life. This is not where they want to be; they sought out my services and realize that they are compensating me for my time and efforts.").

[27] *See* comment by James Hergenroeder, First Vice President, Wells Fargo Advisors, available at www.sec.gov/comments/s7-15-10/s71510-25.htm (suggesting that a move to wrap accounts would be "[g]ood for the firm, good for the broker, not so good for the client," and that "[s]maller accounts will be eliminated" if the proposal is adopted); comments by Jeffrey D. Anton, CPA, available at www.sec.gov/comments/s7-15-10/s71510-38.htm ("[D]on't forget the exceptional value of the mutual fund. They are far more efficient than the popular alternatives, the wrap account, and the variable annuity....It is a much better deal for a small investor to pay the additional 75 bps on a pretax basis, than to have the wrap account with a one percent after tax fee."). Fees charged for smaller SMAs are generally 2.5 to 3.0 percent of assets. For all SMAs, large and small, the average effective fee (asset-weighted) is 1.69 percent. Fees charged for wrap accounts average 1.17 percent in addition to the underlying mutual funds' expenses. *See* 2007 SIO Issue at 2. These SMA and wrap fees are the type of investment expenses that are deductible when paid directly by an individual investor only to the extent that all of the individual's miscellaneous itemized deductions exceed two percent of adjusted gross income. *See* Section 67(a) of the Internal Revenue Code of 1986, 26 U.S.C. Section 67(a).

implementing the aggregate caps.

The single most troublesome such element is the requirement that each fund calculate its own "reference load" for purposes of the aggregate cap. The SEC proposes to define "reference load" as "the highest sales load rate that the shareholder would have paid if, at the time of the purchase of fund shares, the shareholder had purchased a class offered by the fund that does not have an ongoing sales charge and for which the shareholder qualifies according to the fund's registration statement."[28] If no such class exists, the reference load would be set at the maximum sales charge rate permitted for a fund with an asset-based sales charge and a service fee under the NASD Conduct Rules, currently 6.25 percent.[29]

The SEC requests comment on whether the rule instead should treat the FINRA sales charge limit of 6.25 percent as the reference load for purposes of determining the maximum amount of ongoing sales charge in all cases, even if a fund has a front-end load class of shares that can serve as the reference load.[30] We strongly favor this approach, for a number of reasons.[31]

First, non-standardized reference loads would lead to a wide variety of ongoing sales charge levels and conversion schedules. While we generally support regulation that promotes greater choices for investors, we are concerned that in this case, the resulting pricing disparities could create investor confusion and add operational complexity for funds and intermediaries, ultimately making mutual funds less desirable in asset allocation models. Through these accounts, investors hold a mix of funds, acquired at various times through rebalancings or new purchases. As a result, if we assume the proposal was adopted on May 1, 2011, with an effective date of July 1, 2011 and a compliance date of January 1, 2013,[32] by early 2015, an investor purchasing C shares of several funds might hold:

[28] Proposed Rule 6c-10(d)(14)(i).

[29] Proposed Rule 6c-10(d)(14)(iii).

[30] Release at 58.

[31] We are not suggesting, however, that the SEC mandate particular conversion schedules. We believe that with a uniform reference load, market forces will encourage consistency in conversion schedules.

[32] Based on the implementation schedule suggested in the Release. *See* Release at 133.

Type of shares	Scheduled conversion date
Grandfathered equity fund	January, 2018
Grandfathered bond fund	January, 2018
Equity fund purchased in February, 2013, with 6.5 year 75 basis point ongoing sales charge (4.75% reference load)	February, 2020
Bond fund purchased in February, 2013, with 5 year, four month 75 basis point ongoing sales charge (4% reference load)	June, 2018
Equity fund purchased in June, 2013, with 7 year, six month 75 basis point ongoing sales charge (5.75% reference load)	December, 2020
Bond fund purchased in October, 2013, with 5 year 75 basis point ongoing sales charge (3.75% reference load)	October, 2018
Equity fund purchased in March, 2014, with 7 year 75 basis point ongoing sales charge (5.25% reference load)	March, 2021

This array of conversion schedules and dates could easily become so bewildering to investors and challenging for intermediaries to manage as to discourage the future use of C shares. Brokers often distribute a large number of funds from multiple fund complexes. Brokers, funds, and their transfer agents will have to make significant operational and back office changes (including intermediary and investor support and communications) for tracking and applying non-standardized reference loads. C shares have gained popularity in asset allocation models precisely because level load pricing allows investors and their brokers to reallocate investments without regard to the impact of commissions. The introduction of a wide variety of conversion schedules could change this dynamic. Whether through the introduction of new compliance challenges, such as whether a particular decision to reallocate was based on the client's interests or the broker's incentives to avoid a conversion date, or whether simply from the additional complexity, brokers may turn away from C shares for these types of accounts.

Second, non-standardized reference loads create an incentive to find a workaround, either by setting artificially high maximum front-end sales charges with a schedule of breakpoints that would ensure that very few (if any) investors actually pay the maximum rates, or by simply eliminating class A shares altogether.[33] This would not benefit investors and should not be encouraged.

Third, a uniform reference load would eliminate any interpretive questions that arise with the standard as proposed. For example, it is not entirely clear whether the SEC intended reference loads to be calculated with regard to breakpoint discounts. The Release explains that the reference load would "be the highest front-end load of another class of that fund that does not charge an ongoing sales

[33] The SEC and other commentators share this concern. *See* Release at 55 (asking the specific question whether non-standardized reference loads would "encourage funds to offer a share class with a high front-end sales load in order to charge a higher cumulative ongoing sales charge on other classes"); comments by James B. Wiggins, Associate Professor of Finance, Michigan State University, available at www.sec.gov/comments/s7-15-10/s71510-24.htm ("Under this rule, I expect that some fund companies will eliminate Class A shares and apply the (proposed) NASD 6.25% maximum cumulative charge to their Class C shares.").

charge,"[34] suggesting that breakpoint discounts are to be disregarded. But the proposed rule states that the reference load is "the highest sales load rate that the shareholder *would have paid.*"[35] Similarly, it is not clear how to apply the proposed rule in contexts where a particular type of purchaser only qualifies for a particular class (*e.g.*, retirement plans and retirement shares). The proposed rule is clear that the reference load is derived from a class "for which the shareholder qualifies." Does that mean that all classes used exclusively for one type of investor always utilize a reference load of 6.25 percent, because that type of investor would not qualify for other classes? A uniform reference load would be simple, clear, and completely objective.

We understand that a uniform reference load would present the potential that an investor could pay more in ongoing sales charges than he or she would have paid up front. But we believe that this concern is mitigated by the suitability requirements on brokers, and would be further mitigated by the imposition of a fiduciary duty and the implementation of point of sale disclosure rules.

3. Retirement Shares

If the rule is adopted as proposed, some funds currently used as investment options in retirement plans will be required to treat a portion of their 12b-1 fee as an ongoing sales charge and provide for a conversion period. The affected funds are generally used in smaller retirement plans.[36] For reasons explained below, we think this requirement is misplaced and will serve as a practical prohibition on the use of mutual funds for the smallest retirement plans. We urge the SEC to reconsider the application of the proposed rule to share classes sold exclusively to retirement plans and permit funds to provide ongoing compensation for ongoing services rendered in the retirement plan context, without having to consider that compensation a form of ongoing sales charge.

The SEC is forthright in its assessment of the impact of the ongoing sales charge requirement

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[34] Release at 53.

[35] While we are merely making the point that interpretive questions are certain to arise with a more complex definition of reference load, if the SEC goes forward with this element of the proposal, it should clarify that breakpoint discounts are not meant to be taken into account in calculating a reference load.

[36] As recognized in the Release, 12b-1 fees are currently used to offset plan recordkeeping expenses and compensate brokers to the plan. As a general matter, the economics of smaller retirement plans necessitate a higher 12b-1 fee, because share classes with lower 12b-1 fees would not generate enough revenue to offset these expenses.

The Release notes that SEC staff estimates that less than two percent of plan assets are invested in R shares. Release at 131. Although the total amount of assets in plans using R-shares may be relatively small, it is important to remember that small plans represent the majority of 401(k)-type plans and more than 8 million people actively participate in these small plans. Of the 476,305 401(k)-type plans that reported having more than one participant in 2007, 413,238 (or 86.8 percent) reported having fewer than 100 participants. In terms of active participants in 401(k)-type plans in 2007, 8,222,000 (or 13.8 percent) were in small plans with fewer than 100 participants. *See* U. S. Department of Labor Employee Benefits Security Administration, *Private Pension Plan Bulletin, Abstract of 2007 Form 5500 Annual Reports*, (June, 2010), available at www.dol.gov/ebsa/PDF/2007pensionplanbulletin.PDF.

on retirement plans. The SEC acknowledges that "many plan administrators currently do not track and age shares….Plan administrators would have to either develop this capability…or offer only classes of shares that do not impose an ongoing sales charge." The SEC goes on to say that developing that aging and tracking capability and eventually converting shares "may not be a viable option for retirement plans" and that "[t]hus, our proposal would likely make R shares a less attractive investment option for plans to offer."[37]

Unfortunately, we agree with that grim assessment. As the SEC correctly observed, retirement plan recordkeeping systems generally do not have the functionality to track and manage share lot histories. Participant-directed retirement accounts present unique recordkeeping challenges, as regular employee payroll contributions, employer matching contributions, exchanges between funds in the investment lineup, reinvestment of dividends and capital gains, and loan and hardship withdrawals and repayments create a very large volume of share lot activity. Given this volume of activity and the tax exempt nature of the accounts, there has never been any compelling reason for retirement plan recordkeeping systems to develop, at great expense, share lot tracking functionality.

It is theoretically possible that recordkeepers would enhance their systems in light of the SEC's proposal, but it would be a major undertaking requiring a retooling of core processing routines and a significant allocation of resources for the testing and implementation regimen necessary to put the share lot tracking into production.[38] Ultimately, the substantial costs involved would be borne by retirement plan participants in the form of higher recordkeeping expenses, which could be quite significant in basis point terms because of the size of the affected plans.[39]

More likely, however, the aging and tracking systems simply may not be created for this

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[37] Release at 130-131.

[38] A potential alternative would be for the recordkeeper to acquire (either build or buy) an ancillary system to complete share lot tracking. Although that alternative may be less disruptive to the primary recordkeeping system, the resource requirement would still be tremendous to acquire and implement an ancillary system and integrate the processing routines between the primary recordkeeping system and an ancillary system for tracking share lot activity.

[39] Fixed expenses like higher recordkeeping costs have a disproportionate impact on small retirement plans because the costs are spread among fewer participants. Indeed, a survey of 130 defined contribution plan sponsors conducted in 2008 by Deloitte on behalf of ICI showed that plan size was the most significant driver of fees. In particular, as the number of participants and average account balance increased, the total fees as a percentage of assets decreased. According to the study, "[w]hile the median plan's 'all-in' fee was 0.72% of assets, median fees among plans with less than $1 million in assets were 1.89% of plan assets and for plans with more than $500 million in assets, the median 'all-in' fee was less than 0.50%." The "all-in" fee for each plan was calculated by combining administrative, recordkeeping, investment, and consulting fees, which may be assessed at the plan level, per participant, or as an asset-based charge (including 12b-1 fees). *See* Deloitte Consulting and Investment Company Institute, *Defined Contribution / 401(k) Fee Study* (Spring 2009), available at www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf.

market.[40] Instead, small employers may seek alternative investment options that allow them to continue to offset plan expenses, such as annuities or less-regulated collective investment trusts, or may simply forego offering retirement plans altogether because they cannot afford to bear the upfront expenses of starting a plan. Millions of small plan participants will lose their plans or be pushed to higher cost, less transparent, and potentially less regulated investment alternatives. There is no reasonable policy justification for this result.[41]

And, sadly, this appears to be collateral damage from the SEC's core initiative to cap 12b-1 fees for C shares. The use of 12b-1 fees in the retirement plan context is far different from the non-retirement plan context, and the services provided by a broker to a plan are very different from those provided by a broker to a client in exchange for a front-end sales charge. In the retirement plan context, the broker provides a variety of ongoing services that are unique to retirement plans, important to plan participants, and rendered over the entire life cycle of the plan. These services, many of which are simply not necessary in the non-retirement plan context, include:

- *Early assistance.* Particularly in the small plan context, brokers work closely with the plan sponsor (the employer) to determine the plan structure and administration that would best serve the needs of the employer and its workforce. The broker often assists with the request for proposal ("RFP") process, searching for the appropriate service providers for the plan and working with the sponsor during the selection of investment options. The broker typically assists with the participant enrollment process, often through multiple participant meetings held to inform employees about the plan and its investment options. The broker may provide general investment education as well as information regarding the plan's investment options. He or she may also help employees to complete the appropriate paperwork (enrollment forms, beneficiary designations, and investment selections). For plan conversions, the broker may also be called upon to assist with the preparation of the blackout notice required by section 101(i) of the Employee Retirement Income Security Act of 1974 (ERISA).

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[40] *See, e.g.*, comments by The SPARK Institute, Inc. ("[b]ased on our discussions and feedback provided to us by our members, **none intend to upgrade their systems to comply with the Proposed Rule**. Our members believe that the complexity, potential difficulty, and costs associated with complying with the rules have been underestimated and are far too significant to undertake, particularly at this time.") (emphasis in original).

[41] Increasing the rate of employer-sponsored defined contribution retirement plan coverage, particularly among employees of small businesses, remains an important goal of public policy. The Obama Administration consistently has supported initiatives to increase coverage and retirement savings for these workers, including for example, the Automatic IRA proposal and doubling the tax credit for small employers establishing a new retirement plan. *See, e.g., Analytical Perspectives, Budget of the US Government, Fiscal Year 2011* (page 172), available at www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/spec.pdf; and *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* (page 16), available at www.treas.gov/offices/tax-policy/library/greenbk10.pdf. *See also* Treasury September 5, 2009 announcement on new retirement and savings initiatives, available at www.irs.gov/pub/irs-tege/retirement_savings_fact_sheet.pdf.

- *Ongoing education.* Brokers remain involved with plans, providing ongoing support in a variety of ways as needed. Brokers may hold additional enrollment meetings as new employees are hired and become eligible to participate, or may hold additional educational meetings for existing participants to discuss the impact of loans, the importance of compounding, or other basics of investing. The broker may also hold pre-retirement meetings for older participants, or individual meetings with participants on topics such as how to complete the paperwork to effect a rollover. At times, the broker may be asked to conduct a distribution planning workshop if, for example, the company is downsizing.

- *Section 404(c) compliance.* The broker often assists with the dissemination of information such as prospectuses, annual reports, and fund fact sheets required to comply with Department of Labor regulations under section 404(c) of ERISA. This is particularly common with smaller plans, where compliance with the disclosure requirements cannot be fully automated.

- *Annual investment and plan operational reviews.* At least once a year, the broker may be called upon to help the sponsor review the plan's investment options and operations. The review typically covers issues such as a comparison of the plan's investment results to relevant benchmarks, the appropriateness of the investment options for the plan's demographics and the consideration of changes to the plan's investment menu. The broker may also help with a review of contribution rates (plan utilization) and work with the sponsor to identify what steps may need to be taken to increase participation rates.

- *Assistance at termination.* A broker's assistance continues all the way through the termination of the plan, where the broker often helps with distribution planning, educating participants about distribution options and assisting them with the necessary paperwork.

The ongoing nature of these services, and the use of fund assets to compensate brokers for them, is distinctly different from non-retirement plan contexts. Recognizing this, we recommend that the SEC reconsider the application of the new distribution framework to classes of fund shares used exclusively for retirement plans. In doing so, the SEC must carefully consider the impact of the proposal on workers at small employers, who could lose, or never gain, the opportunity to contribute to a workplace retirement plan if this avenue for covering the costs of establishing and maintaining a plan is eliminated.

If the SEC decides to go forward with this rulemaking and apply the proposed framework to

retirement plans, it should take steps to permit funds to provide ongoing compensation for ongoing services rendered in the retirement plan context, without having to consider that compensation a form of ongoing sales charge. It could do this in either or both of two ways: by providing guidance to the effect that the ongoing services described above are not "primarily intended to result in the sale" of fund shares and therefore not "distribution activities"[42] and/or by directing FINRA to craft a separate cap for retirement shares that would reflect the unique nature of the ongoing services provided by brokers in that context. In essence, this latter recommendation would allow for a higher marketing and service fee for classes of fund shares used exclusively for retirement plans. This would be consistent with the policies underlying the proposal, as the current use of 12b-1 fees in this context is clearly not the functional equivalent of a front-end sales charge.

4. Money Market Funds

Money market funds are not sold with front-end sales charges, so in this context the proposal's ongoing sales charge concept – treating a portion of 12b-1 fees as the functional equivalent of a front-end sales charge – is wholly inapt.

Money market funds with 12b-1 fees higher than 25 basis points often are used in commercial sweep accounts.[43] As in the retirement plan context, the transfer agency systems used to manage the flows into and out of the sweep accounts are not built to track and age investments by share lot, and would have to be built if funds were required to treat the amount of current 12b-1 fees over 25 basis

[42] We also discuss this issue below with regard to the proposed marketing and service fee and the administrative services provided by retirement plan recordkeepers. The concern expressed by our members regarding the lack of clarity regarding how to characterize services as distribution-related or not is particularly high in the retirement plan context. It could be argued that most or all these services are for distribution, because without them, the fund would not be included on the plan's investment menu. On the other hand, these services are highly administrative or educational, and solely for the benefit of existing plan participants. It is equally reasonable to view these services as non-distribution related. We request confirmation that services of this sort are not "distribution activities" for these purposes, so that funds and their advisers can appropriately allocate the charges for these services without the need to treat them "defensively" under Rule 12b-2, as some currently do with 12b-1 plans. Given the natural uncertainty introduced by a regulatory change, a fund and its adviser may be hesitant to do so absent such confirmation.

[43] Many financial institutions offer commercial sweep accounts as a way to automatically link an investment account with a commercial account, investing excess cash balances overnight. Investors benefit from having a single consolidated account to manage their securities, credit balances, and cash transactions. Often, the accounts offer investors checkwriting privileges, debit card access, and other helpful features.

In the typical sweep arrangement, the financial institution calculates a sweep amount each evening based on a predetermined target balance. Amounts in excess of the target balance are "swept" into a general ledger account for investment on the following day. If the financial institution's balance is less than the target amount, the general ledger account is charged on the following day to bring it up to the target level. Financial institutions have several options for managing that investment, including the use of money market funds as an efficient externally managed option. For more information on sweep arrangements, see Section 5.2 of the ICI's Report of the Money Market Working Group (March 17, 2009), available at www.ici.org/pdf/ppr_09_mmwg.pdf.

points as an ongoing sales charge – a needless and wasteful exercise, given that the intended purpose of the funds in this context are for managing overnight cash balances, not long term investments. Moreover, the application of the ongoing sales charge concept seems particularly misplaced here, because 12b-1 fees are used in this context far more like platform fees than an alternative to a front-end sales charge. Put another way, 12b-1 fees in this context are much more like marketing and service fees than ongoing sales charges.

It does not appear that the use of 12b-1 fees by money market funds was contemplated in the Release, either with respect to marketing and service fees or ongoing sales charges. Before the SEC goes forward with this rulemaking, it should carefully consider the application of the rule in this context.

Ultimately, our recommendation is similar to the retirement share context. To the extent the SEC goes forward with this rulemaking and decides to apply the new framework to money market funds, it should reject the notion that all current 12b-1 fees in excess of 25 basis points must be treated as an ongoing sales charge. The mere fact that money market funds are not sold with front-end sales charges belies the premise that money market funds should be included in this rule. The SEC might direct FINRA to permit the payment of higher marketing and services fees by money market funds. In any event, requiring systems to be built to track and age *daily* investment of *overnight* balances for the theoretical conversion to another share class years in the future is clearly pointless, and would fail any cost-benefit analysis the SEC undertook as required by statute. The needless costs associated with such a requirement would serve only to make money market funds less efficient, without providing even theoretical benefits to investors.

5. Reinvested Dividends and Distributions

The proposal would permit the reinvestment of dividends and distributions in a share class with an ongoing sales charge, subject to the same conversion schedule as the shares on which the dividend or distribution was declared.[44] While this model may be attractive conceptually, as the original purchase and all related reinvested dividends and distributions would convert at the same time, it is nearly unworkable in practice. A simple example illustrates the problem. Assume an investor has amassed $20,000 in an account through systematic investments in a bond fund that has a current annualized yield of 4 percent, and that the fund pays a current monthly dividend of $66.67.[45] The proposal assumes that the fund will allocate portions of that $66.67 dividend to the potentially hundreds of original purchase lots, including, for example, allocating approximately twenty two cents to the shares purchased with the prior month's reinvested dividends.[46]

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[44] Release at 61.

[45] $20,000 * 4% yield = $800 / 12 months = $66.67.

[46] $66.67 * 4% yield = $2.67 / 12 months = $0.22.

This type of allocation requirement will exponentially increase the number of share lots to be converted. As a result, the conversion process would be complex to program, difficult to recordkeep and would lead to reconciliation and breakage issues because of rounding conventions and systems limitations. Additionally, for cross dividend reinvestment transactions[47] or for partial exchange transactions,[48] it would be impossible to program to allocate dividend and distributions to original purchase lots. In both instances multiple CUSIPs or share classes are affected, and the detailed account history for the shares on which the reinvested dividends and distributions were paid would not be accessible for use in the allocation process proposed by the SEC.

We strongly recommend that the final rule permit funds to treat dividend and distribution reinvestments as a single lot (or bucket) that would convert proportionately based on the total shares held in an account at the next scheduled periodic (*e.g.*, quarterly, monthly, weekly) conversion date. This approach will be far easier to program and administer, thus avoiding the additional costs for complex programming and to resolve account reconciliation issues that would occur if funds were required to implement the practice as proposed. It serves investor and SEC interests, as investors will not pay ongoing sales charges on reinvested shares longer than they hold invested shares. And it is consistent with the way B share conversions work today.[49]

6. Exchanges; Proposed Amendments to Rule 11a-3

The SEC proposes amendments to Rule 11a-3(b)(4) to require funds to give shareholders credit for the payment of ongoing sales charges when determining the amount of sales load due upon an exchange. Rule 11a-3 governs sales loads and other charges that may be imposed on an exchange between funds within the same fund group, and is intended to help ensure that shareholders receive credit for all sales charges incurred on a particular purchase of fund shares and are protected from the sales practice abuse of switching.

We strongly support the regulatory purposes and intent of Rule 11a-3, and support the proposed amendments to Rule 11a-3 in the Release. Nevertheless, we are cognizant that compliance with the amended rule will require funds and intermediaries to implement substantial programming changes, and we provide several suggestions intended to make compliance more operationally feasible while maintaining protections for investors.

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[47] Where the reinvestment dollars are used to purchase shares in another CUSIP or share class.

[48] Where only a portion of the shares in an account are exchanged into another CUSIP or share class.

[49] The Release suggests that the proposed allocation approach "reflects what we understand to be the practice most fund groups use to account for reinvestment of distributions on class B shares." Release at 61. It is our understanding, however, based on conversations with the largest transfer agent vendors to the industry and mutual fund proprietary transfer agents, that the predominant method used by most of the industry is the proportionate method we recommend and not the allocation approach described in the Release.

The Release poses several questions as to the amount of credit to be given for ongoing sales charges already paid, including whether funds should be required to give credit for any marketing and service fee paid under rule 12b-2 and/or any 12b-1 fees previously paid. While we believe that it is appropriate to give shareholders credit for ongoing sales charges already paid, we do not believe that the credit should extend to marketing and service fees or 12b-1 fees. Marketing and service fees are expressly not considered the functional equivalent of front-end sales charges, and are not subject to the ongoing sales charge cap. 12b-1 fees have not previously been tracked at the individual shareholder level for any purpose (including for B shares); it would be difficult, if not impossible, to give credit for portions of 12b-1 fees paid in the past. Accordingly, we recommend that this requirement be limited to ongoing sales charges, as charged under the new distribution framework.

We also strongly support the proposal to modify the rule to clarify that funds must provide credit for ongoing sales charges in terms of the cumulative *rate* of the ongoing sales charge previously paid rather than the *amount* of fees paid. The SEC is correct to recognize that mutual fund transfer agents and intermediaries do not have the ability to track the dollar amount of fees paid. Systems modifications to track dollar amounts for individual shareholders for these purposes would be significant and cost prohibitive, with no commensurate benefit to shareholders.

7. Variable Insurance Products

In general, the proposal seeks to treat funds underlying variable insurance contracts similarly to other mutual funds. We support this aspect of the proposal. While the complexity and two-tier nature of variable products often raises unique regulatory issues, we see no reason why fund-level distribution expenses for underlying funds should be treated differently than distribution expenses of other mutual funds.

As recognized in the Release, however, the tracking and aging of shares for purposes of complying with a cap on ongoing sales charges presents problems for life insurance companies issuing variable products. Similar to the retirement plan context discussed above, life insurance companies currently do not have the capability to track and age underlying fund shares offered as investment options for variable annuity contracts. Other commentators describe the issues in this context in detail.[50]

Given that insurance companies lack the capacity to track and age underlying fund shares, alternatives may be necessary in order to facilitate compliance with the new rules. Such alternatives might include, for example, allowing an insurance company to assume that all underlying fund shares with an ongoing sales charge attributable to a particular variable contract were purchased on the date the contract was issued, for purposes of determining the date when the reference load for those fund

[50] *See, e.g.*, comments by Sutherland, Asbill & Brennan LLP on behalf of the Committee of Annuity Insurers.

shares is reached. Other commentators may have additional suggestions that warrant the SEC's careful consideration.

8. Transition; "Grandfathering" of Existing Shares

Finally, we urge the SEC to explore more flexible alternatives to its proposed approach to grandfathering for existing share classes with 12b-1 fees in excess of 25 basis points, to better reflect the variety of fee structures and purchase dates among fund shares that currently impose 12b-1 fees.

The Release specifically requests comment on whether the grandfathering period should apply only to certain types of classes, such as "level load" share classes, and not apply to other classes, permitting them to convert on their own schedules. It also asks whether the proposed grandfathering period should apply only to classes that charge a certain level of 12b-1 fees (*e.g.*, 12b-1 fees greater than 50 or 75 basis points).

Although not stated in the Release, the benefit of a grandfathering period is that it strikes a balance between the extremes of requiring funds to give credit to existing shareholders for 12b-1 fees already paid (something that many funds may not have the data to do) and allowing current 12b-1 fees to be paid in perpetuity. The five year period strikes this balance appropriately for level load share classes, where the amount of the ongoing sales charge (likely 75 basis points) over the compliance and grandfathering periods begins to approach the reference load.

For funds with lower 12b-1 fees, five years is not an appropriate time period, and may lead to odd results. For example, assume that the rule is adopted with a uniform reference load of 6.25%, an effective date of July 1, 2011, and a compliance date of January 1, 2013. A fund with a current 50 basis point 12b-1 fee might create a new share class with a 25 basis point marketing and service fee and a 25 basis point ongoing sales charge on a 25 year conversion schedule. Shares with 12b-1 fees sold in December, 2012 would convert in January, 2018, having paid 125 basis points in the equivalent of ongoing sales charges. Shares sold the very next month in January, 2013 would convert in January 2038, having paid 625 basis points in ongoing sales charges.

The disparate results produced by a uniform five-year grandfathering period would upset legitimate financial expectations of fund complexes, broker-dealers and other intermediaries, without any compelling public policy reason for doing so. They could also create unintended incentives to encourage investors to exchange existing fund shares with 12b-1 fees above 25 basis points for fund shares that follow the new regime, primarily in order to avoid the effects of the grandfathering period.

Accordingly, we recommend that the SEC consider alternatives that would eliminate or at least mitigate these disparities. More specifically, the SEC may wish to consider providing longer grandfathering periods for fund shares with 12b-1 fees in one or more defined bands (*e.g.*, a grandfathering period of fifteen years for fund shares with 12b-1 fees between 25 and 50 basis points).

Or, it might consider allowing funds to overlay their conversion schedule on existing share classes, provided that the fund gives credit to existing shareholders for their holding periods. Some funds may not operationally be able to take advantage of this alternative, because they do not have the data to recreate lot histories. Many funds, however, may find it useful.

d. Proposed Rule 12b-2; the Marketing and Service Fee

Proposed new Rule 12b-2(b) would permit funds, with respect to any class of fund shares, to deduct a "marketing and service fee" from fund assets. The marketing and service fee would be capped with reference to FINRA's limits on "service fees" in NASD Conduct Rule 2830.

We appreciate the SEC's very clear distinction between marketing and service fees, which are not subject to an aggregate cap, and ongoing sales charges, which are subject to such a cap on the SEC's theory that they are the functional equivalent of front-end sales charges. As the SEC states, marketing and service fees are ongoing in nature and *not* economic substitutes for front-end sales charges.[51]

We also appreciate the SEC's recognition that these ongoing distribution-related expenses benefit the fund and existing fund shareholders in a variety of ways,[52] and strongly support the proposal to allow funds to bear these expenses without the need for a written plan to be approved annually by the fund's board.[53]

Our major concern with the proposed marketing and service fee is that the intended scope of Rule 12b-2 is not clear. With a cap of 25 basis points, funds and their advisers will be under a great deal of pressure to carefully define what constitutes "distribution activities" for the allocation of expenses to the marketing and service fee. Although funds and their advisers will ultimately make whatever difficult determinations are necessary to comply with the SEC's rules, neither the proposed rule nor the Release provides them with much clarity around the definition of "distribution activities." In fact, quite the opposite, as the Release contradicts itself with respect to the intended breadth of Rule 12b-2.

On the one hand, the Release in a number of places encourages funds (and their advisers) to carefully characterize expenses as not related to distribution. It states that "to the extent that funds need not rely on proposed Rule 12b-2 to charge expenses that can clearly be identified as not distribution related (*e.g.*, sub-transfer agency fees), funds could instead characterize those expenses as administrative expenses and thus keep total asset-based distribution fees within the 25 basis point limit

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[51] Release at 73, discussing confirm disclosure ("marketing and service fees (unlike ongoing sales charges) would not act as economic substitutes for front-end sales charges…").

[52] Release at 43.

[53] Although, as discussed below at pp. 27-28, we have serious concerns about the proposed board guidance in the Release.

of the marketing and service fee."[54] Later, in the cost-benefit section of the Release, the SEC elaborates on that point:

> Many funds currently pay for expenses that are not distribution related with 12b-1 fees (such as administrative, sub-transfer agency, or other fees). As a result, we expect that some funds with classes that impose 12b-1 fees of more than 25 basis points, up to and including 50 basis points (*e.g.*, some A and R share classes), might instead be able to treat the amount greater than 25 basis points as a fund operating expense. These funds would have to carefully examine their 12b-1 fees and identify which, if any, expenses could be properly classified as non-distribution expenses. If non-distribution expenses paid through 12b-1 plans are significant enough, these funds might be able to reduce their asset-based distribution fees to the 25 basis point cap and avoid being subject to the ongoing sales charge limits and conversion periods in proposed rule 6c-10(b).[55]

We strongly agree with this sentiment. Expenses that are clearly not related to distribution are not subject to Rule 12b-1, and should not be subject to Rules 12b-2 or 6c-10(b).

The Release muddies these waters, however, with respect to service fees. The SEC explains that "[a]lthough the [marketing and service] fee could be used for any type of distribution cost, we anticipate it primarily would be used to pay for servicing fees of the type currently permitted by the NASD sales charge rule, trail commissions to broker-dealers selling fund shares, and other expenses, such as fees paid to fund supermarkets, that may in part be distribution related."[56] By referencing "servicing fees of the type currently permitted by the NASD sales charge rule" here, by using the word "service" in the name of the fee, by explicitly cross-referencing FINRA's service fee limit, and by asking questions such as whether the fee should be limited to service fees,[57] the SEC appears to have intended that *all* service fees be included within the marketing and service fee exception.

This should not be the result. A number of funds currently pay up to 25 basis points in service fees outside of Rule 12b-1, consistent with FINRA's service fee rule. These include funds marketed and sold as "no-load-no-12b-1 funds," funds used in the bank distribution channel, and funds used in the retirement markets. These funds and their advisers have concluded that these service fees are not primarily intended to result in the sale of fund shares, and thus not for "distribution activities."

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[54] Release at n. 153, citing SEC Release No. IC-16431 (June 13, 1988) ("[T]o the extent a fund is paying for legitimate non-distribution services, such payments need not be made under a 12b-1 plan, even if the recipient of the payments is also involved in the distribution of fund shares.").

[55] Release at 179-180.

[56] Release at 41.

[57] Release at 45.

Even without any clarification by the SEC, such funds should be able to conclude that their non-12b-1 service fees are unaffected by the new rules, because Rule 12b-2 uses precisely the same definition of "distribution activities" as is embedded in current Rule 12b-1.[58] Given that definition, to the extent that a service fee is properly outside of the scope of Rule 12b-1 now, it should be equally outside of the scope of Rule 12b-2. We request that, in any final rulemaking, the SEC clearly state that this is the case.[59]

Moreover, the SEC should confirm that funds and their advisers may continue to rely on FINRA's current guidance on administrative services. Although it is reasonably clear in the Release that the SEC did not intend to call that guidance into question, we recommend that the SEC include an unequivocal statement that the following non-exhaustive list of activities are presumptively not "primarily intended to result in the sale" of fund shares, and therefore not "distribution activities" under Rule 12b-2(e)(2):

- Fees paid to a transfer agent for performing shareholder services pursuant to its transfer agent agreement;
- Recordkeeping charges, accounting expenses, transfer costs, or custodian fees;
- Sub-transfer agency services, sub-accounting services, or administrative services;[60]
- Aggregating and processing purchase and redemption orders;
- Providing beneficial owners with statements showing their positions in the funds;
- Processing dividend payments;
- Forwarding shareholder communications, such as proxies, shareholder reports, dividend and tax notices, and updating prospectuses to beneficial owners; and
- Receiving, tabulating, and transmitting proxies executed by beneficial owners.

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[58] Compare Rule 12b-1(a)(2) and proposed Rule 12b-2(e)(2).

[59] If the SEC denies this request, and instead requires all service fees to be paid pursuant to Rule 12b-2, it must at a minimum allow for the conversion of a non-12b-1 service fee to a marketing and service fee without shareholder approval. A strict reading of proposed Rule 12b-2(b)(3) would suggest shareholder approval is necessary, because such funds would not be converting a 12b-1 plan. *See* Release at 139. This is clearly not the intended result, and would result in needless shareholder expense simply to change the "bucket" from which the fee is paid.

[60] These types of services should include networking and omnibus account servicing fees.

Each of these items is listed in current FINRA guidance.[61]

Consistent with our recommendations here and in the section above on retirement shares, we also recommend that the SEC clarify that non-distribution payments to retirement plan recordkeepers are presumptively outside Rule 12b-2. As the Release correctly recognizes, retirement plan recordkeepers assume many of the recordkeeping and ongoing servicing and support functions for shareholders that funds otherwise would perform, and these are often paid for, at least partially, through 12b-1 fees.[62] Many recordkeepers are not registered as broker-dealers, and their contracts with funds typically state that the payments are not for distribution services even though they may be made pursuant to a 12b-1 plan. The treatment of these recordkeeping services as a form of distribution, required to be paid for out of the marketing and service fee, would be highly problematic for these recordkeepers.[63]

e. Board Guidance

We appreciate the SEC's efforts to modernize and streamline the role of fund boards in overseeing distribution fees. As we said in 2007, we believe that the existing guidance concerning the board's responsibilities under Rule 12b-1 has long been outdated and is not consistent with the current uses and marketplace realities of 12b-1 fees.[64] We continue to support modifying the role of directors to reflect current uses of 12b-1 fees, updating or eliminating the board factors originally suggested by the SEC, and/or eliminating Rule 12b-1's quarterly reporting requirements. Accordingly, we are very pleased that the SEC has proposed to eliminate requirements like annual approvals of 12b-1 plans or quarterly reviews of 12b-1 fees.

We are concerned, however, with certain elements of the SEC's proposed guidance for directors.[65] The proposed guidance would express the SEC's belief that "fund directors should consider the amount of the ongoing sales charge and the purposes for which it is used according to the same procedures they use to consider and approve the amount of the fund's other sales charges in the underwriting contract under section 15(c) of the Act." That belief is inconsistent with a fair reading of section 15(c), which requires approval of only "the terms" of the contract, which include the provisions of the contract (*e.g.*, indemnification agreements), and not the amounts to paid. While section 15(a) expressly requires an advisory contract to "precisely describe[] all compensation to be paid thereunder,"

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[61] *See* NASD Notice to Members 90-56 (September 1990); NASD Notice to Members 93-12 (February 1993).

[62] Release at 27.

[63] As noted above in footnote 41, the concern over the characterization of services as related to distribution or not is particularly high in the retirement plan context. We are also concerned about the statement in the Release that the receipt of a marketing and service fee may cause the recipient to be subject to registration as a broker-dealer. Release at n. 168.

[64] *See* 2007 ICI Roundtable Submission.

[65] Release at 64-65.

section 15(b), which applies to underwriting contracts, omits that requirement. Thus, the statutory language recognizes that sales charges are not a necessary component of the contract to be approved by the directors.

The proposed guidance also would state that directors "must exercise their reasonable business judgment to decide…whether the underwriter's compensation is fair and reasonable…and whether the sales loads (including the ongoing sales charge) are fair and reasonable." The term "fair and reasonable" has no statutory or regulatory basis, and the proposed guidance, which would require directors to consider the "nature and quality" of intermediaries' services, among other things, is inconsistent with the board's proper oversight role. It also ignores the commercial reality, which is that the amount of compensation to be paid to brokers for their services is dictated by FINRA and the marketplace, not by fund boards.

We strongly urge the SEC not to include any board guidance in the final rule. Directors will continue to be guided by their fiduciary obligations with respect to the oversight of distribution. In this regard, fund directors typically receive marketing and sales presentations, probe the reasons for the success or failure of the principal underwriter's plans, monitor the fees associated with the different classes of a fund, and assess the impact of marketing and sales efforts on the funds and their shareholders.[66] They are well-suited to continue to do so absent any further guidance from the SEC.

f. Disclosure Amendments; Confirms

The proposal includes a number of new disclosure requirements in fund prospectuses, annual and semi-annual reports to shareholders, and investor confirmation statements ("confirms") that are intended to "help investors make better-informed choices when selecting a fund that imposes sales charges."[67] While we very strongly support changes that would improve investor understanding of distribution-related fees and expenses, we are concerned that some of the proposed confirm disclosure is unnecessary, will distract investors from the key information the confirm is meant to convey, and may have the unintended consequence of complicating the confirm to the extent that brokers are encouraged to sell other products not subject to the same requirements.

Under the proposal, confirms would be required to include the amount of any sales charge that the customer incurred at the time of purchase, in percentage and dollar terms, along with the net dollar amount invested and the amount of any applicable breakpoint or similar threshold used to calculate the

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[66] Although fund directors have a fiduciary duty under state law to act in the best interests of their funds, we agree with comments by the Independent Directors Council that the Release mischaracterizes the relevance of Section 36(a), which authorizes the SEC to pursue individual misconduct by directors.

[67] Release at 1. The new disclosure requirements also apply to the alternative periodic reporting provisions of Rule 10b-10(b), which in part permit quarterly reporting for transactions involving investment company plans. *See* Release at 71 and n. 231.

sales charge. In addition, confirms would have to include, if applicable: the annual amount of any marketing and service fee; the annual amount of any ongoing sales charge; the aggregate amount of the ongoing sales charge that may be incurred over time, expressed as a percentage of net asset value; and the maximum number of months or years that the customer will incur the ongoing sales charge. Confirms would also have to include a standardized statement warning investors that there are additional asset-based fees and other expenses explained in the fund's prospectus.

ICI consistently has supported regulatory initiatives that are designed to improve the disclosure provided to investors, particularly disclosure that would enhance investors' awareness and understanding of mutual fund fees and expenses and the costs associated with investing in securities.[68] We are most supportive, however, of disclosure that provides investors with information they want, in forms that they can use, at times when it will be useful.

Confirms are not point of sale disclosure documents, nor are they prospectuses. Confirms are, by their very nature, post-sale documents intended to establish a record of the transaction and allow investors to verify information. The information proposed to be included that relates to charges incurred at the time of purchase is important information for these purposes. Forward-looking information about marketing and service fees and ongoing sales charges, however, is not. That information is certainly appropriate for a prospectus, and may be appropriate for a point of sale document.[69] Requiring it in a confirm as well would be redundant, and would run the risk of cluttering the confirm and obscuring the transaction information that the confirm is meant to convey.[70] The warning legend proposed by the SEC is similarly unnecessary in a confirm, and will serve mostly to distract the investor from key information.[71]

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[68] *See, e.g.*, letter from Mary S. Podesta, Acting General Counsel, ICI, to Nancy M. Morris, Secretary, SEC (July 19, 2007) (commenting on the SEC's summary prospectus proposal).

[69] *See* pp. 6-7 above.

[70] Although the Release is clear that the SEC is "not proposing to require that purchase confirmations disclose management fees or other operating expenses, as those costs are disclosed in the prospectus fee table and are not directly implicated by the transaction" (Release at n. 229), it nevertheless asks whether confirms *should* include such information. Release at 73. Consistent with our view that confirm disclosure should serve the specific purpose of establishing a record of the transaction and allowing investors to verify information, we would oppose a requirement that confirms include expense information already contained in the fund's prospectus fee table.

[71] If the SEC nevertheless adopts this particular requirement, it should address the uneven application of the rule as proposed. The rule would only apply "if the customer will incur any ongoing sales charge…or marketing and service fee." Proposed Rule 10b-10(a)(10)(iii). This seems like an odd result, given that the purpose of the legend is to warn investors about the types of ongoing fund fees and expenses that all funds – load or no-load – incur, like the management fee and other expenses. There is nothing unique to funds charging ongoing sales charges and/or marketing and service fees that warrants requiring those funds alone to include such a legend on their confirms.

Confirm changes can be operationally difficult and costly to implement.[72] This is particularly true with respect to fund-specific information that is not related to the actual transaction, like the level of a fund's ongoing sales charge and conversion schedule. Currently, this information is not readily available to brokers for purposes of generating the required disclosure.[73] As a result, requiring inclusion of additional information about these types of ongoing fund expenses on confirms and quarterly statements will be burdensome for brokers and will increase their compliance costs.[74]

Finally, we are concerned that by using this rulemaking to try to address confirm disclosure, rather than addressing these issues on a product-neutral basis in tandem with point of sale disclosure, the SEC runs a serious risk of discouraging brokers from selling mutual funds and incentivizing them instead to recommend other investment products not subject to the same requirements. As we have said before, this would be a highly undesirable, albeit perhaps unintended, consequence.

g. Account Level Sales Charges; Exemption From Section 22(d)

Proposed rule 6c-10(c) would permit a fund in certain circumstances to offer its shares or a class of its shares at a price other than the current public offering price stated in its prospectus. Dealers would then be free to establish and collect their own commissions or other types of sales charges to pay for distribution. The amount of these fees (and the times at which they would be collected) would not be governed by the Investment Company Act.

The SEC "anticipate[s] that this proposed approach would expand the range of distribution models available to mutual funds, enhance transparency of costs to investors, promote greater price competition, and provide a new alternative means for investors to purchase fund shares at potentially

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[72] The SEC is well aware of the operational difficulties with implementing confirm changes. It proposed confirm and point of sale disclosure changes in 2004 that drew over five thousand comments. *See* SEC Release No. 34-49148 (January 29, 2004), 69 FR 6438 (February 10, 2004). The SEC reopened the comment period in 2005 with a supplemental proposal that included over 300 additional questions. *See* SEC Release No. 34-51274 (Feb. 28, 2005), 70 Fed. Reg. 10521 (Mar. 4, 2005). This process vividly illustrated how numerous and difficult the issues are with confirm and point of sale disclosure proposals.

[73] For the same reasons, we objected to inclusion of certain information about ongoing expenses in 2005. See 2005 ICI Point of Sale Letter ("If the Commission goes forward with this approach, investors will bear the substantial costs of developing systems and retooling confirmations to include this redundant information."). We note that the DTCC's Mutual Fund Profile Security Database may eventually be useful for these purposes. This service is intended to provide a centralized, automated way to collect the operational and prospectus details needed to support mutual fund distribution, trade processing and service. The database would need to be enhanced to handle the new sales charge information, and then populated by funds, before it could be integrated by intermediaries into their master security file, systems and statement process.

[74] The cost of compliance for confirmation statements generated for investor accounts held direct that are serviced by the fund's transfer agent was not contemplated in the SEC's proposal. It is also likely that confirmation and quarterly account statements would increase in size (requiring additional paper and postage) further increasing the cost of compliance. We expect to include detail about these anticipated costs of compliance in our supplemental submission.

lower costs."[75] We appreciate the SEC's efforts to achieve these important policy goals, and we would support the proposed exemption if we thought it would achieve them. But the real world impact of the proposal is far too uncertain for us to support it.

We have heard a wide range of views about the impact of the proposed exemption. Some are supportive, generally highlighting the conceptual attractiveness of removing funds from the role of compensating brokers. Others are strongly negative. In general, those opposed to the exemption fear that its real impact will stand in stark contrast to the SEC's goals. Instead of expanding the range of distribution models, the exempted NAV share class will "swallow the whole," effectively eliminating a broker's incentives or ability to sell other share classes.[76] Instead of enhancing transparency, it may stimulate greater demands that fund sponsors share their revenue with distributors.[77] Instead of promoting greater price competition and lowering costs, investors may ultimately pay more as NAV share classes are used in more expensive fee-based platforms[78] or the SEC's anticipated cost savings do not materialize.[79]

We are still assessing the potential impact of the proposed exemption on fund operations, and we expect to include additional information gathered on this part of the proposal in our supplemental submission. Even preliminarily, however, we have a number of operational questions about how the proposal would work in practice. Many of these focus on portability. For example, would there be portability constraints for certain types of arrangements? What would be the obligations of the receiving entity for accounts held in the NAV share class transferred between intermediaries and firms? Does the sales load schedule and the share lot history of the delivering broker need to be communicated and continue to be applied to the respective shares transferred by the receiving entity? Does the investor need to receive credit for any amounts paid to a previous intermediary? Other questions relate to how a truly externalized model would work with the range of shareholder privileges that exist today. For example, would exchanges and cross-dividend reinvestments still be permitted? Other questions are far more basic. How external is external? The recordkeeping burden of tracking unique compensation schedules and applicable disclosures would be extraordinarily burdensome and cost prohibitive, if placed on funds. Ultimately, the costs of creating an NAV share class as well as the costs

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[75] Release at 90.

[76] *See*, *e.g.*, comments by the Securities Industry and Financial Markets Association (SIFMA).

[77] In contrast to the SEC's suggestion that an externalized fee structure may appeal to small funds (Release at 92-93), ICI members representing smaller fund groups expressed a great deal of concern that the proposed exemption could lead to demands for revenue sharing that are unsupportable given the economics of their business models. This concern reflects the economic reality that distributors, not funds, have the market power to dictate prices.

[78] The SEC is well aware of these concerns, as expressed by ICI and numerous other commentators. *See* Release at n. 286 and accompanying text.

[79] The SEC may wish consider the experiences of other countries. For example, our understanding is that in Canada front-end commissions on funds are negotiated, which has altered the structure of how intermediaries receive their compensation but not necessarily the overall level of that compensation, which is determined by market forces.

to modifying or eliminating existing share classes in response to new intermediary arrangements will be extremely difficult to estimate until these, and other questions, are answered.

Many, perhaps most, of our members continue to evaluate the proposal and have not yet arrived at a firm view of its merits or potential drawbacks. This uncertain view may be due, at least in part, to the fact that there are a number of current trends that suggest that an exemption along these lines is simply unnecessary. Funds currently offer NAV share classes in a variety of ways that allow for a form of externalized pricing. Given that such classes are already permissible and exist, it is unclear why SEC rulemaking is necessary to make such an arrangement permissible. Indeed, the market is well on its way to developing a full range of external pricing options that are consistent with existing law and supportable by current fund operations.

Given these mixed views and open questions, and the fact that proposed Rule 6c-10(c) does not appear to be fundamental to the SEC's primary goal of reforming Rule 12b-1, we would urge the SEC to further study this aspect of the proposal before proceeding.

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We appreciate the SEC's consideration of our comments. If you have any questions or need additional information, please contact me at (202) 326-5815 or Bob Grohowski at (202) 371-5430.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
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