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Mutual Fund 12b-1 Fees: Key Reform Proposals

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Summary

Rule 12b-1 was adopted by the Securities and Exchange Commission (SEC) in 1980 pursuant to the Investment Company Act of 1940 (ICA). The rule allows funds whose boards approve 12b-1 plans (structures) under the rule to draw from fund shareholders' aggregate assets to market or advertise and distribute (sell) fund shares, something they had not been allowed to do.

Prior to 1981, funds were allowed only one means of compensating the broker who sold them, the "front-end load." But in 1980, the SEC adopted Rule 12b-1, after years of lobbying from various funds who cited financial hardships and a need to use fund assets to underwrite expanded marketing and distribution to boost their size, viability, ultimately lowering their investors' costs. The rule allows funds to deduct a percentage of a fund's assets each year to pay the broker an annual fee, the 12b-1 fee. Initially, the agency expected that 12b-1 fees would be a temporary fix to help smaller struggling no-load funds to grow healthier. But fund companies began using the fee to either eliminate or to offset front-end loads as well. Now, the vast majority of funds levy 12b-1 fees. The research consensus is that 12b-1 plans do not appear to have helped to lower fund investors' costs as was originally hoped. They have, however, helped to provide them with the benefit of greater choice in the fund payment structures available to them. But some broker-dealers who sell the funds may not be steering investors into the most beneficial structures. Reports indicate that a minority of funds, that are closed to new investors, still charge 12b-1 fees. Though the practice is permissible, critics condemn it as violation of Rule 12b-1's original intent, allowing asset-based funding to attract new fund investors. Funds, fund distributors, and some independent industry observers, however, say that investors in closed funds still demand and receive attention from broker-dealers who may have sold a fund to them years ago and 12b-1 fees still need to be collected to continue to pay for those services.

In a February 2004 proposal, the SEC asked for public comment on the need for additional changes to Rule 12b-1. Among other things, it proposed requiring distribution-related costs to be directly deducted from individual shareholder accounts rather than from aggregate fund assets, potentially benefitting investors by giving them a more direct and thus a better understanding of sales charges. But critics say such reform would result in investor's accounts eventually paying smaller nominal amounts as they age, giving broker-dealers added incentive to churn the accounts. There are additional concerns that such changes might result in complicated record-keeping burdens and added tax liabilities for investors. The 2004 proposal, also asked for public comment on whether Rule 12b-1 should be repealed. But some observers have, however, noted that the plans are ingrained in the financial system and repeal could mean reduced service for small investors by brokers and a shift to front-end loads, which do have the benefit of greater visibility relative to 12b-1 fees. In the spring of 2007, SEC Chairman Cox announced that due to perceptions that 12b-1 fees had strayed beyond their original intent, the agency would be reexamining 12b-1, which it is currently doing. If the agency adopts reforms, it might possibly involve changes to the way 12b-1 fees are disclosed. H.R. 3225 (Castle) would direct the SEC to improve the disclosure of fund fees and expenses.

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The Origins of Rule 12b-1

Section 22d of the Investment Company Act of 1940 (ICA) requires a mutual fund to set the same fee for all brokers who sell the fund. From 1940 to 1981, the SEC, empowered by this act to regulate funds, allowed only one type of broker compensation—the "front-end load." If an investor wanted the services of a broker, he or she paid a percentage of the money invested at the time of the investment and nothing more.

In the late 1970s, various mutual funds confronted a troubling outflow of fund assets and the industry lobbied the SEC to allow it to use fund assets to underwrite expanded marketing and distribution, thereby boosting funds' size and viability. In 1980, after substantial lobbying from mutual funds, the SEC adopted Rule 12b-1, which allows funds to deduct a percentage of the fund's assets each year to pay the broker an annual fee, the 12b-1 fee.[1] In doing so, the agency reversed its long-held position that a fund's assets should not be used to help sell more fund shares and made it legal to use such money to pay for marketing and distribution expenses. Initially, the SEC expected that 12b-1 fees would be a temporary fix to help smaller struggling no-load funds become financially viable.[2] But fund companies began using the fee to either eliminate or to offset front-end loads, which were running as high as 8.5% during the 1980s. Later, the revenue from 12b-1 fees was also applied to the cost of selling funds through large financial product "supermarkets" like Charles Schwab's OneSource.

The SEC shares regulatory responsibility over the 12b-1 fees with the Financial Industry Regulatory Authority (FINRA), a non-governmental regulator for all securities firms that do business in the United States.[3] FINRA limits the annual rate at which 12b-1 fees may be paid to broker-dealers to no more than 0.75% of a fund's average net assets per year. Funds are also allowed to include an additional service fee of up to 0.25% of average net assets each year to compensate sales professionals for providing ongoing services to investors or for maintaining their accounts.

According to the Investment Company Institute (ICI), the major mutual fund national trade group, about 70% of all funds currently levy 12b-1 fees. In 2004, ICI reported that 40% of 12b-1 fees were used for compensation to financial advisors for initial assistance in helping investors

[1] The agency's adoption of rule 12b-1 pursuant to the ICA is an example of the rulemaking process under which federal agencies implement federal laws. In the securities areas, major legislation such as the Securities Act of 1933, the Securities Exchange Act of 1934, and the ICA, provide the framework for the SEC's oversight of the securities markets. The statutes tend to be broadly drafted and largely focused on establishing basic principles and objectives. The SEC's central goals are to maintain fair and orderly markets and to protect investors. To carry out these goals as securities markets have evolved, the agency has used the authority granted to it under the laws to amend its regulations or to adopt new ones.

[2] A central controversy surrounding the SEC's decision to permit the fees is between those who assert that the fees were largely a response to the financial needs of a floundering fund industry and were only intended to be a "temporary fix" and those who disagree, characterizing the assertions as misperceptions. At an SEC-sponsored roundtable on 12b-1 fees in June 2007, some former SEC staffers who were involved in implementing the 12b-1 fee rule reportedly observed that such the assertions were not true.

[3] In 2007, FINRA merged the NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange. Heretofore, the NASD (formerly the National Association of Securities Dealers), established under the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934, had responsibility for regulating every broker-dealer in the United States with a public securities business, which included setting the parameters for 12b-1 fees.

select the funds, 52% went to ongoing shareholder services, 6% went to fund underwriters, and 2% went to advertising and promotion, the original purpose of the fees.

The Role of 12b-1 Fees in the Overall Scheme of Fund Fees

Shareholders are assessed a number of fees and expense charges in return for the opportunity to invest in mutual funds. There are two broad categories of costs: transaction fees and annual operating expenses. *Transaction fees* are costs that are charged directly to the shareholder's accounts for specific transactions and include sales loads, and redemption fees. *Ongoing or annual operating expenses* are costs associated with the normal cost of operating funds such as maintaining offices and staff. They include asset-based charges like management fees and 12b-1 fees. In contrast to transaction fees, these costs are not charged directly to an investor's account, but are deducted from fund assets prior to the earnings being distributed to shareholders. The various components of the annual operating expenses combine to form the *expense ratio,* the central gauge of a fund's costs vis-a-vis the value of its assets. A fund is often composed of a number of generic classes, each with a claim on the same underlying assets. Thus, the classes have identical performance characteristics. Where the classes do differ is in the way that their transaction fees or their annual operating expenses are structured.

These generic fund classes and their constituent fees, including their 12b-1 fees are described below:

- Class A shares charge investors a *transaction fee* called a front-end sales load. The fee is generally associated with the purchase of fund shares and is used to compensate financial professionals such as brokers and financial planners for their services in marketing the funds. Legally, such charges can never exceed 8.5% of the amount invested; the fees tend to be in the 4% to 6% range. They may also include a 12b-1 fee.
- Class B shares generally have no up-front charge, although occasionally they may impose an up-front transaction fee that is smaller than what is charged by Class A shares. Instead, they generally have transaction fees called *contingent deferred sales or redemption fees* that are charged when shareholders redeem their shares. These fees generally range between 5% and 7% of assets and usually decline over time, disappearing after several years. The intermediaries who sell Class B shares to investors are paid a commission by the fund companies who generally then recoup that money from their shareholders in two basic ways: 1) via the back-end charge described above; and 2) sometimes through 12b-1 fees that range from 0.25% to 1.0% of assets. After several years, B shares may convert to A shares. Before 1980, most mutual funds were Class A-type, front-end load funds.
- Class C shares generally charge no up-front or back-end fee, although some impose redemption fees if investors redeem shares within a couple of years. Class C shares generally carry the highest 12b-1 fees, usually 1% a year. And unlike class B shares, C shares usually do not convert to other classes with lower 12b-1 fees. The intermediaries who sell the shares generally get their commissions from the fund company which relies substantially on the proceeds

> from 12b-1 fees to pay the commissions. The number of Class C shares that are pure no-loads, defined as shares that do not impose front-end charges, redemption charges, or 12b-1 fees, have been in steady decline through the years. In the early 1990s, Class C shares with 12b-1 fees below 0.25% annually were allowed to call themselves no-loads.

After the SEC permitted the use of 12b-1 fees in 1980, Class B shares that combine a 12b-1 fee and a contingent deferred sales charge grew markedly, while ownership of front-end load funds plummeted despite a significant overall decline in load size. In contrast to an observed indifference to the impact of annual operating expenses, investors are generally identified as being more sensitive to front-end loads in part because they are clearly identified as deductions from an investor's initial investments in the fund investor's account statement.[4]

No-load funds were a small part of the mutual fund landscape until the 1970s, when companies like Dreyfus, Vanguard, and Fidelity dropped their front load funds and began selling pure no loads directly to the public. But as the size of fund investments held by the average investor rose, demand for financial intermediaries who can guide them in their investment decisions has grown apace. Likewise, the dramatic growth in the number of funds has also boosted the demand for the intermediaries' guidance and load funds—a development that has been at the expense of the no-loads. And while loads have replaced no-loads, the sizes of the load have fallen, a development that is at least in part traceable to the increased use of 12b-1 fees as a partial substitute for them.

Costs and Benefits of 12b-1 Fees

As discussed earlier, the intent behind the SEC's adoption of rule 12b-1 was that the fee would help underwrite expanded distribution and marketing, resulting in fund economies of scale that would ultimately benefit fund shareholders: With an expansion in fund size, the assumption was that the fixed costs of fund management would be spread over a larger base of assets, resulting in a reduced average cost of management per fund investor dollar. There was additional hope that a more consistent inflow of new investor cash would mitigate some of the volatility of fund deposits and redemption flows. It was also thought that this would allow funds to hold less cash and invest more of the fund's assets, yielding increased returns to the fund.

Research conducted by SEC on the question of whether 12b-1 plans have helped funds to grow to the benefit of shareholders found that the plans generally helped funds to grow faster than non-12b-1 funds. It also found that shareholders have not benefitted through lower average expenses or lower flow volatility. Fund manager compensation generally grows with the size of the fund assets under their management and the research concluded that fund managers were the true beneficiaries of 12b-1-based fund growth.[5] It joined some earlier studies that found a positive

[4] U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, GAO-04-317 T, June 2000, p. 75.

[5] Lori Walsh, "The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns," SEC Office of Economic Analysis, 2004.

correlation between a fund's 12b-1 fee and its expense ratio,[6] some concluding that 12b-1 fees impose a deadweight loss[7] on mutual fund investors.[8]

Another study found that the link between 12b-1 fees and holding-period returns is a complicated one. And among the complicating factors are the length of time an investor holds a fund, the size of any front or deferred load, the size of the 12b-1 fee itself, and other details of a mutual fund's fee arrangement. For example, it noted that investors with short horizons will tend to be better off paying a higher-than-average 12b-1 fee (thus incurring a higher-than-average expense ratio) to avoid paying higher front loads. But, overall, it concluded that current fund fee structures do not generally allow for definitive judgments on the shareholder welfare implications of 12b-1 plans and expense ratios without taking account of the complicating roles played by front and deferred loads.[9]

Some observers, however, argue that this kind of research on the cost implications of 12b-plans is misguided given the contemporary realities of how the plans are actually used: It is widely agreed that the 12b-1 fees have largely become alternatives to front-end loads, alternatives that have given fund shareholders greater investment choices. Thus they argue that research on the way in which the fees have or have not contributed to lower shareholder costs has thus become irrelevant.[10]

Instead, they emphasize the role 12b-1 plans have played in the creation of the various fund fee classes that are described above—structures that give investors a range of choices with respect to various fee structures and payment arrangements. As a rule, economic theory says that there should be a positive correlation between a consumer's level of satisfaction and the number of choices a consumer has.

But this benefit may be mitigated by the way in which the multi-class share structure may foster confusion among investors to the benefit of the broker-dealer. Class B shares do not impose a front-end sales charge, but they may charge higher expenses that investors are assessed over the lifetime of their investment in a fund as compared to Class A shares. Class B shares also normally impose a contingent deferred sales charge (CDSC), which you pay if you sell your shares within a certain number of years. B shares may appear to be more appealing to investors than shares with a front-end sales load such as A shares but they may have higher long-term costs; broker-dealers may be relatively better compensated for selling them, giving them added incentives to push the shares, incentives that investor may not be well informed about.

In early 2005, a number of fund companies, including the large Franklin Templeton family, announced that they would no longer be selling Class B shares.[11]

[6] When Rule 12b-1 was adopted, SEC officials appears to have hoped that the 12b-1 fees would allow fund firms to grow, eventually attaining scale economies that would lower their expense ratios.

[7] A deadweight loss is defined as the value of real resources lost to some type of market inefficiency.

[8] For example, see the various studies identified in Sean Collins, "The Effect of 12b-1 Plans on Mutual Fund Investors," *Investment Company Institute*, March 2004.

[9] Sean Collins, "The Effect of 12b-1 Plans on Mutual Fund Investors." In one example, the study noted that investors with short horizons will tend to be better off paying higher-than-average 12b-1 fees (with higher-than-average expense ratio) in lieu of paying a front load.

[10] For example, see Letter from Matthew Fink, president of the Investment Company Institute, to William H. Donaldson, chairman U.S. Securities and Exchange Commission May 24, 2002.

[11] Steven Goldberg, "Bye-Bye B Shares," Kiplinger's Personal Finance Magazine, February 2005.

Disclosure Reform

The mandatory disclosure of financial information deemed important for investors to make rational decisions is the centerpiece of the federal securities regulatory system overseen by the SEC. Because of the continually changing nature of the nation's financial landscape, the body of required disclosures continues to be revisited. Such is the case with mandatory 12b-1 fee disclosures.

When a fund charges a 12b-1 fee, it is identified as a line item in the fund prospectus fee table as part of the fund's annual operating expenses. The fee is also incorporated in the fund's total annual operating expense disclosed in the fee table and in the hypothetical example of fund expenses that accompanies the fee table. Funds that levy a 12b-1 fee must also disclose in their prospectuses that 12b-1 fees will increase the cost of an investment in the fund and may cost the investor more than paying other types of sales charges. However, the disclosure protocol has been criticized for being insufficiently revealing. Various investor advocacy groups say that many fund investors do not understand that when they avoid funds with loads they may still be paying for marketing costs indirectly through continuous 12b-1 fees. There are related concerns over what some perceive to be a widespread lack of investor awareness of the significance of 12b-1 fees and their contribution to total fund costs. Lipper found that while the average large-cap core stock fund gave 0.68% of its assets to its advisers, it charges a nearly identical 0.64% to pay for 12b-1 marketing fees.[12] The research firm has also identified inadequate disclosure as the central problem with 12b-1 fees, noting that most fund prospectuses do not identify where the fees go.[13]

Some observers argue that there should be additional mandatory disclosure among fund companies concerning 12b-1 fees, particularly concerning how they are used and how they are charged. The expanded disclosure would ostensibly enable fund investors to make more informed decisions.

But the science of securities and fund investor disclosure is a very inexact discipline. The "bottom line" issue of whether a prospective disclosure is meaningful and useable will vary depending on a host of key factors, including (1) the clarity of the disclosure; (2) an investor's level of financial sophistication; and (3) the extent to which an investor is willing to invest time in examining the disclosure documents.

It is widely acknowledged that at best, many fund investors do a very cursory reading of fund disclosure documents. Through the years, in pursuit of more "investor friendly" documents, the SEC has pushed for but not completely succeeded in requiring less minutiae-laden, more streamlined key disclosure documents such as fund prospectuses. In addition to factors that may influence the useability of disclosure data such as the clarity of the disclosure language, an investor's interest in reading disclosure data, and how financially sophisticated an investor is, an additional factor may be the extent to which a document is characterized by "data overload": Some research indicates that when consumers confront too much data, they may tend to examine an even smaller percentage of the overall information provided.[14]

[12] John Waggoner, "SEC Proposals Aim to Tweak Fund Oversight," *USA Today*, February 7, 2003, B-03.

[13] Ellen Kelleher, "Closed Fees Come Under The Spotlight," *FinancialTimes.com*, December 11, 2003.

[14] For example, see Chip Heath, and R.P. Larrick, "Cognitive Repairs: How Organizational Practices Can Compensate for Individual Shortcomings," *Review of Organizational Behavior*, vol. 20, June 1998, pp. 1-38.

The marginal production cost of requiring funds to include mandatory disclosures on how 12b-1 fees are used and how they are charged as part of their disclosure documents would be negligible. The key concerns involve the disclosure's usefulness for investors and the extent to which it could contribute to potentially counterproductive disclosure data clutter or overload as discussed above. New disclosure on the nuts and bolts of 12b-1 fees may run the risk of being dauntingly complex for many unsophisticated investors. And the SEC has recently adopted and proposed a number of additional fund disclosure requirements, heightening the potential for disclosure overload from newly mandated disclosures. The clearest public beneficiaries from the 12b-1 fee disclosures would probably be the minority of sophisticated fund investors—investors far less likely to be confused or overwhelmed by such disclosures.

Because of concerns over the potential contribution of new 12b-1 fee disclosure to disclosure document data overload, some argue that the public would be better served if the disclosures were done through other means. One such alternative would be disclosing the data at the time when a fund investor purchases fund shares from a broker-dealer, the point-of-sale: Broker-dealers would be required to give fund investors information on the embedded 12b-1 fees when fund shares are acquired. Transactions conducted by phone would probably involve oral disclosure. Face-to-face transactions could either involve oral disclosure, or the provision of printed matter. Research indicates that information that is transmitted verbally tends to be remembered better than information that is read, suggesting that oral point-of-sale disclosures may have certain advantages. But point-of-sale disclosures would still confront issues concerning their usefulness posed by the complicated subject matter. Moreover, in contrast to mandatory fund disclosure documents, regulators would have a much more limited ability to monitor and enforce the quality of point-of-sale disclosures.

Currently, perhaps the least controversial and most widely embraced disclosure reform (which includes support from the ICI) would involve scrapping the rather opaque 12b-1 designation and replacing it with a more descriptive and meaningful identification.[15]

H.R. 3225, the Mutual Fund Fee Reform Act, was introduced in August 2007 by Representative Michael Castle. The bill, which was referred to the House Financial Services Committee, would "require the Securities and Exchange Commission to improve the disclosure of fees and expenses" of mutual funds under "the Investment Company Act of 1940."

Closed Funds and 12b-1 Fees

The Investment Company Institute and Standard & Poor's reported that in 2006, about 580 fund classes that were closed to new investors also charged 12b-1 fees. These fees ranged from 0.02% to the maximum rate of 1.00%. According to Standard & Poor's, the average rate was 0.66%.[16]

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[15] The SEC staff is currently formulating a recommendation to the Commission that would permit funds to offer securities using streamlined disclosures that would be given directly to investors and could provide investors with key information in plain English and could include investment objectives and strategies, costs, risks, and historical returns. The more detailed currently available investor fund information would still be available to investors and others who desire them.

[16] Reported in: Palash R. Ghosh, "Some Closed Mutual Funds Are Charging 12b-1 Fees," *The Mutual Fund Focus Newsletter,* March 1, 2006.

Although the practice of charging a 12b-1 fee to investors in closed funds is legal, S&P officials and others have said that the existence of closed funds that still charge 12b-1 fees as a clear violation of the intent behind Rule 12b-1, that fund assets should be used for marketing and distribution to generate new sales of fund shares.[17] Funds, fund distributors, and some independent industry observers, however, say that investors in closed funds still demand and receive attention from broker-dealers who may have sold a fund to them years ago and 12b-1 fees still need to be collected to pay for these services as well. It is also argued that closed funds still remain open to existing shareholders if they want to buy more shares, and that the funds use ongoing annual 12b-1 fee payments to recoup front-end commissions that they advanced to the fund distributor, a period often lasting six or seven years.

Information on details such as how long the funds that still charge 12b-1 fees have been closed relative to those that are closed and no longer charge the fees are not available. But on the face of it, the existence of the large number of closed funds that do not currently charge 12b-1 fees would appear to help undercut arguments defending the practice.[18]

Representative Castle indicated that "it is not fair that investors in closed funds be subject to a fee that's purpose is to support marketing and distribution when the fund is no longer open to new investors."[19]

Amending the Treatment of 12b-1 Fees

In a proposal released in February 2004, the SEC asked for public comment on the need for additional changes to Rule 12b-1. Among other things, it proposed requiring distribution-related costs to be directly deducted from individual shareholder accounts rather than from aggregate fund assets.[20]

[17] Chris Frankie, "S&P 12b-1 Fee Report Irritates Industry," *Money Management Executive*, August 18, 2003.

[18] H.R. 2179 (Baker), legislation introduced in the 108th Congress, was primarily aimed at giving the SEC additional tools to protect investors. But as reported by the House Financial Services Committee in February 2004, the bill also contained an amendment introduced by Representative Mike Castle, which would have banned the use of 12b-1 fees by funds closed to new investors.

[19] "Rep. Castle Amendment Banning 12b-1 Fund Fees on Closed Funds Included in Larger Securities Fraud Bill," *States News Service,* February 25, 2004.

[20] "Prohibition on the Use of Brokerage Commissions to Finance Distribution, Proposed Rule by the Securities and Exchange Commission" (Release No. IC-26356; File No. S7-09-04), February 24, 2004. The proposal also called for the repeal of an arrangement governed by Rule 12b-1 known as directed brokerage. Most funds are sold through fund intermediaries like broker-dealers. This has combined with a decade-old explosion in the number of funds being offered to produce vigorous interfund competition for "shelf space" at selling broker-dealers. Arrangements for shelf space can include such things as a broker-dealer simply making a fund available to his clients—to a broker prominently featuring a fund. Over the years, broker-dealers with large distribution networks have increasingly demanded that fund advisers make payments for shelf space to supplement the sales loads and 12b-1 fees they receive when their retail clients purchase fund shares.

Directed brokerage involves funds paying broker-dealers for shelf space. To do so, funds use part of the asset-based commissions that they pay broker-dealers to execute trades for them to also compensate them for selling the fund's shares. Broker-dealers praise the arrangements for helping to subsidize more efficient, centralized, and accessible environments for accommodating investors' fund selection and financial planning needs. But the arrangements may also pose a number of potential conflict of interest issues, issues that stem from the fact that they involve funds' use of brokerage firms for two unrelated purposes: (1) selling mutual funds to investors; and (2) executing securities trades. Rule 12b-1 regulates how funds use their assets to reimburse brokers who sell fund shares to the public and thus directed brokerage arrangements fall under it. In its February 2004 proposal, SEC officials cited several reasons why (continued...)

For example, an investor with $10,000 of the typical Class B shares of a fund currently experiences the 12b-1 fee through a lower total return on the fund since the fee reduces the expense ratio. But under the proposed change, the investor would more explicitly and more directly pay for 12b-1-compensated services by periodic payments to his or her broker-dealer through some share redemptions.

SEC officials suggested that the alternative scheme might better benefit fund shareholders because actual sales charges would be clearer; they would not have to pay for sales to new investors; and long-term shareholders would not pay 12b-1 fees that exceeded their fair share of distribution costs.

Mutual funds and fund intermediaries like broker-dealers and financial planners have said that given the services provided to fund investors, 12b-1 fees are quite reasonable, producing a number of efficiencies. They also have argued that the fees provide middle income investors more payment options, and might be the cheapest way to pay for certain shareholder services, like ongoing investment advice, phone counseling, and reviewing investment strategies. Some fund distributors acknowledged that deducting the 12b-1 fees from shareholder accounts would be cleaner than the way they are currently deducted from the overall fund. But they had larger concerns that such a system would generate investor confusion, by making investors think 12b-1 fees go straight to the broker-dealer or investment adviser. Others are concerned that because the shareholder accounts would eventually pay smaller nominal amounts as they age, the risk that the broker-dealer would trade the account may increase, increasing the possibility of churning. And there are other concerns that the proposal would result in complicated record-keeping burdens and added tax liabilities for investors. But others question the claim that the proposal would trigger additional tax liabilities.[21]

Repealing Rule 12b-1

In its February 2004 proposal on Rule 12b-1, the SEC also requested public comment on whether Rule 12b-1 should be repealed. Supporters of repeal basically say that funds' use of rule 12b-1 has evolved far beyond what was originally expected. But most mutual funds and the distributors who sell them generally say that given the services provided to fund investors, 12b-1 fees are quite reasonable and Rule 12b-1 should remain as it is.[22]

(...continued)

directed brokerage arrangements may harm funds and their shareholders, including that the portion of brokerage commissions that pay for distribution is not disclosed as an expense. They can give broker-dealers financial incentives to recommend to customers the funds that provide the best compensation to the broker, instead of the funds that are best for the client; and they can increase a fund adviser's advisory fees and reduce their out-of-pocket expenses for distribution. In August 2004, the SEC commissioners adopted the staff recommendation that directed brokerage be prohibited, a recommendation that earned wide-ranging support, including the backing of investor advocacy groups, the Investment Company Institute, the Securities Firm Trade Association, and the Securities Industry Association (now the Securities Industry and Financial Markets Association, which merged the SIA with the Bond Market Association, an association of firms involved in the bond market industry) . The directed brokerage ban went into effect on December 13, 2004.

[21] For example, see the correspondence of Marshall Blume, Professor at the Wharton School of Business, to the SEC regarding File No. S7 09-04, April 5, 2004.

[22] Among other things, legislation introduced in the 108th Congress, S. 2059 (Fitzgerald), and H.R. 4505 (Gillmor) would have repealed Rule 12b-1.

The Investment Company Institute, the fund trade association group, has acknowledged that the manner in which rule 12b-1 has evolved was at odds with the original intent of the SEC. But the fund trade association has stressed that the ways in which the rule has been used were not at all inconsistent with its administrative history: The rule's adopting release stated that the rule was intended to be sufficiently flexible to cover new distribution financing arrangements that might emerge from the fund industry and that the agency would closely monitor the rule and make any necessary adjustments.[23]

The trade group has also noted that through its various regulatory actions, including its sanctioning of multi-class shares, the SEC has been an integral part of the creation of the infrastructure supporting the 12b-1 fees.[24] But through the years, the SEC has been not given unqualified support to Rule 12b-1: Through the years, the agency has floated a number of proposals meant to put curbs on the way the rule was being applied. For example, the agency promulgated a number of proposed amendments to modify Rule 12b-1 in 1988, proposals which sparked significant fund industry opposition.[25] And in 1992, noting that while multi-class fund fee structures had given fund investors greater choice, agency staff expressed serious concerns over the role they potentially played in inhibiting interfund price competition, and recommended that the agency propose legislation to permit the introduction of a new fund entity called a unified fee investment company (UFIC) with a much simpler fee structure. The agency never adopted the recommendation.[26]

The idea of repealing Rule 12b-1, however, confronts a reality in which 12b-1 fees have become a deeply ingrained fixture of the mutual fund and the broker-dealer worlds: A report released by Lipper in 2004 observed that dismantling or modifying the rule would "wreak havoc" on all aspects of the financial services industry.[27] SEC officials have also acknowledged the profound impact that eliminating 12b-1 fees would probably have on the fund and broker-dealer industries.[28]

More explicit perceptions of the probable impact of repealing Rule 12b-1 and 12b-1 fees include the prospect that

[23] "Bearing of Distribution Expenses by Mutual Funds," *SEC Release. No. IC-11414* (Rule 12b-1 Adopting Release), October 28, 1980.

[24] Ibid.

[25] The proposals included limiting the use of excess distribution expense recoupment (expenditures beyond a 12b-1 plan's maximum may be recouped in subsequent years); updating NASD limits on maximum sales charges to include 12b-1 fees; restricting the ability of funds to define themselves as "no-loads" when they charge 12b-1 fees; requiring more methodical analysis between 12b-1 plan expenditures and shareholder benefits realized; formally validating that 12b-1 payments are within a range that would have been recognized at arms-length; and requiring annual shareholder approval of 12b-1 plans. Only the "no-load fund" definition and the NASD sales charge cap rules on funds levying 12b-1 fees were adopted by the agency. Since then, the SEC has considered various revisions to Rule 12b-1 but some observers suggest that it chose not to reexamine Rule 12b-1 per se probably because of limited resources and more pressing concerns. For example, see Testimony of Jeffrey Keil, Vice President for Global Fiduciary Review, Lipper Inc., in U.S. Congress, Senate Governmental Affairs Committee, Financial Management Subcommittee, January 27, 2004.

[26] The UFICs would have had a single, fixed fee set by the fund's investment manager and no separate sales charges or redemption fees. In addition, all fund expenses, except brokerage commissions, and extraordinary expenses would be paid from a single fee or from the manager's own assets. The structure would not have been under Rule 12b-1's ambit.

[27] As reported in John Churchill, " Not-So-Fine Print," *Registered Rep.*, March 1, 2004.

[28] "Speech by the SEC Chairman: Introductory Statement at February 11, 2004, Open SEC Meeting."

- Broker-dealers may be more inclined to churn client accounts to recoup lost 12b-1 fees by switching the accounts from one fund to another;
- Broker-dealers could be less inclined to market the Class A fund shares (explained above) frequently described as the best type of product for many fund investors;
- In return for lost 12b-1 fees, front end loads may increase; and
- The prospect that smaller investors may be ignored by financial professionals and may thus be precluded from owning some funds.

If repeal were to result in a larger proportion of funds sold with front end loads, this would translate into fewer structural choices for fund investors. In at least one area, it might benefit investors: In contrast to front-end loads, 12b-1 plans permit investors to give greater consideration to the time-related aspects of their investment goals. The plans do enable investors to earn returns on the full amount of money they invest, rather than having a portion of their assets immediately deducted (via the front end load) to compensate the fund distributor. But front-end loads are one-time charges that are deducted before an investor's assets are invested in a fund. Thus, they are widely perceived to be much more clear and transparent to fund investors than are the ongoing 12b-1 fees.

Moreover, the extent to which funds would respond to a ban on 12b-1 fees by raising their loads is an open question. Some research on the fund purchase and sale decisions of over 30,000 households with accounts at a large U.S. discount brokerage firm found fund investors to be fairly sensitive to funds with high transaction fees like front-end loads.[29]

In the absence of the 12b-1 fee structure, there are some concerns that smaller investors could be particularly disadvantaged. But as in the scenario proposed by the SEC, if in exchange for their services, broker-dealers are directly compensated by the fund investors—whether the investors are big or small probably should not matter.

Any move to eliminate 12b-1 fees and to restructure the way that fund sellers are paid would necessitate radical changes within mutual funds, including shareholder votes to eliminate the multiple share classes.

The NASD Task Force

In May 2004, an NASD Task Force aimed at considering ways to provide greater transparency to mutual fund costs and distribution arrangements and to provide those ideas to the SEC began operation. In November 2004, the Task Force submitted a number of recommendations to the SEC regarding mutual fund portfolio transaction costs, including directed brokerage arrangements, soft dollars and disclosure.[30]

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[29] Brad Barber, Terrance Odean, and Lu Zheng, *The Behavior of Mutual Fund Investors*," UCLA's Anderson School of Business Working Papers, September 2000.

[30] Soft dollars are payments made to a brokerage firm for its services through commission revenue instead of cash payments.

In the spring of 2005, with respect to 12b-1 plans, the Task Force formally recommended (1) updating and modernizing the findings a fund board must make in approving a 12b-1 plans, (2) changing the reference to those fees in the prospectus fee table to a less confusing title (distribution and shareholder servicing fees), and (3) improving disclosure about the costs of B shares and consideration of regulatory caps on B share sales and limitations on conversion periods.

Spring 2007: SEC Officials Say the Agency will Reexamine 12B-1 Fees

During an April 2007 speech, SEC Chairman Christopher Cox observed that "... the original premises of Rule 12b-1 seem highly suspect in today's world. If ever it was justified to indulge an irrebuttable presumption in favor of using fund assets to compensate brokers for sales of fund shares, that time surely has passed. Collecting an annual fee from mutual fund investors that is supposed to be used for marketing is no more consumer friendly than forcing cable TV subscribers to pay a special fee of $250 a year so the cable company can advertise...."[31]

In response to these concerns, Chairman Cox announced that the SEC would be reexamining Rule 12b-1 during 2007.[32] He also noted that on June 19, 2007, the agency would be hosting a roundtable discussion on issues surrounding 12b-1 fees, an event the SEC hoped would assist it in reviewing the current uses of 12b-1 fees; how those fees affect retail investors; the interests of independent directors, who must approve 12b-1 plans; and identify and evaluate the possibilities for reforming the rule.[33]

The roundtable provided an opportunity for an eclectic array of interests with varying perspectives on 12b-1 fees to express their views. The wide-ranging views presented at the event ranged from an "it ain't broke, so don't fix it," to a plea for the complete repeal of the fees and an overhaul of the way funds pay brokers.[34]

The question of disclosure reform was also addressed. For example, Brad Barber, a professor of finance at the University of California, observed that he would like to see investors being provided with a disclosure that outlined in simple dollar terms the amount they pay in 12b-1 fees. But Joseph Russo, the chairman and chief executive officer of Advantage Financial Group, Inc. opined that there currently is "enormous disclosure" of 12b-1 fees.[35]

The panel also discussed the elemental issue of the name, 12b-1 fees, with some panelists emphasizing that the name in and of itself can be very confusing and uninformative. A number of panelists were also in agreement that more work needs to be done in explaining what the fees

[31] "Speech by SEC Chairman to the Mutual Fund Directors Forum, Seventh Annual Policy Conference by Chairman Christopher Cox," April 13, 2007, available at http://www.sec.gov/news/speech/2007/spch041207cc.htm.

[32] Ibid.

[33] A link to the roundtable can be found at http://www.sec.gov/spotlight/rule12b-1.htm.

[34] Hannah Glover, "Discord Over How, and Whether, to Fix Fund Fees," *Money Management Executive. American Banker*, June 28, 2007, p. 124.

[35] Robert Schroede, "Mutual Fund Fees Come Into SEC Sights At Review," *Dow Jones Business News*, June 19, 2007.

do.[36] And indeed, a number of funds voluntarily provide a breakdown of the broad uses to which their 12b-1 fees are disbursed.

SEC officials present at the roundtable, including Chairman Cox, reportedly avoided tipping their hands with respect to the direction that the agency might be heading on 12b-1 reform. But a number of observers predict that if reform is forthcoming, it will possibly take the form of greater 12b-1 fee disclosure and tighter rules on what can and cannot be funded with 12b-1 fees.[37]

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[36] Hannah Glover, "Discord Over How, and Whether, to Fix Fund Fees," *Money Management Executive. American Banker*, June 28, 2007, p. 124.

[37] Kristen French, "The Looming Battle over 12b-1 Fees, *Registered Rep*., August 1, 2007. An unofficial transcript for the roundtable can be found at http://64.233.169.104/search?q=cache:nAF9JLuxiVMJ:www.sec.gov/spotlight/rule12b-1.htm+12b-1+and+roundtable+and+transcript&hl=en&ct=clnk&cd=2&gl=us.