THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

DIVISION OF INVESTMENT MANAGEMENT

RULE 12b-1 ROUNDTABLE

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P R O C E E D I N G S

CHAIRMAN COX: Welcome to the Securities and Exchange Commission Roundtable on Rule 12b-1, under the Investment Company Act.

To many of you who are seated here, or who are listening on the Internet today, Rule 12b-1 has a special meaning, and a long history, as least as far as mutual fund regulation is concerned. To others, Rule 12b-1 is merely an obscure reference to one item in a thick book of rules.

But for the millions of Americans who invest their savings in mutual funds, Rule 12b-1 is important. If you don't appreciate the rule number, you surely will appreciate the dollar amount.

Rule 12b-1 allows mutual funds to spend nearly $12 billion a year in investors assets, to reimburse expenses, such as the marketing of mutual funds to other investors and administrative services. The Commission originally adopted Rule 12b-1 in 1980. At that time, the Commission noted in our adopting release that we and our staff would monitor the rule's operation closely.

And if experience suggested the rule's restriction on the use of fund assets weren't strict enough, we would be prepared to act to remedy the situation.

Now, with nearly three decades of experience under our belt, it's time that we take serious steps to re-evaluate the rule. Today, we have gathered an impressive group of panelists to help us take a fresh look at Rule 12b-1. I expect that they will express a wide range of views on the history and on the future of the rule.

Today's discussions will help to inform the Commission, as it determines the next steps it will take, later this year. The roundtable is going to consist of four panels.

The first panel will discuss the history of Rule

12b-1. What were the circumstances that led the Commission to adopt it back in 1980? What was the original purpose of the rule, and how did the use of the rule evolve and change over the intervening years? We will hear from individuals who were intimately familiar with all of these developments.

The second panel will discuss the ways that mutual funds, their investment advisers, and broker dealers currently use Rule 12b-1. We will hear about these modern business practices from a distinguished group that includes representatives of mutual fund firms, broker dealers, and the NASD.

After the lunch break, the third panel will discuss the costs and benefits of Rule 12b-1. Sometimes we think of cost benefit analysis as applying to new rules and amendments. But it also applies to rules that have been on the books for years. On this panel, we will hear from experts who can speak to the economic effects of Rule 12b-1, from an academic, as well as a business perspective.

Finally, the fourth panel will discuss the various options the Commission will have, going forward. The panelists will consider a number of cutting edge questions. Should 12b-1 be rescinded? Should it be revised, or revised only on the margin? Should the money that broker dealers receive come not from fund assets, but directly from investors, out of their brokerage or mutual fund accounts? Is there a different way to disclose these payments to investors, that is more understandable? On this panel, we will hear from those who have thoroughly analyzed these issues, with regard to mutual funds, broker dealers, and investors.

On behalf of the Commission and our staff, I would like to thank our panelists who have devoted the time and the energy that I know that you have invested in order to be here, and help us grapple with these issues.

I look forward, as do all the commissioners, to your insights at today's roundtable, as we go forward in this important area.

With that in mind, I would like now to turn it over to Doug, who will help us moderate this panel, and to Buddy Donohue, the director of the investment division, for his opening remarks.

MR. DONOHUE: Thank you, Chairman Cox. Thank you all for being here today, at our roundtable on 12b-1. Before I begin, I need to note that the views expressed by me, and all SEC moderators throughout the day, are our own, and do not necessarily reflect the views of the Commission, or our colleagues on the staff at the Commission.

In fact, as moderators, we may at times ask questions or make statements that do not necessarily reflect our personal views, but are, instead, designed to elicit an insightful dialogue. We hope these questions will contribute to a meaningful and constructive discussion regarding Rule 12b-1.

I am pleased to see the interest that Rule 12b-1 has generated among our panelists and audience members, and those who are joining us by webcast from their homes and offices. I have a personal interest in the rule, as well, because I have lived with the rule throughout its existence.

When I began my career in 1975, mutual funds had $50 billion in assets under management. During that decade, in 7 of 8 years between 1972 and 1979, funds experienced significant net outflows. At the time, the Commission generally prohibited funds using fund assets to pay for the sale of its shares, out of concerns about the inherent conflicts of interest in such arrangements.

In view of the market conditions of the time, however, some petitioned the Commission to reverse its long-standing position, and permit funds to use a small portion of fund assets to pay for advertising and selling.

This, it was argued, would benefit shareholders, because advertising and selling efforts would increase fund assets, and increasing fund assets would have the effect of decreasing fund expense ratios. And with a more stable asset base, would enable fund managers to better manage their portfolios.

Following hearings and several rounds of public comment, the Commission concluded that there may be circumstances under which it would be appropriate for a fund to bear its distribution expenses. The Commission was willing to test the notion that increased fund assets would benefit shareholders by creating better economies at scale, and a more stable asset base.

In addition, there was some recognition that small 12b-1 fees could subsidize the marketing and advertising expenses of the growing legion of no-load funds, and thereby promote healthy competition between no-load funds and broker-sold funds.

Thus, in 1980, the Commission adopted Rule 12b-1, to permit funds to use fund assets to finance distribution, subject to the control and supervision of fund directors.

Admittedly, this is not a very nuanced description of events, but I shall leave it to the first panel to give us the inside story on how and why 12b-1 was adopted. I raise the subject, only to show that we have come a long way from 1980.

Today, it is hard to imagine a time when people were concerned about net redemptions and mutual funds. Since the Commission adopted Rule 12b-1 mutual funds experienced a period of tremendous growth, with almost uninterrupted increases in sales and assets. The industry is thriving.

As of the end of 2006, assets under management exceeded $10 trillion. Funds now serve as a primary long-term investment vehicle for almost half of all Americans, and account for almost a quarter of all financial assets of U.S. households.

The use of 12b-1 has similarly experienced dramatic growth during this period. Approximately two-thirds of all mutual fund classes have adopted 12b-1 plans, and over 90 percent of load share classes have 12b-1 plans.

In the early 1980s, shareholders paid a few million dollars in 12b-1 fees. In 2006, they paid almost $12 billion in 12b-1 fees. The use of 12b-1 fees also has shifted from the limited marketing and advertising purposes that were originally envisioned.

Now, the nearly $12 billion that shareholders pay annually in 12b-1 fees are used primarily as a substitute for a sales load, or to compensate brokers for servicing their clients, uses that are much different from what the Commission originally intended when adopting the rule.

Although there is much room for debate on Rule 12b-1, which will be made abundantly clear today, most observers agree that there is a disconnect between how the rule is supposed to operate, and how it used today. As I have said before, one would be hard-pressed to believe that Rule 12b-1 wouldn't benefit from at least a tune-up.

As Chairman Cox previously remarked, when the Commission adopted Rule 12b-1, it noted that it would monitor the operation of the rule, and be prepared to address the rule if the circumstances or experience warranted. In view of the changes in the mutual fund market, and the role of 12b-1 in fund distribution practices, the Commission is re-examining the rule, to evaluate whether it continues to benefit mutual fund shareholders, or whether it would profit from re-consideration.

This roundtable is part of a deliberative process. In putting together a roundtable, we made an effort -- and I believe a successful one -- to bring together representatives from a wide variety of interested groups, to share their perspectives and insights on the issues that we are examining today.

We are fortunate to have so many esteemed and

distinguished panelists, all of whom are steeped in the issues, participate in the panel today. And I expect that, given the wide range of views that are represented here, we will have a highly engaging, informative, and constructive dialogue about the issues surrounding Rule 12b-1.

We realize that there are limitations to the roundtable format. There are only so many seats at the table, and at the auditorium. But in this day and age, this is just a minor inconvenience. The roundtable is being webcast over the Commission's web site, so that people all across the country can observe the proceedings.

In addition, we are asking -- in fact, we are strongly encouraging -- members of the public to tell us their views on the issues discussed by the roundtable today, or any other issues related to the use of fund assets to pay for distribution. All interested persons can submit comments on the Commission's web site at www.sec.gov. We will keep the comment period open for a full month, until July 19th.

As many of you know, this is not the first time the Commission has considered changes to Rule 12b-1 since it was adopted. Some have questioned whether there will be a serious re-examination of the rule at this time. I can assure you that the division of investment management is not only serious about the reconsideration of Rule 12b-1, it is a top priority for us.

The market has changed around us, and we can't ignore that. Because there is a long history associated with Rule 12b-1 and its use, however, we want to be sure that our review is comprehensive, and that the recommendations we make to the Commission about whether and how to reform the rule reflect the true understanding of all the issues involved. With your assistance, with the benefit of your comments and your insights, we believe that these efforts will result in the best possible outcome.

As you are all aware, putting together an event of this magnitude is no easy task. And there are several staff members from my division who have worked tirelessly to organize today's roundtable. The team was led by Penelope Saltzman, and Thu Ta, and they were ably assisted by Carol Bartman, Jennifer McHugh, and Karen Rossotto. I greatly appreciate all of their efforts.

In addition, I would like to thank Eric Sirri, Bob Plaze, and Doug Scheidt, who will be serving as moderators during today's discussions.

With that, it is my pleasure to turn to Doug Scheidt, the division's chief counsel, and the moderator for our first panel. Thank you.

PANEL ONE -- HISTORICAL PERSPECTIVE

MR. SCHEIDT: Thank you, Buddy. And everyone, welcome to the first panel of today's roundtable on 12b-1.

As Chairman Cox stated, the first panel will focus on historical circumstances that led to the adoption of 12b-1, the original intended purpose of the rule, and how the use of the rule evolved over time.

The panelists today are a distinguished group. All of them played an important role in the events leading up to and including the adoption of Rule 12b-1, or the evolution of Rule 12b-1 plans, thereafter.

In no particular order -- although it does work from my far right to my left -- the first panelist, Matt Fink. Matt Fink was a long-time representative of the Investment Company Institute, which is the trade association for the mutual fund industry. Matt served in various roles for the ICI, including as its president. He currently serves as a fund director.

Second panelist, Joel Goldberg. Joel served on the staff of the division of investment management in the 1970s and 1980s, and served as the director of the division in 1981 and 1982.

Dick Grant served as a special counsel to the director of the division of investment management, and he served as an associate director in the division in the late 1970s and early 1980s. He was a principal architect of Rule 12b-1.

And last, but by no means least, Kathie McGrath.

Kathie McGrath served as a division -- director of the division of investment management from 1983 to 1988.

We will start our panel today with Joel Goldberg, who will begin the discussion of the historical circumstances that led to the adoption of 12b-1. And Joel will cover, among other things, how the distribution of fund shares was financed before Rule 12b-1, what the historical position of the Commission was towards the use of fund assets for distribution.

And so, Joel, take it away.

MR. GOLDBERG: Thank you, Doug. I would like to start by disposing of one of the myths surrounding the adoption of Rule 12b-1. The myth is that Rule 12b-1 was adopted in response to concerns about net redemptions. In fact, net redemptions had ceased long before Rule 12b-1 was proposed or adopted. It had nothing to do with it.

There was a confluence of events that led the Commission to reconsider its historic position that mutual funds should not pay for distribution. The first of these events, which received little public notice at the time, was a no-action request from a company called Armstrong Associates. It was a broker-dealer in Texas, had a no-load fund, which had never reached economic size.

And Armstrong Associates came in for a no-action letter, asking for permission to use half of their advisory fee to pay broker-dealers what we would now call a trail. They didn't call it that then, but pay half of their advisory fees to broker-dealers to get them to sell shares of a no-load fund, and keep shareholders invested.

The fund had been in existence for a number of years. The advisory fee, although a little bit on the high side, had not been increased, it was what it had always been.

The staff said, "Well, there is no basis for us to say that they can't use half their advisory fee however they want; it's their money." So the staff gave Armstrong the no-action letter.

This was in 1976, before there was electronic research. It was in its infancy then. And very few people were aware of the Armstrong letter. It was a public letter, but nobody heard about it.

About a year later, the sponsors of two newly formed money market funds were casting about for ways to incent broker-dealers to place customers' cash in their funds. One of these funds, called "Mutual Liquid Assets," requested no action permission to give half of its advisory fee to broker-dealers who sold shares of the funds. You know, the staff obviously recognized the similarity to Armstrong Associates. The only material difference was, Mutual Liquid Assets was a newly formed fund. So you couldn't be sure that the advisory fee would have been the same if they weren't giving up half of it. But the fee was in the range of what other money funds were charging at the time, which was 50 points.

So, the staff gave Mutual Liquid Assets the no-action letter. In those days, no-action letters remained non-public for 30 days after being issued. So we had a brief period of peace.

While we were in that quiet period, the staff was processing a registration statement from another money market fund called "Banner Ready Resources." It was sponsored by

Blythesman Dillon. And Banner Ready Resources wanted to do the same thing we already told Mutual Liquid Assets they could do, which was keep 25 points of an advisory fee, pay 25 points to the broker-dealer.

The only difference between that and Mutual Liquid Assets was that they said, in effect, "Look, we don't want to pretend that we have a 50-point advisory fee, and we're paying half of it over -- we want to disclose exactly what we're doing, which is we're charging 25 points for investment advice, and paying 25 points from the fund to broker-dealers."

That put the staff in a funny position, you know. We really didn't want to say, "No, no, this is only okay if you pretend you're not doing it." And while we were pondering that conundrum, the industry got wind of the Mutual Liquid Assets letter. The Investment Company Institute hyperventilated.

The commissioners were flooded with mailgrams and telegrams saying that, in effect, "Yes, although we have often said mutual funds should be permitted to pay for distribution, the staff is changing the rules in the middle of the game. You should do this by rule-making, you can't do it by a no-action letter."

The Commission then did something which, as far as I know, has not happened before or since, which instructed the staff to withdraw the Mutual Liquid Assets no-action letter. That's my personal claim to fame. I signed the only no-action letter which was ever withdrawn by the Commission.

And in the same release, announcing that the Commission announced it was holding hearings, and the rest, as we say, is history.

MR. FINK: Can I ask Joel a couple of questions?

MR. SCHEIDT: You certainly can.

MR. FINK: I gather you're saying these were the predecessors to the rule-making, right? These were the models --

MR. GOLDBERG: Yes, yes, correct.

MR. FINK: I have a couple of questions. We have heard some statements about 12b-1 in the media, particularly. One is that it was meant to be temporary. Were these three funds -- Banner, Mutual Liquid Assets, Armstrong -- were they saying, "Gee, we're going through a tough time now, let us do it just for this period?"

MR. GOLDBERG: No, no, absolutely not. Armstrong Associates was making the argument that they just couldn't get their fund to an economic size, but they never suggested, once they reached a certain size, they would stop paying.

MR. FINK: Secondly, did they say, "We're doing this just while the industry is in this period of net redemption. This is all just to cure net redemption issues."

MR. GOLDBERG: Net redemptions had stopped by that time, it wasn't an issue.

MR. FINK: Third, did they say, "We're just going to use it for advertising, and not pay dealers"?

MR. GOLDBERG: All three intended to pay dealers.

MR. FINK: I just wanted to say, because when you read a lot in the media, people say, "Gee, this was done in response to net redemptions, it was meant to be temporary, it was meant to be used for advertising, and not to pay dealers." But at least the three predecessors of the rule, the three models, or whatever we want to call it, were not to be temporary; were not aimed at net redemptions; and were paying dealers.

MR. GOLDBERG: But I think it's important to emphasize, Matt, the reason the staff took the position it did on Armstrong and Mutual Liquid Assets, and would have taken it on Banner, if we had had the chance, was because the intellectual flaw in the position that funds can't pay for distribution had come to the surface.

We had always said -- the Commission always said -- mutual funds can't pay for distribution. But these three -- Armstrong, first, Mutual Liquid Assets, and then Banner -- showed that was an intellectually indefensible position. You couldn't do it.

MR. FINK: And here, I always thought it was the institute pleading net redemption.

MR. GOLDBERG: Well, that also helped.

MR. FINK: I guess --

MR. SCHEIDT: Joel, what were the reasons for the Commission's direction to you to withdraw the no-action position? What were the concerns underlying the Commission's views?

MR. GOLDBERG: You mean the position that you shouldn't pay for distribution?

I think the Commission had always been concerned, rightly, that there was a conflict of interest. Clearly, the promotion of sales is good for the investment adviser, because the advisory fee is a percentage of assets, right? The bigger the fund, the bigger the advisory fee.

If mutual funds were allowed to pay for distribution, the Commission was concerned that the benefits to shareholders would be questionable, at best. But there would clearly be a benefit for the adviser.

And, of course, Rule 12b-1 didn't exist at that time, so there were no requirements about directors approving it, and all of that.

MR. SCHEIDT: So, what happened next?

MR. GRANT: I think I take my cue from that one. The Commission, as Joel mentioned, did initiate a rule-making process. It was an arduous one, and one that took a long time. It was five releases over a period of four years.

As Joel mentioned, accompanying the withdrawal of Mutual Liquid Assets, the Commission put out a release. It was numbered 94-70 -- you can tell how long ago it was -- it was October 4, 1976, announcing that hearings would be held the next month, in November.

The issue was described as the appropriateness of mutual funds bearing distribution expenses, directly or indirectly, a concern that existed then, and has existed over the intervening 30 years, and still exists.

And I see I'm about to sound a theme that's going to get sounded over and over again, the specific examples of the types of expenses that might be incurred that were listed were advertising and compensation for dealers.

As background in this very brief release, the SEC said that it had questioned the propriety of mutual funds bearing distribution expenses, citing the statement of the future of the securities markets, which was, I guess, issued in 1972. As noted, the Commission withdrew the Mutual Liquid Assets letter. The hearings were then held on five days in November, and it was the following August before the Commission was heard from again.

Another brief release -- the number is 99-15, the date is August 31, of 1977, and the SEC briefly but clearly said, "We haven't changed our position yet. We think that any plans for mutual funds to use their own assets to finance distribution would require a Commission order. And people who proceed differently do so on their own risk," which I thought was a fair warning to people, not to get ahead of the Commission on this.

The SEC briefly characterized the views that had been expressed at the hearings as divided between those who thought there were circumstances under which fund shareholders could benefit from sales of shares -- and this, again, was focused not on whether the mutual fund business was in trouble, because of net redemptions, although certainly that had been a serious concern, it was on the question of whether, on an ongoing basis, shareholders could benefit from having their own assets spent on distribution.

But the SEC also noted that there were plenty of people whose view was that selling shares primarily benefitted management, that management had significant conflicts of interests in making any recommendation about the expenditure of fund assets, and that that would be a problem in any rule-making that ensued.

So, the next step was in May of 1978, and it was eloquently titled, "An Advance Notice of Proposed Rule-Making." In other words, the Commission still wasn't ready to move forward, wanted to hear more from the public on basic concepts as to whether this would be an appropriate thing to do, and if so, what sort of regulation ought there to be.

The Commission did indicate that they would suggest some alternatives in order to provide structure for the comments. And I don't think I mentioned that was release 10-252, the date is May the 23rd.

The Commission elaborated a little bit on its view, as to the general tenor of the comments that had been received during the hearings. Problems had been noted about the industry experiencing net redemptions for a significant period of time, but there were also concerns about the small size of many funds, as to whether they were large enough to be viable on an ongoing basis, and a perception that there was a growing resistance to paying high front-end loads.

And in those days, as Buddy pointed out, the industry was still pretty small, and the choice was either a no-load fund, with no special provision made for financing the shares, distribution of the shares, or very high front-end load.

There were assertions that, in addition to addressing these kinds of problems, again, that there could be benefits, on an ongoing basis, in the distribution effort, because it was in the interest of funds to grow, to maintain their size. There was a natural attrition of funds, because in the absence of any selling, on average, the funds would be gone in five years or so, because of steady patterns of investor redemption that are pretty constant, even today.

The advance notice of proposed rule-making said there were three objectives to any rule-making that would follow. One was minimizing the inherent conflicts of interest -- again, the management has a clear interest in having the fund itself bear a part of the burden of selling the shares.

There would be clearer interest in putting the decision and the oversight of any such expenditures in the hands of the directors, especially the independent directors, and the shareholders.

And there would be an objective to ensure that all shareholders -- including existing shareholders who had already basically paid the admissions price to get into the fund -- that everybody should be treated fairly.

The Commission indicated that it would proceed with rule-making, and it did proceed with rule-making, under section 12b of the 1940 Act, which is, of course, what they ultimately did.

The Commission asked for comments about the types of expenses that might be permitted. The examples that were listed were cash payments to dealers, advertising, and payment for prospectuses used with prospective investors, as opposed to existing investors.

In connection with the notion of cash payments to dealers, the Commission specifically asked whether there should be a distinction between what they characterized as transaction fees -- sales loads and similar expenses paid in connection with the transaction -- and those transaction fees and payments to third parties for distribution services, particularly to dealers in fund shares.

I guess I'm going to be the third person on the panel to emphasize this particular point -- and not that that's a surprise; I think we all had it in mind -- a number of people in a number of ways have questioned whether the Commission anticipated or intended that payments to dealers would become part of the framework of the cost of selling fund shares. And the answer to that question is, absolutely.

The Commission understood that, the Commission expected that. And as a person who lived with this rule -- and, in fact, had designing such a rule in my job description at one time -- I can tell you it was my main hope that, if such a rule was done, its major benefit would be the reduction -- and, in some cases, the elimination -- of front-end sales loads.

The Commission also addressed the issue of indirect use of fund assets, which again, continues to be a hard one for people to get a hold on. It's particularly an ongoing struggle for directors, because the Commission then, as it does today, and always has, acknowledged that third parties who would have an interest in the mutual fund's shares being sold were entitled to use their own resources to fund that distribution.

The problem would arise, however, if, in fact, that party -- and the Commission usually spoke in terms of the investment adviser using its assets to fund distribution, because it was the investment advisers who were doing most of the subsidization of the sale of fund shares, and it was the advisers who were receiving the largest compensation from the fund.

But it was only an example. And if the question was related to any third party using its own resources for distribution, where that party had received compensation from the fund, the Commission said it would be important for the board to satisfy itself that the fee was fair, and had been set without making any allowance in the fee for the advisers' expenditure for distribution. And that same theme was sounded, I guess, in virtually all the releases thereafter, although the wording changed over time, as the Commission tried to clarify the intent.

It was over a year before a rule proposal appeared. That was September 7, 1979, the release number is 108-62. The Commission noted that there had been 50 comments on the advance notice of proposed rule-making, 20 that were in favor of the use of fund assets for distribution, and 30 that were opposed.

I'm not going to go through -- and you will all be grateful that I am not going to go through -- the comments in any detail. Because, the fact of the matter is, they really didn't form the basis of the Commission's rule-making. I think it's fair to say that the staff of the division of investment management thought that it was necessary to have a fresh approach.

At that point, basically nothing had worked. In fact, I think we could have gone even further back in history to try to find efforts to deal with the issue of spending fund assets on distribution.

MR. GOLDBERG: Dick, I would like to correct one thing I said, if I could interrupt you for a moment.

MR. GRANT: That's never happened before, Joel.

MR. GOLDBERG: Matt Fink, not for the first time, has pointed out that I said something incorrect. I said that net redemptions had ended by 1976. In fact, he just gave me a whole sheet of numbers here, showing that they continued pretty much through 1980.

But I would still tell you that that had nothing to do with any of the events, as far as I was concerned, leading to 12b-1.

MR. GRANT: Well, I think that's a fair point. The Commission actually observed, in the 1978 release, net redemptions seemed to have ended. But it wasn't deterred, in going down the road of addressing this issue.

I think that's further evidence that the resolution the SEC was looking for was a permanent one to this issue.

MR. GOLDBERG: And isn't it really that when you couple funds paying for distribution with the sort of undeniable permissibility of the management paying for distribution -- when the management gets its money, guess where, from the fund -- it is really very difficult to prevent mutual funds from paying for distribution. What you can do is to regulate it.

MR. GRANT: Well, you know, I think you have to be realistic. It costs money to sell things, and it doesn't matter whether it's a can of beer or a mutual fund share.

There are going to be people involved in the process.

Today, there is wide availability of no-load funds, and yet most people are still buying their shares outside of retirement plans and the like by paying somebody who is a salesman or an adviser, however you would like to characterize it.

MR. FINK: You spared us reading the comment letters, and I don't want to force the audience to listen to these, but not only was it clear from the commentators, that they expected to be paying dealers; a number of them said they expected to get rid of front-end loads if and when a rule was adopted, and go to continuous fees.

I actually came out of the retirement home and went down to the Institute a couple of weeks ago, and read the 800 pages of the 1976 transcript. And this is IDS, the largest fund group in 1976. It was the Fidelity, or the Vanguard of the American funds at that time.

This is Hamer Budge, former SEC chairman, chairman of the IDS board, "It is the judgement of the board of directors, and of IDS, the management company, based upon its long experience in selling financial products, that the sales load charge investors at the time of purchase should be eliminated. There appears to be no way of doing this, except to have the investor pay for sales distribution during the life of his investment, rather than paying an initial sales load at the time of investment. It seemed to us that the straightforward solution would be to impose a direct charge on the funds assets to pay for these efforts."

The Institute also submitted a brilliant comment letter by Matthew P. Fink, general counsel, which said, "We can foresee funds electing to supplement existing sales loads with the use of fund assets for distribution expenses. We can just as easily foresee funds electing to decrease or eliminate sales loads if fund assets are used for distribution expenses."

So, these were -- as the rule was being -- people were well aware it was going to be used to pay dealers, as you said. And people also thought about one of the options -- there were different options.

One was to supplement the load, like we have for A shares today. We have a load plus a 25 trail. Or, B and C shares, where there is no load, there is a continuous fee. And at least people in the industry said, "If you adopt a rule, that's what we plan to do."

MR. GRANT: Matt, I would like to say --

CHAIRMAN COX: I'm sorry, I wonder if I could just interject at that point, because there had been a fair amount of discussion just now about what was intended back in 1980. And it may or may not matter, but I have a letter before me here from ICI of May 2004, a comment letter on 12b-1. And it's signed, not by a general counsel, Matthew P. Fink, but by President Matthew P. Fink.

And it says, "Mutual fund distribution practices have changed dramatically since Rule 12b-1 was adopted in 1980. Most notably, the predominant use of 12b-1 fees for most of their history has been as a substitute for front-end sales loads, and/or to pay for administrative and shareholder services that benefit existing fund shareholders. Although these uses were not anticipated when the rule was first adopted."

MR. FINK: I have no recollection of that letter.

(Laughter.)

MR. FINK: That's the reason I retired, Mr. Chairman.

CHAIRMAN COX: I think all of this history is extremely useful. And, you know, in fairness to President Fink -- at the time -- the point you're making in that letter is that, intended or not, ICI and you believe that those uses are completely consistent with the original purposes of the rule. And I think what we're examining here, and what we're bringing out, suggests that that may well be the case.

MR. FINK: Mr. Chairman, I might just say this -- and I don't know if it's a full explanation -- I think -- and we're about to get to it; I don't want to cut into Kathie's time -- I think what we anticipated --

advertising, payment for prospectuses for non-shareholders, payments to dealers, either supplementing or replacing -- what we didn't foresee was the contingent deferred sales loads, which let amounts be paid that were equal to the front-end load.

I think that was the -- and that may have been, if I had to justify -- which I don't have to any more -- but if I had to, I think that's what surprised all of us. We're going to get to that in a minute, but that was the event -- it's now called B shares -- that at least Dave Silver, who was president of the Institute, and I think other people, were very surprised about.

MR. GOLDBERG: And, you know, what's interesting about that, Matt, is we shouldn't have been surprised, because the insurance industry had been using that method of financing sales commissions for many years. They had mortality and expense charges, and they would advance the sales commission to the salesman, pay it back through the M&E.

But I agree with you. Certainly no one on staff, I think, ever thought --

MR. FINK: We also thought it wouldn't survive. I remember the day -- I can't remember what I had for lunch yesterday, but I can remember clearly, when we saw that, we said, "Oh, boy, this is going to have a life of about a half-a-day."

MR. SCHEIDT: Let's further test our memories, and get back to 1979.

MR. GRANT: I will pick up the --

MR. SCHEIDT: And one thing I wanted to ask about other things that were going on at the time, while the Commission and the staff were considering Rule 12b-1, there were the Vanguard proceedings, and there were -- there was a general trend, after the 1970 amendments, which put the focus more on independent direct fund directors -- there was an increasing reliance by the Commission on the independent directors of funds to police conflicts of interest.

MR. GRANT: Doug, let me sort of pick up the thread, and talk a little bit about the dynamic.

As I mentioned before, the rule reflected kind of a fresh start, if you will, rather than something that flowed out of the various hearings.

Internally, there was a continuing struggle, if you will, over this issue. As I have indicated, the Commission, went sort of on record, saying that it was generally inappropriate for funds to use their own assets for distribution. Internally, the division of investment management was looking for an answer, but certainly concerned about the conflicts of interest, and how those could be regulated.

The division of enforcement was adamantly opposed to giving an inch. Two of the commissioners were equally adamantly opposed --

MR. GOLDBERG: Do I recall the division of enforcement threatened to bring a 2(e) proceeding against you?

MR. GRANT: I think they threatened to send me to jail. It was others who just were going to be 2(e)'d.

But they fought it tooth and nail. The general counsel had considerable questions about some of the legal issues that were posed by the Commission's authority in the proposed approach, and so they were, you know, kind of on the fence. I would say an "annoyance," but that would be impolite, so I won't say that.

One thing that was going on -- to pick up on Doug's comment -- was that the division heads started kind of a regulatory reform program with the support -- I might say "prodding" -- of the then-Chairman Harold Williams. And the essence of it was to identify areas that were regulated that reflected business judgements, and to allow those business judgements to be made by the fund, with significant input and oversight from the independent directors.

So, we sort of picked that theme up with a rule, and added to that a sort of concept of a -- made it basically, a procedural rule, rather than one that sought to

regulate the kinds or amounts -- the kinds of expenses, or the amounts that could be spent on distribution to have a rule follow a process calling for approval by the directors and by the shareholders, at least in the case of a new plan for an existing fund, all with the oversight of the independent directors.

And, in fact, that process was designed to reflect, or be very similar, to the process that funds have to go through anyway, in the approval and annual renewal of investment advisory agreements, and with agreements with the principal underwriter, the idea being that all those decisions can be considered, collectively.

The rule was put out by a three-to-two vote, the chairman providing the third vote, and I think he was basically really willing to hear what the public had to say. And I think he might have voted the other way, had it not been for the fact that he was the one who was promoting this regulatory reform idea, in the first place.

The comment was hostile. I think that's really the only word for it. And, Matt, I wanted to say that your comment letters were frequently brilliant, and almost always painful for the recipient. I remember them well.

But, ironically -- and I'm only half facetious when I say this -- I think the two commissioners who were most reluctant were persuaded. One of them said, although with a smile, that, "Well, if they hate it that much it can't be as bad as I thought it was."

So, the Commission maintained the basic structure of the rule, and you know, tweaked a few things, and adopted it. The release is 11-414, the date is October 28, 1980.

And just sort of three final comments about the rule, as it was adopted. Again, the Commission tried to address the issue of direct versus indirect. That is, to what extent can the adviser, or other third-party recipient use its own assets to promote distribution.

The Commission again said, "You know, there can't be an allowance in the fee for distribution, there can't be inflation of the fee for distribution, there can't be an arrangement that a third party who receives money from the fund is acting as a conduit" -- I guess I should say a second party is acting as a conduit for payments through.

But the bottom line was that if the fee met the applicable legal standard -- in the case of advisory fees, it is, of course, section 36B -- the recipient of that fee could use the assets, use its resources as it saw fit.

Second thing on the role of the board, the Commission stressed that this was a business decision, stressed the Commission was not going to regulate the amount or the nature of 12b-1 fees. A clear expectation that people would use their imagination in coming up with things that were, in fact, not anticipated at the time.

And the role of the board was strengthened through the adoption of the requirement that the independent directors essentially had to nominate the other independent directors, to try to decrease the degree to which management had overreached the board, by threatening their tenure.

Finally, the rule had -- as proposed -- had contained some factors. And not surprisingly -- this may come as a surprise to people, but sometimes regulators put things in rules that they expect to back off from, you know, to give the public something to chew on, an objective. The factors came out of the rule, because the -- and we will put into the release, as general guidance.

The concerns the Commission expressed at that point was they did not want to constrict the business judgement of the board, and they did not want to provide a mechanical checklist for compliance, either.

The other thing I would say about the factors is that they reflected the concerns at the time, in the sense that they talk about problems that might be addressed by a 12b-1 fee. But they were clearly not regarded as a temporary fix. Instead, to say it one more time, it was a basic decision to let boards oversee a business judgement about how to use the fund's assets to promote distribution.

MR. FINK: We have talked about some of the myths -- temporary, not just for dealers -- some of which seem to be promulgated by Matthew P. Fink in 2004, which I will have to go back and look at, but there is another thing I have heard. And that is not from directors on my board, that, "My goodness, we cannot make these decisions, because these factors do not fit."

And my own reaction -- when I went back and researched this for a book I'm working on -- is the SEC didn't say you have to meet these factors. The rule expressly says these factors are suggestions, there may be others, "Use your business judgement." And the only decision, if I understand, that directors have to make, according to the rule, is, "There is a reasonable likelihood the plan will benefit the company, and its shareholders."

So, the fact that you may be approving a plan that the purported or suggested factors don't fit, it's totally irrelevant. It seems to me, directors are paid a lot of money from directors. They're supposed to be educated, up-to-date, use their business judgement. And the fact that some of the possible factors don't fit doesn't hit me as a big obstacle.

MR. GRANT: Well, obviously, boards have struggled with how to satisfy their duties, and they want to look to the guidance that the Commission has provided. I think, you know, a number of people have said it, I think it's certainly time to take a look, at the very least, at the kind of guidance they receive, and see if there is a way to give them a little bit more of a framework to help them with this.

But nevertheless, you know, obviously, a huge number of shares are sold with 12b-1 fees, and that means that directors are finding a way to live with it. I think the more we can stress that -- at least some of the rules now -- it is a business judgement. And they bring that to boards, whether or not they bring specific expertise.

They should look carefully at what the plan of the program is, to sell the fund's shares, and figure out whether it's working, and figure out whether it's practical to make changes, and if so, advise it.

MR. SCHEIDT: Dick, was any serious consideration given to imposing a cap on the amount that funds could spend for distribution?

You know, you talked about it in terms of business judgement, and that would reflect that there would be no cap. But if the expectation was that only a small amount of fund assets would be used for distribution, you think that the two could have worked together, and set a cap?

MR. GRANT: No, I think that the Commission did stress that they would monitor the operation of the rule. In other words, they opened the door to allow people to use their imagination to come up with schemes, but planned to -- I mean that in --

MR. SCHEIDT: We don't like using the word "schemes" to describe --

(Laughter.)

MR. GRANT: But they would continue to watch what was going on, and adjust as necessary.

MR. GOLDBERG: I think, Doug, if you accept my theory, that it's really a chimera to say that mutual funds can't pay for distribution, it sounds great, but it doesn't work, that would be equally true of a cap -- if you said, you know, "You can't pay more than 25 points," or whatever figure you want to name, then you would come back to a latter day Mutual Liquid Assets saying, "Okay, the fund will pay 25 points, and we're going to pay another 25 out of our advisory fee."

Then you would have a latter day Banner Ready

Resources saying, "We don't want to pretend we're paying it out of advisory fee, we're taking it out of the fund."

So, I think a cap is the same as a prohibition, analytically. It's very hard to make it stick.

MR. FINK: I will give you another example. Transfer agent, or omnibus account, I don't know, load funds, whatever we call them now, have a huge percentage, probably 60 or 70 percent of their shares, held in omnibus accounts by brokers or 401(k) providers, who charge a fee per account.

Now, are you paying that fee for record-keeping? Or, is part of it paying for distribution? Now what is that fee to Schwab or Merrill Lynch for?

So, if you try to cabin it, and say, "No more than X for distribution," what do you do about your omnibus fee -- fee to your omnibus record keeper? What is that? I think these kind of categories just don't work.

MR. SCHEIDT: Okay. So, the SEC adopted Rule 12b-1 in 1980. What did the industry do next? How did -- how many funds quickly adopted 12b-1 plans, and what did they initially use fund assets for?

MR. GRANT: I will let others to talk a little bit more about the development, but my own impression is that, at first, nobody used it. In fact, I think it was virtually a year before anybody adopted a 12b-1 plan, because I think that people really were quite concerned, you know, about what it meant, what would the SEC's attitude be towards these things? And, you know, what were the competitors going to do?

So, it took a while before people were comfortable enough to take those first steps.

MR. GOLDBERG: I think that's right. There was surprisingly little use of the rule in the early years. And it wasn't really until E.F. Hutton came in with its application for contingent deferred sales load, a company called "Hutton Investment Series," that was the first use of 12b-1 in conjunction with a contingent deferred sales load. That sort of blew the lid off. But until then, there was very little interest in the rule.

MR. FINK: Joel, can I -- a question, which I don't know the answer to this. Merrill Lynch had the big money market fund, Ready Assets.

MR. GOLDBERG: Yes.

MR. FINK: That had a 25 basis point trail for brokers. And what I don't know -- maybe Tom Smith, sitting there, will remember, or somebody else -- when that went on. And I don't know the answer to that.

MR. GOLDBERG: It would have had to have been after --

MR. FINK: Why?

MR. GOLDBERG: -- 12b-1.

MR. FINK: Oh, yes. It would have to be after 1980, but it may have happened before Hutton happened. Tom is nodding, so I think that -- so I think it's hard to collect that information, but my guess is that we may not know everybody. I think the brokers were putting on trails on their money funds. There were no-load money funds with trails.

MR. GRANT: There was a fair amount of controversy about that before the rule was adopted, because the view of the staff, at least, was that if you were prohibiting mutual fund payments for distribution, and if the adviser, or other third party, had a fee that it was splitting in some sense with sellers, wasn't that arrangement really a conduit for the use of the fund assets?

So, both before and after adoption of the rule, the staff was frequently off pursuing a rumor that one broker or another was making these kinds of payments. And, of course, we never could find it.

MR. SCHEIDT: It may have made sense, in the early 1980s, when interest rates were really high, and money market funds were paying yields that were far higher than bank accounts, for funds to look to those high yielding accounts to be the first one to extract a small 25 basis-point fee.

MR. FINK: I don't know if that's true, but it happened about that time. That's my recollection.

MR. SCHEIDT: Equity funds were still in a slump from the 1970s, maybe starting to come out of it, but in a high inflationary environment, they may not have had the returns that would have made the imposition of 12b-1 fees -- at least large ones -- palatable with investors.

Well, Hamer Budget presaged the use of 12b-1 fees with the contingent preferred sales loads, but it was legally prohibited prior -- it was legally prohibited. And it required E.F. Hutton Investment Series to come in for an exemptive order to allow funds to do what the insurance industry had done previously.

So, Joel, can you describe those events, briefly?

MR. GOLDBERG: Well, the precise prohibitions that would have prevented a contingent deferred sales load were somewhat unclear. I think Hutton recognized that this was a very aggressive and unusual use of 12b-1, so they filed an exemptive application under various sections of the Act.

But there was nothing specifically prohibiting this type of arrangement. Essentially, what it involved was advancing a sales commission to the broker. And then, if the investor redeemed within the stated period -- let's say, six years -- they would have to pay a sales load on the way out. Otherwise, the fund would pay what, at the time, seemed like an extraordinarily high 12b-1 fee to recompense the distributor for having advanced the sales commission.

Hutton's 12b-1 plan, I believe, was 100 points. I might be a little off on that, but -- and that was just way beyond what anyone had envisioned.

I will confess that that application was issued by the staff under delegated authority without going to the Commission, should have gone to the Commission. The people processing it just didn't recognize its significance.

We did recognize its significance after it was issued, and the final order was granted by the Commission.

But I think it's unfortunate that the notice was issued without the Commission seeing it.

MR. SCHEIDT: So, within two years of the adoption of Rule 12b-1, the brilliant minds in the industry had come up with a new way to use 12b-1 fees as a substitute for front-end sales load?

MR. FINK: This is a little bit off, but I have to say this was the creation of one person who was -- I just want to give somebody credit here -- Gary Strum, who had been an attorney at Lord Abbott for years, left there to go to Hutton, and dreamt it up.

And his boss at Lord Abbott, Ron Lynch, was a very good guy. And Lynch once said to me, "Strum was the brightest guy I ever had work for me. Thank God he left, because he would have bankrupted me." So that was quite an -- he was the one person who thought of this.

MR. GOLDBERG: Well, one of the characteristics of contingent deferred sales loads -- and it caught some people in the industry by surprise -- is that the more shares you sold, the more money you lost.

MR. FINK: Right.

MR. GOLDBERG: Because the distributor had to advance the sales commission, and it would take years to get it back. And it's like the old joke that "I sell suits way below cost," you know, "How do you stay in business?" "I do it on volume." And many people in the industry discovered that about contingent deferred sales loads.

MR. GRANT: So, the 12b-1 fee was used to pay the principal underwriter of the fund, who had advanced monies to the dealers who had sold fund shares.

MR. GOLDBERG: Yes, that's correct, and it involved a little bit of a Procrustean application of 12b-1, because 12b-1, as you know, says that the plan can continue, in effect, only if it's renewed annually by the board. And, even then, it can be terminated at any time by the board.

So, every year, the board goes through this pretense -- I will use that word -- of, "Should we renew the plan?" Well, the distributor has advanced millions of dollars for contingent deferred sales loads. If the board said, "Gee, we have decided not to renew the plan, we're not going to pay you back this money," the distributor would be, shall we say, surprised.

MR. GRANT: Of course, even a traditional A share, as they're sold now with a sales load in a 12b-1 plan, it's very difficult for a board to decide, "Well, we're going to discontinue it this year," because, of course, all those people who sold it originally are receiving those ongoing fees, and seeing themselves now as asset-gatherers. You stop paying them that fee, they're going to find another fund.

MR. GOLDBERG: Yes, I think --

MR. GRANT: So, a zero-based revisiting of these fees is really not practical.

MR. GOLDBERG: I think the notion that a 12b-1 plan is a year-to-year thing, and is redecided every year, is a little bit of fiction.

MR. SCHEIDT: Well, that's true, when it's used as a substitute for front-end sales load.

MR. GOLDBERG: Or, as Dick described, for a trial --

MR. SCHEIDT: Yes.

MR. GOLDBERG: -- where the broker expects it to continue.

MR. SCHEIDT: But it's not necessarily true, is it, when fund assets would be used for advertising expenses?

MR. GOLDBERG: No, no. And that's what the Commission was anticipating. That's why the rule has these provisions, because they thought it would be advertising, training of sales people, that kind of thing.

MR. GRANT: I think it is still a business decision that they can grapple with, it's just a question of being able to take a business-like approach to it, as opposed to sort of a theoretical or conceptual approach to it.

MR. SCHEIDT: Okay. Let us forward a couple of more years and Kathie McGrath is on the scene in 1983.

MS. MCGRATH: Yes. I came back to the Commission in the division of investment management in the summer of 1983, and things were pretty quiet on the 12b-1 front, at least at first.

But by 1985, some problems had begun to surface. The first thing I remember getting upset about was one fund group proudly went to a conference and explained to everyone how they had figured out a new method of boosting their performance yield by capitalizing on their 12b-1 fees, instead of expensing them.

And so, we had to run off -- since they just explained to the entire industry how to do that -- and get the chief accountant's office to put a stop to it.

But then, in the fall of 1985, I was presented with a memo by a division staff outlining what they referred to as the "use and abuse" of 12b-1, and proposing solutions, chief among which was a repeal of the rule, and going back to the idea of allowing advisers to use their advisory fees to pay for distribution.

The end of 1985, there were about 600 funds with 12b-1 fees. The amounts had gone up, in some cases, up to 125 basis points. And they were being used to pay brokers' sales commissions up front, which, of course, the rule permitted, and were being combined with back-end loads.

They weren't very well disclosed, and the press got onto the bandwagon, and there were numerous articles excoriating the fund industry, and the SEC staff for allowing these hidden loads. And then, the mail from Congress started arriving, and lots of small investors, surprisingly enough.

One thing that got everybody riled up was the fact that funds who were charging these fees and using them to pay salesmen in, you know, amounts of 125 basis points, which pretty quickly got up to where sales loads were, were advertising themselves heavily as no-load funds. And the SEC said that Vanguard could do this, in an order, with its 25 basis points. So we didn't think we could stop it. But we thought it was a problem.

So, the SEC had promised, when it adopted the rule, to monitor it. So we decided we needed to take a look, and we did so through the disclosure office, which looks at prospectuses, and also the regional offices. And we found some things we didn't like. We thought they were problems; others didn't.

One was, of course, the no-load advertising campaign. The second was on these 12b-1 fees that were paired with contingent deferred sales loads. The distributors were fronting an awful lot of money. And in order to get that paid back, the 12b-1 plans needed to go on for a long time.

And they were also charging the funds interest, financing charges, which made it an even larger amount that would have to be paid back. And we thought this was inconsistent with what the Commission had laid out, which was these things had to be re-approved every year.

And then, investors were not being told, in the prospectuses or anywhere else, about these finance charges and the sort of long-term nature of the 12b-1 plans. So, we also saw some situations in which these combinations of sales charges resulted in spectacular growth, but there weren't any break points or reductions in advisory fees coming as a result.

And then, we saw another type of 12b-1 plan that we called a compensation plan, and that's basically where the fund board said, "Here is money we're going to give you. Take it, Mr. Distributor, and spend it how you please." But they really weren't required to return any unspent monies, and we had some problems with that.

So, we did a couple of things, initially. We started asking for additional disclosure about how these finance charges worked, what amounts were being carried forward, how long a 12b-1 plan would have to go on in the prospectus, through the comment process.

We saw some issues with how the 12b-1 fees were being used, where they collected from one series of a fund, and then use it to pay for distribution of a separate series. And we found some bad facts.

In one case, where the distributor spent the money on, you know, dinner, flowers, a car wash, dry cleaning, chocolates, health club memberships, you know, and you sort of said, "Well, gee, a distributor must figure that a buff, well-fed guy in a neatly pressed suit must be able to sell more shares." But then we said, "Maybe they meant to bill it to the soft dollar account, and made a mistake."

So, we looked at board records, to try to figure out what directors were being told. And in a number of instances, the specifics weren't there.

We found plans that had lapsed, but the money kept on being paid, and some cases where they accrued and took from the funds 12b-1 fees, or deducted them from NAV, but never spent the money, and we had to go beat the fund up to get the money back.

But we managed to put a stop to the use of the no-load advertising label with contingent deferred sales loads through a letter, but we still felt we weren't able to do anything on the fact that a fund had a very large 12b-1 fee.

We hit upon the idea of asking the NASD to take care of some of these concerns. It seemed inconsistent to us that the NASD would have these rules that said, "A front-end sales load in excess of this amount is excess of this amount is excessive, and brokers can't charge it," but not to have any governor at all on the amounts that could be collected through contingent deferred sales loads, or asset-based 12b-1 fees.

And also, the NASD was, at that point, taking over the review of fund advertising. So they seemed like a logical place to go. But we talked to them for a couple of years, and they insisted that they had no jurisdiction over anything but front-end loads.

So, we went ahead with a fee table for the prospectus, which we thought would help investors get a handle on what they were paying in 12b-1 fees, and other costs of investing in a fund. And we kept getting pounded by the Congress and the press. I noted somewhere in a speech that we had gotten 65 inquiries from members of Congress on the subject, and I lost count of the press articles.

After a while, the press actually did a lot of good. They increased investor awareness of 12b-1 fees, which was all to the better, and they had an effect on the use of the no-load label, because they would write nasty articles every time somebody did it. And, in fact, I found a prospectus in an old file from 1987, and this is what the fund started advertising. This was their new promotion -- the heat had gotten so bad -- "No 12b-1."

So, in 1988, we gave up butting heads with the NASD over its jurisdiction, and put out our own rule proposal.

And I remember that one of the first outlines of it that I got was titled by the division staff, "Seven Ways to Tighten the Screws," which should tell you what kind of a mood we were in at that point; it was not good.

And it was more or less a failed proposal, but here is what we proposed to do. We said, "Unreimbursed distribution expenses going forward would have to be paid back within a year." This was sort of an effort to try to make sure the costs fell on, generally, the right group of shareholders.

To deal with compensation plans, we said, "No, your plan has to spell out what you can spend the money for. And if you don't use it for those things, you've got to give it back to the fund."

To deal with how much any one investor could be charged between 12b-1 fees, front-end/back-end loads, we basically cooked up something that said that in setting amounts of 12b-1 fees, the board needed to look at the NASD sales limits, and kind of figure what an investor would pay overall, and take that into account.

We proposed annual shareholder approval of the plan -- that was the nastiest one -- and, of course, no more no-load labels.

Well, in face of the seven screws, the NASD had a miraculous change of heart about the scope of its

jurisdiction. And a committee headed by Ron Lynch came over and asked if we could smoke the peace pipe, and if we would defer action on our rule proposal and let them take a crack at it.

So, I talked to the chairman and a couple of the commissioners, and they said, "Okay," and they came back fairly promptly -- within a year -- with a proposal that got at most of what we were concerned about. But then it took them until 1983 to get it on the books -- 1993. I left in 1990.

So, they did put the brakes on it, to some extent. They kind of did a rough justice limit, so you had to take into account front-end loads, back-end loads, 12b-1 fees. They allowed 25 basis-point service fees to go on ad infinitum, not subject to the cap, and you know, by and large, they limited what funds could pay, rather than what an individual shareholder could be charged.

So, it didn't perfectly resolve the concern that the money was falling on the wrong shareholders. But in those days, computer programs and accounting systems really were not up to trying to do something on a shareholder-by-shareholder basis.

My two cents on all of this, you know, Americans like to pay on time. And most investors really don't know how long they're going to stay in a fund. So -- and one of the reasons they buy mutual funds is because they know they can get out whenever they want. So, you know, I don't think front-end loads are the answer. People hate them. They also don't like deferred sales loads, because that causes them to feel they're stuck.

So, it would be nice if something could be worked out to continue asset-based fees, if we can figure out how to clearly explain them to investors so they know what they're paying, and what they're getting. And we haven't gotten that right yet. Anyway, I left in 1990, so --

MR. SCHEIDT: Why were the other proposals failures? Did you get the sense that, by focusing attention on these issues, the industry responded, if there was concern about reimbursement plans, or about compensation plans, and your concern was that directors didn't pay enough attention? Did you get the sense that merely by focusing attention on those issues, directors paid more attention?

MS. MCGRATH: No. I mean, I don't really think they -- everybody seemed to think I was crazy. I think what really had an impact was the financial press that came to be directed to individual investors. And they took up the cause, and they got a lot more attention.

In fact, we found it very useful. It was a way of educating investors. "Money Magazine" was good at it, a lot of people read that. And it was a way to get the word out

that the SEC really couldn't -- they would follow what was going on with 12b-1 and write about it. It was a good thing.

MR. SCHEIDT: You also mentioned that the computer systems at the time weren't sophisticated enough to individualize account treatment.

I noticed, Matt -- and maybe you remember -- the ICI filed a statement in connection with a 1988 rule proposal, in which it raised the issue of imposing 12b-1-like fees at the shareholder account level, but argued that doing so would be operationally impractical, expensive, and burdensome. So there were some --

MR. FINK: We looked at it. And I just remember one large member thought that they could do it in a couple of years, and the others said they could not do it.

MR. SCHEIDT: Okay. We're --

MS. MCGRATH: I think that was true, that the accounting systems at the time were just not up to doing it, across the industry. Either that, or they really fooled me.

MR. SCHEIDT: Okay. We have come to the end of our historical perspective on Rule 12b-1, and this is the time when the individual panelists are invited to make brief personal remarks on their views -- who would like to start?

MR. GOLDBERG: Let me say first what I think should not be done. I think an attempt to go back to prohibiting or limiting to a specific amount the bearing of distribution

expenses by mutual funds is an imaginary line. It will survive only until somebody tests it. And we found that, historically, the evolution through Banner Ready Resources.

So, the question is, "What should be done?" I personally would advocate bifurcating 12b-1 into two parts.

One, where it's used as a substitute for a sales load, a contingent deferred sales load, a level load, I think there we should drop the pretense that the plan is a temporary thing that is in existence for only a year at a time, and is subject to termination. It's a contract. People have advanced money on the understanding it will be repaid. And, in fact, people are so sure it will be repaid, that the 12b-1 stream is sometimes used as security for a loan.

Obviously, nobody believes the pretense that the board won't continue a 12b-1 plan in those circumstances. So let's call it what it is, a contractual obligation on the part of the fund to pay back a certain amount of money.

Now, we might call the originally anticipated 12b-1 plans advertising the type of expenses that can be terminated at will. There, I would keep 12b-1 in pretty much its present form. But the factors that Dick labored so hard to write in 1980, I think could use a serious updating.

MR. FINK: Thanks. I will stick to the subject of this panel history, and not try to offer solutions. I must say I have come up with solutions that will satisfy the SEC, most importantly, the investors, the media, and the industry, but you will have to read my book on the history of the industry to get those.

So, for now, I will stick with history. In the time -- I've been doing a lot of reading on history, and read a lot of books on the British Empire. And it has often been observed that the British Empire was created "in a fit of absent-mindedness." Some observers similarly maintain that the SEC somehow was absent-minded in 1980 when it authorized 12b-1 plans, and didn't realize what it was giving creation to.

Specifically -- and you read these observers -- they say the SEC thought that 12b-1 plans would be temporary, that they would be confined to the problem of net redemptions, that they would not be used to compensate dealers.

Moreover, they claim that this absent-mindedness has continued over the last 27 years, and the SEC has never revisited the issue. And, finally, they say the SEC clearly wasn't focused, because it imposed impossible conditions on fund directors.

But if you look at the historical record -- which I, frankly, was doing before these hearings this excellent roundtable was called -- all of these are not true. The record -- and you've heard from the two authors of the rule here, two principal authors -- the historical written record shows that the SEC did not assume that the plans would be temporary.

The SEC did not assume that the plans would be restricted solely to address net redemptions. The SEC clearly contemplated, and expressly says in the rule that the fees would be used to compensate dealers. As a fund director, I can tell you that the SEC has not required directors to make virtually impossible findings.

And, finally, you heard Kathie. The SEC has revisited the rule on a number of occasions. Obviously, the current Commission sitting here is free to retain, rescind, or change the rule. The Commission could decide that in 1980 the SEC got it about right. Or, you could decide that the SEC in 1980 made some mistakes, which ought to be corrected. Or, you could decide that new conditions that prevailed today that didn't prevail then required changes in regulation.

But whatever you do, I would ask that you base your decisions on the actual historical record, and not on myths that have developed. Thank you.

MR. GRANT: I am not going to beat that horse any more, because we have all made the point. But I will say that the rule, of course, is not a substantive rule. It doesn't regulate the types or amounts of expenses that can be made. It's a procedural rule, that tries to tailor the process of considering distribution expenses with the other kinds of major decisions that boards have to make about the advisory contract, and the underwriting contract.

I don't have a recommendation as to how the rule should be changed. It clearly -- at the very least, the guidance under the rule needs to be updated. I think everybody understands that.

As for the rest of it, I would say, as I have said in the past, when people have wanted to change the rule, you know, just be sure not to make it worse.

(Laughter.)

MS. MCGRATH: Well, I think that the payment of fees by investors, either directly or indirectly, over the life of their investment is probably the best way to continue to go.

Brokers and other intermediaries, you know, with whom we buy and hold and hold and hold fund shares provide us a lot of services. They do account statements and talk to us, they send us prospectuses, mailings, this, that, and the other. They deserve to be paid for that, that's a real service.

And the problem is, you know, we haven't gotten the right way to explain it to investors, so they can understand it, the prospectus is not a very good point of sale

disclosure mechanism. People don't need it, they don't read it, they don't even have to get it for five days after the sale. And that, I think, is where we have consistently failed. How do we make investors understand this?

MR. SCHEIDT: Okay. Thank you very much. This concludes our first panel of the roundtable today. Thank you.

(Applause.)

CHAIRMAN COX: And on behalf of the commissioners, I just want to add my thanks. This was an outstanding presentation. We have the right people here to help us with the history, and we really will read your book in order to get the answers to this, one way or another.

Thank you very, very much for your contribution, and we look forward to continue to hear from you, as we move forward on these important issues.

(A brief recess was taken.)

PANEL TWO -- CURRENT USES: THE ROLE OF 12B-1 PLANS IN CURRENT FUND DISTRIBUTION PRACTICES

MR. PLAZE: Good morning, welcome to the second panel of today's roundtable on 12b-1. I am Bob Plaze, I am the associate director in the Division of Investment Management, and I would like to welcome you here, to the second panel.

You have just heard a very interesting discussion on the historical perspective, what happened, and from whose perspective exactly what happened -- a couple of perspectives there.

Similarly, there will be different perspectives offered in this panel of distinguished members of our investment company and regulatory community. This panel is on the current uses of Rule 12b-1, and current fund distribution practices. It's not the panel on how a 12b-1 fund should be reformed, or changed, or rescinded, or amended. We're going to save that for the fourth panel, so we all keep your attention here today, while you eat your vegetables on this panel.

Joining me on the panel is, alphabetically, Marty Byrne, Managing Director, the Office of General Counsel, from Merrill Lynch. Marty oversees the legal aspects of the investment advisory, investment company, and other investment management activities of Merrill Lynch's global private client business unit.

Paul Haaga, here, is Vice Chairman of Capital

Research and Management Company, as well as Chairman of the firm's executive committee. Paul is also an officer and director of several funds in the American Funds group, which is managed by Capital Research. With more than $1 trillion under management, it's one of our larger fund groups in the country.

Mellody Hobson is President of Ariel Capital Management, a Chicago-based mutual fund company and investment management firm. Ariel Capital Management is the investment adviser to the Ariel Mutual Funds, which have more than $7 billion in assets under management. Although $7 billion seems like a lot of money to most of us, in this group, Ariel Capital Management and Mellody is the representative of one of our smaller fund groups here, and will speak to the issues of 12b-1 to those small fund groups.

John Morris is Senior Vice President, Asset Management Products and Services, at Charles Schwab & Company. In addition to its discount brokerage business, Schwab offers the OneSource program, the largest mutual fund supermarket, which allows investors to invest in a wide choice of mutual funds in a single account, and those services are intricately related to 12b-1 plans.

Charlie Nelson is Senior Vice President of Great-West Retirement Services, a division of Great-West Life and Annuity Insurance Company. Among the largest 401(k) providers, Great-West provides retirement products and services. At the end of 2006, $1.5 trillion were invested in mutual funds through 401(k) plans, and they provide a significant portion of the distribution of mutual funds in the United States.

Tom Selman is Executive Vice President, Investment Companies Corporate Financing at NASD Regulation. NASD is an SRO of securities firms; it plays a very important role in 12b-1 matters because it has adopted for its members rules that limit the distribution and services of mutual funds that brokers can sell, in addition to being responsible for mutual fund advertising, which was alluded to in the last panel.

And, finally, but not last, Bob Uek is an independent trustee on the board of trustees of the MFS family of funds. MFS Funds, which include the first mutual fund in the United States, have over $120 billion of assets under management.

Let's start right off here with the current model. Our Rule 12b-1 plans today typically work in conjunction with multiple classes issued by the same fund. I think there may have been some allusion to that in the first panel, but this is where we're going to dig into it, how it operates.

Paul Haaga, could you describe, generally, some of the classes that are offered to retail investors, and the role 12b-1 plans play with each?

MR. HAAGA: Sure. Thank you. And thank you very much for having me on the panel, Bob, and Commissioners, thank you.

I have a hand-out, and I am not going to walk you through it, but I hope everybody has a copy of it. It gives, on one side, what the investor pays, either directly or through the fund, and how they pay it. And then, on the other side, it has by whom the payment is received.

But let me just talk generally about it. I can circle back and answer questions about specific fees and classes that are listed here.

I think this roundtable would be greatly improved, the whole thing, if no one were allowed to say the word "12b-1 fees." Because every time it gets said, people think of different things. 12b-1 happens to be the rule. There are really three basic expenses, or fees, or bits of compensation that come out of 12b-1, and we really ought to separate them. And I hope someone will raise their hand, or say something if I use the word "12b-1 fees."

There are -- the three kinds are -- ongoing service fees. Those are often 25 basis points in A shares. They are paid forever, they are excluded from the NASD maximum sales charge rule. They are 25 basis points on A shares. They're often higher on retirement shares, and you can see that from our piece here.

The second is what I will call spread loads. Those are -- actually, they're a commission, they're transaction-based payments that happen to be spread out over time. They're paid on B, and to some extent, C shares. Think of them as the spread loads. Those are the ones that are financed by the 12b-1 plan.

I might add that when Kathie McGrath talked about 1988 and all the problems, everything she talked about was B shares. It was all spread loads. She didn't say a word about the 25 basis-point ongoing service fees, and I think it's important to distinguish.

And then, the last is the classic advertising expense, the one that Vanguard pioneered through their 17(b)(3) order. But some other people have picked up it's a much smaller mark.

The other thing I would like to say about it -- and it does relate to the types of classes -- is that I think our vocabulary traps us in thinking about this, what this is paying for, as being just something that takes place at the point of sale -- or I will call it the "opening of the account." But we have to devise a system that includes compensation for the entire relationship, the entire period of relationship, between the personal adviser or broker-dealer, and the investor.

The up-front transaction opening of the account, initial purchase, is probably the least important time in that relationship. The most important, by far, is the end of the relationship, when -- or the back end of the relationship -- when the investor is taking money out of the fund, and seeking to do so without outliving their assets. That's when they need the most advice.

And we have to have a system that pays for that. And, by the way, it's the one period when there are no more transactions. So if all of our compensation is based on transactions occurring, it's not going to happen, then there is going to be no motivation to keep that.

Lastly, I heard someone refer in the first panel -- refer to the old argument, "Does it benefit existing shareholders to have more assets come into the fund?" You can debate both sides of that, but I don't think it's relevant here.

I could concede to you that it doesn't benefit existing shareholders to have assets come into the fund. And I could still argue that a service fee payment to that person's adviser, and every other person's adviser, paid on an internalized basis, is a good thing to have, and it couldn't matter less how many assets are coming into the fund, or not coming into the fund.

And finally, I just -- one other comment about the earlier panel. There were some negative comments about the role of directors in annually renewing the plan. And the underlying assumption there was that directors have two choices: continue the plan exactly as is; or terminate it completely. And that isn't what goes on in the renewal.

There are many other choices, including: modify the plan; cut off sales of B shares and let the other ones roll off while paying the outstanding fees. That's a perfectly reasonable way to do it.

I will just give you a couple examples of when modification has happened, even without cutting it off. The early B shares did not convert to A shares after a period of years. After several years of Merrill Lynch funds that had B shares, their directors observed -- the independent directors observed -- that they had been repaid for a lot of their up-front commissions, and said, "What next?"

And from that was born the practice that is now universal, of converting into A shares, so that only the 25 basis-point service fee would be paid by those investors after their early 1 percents.

A very small part of our A-share 12b-1 -- a couple of basis points -- goes to pay commissions on very large accounts. They start at one percent, and drop below that for million dollar-plus accounts. In conversations with our directors, as those crept up over the years, we made several modifications, and removed most, but not all, of the recipients of those fees from the A share classes.

We put them in -- our shares and others in quick-paying net transaction-based compensation. That was based on a conversation with directors, that was based on annual renewal. But it didn't involve the binary decision of keep it or cut it off. So I hope we will think a little more broadly and a little more nuanced about that.

Let me stop there, and just refer everybody to the piece of paper.

MR. PLAZE: Purchase a portfolio of, say, common stocks from a broker. I pay the broker a commission, the amount of which I am free, by law, to negotiate or accept their -- whichever broker I wish to.

When I buy a portfolio of mutual fund shares, the way 12b-1 operates, I actually pay a sales load to the issuer, and then pay assets to the issuer, which are then directed back to the broker at amounts established by the fund. I have three payment programs -- class A shares; class B shares; class C shares.

Why is this so different in the mutual fund industry than if you were buying common stocks? Which, I might add, you will need advice about in your dotage, also?

MR. HAAGA: You are referring to the -- just to the transaction-based payments, not ongoing fees. It's operational, the reason that the brokers don't collect the sales charges, we collect them, is because we are actually maintaining the records and keeping the books. We're the only people who can collect them, particularly if there are follow-up payments for which a sales charge will be collected. That's why 22-D existed.

Now, as -- over the years, it has happened that brokers have begun to maintain street name accounts that keep the accounts by name. They could start collecting the fees, the brokerage commissions. They haven't, but they could start collecting them.

MR. PLAZE: Martin, could you -- we all know that funds pay 12b-1's and ultimately fund shareholders pay 12b-1 fees, and they're disseminated through a distribution network. Can you explain how that works? I am particularly interested in how that affects net asset value, and then how the net distributions are made.

MR. BYRNE: I guess let me step back just a minute, and just set out what I will assume are the usual arrangements.

A fund usually enters into a distribution agreement with its principal underwriter, or fund distributor. Many times it's an affiliate of the management company. That company -- and that is the agreement and arrangement pursuant to which 12b-1's are paid. So they're paid from the fund to the principal underwriter. And then, typically, the principal underwriter will enter into arrangements with intermediaries who sell the funds.

So, with that, I will go into how it actually works. Each day, the fund accountants will accrue the appropriate 12b-1 fee for the particular class, based on the NAV at the end of the day, to strike the NAV. Therefore, on a daily basis, the fund's NAV assumes that daily payment, because it's an accrued liability.

Once a month -- well, let me step back. As an example, in a class A share, that would be 25 basis points accrued each day. And for a class B and C share, that would be 100 basis points accrued each day. Once a month, based on all those accruals, the fund will pay the fund distributor those amounts. And then, the fund, the principal underwriter, is responsible for paying the financial intermediaries.

Now, what they will end up paying the financial intermediaries depends on the class. And starting with my previous example, for a class A share, they will usually pass along 25 basis points to the intermediary.

In a class B share -- and we really didn't go into this -- there is usually an up-front payment to the broker. So, in a B share, the principal underwriter typically retains 75 basis points of the 100, and passes along a 25 basis-point trail to the selling broker-dealer, or other intermediary.

On a C share, because of the way a C share works, there is an up-front compensation to the broker of one percent for the first year of the -- since the initial purchase, the fund company, fund distributor, will retain the entire 100 basis points, because it up-fronted 1 percent to the financial intermediary. Thereafter, the payments will be one percent to the selling dealer.

MR. PLAZE: What kind of investors are each of these classes designed to meet the needs of?

MR. BYRNE: It depends what their preferences are, right?

MR. PLAZE: Right.

MR. BYRNE: As we heard from the previous panel, a lot of investors don't like to pay up-front loads, so -- because they don't know how long they're going to want to be in a fund. So, they will want to defer their payments of the service fees and distribution fees.

Now, from an economic standpoint, A shares are probably best, economically, for folks who are going to purchase over $100,000 in an equity fund, or $50,000 in a fixed income fund for intermediate to longer periods of time, because of the break points. A B share --

MR. PLAZE: Could you explain the break points, for a moment?

MR. BYRNE: Usually, there is a maximum front-end sales load, which could be, let's say, 5.25 percent. Based on if a person purchases certain levels, purchases in volume, they get a reduced sales load. So, often times, the first break point is either at $25,000 and $50,000.

And if a person, on a cumulative basis, purchases up to that amount, their initial sales charge is reduced. So it will reduce in increments all the way to zero, typically at one million dollars.

MR. PLAZE: So, a person eligible can actually be drawn to -- you have an economic interest in buying A shares. B shares people who want to avoid paying up front have their money go to work early. What role do C shares play?

MR. BYRNE: One more thing. B shares are not only for people that want to defer. B shares could be economically better for someone who is buying lower amounts. So, the person who only wants $25,000, and has a long horizon because of the way B shares convert to As, they would often be better buying a B share, long term, than the A share.

C shares, because of the compensation structure of one percent a year, are most economical for folks with relatively shorter -- short to intermediate -- time frames, and in amounts under one million.

MR. PLAZE: How do investors figure out which of these three classes is in their interest?

MR. BYRNE: Well, at a firm like ours they talk with their FA. We have tools to help them. The NASD has a tool to help investors considering their proposed holding period, their anticipated purchases, to try to come up with a class that is, price-wise, the most appropriate for them.

MR. PLAZE: How do you deal with the issue when the financial advisor, the broker, has a different incentive structure to sell class A shares, or class B shares, instead of class A shares with a break point. How do you deal with this issue?

This has been an issue -- a matter of a number of enforcement cases here, and at the NASD, over the years. And I know it's an issue troubling to brokers. It's a control issue with a brokerage firm.

MR. BYRNE: Yes. Well, at our firm, we have limits and rules around -- ultimately, hard limits -- on what investors can purchase. So, for example, on the B share, we will hard block any purchase by a client that is -- on an aggregated basis, not a single purchase, but aggregated -- no more than $100,000 in an equity fund, in a fund family, $50,000 in a fixed income fund, and we don't permit purchases in B shares for low-duration funds.

So, again, there is really no ability to purchase $90,000 and another $90,000, those would be aggregated, and it will be blocked.

MR. PLAZE: Next, I would like to turn to another aspect of our panel this morning, to discuss the role 12b-1 plans play in the business plans of different organizations that participate in the distribution of shares.

I would like to go around the table, because we have here representatives of different organizations that either pay, or receive, 12b-1 fees or provide various types

of services to investors that invest in mutual funds.

I would like to start off with representatives of load fund groups, perhaps start off with Mellody Hobson, from Ariel Capital Management.

MS. HOBSON: I would start off by saying that, with $7 billion under management, as you said already, we are still a very small fund company, and maybe you would think of us as David versus Goliath, because you're used to hearing from all the big guys. But we are really the majority of mutual fund companies that are out there. The majority of funds are under $5 billion in assets. That is the starting point that I think is very important.

Ninety percent of our assets, of Ariel Mutual Funds, come from third parties. And so that's another very important point to frame the discussion. We would argue we could not exist without the existence of the 12b-1 fee to grow the funds, ultimately.

We would also argue that we believe the entrepreneurial spirit that has led to such a competitive marketplace in the mutual fund business would be very significantly affected, should 12b-1 fees not create an opportunity for small, entrepreneurial mutual fund companies to exist.

There are four ways that 12b-1 fees are used within our firm. Specifically, we pay the financial advisors and consultants who sell our funds. They may be selling direct as independent organizations, or they may be selling through the large brokerage firms.

Secondly, we pay the supermarkets, the Schwabs and Fidelities of the world, that clearly offer the platform for the convenience of customers that like the combined statement.

Thirdly, we pay the 401(k) plan administrators. Now, this has become an increasingly important part of our business, as defined benefit plans have gone away, more and more.

And, specifically, it's the only reason, having that 12b-1 fee plan, that we can be in the plans at Wal-Mart and General Motors, alongside other gigantic mutual fund companies, like Fidelity and others. And we would argue that, really, the playing field is completely level when a small fund company, like Ariel, can be added at no cost to the plan or the participant, because 12b-1 exists, and can be passed on to help with the administrative costs.

Last, but not least, we use our 12b-1 fee to offset our internal marketing costs, and those generally come from our direct shareholders, which, I remind you, is only 10 percent of the shareholders that we have, in total. And so, that pays for our web site, it pays for the phone service that our shareholders get from any source that they may use,

to call and request information from Ariel. It pays for our marketing materials, it pays for our advertising.

The one thing that we have heard people say is that this is a profit center for mutual fund companies. Well, the math does not suggest a profit center for us. We spend in excess of our 12b-1 fee each and every year.

And to give you a sense of the magnitude of that spent, last year we spent $2.9 million in excess of our 12b-1 fees on ongoing marketing, and marketing-related opportunities in order to grow the funds, which ultimately, of course, decreases their expense ratio for our shareholders.

Lastly, I would just argue that once a fund is sold, we know, firsthand, that the work is not done, it is not over. And there is an ongoing relationship that has to be maintained. Either the financial consultant who is offering that ongoing advice; the supermarket that is providing that wonderful convenience and simplified statement; or firms like Ariel, ourselves, in dealing with the direct customer.

And then, last but not least, since we know that four out of five mutual fund customers seek advice when buying a fund, I did want to add one nuance to this discussion I think that is largely missing on conversations about mutual fund and investing, and it's a result of

actually pioneering research that Ariel has done with Charles Schwab and Company, where we have actually studied black investors for the last decade, when no one else has.

And the one thing we know about black investors is they're more likely than even the majority population to seek advice, because we tend to be novice investors. And so, that advice component, and to be paying for that advice, we would suggest, is money actually very well spent.

Last, but not least, in the context of my role as financial contributor on "ABC News," and weekly on-air person for "Good Morning, America," talking about the stock market and investing, I literally get hundreds of letters from investors on various topics. And I have said this before. I have never gotten a letter on a 12b-1 fee. But I have gotten a lot of letters saying, "There are so many choices out there. Help me understand, how do I decide?"

And, again, I would go back to the fact that that's why that advice component is so important.

MR. UEK: Without repeating a lot of the things that Mellody talked about, I think MFS, which is a little bit larger, in terms of its 40 Act fund business, is roughly $100 billion. And in terms of what happens with all of its 12b-1, MFS is a load shop, and depends almost exclusively in terms of its distribution capabilities and strategies on 12b-1.

And of the 12b-1 fees that it collects, something north of 95 percent of those are redistributed back through the intermediaries, whether they be brokerage houses, or independent financial consultants, or banks, or supermarket platforms, et cetera.

Much like Mellody's comments, the 12b-1, or distribution capability or departments, if you will, of MFS are not a profit-making organization, either. When you add all the expenditures that they have, in addition to what they pay out to intermediaries, they pay out a substantial amount more money than what they take in, in 12b-1s. So it's not a profit-making entity, nor is it even near a break-even entity. The distribution costs are higher than the aggregate 12b-1s collected annually.

MR. PLAZE: That's interesting. The authors of the 1940 Act were concerned about underwriters -- mutual fund underwriters -- being a profit center, inappropriate profit center. And yet, history has shown them to be a loss center, a loss in order to grow the assets of the fund, because the profits are from the advisory fees.

MR. UEK: Well, I think if you stand back and look at the last, say, 10 or 15 years, the cash flows have migrated much stronger to the distribution end of the business.

MR. PLAZE: Right.

MR. UEK: And away from the manufacturing. And I think that's what is driving it, is to get your product sold. And I think Mellody made some very effective comments on that.

To get your product sold is a very much more expensive proposition today. And whereas 12b-1 has been capped here for a number of years, and the cost of living doesn't get any less in general, and the distributors demand more, in terms of distributing the product, I think if we took a survey around most brand name load shops, we would find out that they were in a similar posture.

MR. PLAZE: Mellody, the large fund shops, like MFS and Cap Research, can pay the same 12b-1 fees to brokers to sell their funds that you can.

Does it -- at the end of the day, do you sense that it is a wash? That is, that Ariel Capital has to stand on the quality of its management services and its performance fees, because they're going to be able to match you, dollar for dollar, for a fee you're going to be able pay your broker. Or am I not getting something?

MS. HOBSON: Obviously, scale makes a difference in any business. And so, if you're big, you can get preferential treatment, because in the case of the brokerage firms, they're obviously going to respond to MFS's call, probably, before they respond to mine, just based upon the actual revenues that we're both sending them.

So, dollar for dollar, yes, we are paying the same amount. But in totality, the accumulated amounts are so much different, that it can make a difference. And, obviously, in the brokerage firms, scale also helps, in terms of brand name and name recognition, which ultimately leads to more sales.

So, your goal, if you're Ariel, is to try to do your best to get as many financial consultants in a wire house to know you, so that, ultimately, you have the opportunity to have them sell your fund, and allow you to grow.

But I wouldn't say, on a dollar for dollar basis, we are treated differently, with the exception of scale, if that makes any sense to you.

MR. PLAZE: Well, my point is that a broker is going to receive the same amount of compensation, both now and over time, from selling two fund groups. The differential won't be the amount of compensation, it will be, perhaps, the quality of the management services.

MS. HOBSON: The quality of the management services, and the quality of the job that we do, in keeping that broker abreast of who we are, and what we do.

And so, if you have $7 billion under management, and you have to market to Merrill Lynch, and they have thousands of financial consultants, it's going to be harder to do that for us, than it will be for a mutual fund company that has $200 billion under management that, literally, will just have more people on the ground.

MR. PLAZE: And let's hear from the man with real scale to talk about, Paul Haaga from Cap Research.

MR. HAAGA: Well, yes. I'm having trouble with what the question is, but you know, on just the follow-up you had with Mellody, we have had the same pricing and compensation structure for the last number of years.

In the late 1990s, we couldn't give our funds away, because everybody was buying tech stocks and tech funds, and Internet funds, and we didn't have those. And then things turned around for us after the market crashed. And, happily, they have stayed good.

So, I would suggest that the amount paid is relevant, but it's hardly determinative. And when brokers come to us and talk about why they use our funds with their clients -- and notice that vocab, right, they don't "sell" our funds, they "use" them with our clients, or advise their clients about investing in them throughout their lives -- the first thing they say is, "We have never had to apologize for you." And I think that's important to them, too.

So, we all think in terms of distribution channels, and products, and things like that. And we ought to think about relationships between the personal advisers, and brokers, and their clients, as they're trying to have a long-term relationship too, not just peddle stuff.

MR. PLAZE: Let's move on to the broker-dealers, the first large -- perhaps the largest distribution part of the business.

Marty, if you would, explain to me how 12b-1 fees are used and how they're integrated into the distribution network for brokers.

MR. BYRNE: Sure. Like many of our other broker-dealer competitors, we provide our customers with a lot of choice, what mutual funds are available to them. So we have approximately 125 or so fund families, and over 3,500 individual funds, and probably more than 14,000 share classes available to our clients.

And our financial advisors are compensated, based on the same formula for all the funds, so there are no significant, if any, incentives to pick one fund over another. So they're really competing on the quality of the management and service they're provided by the fund companies. Our financial advisors work with our clients to help them select the right -- the appropriate funds for them, and to monitor them over time.

To do that, it takes substantial infrastructure, information, materials, tools, and other resources to support the information flow regarding all of these different funds and different share classes.

So, the 12b-1s in our firm are used, in part, to compensate our financial advisors for their efforts with clients, and to support the infrastructure, to allow both FAs and clients to know and understand the funds. And I can give you a few examples of things that we have available to clients and FAs.

MR. PLAZE: Well, let me turn to a slightly different direction here, if I can. The principal way Merrill Lynch is compensated from the fund groups is either from the collection of the sales load, or the stream of the 12b-1 fees from the fund companies. That's the principal --

MR. BYRNE: That's the combination.

MR. PLAZE: Combination.

MR. BYRNE: Right.

MR. PLAZE: That's the principal combination. But there are other platforms available at Merrill Lynch in which mutual funds are sold at net asset value, am I correct?

MR. BYRNE: Yes.

MR. PLAZE: Without fees --

MR. BYRNE: Correct.

MR. PLAZE: So, in one case, there is -- the distribution system controlled by the mutual fund companies, and the structure of the sales load to the 12b-1 fee. But there are other platforms you have that sit side by side.

Could you explain some of those? Because I think they're interesting, because operationally, there is another kind of distribution that people may not be nearly as familiar with.

MR. BYRNE: Are you referring to the --

MR. PLAZE: The programs were all distribution I presume -- what kind of shares are sold to wrap fee programs?

MR. BYRNE: Yes. Typically, A shares load-waived --

MR. PLAZE: Load-waived --

MR. BYRNE: -- with the wrap programs, and that is consistent with the fund prospectuses that we would require a fund to sell in one of our wrap programs, a fee waiver for the shares sold in that program.

MR. PLAZE: And similarly, with the fee-based accounts, which, of course, are at issue now.

MR. BYRNE: Correct. Right. So they are sold through -- right. Our fee-based brokerage account has a mix of individual securities, as well as funds in some of the client accounts.

MR. PLAZE: They won't pay a sales load and they won't generally pay a 12b-1 fee, either, will they?

MR. BYRNE: Well, it depends. Whether they pay a 12b-1 fee depends on the share class made available by the fund's prospectus. So, if the prospectus makes A shares with the 12b-1 available through the program, then it will be A shares that will be sold. In certain cases, the fund families will make I shares, or pure no-load funds available, and those would be the ones.

We have a policy at Merrill Lynch always to choose for those programs the lowest expense share class that is available by the fund's prospectus for that program.

MR. PLAZE: So, in those platforms, in that context, the distribution expense is all pretty much paid at the account level, by the wrap fee, or whatever the fee is, the fee-based brokerage -- the principal.

MR. BYRNE: Well, the client doesn't --

MR. PLAZE: Right.

MR. BYRNE: The client does pay a portion of it, yes.

MR. PLAZE: Right. Now, you also sell ETFs, correct?

MR. BYRNE: Yes.

MR. PLAZE: And ETFs, they pay a brokerage commission. So the distribution component of an ETF transaction is paid at the brokerage account level, not by the fund.

MR. BYRNE: In a fee-based program, or --

MR. PLAZE: Any program.

MR. BYRNE: Well, in a fee-based program, they wouldn't be paying a commission.

MR. PLAZE: Right, right.
MR. BYRNE: They would be paying, you know, the fee-based --
MR. PLAZE: But even in a commission-based program --
MR. BYRNE: In a commission-based account, they would pay a commission on the purchase --
MR. PLAZE: Right.
MR. BYRNE: -- as well as the sale.
MR. PLAZE: Okay.
MR. BYRNE: Which is important, because in a mutual fund --
MR. PLAZE: Right.
MR. BYRNE: -- you know, if you buy an A share, you only pay on the purchase.
MR. PLAZE: Right.
MR. BYRNE: Not on the sale. So there is a difference.
MR. PLAZE: It's a --
MR. BYRNE: And something to note is -- which a lot of our clients, like particular fund families, if they do a one-time purchase into a fund family and pay an up-front load, they can, for 20 years, buy and sell funds within that fund, within that family, with no transaction fees at all.
So, if you were to do that with ETFS, economically you would be far, far behind where you would be with a mutual fund. It depends on the client, what they want, and what they choose to do.

MR. PLAZE: Okay. Let's move on to retirement plans. Charlie Nelson, representing a larger retirement plan company, explain the role of 12b-1 revenues in financing these plans.

MR. NELSON: Sure. Thank you. To really understand the context of how 12b-1 fees and other fees are receiving inside of a retirement plan, I am going to kind of set the context of the retirement market. Because it's not just kind of a uniform approach over all plan sizes.

I do have a chart, and it will be on the SEC web site -- but I think they will put the first one up here on the graphics -- that really shows the size segments of the 401(k) market that looks at, from microbe, all the way up to the mega-size.

About 96 percent of plan sponsors are represented in the small to micro side of the 401(k) market. Now, they represent only about a third of the participants. The products that are used in each one of these segments in the 401(k) market really do differ an awful lot by the size of the plan sponsor.

I think the next point that is important to put in context is the revenue that a record-keeper receives from a mutual fund, which really, I think to Paul's point, comes in two kinds of categories. We refer to it as shareholder service fees, and then 12b-1 fees.

Shareholder services and fees are for ongoing services provided for the retirement plan and the participants, and the record-keeping in the program. And that's about a 50/50 mix, for a retirement record-keeper, on average.

So, if you then take the next step, and say, all right, you look at advisers, brokers, advisers that distribute and provide services to participants and plan sponsors, they provide a wide range of services to plan sponsors and participants.

But about two-thirds -- almost two-thirds; 62 percent of them -- mainly receive their compensation through a commission, or 12b-1-type fees, one or the other type of a concept. These are not one-time sources of compensation, they're really an ongoing source of compensation. And it rewards and recognizes an adviser's time for any education, communication, enrollment services, a wide range of services they will provide, both to the participant, as well as at the plan level.

So, with this kind of framework around it, you kind of then start to go into the types of products that are offered in a 401(k) plan.

Probably at the small to micro end, we would talk about bundled programs, or bundled products. This is generally where you have one record-keeper that provides all the statements and the Internet site, and all the trading for participants and plan sponsors. And that provider would then, essentially, collect all the 12b-1s. And that, actually, in terms of their total revenue for a record-keeper, is generally around 15 percent of the total revenues that are required to run a retirement plan. So it's only 15 percent of the total.

But out of that total, the bundled record-keeper, or the provider, would then pay the broker-dealer, who would then pay an adviser compensation for their services, which are generally around, again, enrollment communication and education and participants providing investment guidance to the plan sponsor. Very important and valuable services, both to a plan sponsor, as well as a participant.

You then move up maybe to what you might think of as a mid-market, or a mid-size plan, they often utilize products that are called semi-bundled. In a semi-bundled product, again, you would have one record-keeper, but you would also have an adviser or a broker, and potentially a third-party administrator, who would be providing various types of services.

Again, the third-party administrator and the adviser-broker are really being contracted by the plan sponsor to provide services to their participants in the program.

Now, in those situations, most often a 12b-1 compensation is paid to the broker-dealer, and then paid directly to the adviser-broker, or third-party administrator. So the record-keeper in the retirement plan is not really a part of that transaction, it's more of a transaction between the plan sponsor, if you will, hiring the broker-adviser, and then the mutual fund company paying the corresponding compensation.

The last type of product is a little bit more rare in some ways, in that it's only used by the large plans. And not all large plans use this, because it's a very expensive way, and complex way, to provide services. And this is really in what we will call the unbundled world, the unbundled record-keeping situation.

And this is where a plan sponsor, a large or a mega-plan, would hire a record-keeper for their 401(k), or 457, 403(b) plan, whatever, and provide the services.

But then, the plan sponsor will go out and hire all the other vendors that are needed for services, maybe someone to create communication materials, someone to do enrollment meetings, someone to provide plan design and consulting services, all the different kind of vendors that are needed to support a retirement plan.

Now, with that, the plan sponsor will also direct the record-keeper, who will then collect all the 12b-1 fees and shareholder services fees, to pay the various vendors their fees for providing the services to the plan's participants. It's really kind of more the open concept, if you will.

MR. PLAZE: Charlie, why -- it strikes some as odd, and there is a reason for it, do the plan participants not pay the fees? Why is it cycled up through the fund and comes from fund payments, from out a 12b-1 fee, in sort of the bundled world, as you described it?

In an unbundled world, wouldn't the actual cost of the plan be more apparent to the participants?

MR. NELSON: Well, first, the plan sponsor is the entity -- or is the organization, if you will -- that dictates how the fees, and which products, are actually purchased.

Now, there tend to be some general themes, by market segment size, of the types of products that are purchased by plan sponsors. So plan sponsors are really the ones, in a lot of ways, that dictate, "All right, I'm going to purchase a bundled product, or an unbundled product, or a semi-bundled." And there are certain economic situations that might make them more attractive in different size segments.

MR. PLAZE: So, a plan sponsor would have an incentive to choose a fund group to manage its 401(k) that provided the funding for those services, rather than the one that simply, say, provided a lower level of expenses.

MR. NELSON: Well, plan sponsors have a fiduciary responsibility to look out after -- obviously, over the plan. I think we all are aware of that. And so, they have to look at the whole context of the program, the services, balance out the services, balance out all the revenues and the expenses that are required to run that plan, to provide those services.

So I think when you look at it in total, and in concept, they have the fiduciary responsibility, and I believe because the expenses are then disclosed, in 5500s back to the plan sponsor and ultimately made available to participants, if they choose, they are disclosed to a participant.

MR. PLAZE: But as a plan administrator, whether the fund pays or whether the account pays is not important to you, it's not significant to you.

MR. MORRIS: No.

MR. PLAZE: We have another very important segment of this issue, which is the fund supermarket, which Mellody and Paul alluded to earlier. We have a representative of Schwab, Mr. Morris. Good morning. Tell us a little bit about the supermarket, what it does, and how the supermarket is financed.

MR. MORRIS: Sure. Thanks, Bob. And, yes, 12b-1 fees are often used by funds to pay fees to fund supermarkets for the various services they provide, and I will provide some context about the various types of services that a supermarket, like Schwab, does provide.

Funds have long been at the core of Schwab's business. We started the first supermarket to focus on no-load funds, and that was over 20 years ago. And in 1992, we launched Mutual Fund OneSource, which was the first no-load and no transaction fee fund supermarket.

Today, clients can choose from over 4,000 mutual funds, from 450 different families, 4.2 million Schwab accounts hold funds with $445 billion in assets.

We believe strongly that few innovations have had as significant a benefit to investors as supermarkets. They have democratized mutual fund investing by increasing the choices available to investors, and provide the infrastructure for, literally, thousands of funds to become successful. And I emphasize some of the smaller funds that Mellody was mentioning earlier.

We help keep costs down. You know, when you look at the competition that was brought about by supermarkets, it's critical for a fund to keep their expenses as low as possible, especially in light of the fact that investors can easily compare the expenses and other aspects of funds in order to make better informed decisions.

Certainly, supermarkets have made investing simple. If you look back, I think many of us can recall back before supermarkets, if you wanted to buy a fund, that may be one thing if you're self-directed. If you wanted to buy a number of funds, that became a little more complicated. You would send your check in and maybe an application to a fund.

And then, of course, if you wanted to switch among funds, that's when things really got interesting. You would have to send in your redemption to the one fund, wait for the proceeds, take those proceeds, and then send it off to the next fund, and all this time being out of the market. So that was pretty time consuming and cumbersome and inconvenient. And, of course, with supermarkets, this painstaking process is a thing of the past.

So, in terms of the services that we provide to individuals and mutual funds companies, these are services that the funds would otherwise have to provide themselves. What we do is: we execute and settle fund transactions; we distribute dividends; prepare trade confirmations and account statements; we send fund prospectuses, annual reports and other communications; we maintain branches and call centers,

most of which are staffed 24 hours a day, 7 days a week, all to support the investor.

We also have a state-of-the-art web site that provides a broad array of resources, tools, and information that investors can use to easily compare funds, based on their own needs and priorities.

And then, finally, to the fund we offer a variety of record-keeping and other administrative services. It benefits from savings on transfer agent costs -- the fund does -- from the scale of omnibus cost savings.

For example, we aggregate all the trades that we get each day for a fund, and place that aggregate -- place it as a single purchase and single redemption, so the fund receives a single order, as opposed to thousands.

MR. PLAZE: I am interested in a couple of your statements. One, your interest in keeping fund expenses low, which I think everybody does, particularly directors. The Schwab plan charges 40 basis points for a fund to participate. Now, the average expense ratio of an equity fund in the United States is 81 basis points.

So, we're talking about a significant expense there. Who pays that fee?

MR. MORRIS: Well, various arrangements. I was going to get to --

MR. PLAZE: Oh, I am very sorry.

MR. MORRIS: I will do that now. In OneSource, the payment to Schwab is 40 basis points, typically. And they can -- the fund can use -- they can choose to use part of the 12b-1 to pay for part of that. They can use a shareholder servicing plan from the fund, or from the affiliates -- the legitimate profits of the affiliate.

I think if you look at it in terms of the fee, we're in a competitive marketplace. And I don't think anybody would pay us a dime if there weren't -- if there wasn't value received for those services that we're providing.

And I think that in terms of the scope, and the services, the quality of the innovation that we provide, we're market leading. You know, you just look at the call centers, the 24-hour access, the web site we provide to investors, the support to investors, what we provide to the fund companies, as well. For example, in 2003 we introduced something called the STAP, the Schwab Trade Activity Portal, which allows funds to look into the omnibus account, and see the trading activity on a real-time basis. Those are the types of benefits that we provide. I think the 40 basis points reflects that.

MR. PLAZE: When Schwab started, it was basically a transaction fee, so that investors paid when they used the services. And then you moved, I believe, in 1984, 1985, to

an asset-based model, so that transactions are essentially free.

MR. MORRIS: Well, what --

MR. PLAZE: Why did you make that move?

MR. MORRIS: Right. So, as I alluded to, we first started the no-load marketplace back in the mid-1980s --

MR. PLAZE: Right.

MR. MORRIS: -- and there, the clients enjoyed all the conveniences I mentioned. But they didn't pay a transaction fee, they paid a ticket charge, or a fee when they purchased and when they redeemed the fund.

And our chairman, Chuck Schwab, always implores us to listen carefully to clients. Clients were saying, "This is a convenient service, but this transaction fee is not so convenient." And we then looked at, okay, we're providing these services for the funds. Is there some way that we could remove the transaction fee that the client pays, and be compensated by the funds for the services that we provide?

And, of course, what that does is give the individual investor great choice. They can choose to select funds with transaction fees or without transaction fees. A lot of our smaller investors love no-loads and no transaction fees. It's kind of in their DNA.

So, that's been born out by -- just after we started OneSource, there were about a million positions in OneSource, and now there are over nine-and-a-half million positions. So I think that clients just -- a key is choice, they can have that choice. But as I said, many prefer no loads with no transaction fees.

MR. PLAZE: Ms. Hobson?

MS. HOBSON: Yes. I just wanted to add, I know you didn't ask me the question, but it's such an important source of assets for us -- we've got about $1 billion with Schwab -- I want to make the point that we've been able to demonstrate -- and we have to, at our board meetings -- that our mutual fund investors are not in any way disadvantaged by going through Schwab, versus going direct to Ariel.

So, even though it's 40 basis points that we're paying, the 25 basis point 12b-1 fee would be paid, regardless. So that's first and foremost.

Then, the 15 basis points that is the difference comes out of what we call the sub-TA fee. So basically, what we say is, if this account had been on our system at Ariel, all these thousands, hundreds of thousands of accounts that we have with Schwab, what would it have cost us to maintain them ourselves? What our trustees tell us is we can't pay any more than what we would pay ourselves.

And so, it runs us about 15 basis points to service our shareholders. So, at the end of the day, because Schwab is one omnibus account for us, our funds are actually advantaged by having that billion dollars in one account, as opposed to being spread out over hundreds of thousands of accounts, so it drives the expense ratio down for us, on an overall basis, and at the same time is a net flat effect to all shareholders of the fund.

MR. PLAZE: So you have a very large percentage, you're suggesting, of your shareholders who have come in through the Schwab plan.

But the 40 basis points applies, across the board, regardless of whether a particular shareholder's assets have come in through that plan, am I correct?

MS. HOBSON: That's actually the point I am trying to make. So just to run the fund, to send out a statement to a shareholder that comes to Ariel Capital, to send them a prospectus every year, and all the other things, to price the fund, all those things, there is about a 15 basis-point charge, if you were to look inside the expense ratio, that an Ariel mutual fund direct shareholder would pay.

Schwab does that for us in this scenario, so we just pay them to do it for us.

MR. PLAZE: Okay. Let's move on to shareholder servicing, which is something we have touched upon here, but let's deal with it perhaps more directly, and have some comments from some different panelists.

According to the ICI, 52 percent of 12b-1 payments are used to pay ongoing shareholder services. Yet they are paid pursuant to 12b-1 plans. Shareholder servicing expenses are not necessarily a distribution expense. One might think that they would not otherwise be paid through a 12b-1 plan.

The NASD has struggled over this in its rules. What is the distinction between shareholder services and distribution, and what do you make of the fact that this is paid pursuant to a 12b-1 plan? The 15 basis points subaccounting fee is not paid pursuant to a 12b-1 plan, of course.

MR. SELMAN: Okay. First of all, I would like to thank the Chairman and the Commissioners for inviting me to participate on this roundtable.

I did discuss with some of our broker-dealer members what this service fee is being used for, and I did hear from some of our broker-dealers, especially the smaller NASD members. And I have a brief list that I would like to go through, because I thought it was fairly instructive.

Some of our members said, for example, that the service fee -- and this is the part of the 12b-1 payments that doesn't have to do with the transaction itself, nor does it have to do with the record-keeping type activities that brokers do.

Those services would include: reassuring customers during declining markets, which was particularly important in the last few years; assisting customers in rebalancing their portfolios; reviewing customer holdings on a regular basis; reassessing customer needs and investment strategies; assisting customers with lost dividend checks and certificates; assisting inactive customers; answering tax questions, at least that the broker is able to answer; answering other questions from customers; and helping investors just generally understand their investments.

Moreover, if you look at some dealer agreements with mutual fund companies, you will see that, in some cases, mutual fund companies will require the dealers in the dealer agreements to make regular contact with customers, to ensure that the customers are getting the level of service that the mutual fund companies expect them to get.

Now, I will say, of course, the NASD regulates, we cap, both the asset-based fees -- which are really the distribution part of 12b-1 fees -- and the service fees. And I guess I'm here to confess that maintaining price controls is not a very easy thing for a regulator to do, and I wouldn't recommend that any regulator do it.

It is very difficult, as a practical matter, to decide whether somebody is incurring a fee for services, versus distribution. Let me give you just one example.

If you have a customer who is getting nervous about a particular mutual fund that the customer owns, and that customer goes to the broker and says, "I would just generally like to know some information about how redemption would work. What would happen if I redeem these shares?" And the broker says, "Well, I would like to go through why you would like to redeem them."

And after the conversation, the broker recommends that the customer redeem those shares, and purchase shares of another fund that might be more appropriate for the customer, and then executes that trade. What part of that activity is designated for what fee?

Arguably, when the customer first comes in and asks the broker, "How does redemption work?" That's a service fee. When the broker recommends a different fund, that's a fee for distribution. When the broker executes the trade, that's the part of the 12b-1 fee that goes to the broker's administration of the account.

So, you can see by the example that it's a bit silly to try to distinguish the different aspects of that transaction. I think, as Paul was making the point earlier, we are really talking about one relationship that is a continuous relationship, and it requires a lot of dialogue between the broker and the customer. And to try to categorize the fees and cap them has been a very challenging process.

MR. PLAZE: I would like to talk to you about C shares for a minute, while I've got you here, Tom. The NASD limits front-end loads to 8.5 percent, we know in the equivalents for 12b-1 fees. Then there are these C shares, which have been developed fairly recently, in which a fee is one percent charge, basically, forever.

Now, we know from mathematical certitude, that at some point that will exceed 8.5 percent of the amount of purchase. Why don't the caps operate to limit the ability of the C shares to go on forever?

MR. SELMAN: Well, we have two types of caps. The first cap is basically a one-percent cap on 12b-1 fees. The other cap is a cap that requires what we call a remaining amount calculation which, believe me, you don't want me to go into here.

But it is meant to look at net new sales by the fund, and take into account further fund activity, and it's an overall cap that is meant to bring the total 12b-1 fees in a B or C class into some economic equivalence with the front-end load in an A.

The C shares are subject to that cap. And B shares are also subject to that overall cap, as well as the specific one percent cap. But with both B and C shares, there may be points. For example, if somebody qualifies for a high break point, or a good break point on A shares, even with B shares it may exceed what they would have paid in a load with the A shares.

It's just -- I think the reason why that happens is, first of all, there is no shareholder level accounting. There is fund level accounting for the cap. And second -- again, I get back to my earlier theme -- when a regulator attempts to try to create economic equivalence between different types of fees, it's extremely difficult to do that in a way that creates economic equivalence for every shareholder.

MR. PLAZE: So, if I can understand -- and you tell me if I am incorrect -- the C shares go on forever, and in fact, an individual may pay much more than 8.5 percent. But the overall fund, the overall amount collected, would not exceed some economic equivalent, because of the fund level.

MR. SELMAN: Well, I mean, theoretically, the way that the overall cap works, it's designed to create the potential that the overall fee you pay in B or C shares would not exceed the total load that you would have paid in the A. But the fact is, it's possible, and that happens.

MR. PLAZE: Now, when 12b-1 fees, or any other fees, are used to support shareholder services, there is obviously a requirement that the board approve that use of assets as an appropriate use of assets.

How, as a practical matter -- and we have heard recently from the mutual fund directors forum about the difficulty of doing this -- do funds and fund directors make sure that the services they're getting, or their shareholders are getting, are worth the amount they're paying?

We have a letter, for instance, from -- we do read these e-mails that people send us -- Mr. Andrew Gross, who sent it on June 9, 2007. He said, "Although I'm charged this 12b-1 fee every single year, I receive absolutely no services whatsoever from the broker that sold me my funds. I shouldn't have to pay them forever. The broker made a one-time commission. That should be it. When I buy a sofa or car, I pay once, not a trailing commission every year to the salesman for the rest of my life."

Now, that's his issue, obviously, but it does illustrate an issue I would like you to address. And panelists, feel free -- Mr. Uek -- how do you oversee the services that brokers provide, and whether, in fact, the fund is getting its money for those services?

MR. SELMAN: Well, I mean, I will let others discuss it, but if you're asking whether the customer is getting 25 basis points worth of service --

MR. PLAZE: Right.

MR. SELMAN: -- the same question applies with any service. For example, an investment adviser charges a one-and-a-half percent fee. Some investment advisers may be providing a service that we would all agree is worth that, and others might not.

MR. PLAZE: But that's where the adviser is paying services to somebody, itself. This is where a third party is providing services to a shareholder. It's kind of an unusual arrangement, we have a third-party payment.

MR. SELMAN: But I guess my point is that shareholders do have a choice with these fees, as well. I mean, to answer your question, undoubtedly for some of us, we would say that if a particular broker isn't providing adequate service, then we would choose another broker, or maybe go no load. But if others want to try to answer --

MR. PLAZE: But, generally, when a shareholder is paying his assets, that's his responsibility. When the fund is paying its assets to provide services, generally it's the fund's or the fund board's responsibility.

And I think this was perhaps out in left field for you, Tom, at the NASD. Mr. Uek has his light on, so I presume --

MR. UEK: Well, I think first of all, in the first panel, Mr. Fink this morning suggested, I think, that 60 to 70 percent of the accounts in the load world are in omnibus accounts. And Mellody just talked a little bit about omnibus accounts.

My own speculation is that it's higher than 60 to 70 percent. I might say that it approaches 80 percent.

Omnibus accounts, I think as many of us know, are single accounts, as Mellody talked about. And what's behind those in, say, the broker world, or in the platform world, are literally, millions of accounts.

I believe there currently are around 100 million accounts in the United States, and the bulk of those are in omnibus accounts, of which very little is known about the omnibus accounts, because they are one transaction that happens to settle up net sales, net redemptions. And what happens with all those, and to what degree they're serviced, is within the broker-dealer community.

Now, as Tom had suggested, there are in many dealer agreements levels of service that are kind of maintained, and there are conversations.

But if your question is do the directors audit, if you will, the service level that goes on in 100 million accounts, the answer is no, they don't. And there are -- in the case of MFS, there is a marketing sales committee of the board, which meets at each meeting, which is 10 times a year. And conversations are had around this issue all the time. But we do not have any particular procedures.

And I would suggest that the large entities that are really controlling the business didn't get there because they are offering lousy service. The fellow that you alluded to, and the fellow that wrote you the letter, my guess is

whoever his broker is isn't going to be his broker very long, and he is going to migrate somewhere else.

So, if you have a habit of continuing that behavior, you're not going to be in the business very long as a major player. So I think it's in the self-interest -- and if you look at the number of millions of accounts that these distributing arms have, they are obviously doing the job right for many people. Maybe not all, there may be some at the margins, but we don't get a lot of feedback that's adverse back from us.

We hear certain things through our shareholder servicing arm. But most of those are way down the arm of the distribution network. So the answer is no, we don't get a lot of that --

CHAIRMAN COX: Bob, I thought that the example that you provided was a useful example, but it may be that we're discussing it through a significantly different pair of lenses here.

Because the suggestion has been made here that the fellow who wrote the SEC the letter should get a new broker, because the broker is not providing the level of service that he expects. But I didn't understand it that way. I thought that he was saying is he got exactly what he expected, but that that service, having been provided, should not be forever compensated.

MR. PLAZE: Right.

CHAIRMAN COX: Isn't that a different question?

MR. UEK: Okay, all right.

CHAIRMAN COX: So, what's the answer to that question?

MS. HOBSON: Well, one thing, I mean, I would just chime in here. The letter in isolation does not provide enough information, because we don't know if this gentleman calls direct to the mutual fund company to ask them questions about the portfolio --

CHAIRMAN COX: Right, but let's not make it any harder than it needs to be. Let's just take it at face value, and assume that this is an investor who bought a fund who wanted to be a long-term owner -- or at least who wanted to be an owner through the date that he wrote the letter, and that his complaint is as he states it. And what's the answer here?

MS. HOBSON: In that situation, I would say that he either needs a different broker, if he would like more service, or --

CHAIRMAN COX: But he's not asking for more service.

MS. HOBSON: Then he should have a fund with no 12b-1 fee. And they're out there. I mean, that's the great thing, there are lots of choices.

CHAIRMAN COX: And so, his beef with his broker is that he shouldn't have bought a fund with a 12b-1 fee in the first place, is that right?

MR. HAAGA: He is -- whether he wants to or not, he is a do-it-yourselfer. I would wager -- look the guy up, because apparently he's one of our shareholders.

(Laughter.)

MR. HAAGA: I would wager that he is not retired, because -- and, you know, he may be just in a happy halcyon five-year period, when he doesn't need any help. But if you look at his life span, I'm not so sure that he hasn't gotten any help. And maybe it wasn't worth this. But a do-it-yourselfer doesn't belong with us, and we don't offer our shares to do-it-yourselfers.

But can I answer Bob's question, because I disagree a little bit with Bob. You can't monitor services directly, but you can certainly monitor the quality of services indirectly. We don't have to sit with every broker, and see how often they're calling people.

There are a number of ways we monitor. For one, we have a transfer agent, that is a shareholder servicing agent, that maintains the shareholder accounts. They get 24,000 incoming calls a day to ask specific questions about shareholder accounts. No marketing, no distribution. This isn't where you call if you want sales material. 17,000 of those 24,000 calls come from brokers or brokers' assistants. So, somebody is giving ongoing services to somebody by that number. It's not where you call to buy shares, it's where you call to service an account.

Secondly, we have a group of 100 people now called our home office service team that actually goes out and meets with firms that use our shares with their clients, advisory clients, and actually oversees and talks to them about how they do their services.

They do it partly because sometimes -- they do it mainly with the subtransfer agents, or the street name accounts, to make sure they're actually getting valid service and accounting. But they also visit the people, the firms, and talk to them about what kinds of services they're providing through the 12b-1, and we check to see that the literature is getting mailed out and used with the clients.

And, third, we provide complaint letters -- more likely complaint e-mails -- to our directors on a regular basis. And the executives, I get a list of the e-mails -- or, actually, a copy of the e-mails -- that have been forwarded on to our web site once a week, and I just kind of flip through it quickly, and look to see what people are saying about the services they're getting from us, the services they're getting from their adviser, and we use that to monitor it.

And we're very pleased with the level of service, but we have occasionally had to cut off a dealer agreement with somebody, because they weren't providing the appropriate level of services for which they're being paid.

MR. UEK: I think Paul's comments are well taken, and they're from his perch in the management company complex or, as I think my comments were trying to be directed, from the position of the board of trustees of the fund complex. I don't think there is an inconsistency.

MR. PLAZE: Okay. We have 15 minutes left. I would like to use this time for the panelists -- we have seven; this is the largest panel of the day -- to each spend a couple of minutes summarizing -- this is their opportunity, as Doug gave the previous panelists -- their points of view on the subject matter at hand.

Please start, Marty, with you, and go right down the --

MR. BYRNE: Sure. In my view, Rule 12b-1 has provided substantial benefits to investors, in providing them with choices and simplicity, a choice that they can decide how they want to pay for fund shares and the distribution of shareholder services they receive either up-front, over time, or back-end. And simplicity, in that it's done -- all the expenses are bundled into a single vehicle.

Also, I think that the view that payments to broker-dealers and other intermediaries is not distribution or advertising is not necessarily appropriate.

I don't personally see much difference between using, you know, a 12b-1 to do newspaper, direct mail, television advertising, or going to a financial services company that, like ours, has 16,000 financial advisors who are marketing these funds, have information relating to the funds, are handing out marketing literature, prospectuses, to over two million shareholders.

Both are distribution, they're done in a slightly different way. But I think they're both beneficial to the funds and, ultimately, to investors.

MR. PLAZE: Tom, from your perch as a fellow regulator?

MR. SELMAN: Well, I guess if I might be so presumptuous, it seems to me that the basic question that's being asked is whether there should be a demutualization of these fees, whether the fee should be incurred by customers at the intermediary, the broker-dealer level, rather than at the fund level.

And I guess my question is, why does it have to be either/or? For example, the service fee, if we were to assume that the 25 basis-point cap on service fees doesn't work too well, we can pretty much guess that a zero cap would be even worse. What would happen is that services would probably go down, or the fees would simply go up elsewhere, or perhaps other products would be sold.

I think, instead of deciding either/or, the binary decision of either maintaining 12b-1 and restricting the ability of intermediaries to price their services, or moving everything out at the intermediaries, I think we should preserve 12b-1, but encourage new types of fee arrangements at the intermediary level. And I will give you two examples.

One is 22(d), the retail price maintenance provision in the 40 Act, which, for example, prohibits a broker-dealer from simply charging its own commission for the sale of a fund at NAV, like they would a stock. There is no reason, really, why that restriction still should be in place.

The other, of course, is the fee-based brokerage issue that we all have been grappling with. I think the more fee arrangements you allow a broker-dealer to develop with its customers, the more competition you have with 12b-1 fees.

And likewise, for example, C shares could compete with the broker-dealer's own fee arrangements, so you would have a competitive momentum to try to reduce expenses overall, and give customers more choice.

The only thing I would add is that, other than more choice, I think that customers need simplified disclosure. We continue to feel that way. Our Profile Plus, for example, would not have included the entire fee table, it would have just included the total return -- the total expense ratio.

When you buy a car, for example, you're not interested in how much of the purchase price goes to the marketing company that marketed the car, or the auto parts dealer that provided the parts, or the designer of the car. You're interested in the sticker price. And we still feel that that's the number -- of course, you need to preserve the fee table and the full prospectus, but it's that total operating expense ratio that investors really need to focus on, that needs to be put squarely in front of them.

MR. PLAZE: You might want the retailer's invoice number, also, to find out how much buying that car goes to -- anyway --

MR. SELMAN: Sure. Right.

MR. PLAZE: Charlie?

MR. NELSON: Thanks. You know, I think, clearly, 12b-1's are an important and critical part to the retirement market. Sterling Research does a study each year, and measures profitability of retirement providers. From 2003 to 2005, 48 percent of the companies surveyed would have been break-even or less.

Now, if you take away 12b-1's, that number goes to 64 percent of providers break even or less, record-keepers in the retirement market. Now, obviously, less competition is not good. We think that more competition is good for the market.

But then what's the next alternative? And I think in the retirement market, we probably have some other alternatives that are becoming more popular. If 12b-1s were changed, I believe what will happen is people will go to other unregulated, separately managed accounts. You can get to the same point, and still pay the important adviser along the way.

So, they will just go to other solutions and other types of investment media. Because investment advisers do provide a very important, very valuable, and critical service, in particular to that small to micro end, which is 96 percent of plan sponsors in the 401(k) market. So if that's the largest segment, we've got to make sure we continue to provide services, both to participants, as well as to plan sponsors.

And I think that they will have to get paid one way or another, it will either be through 12b-1s, or they will go through other sources, or other types of investment media, where they can get that type of compensation.

MR. UEK: As a director, I wanted to spend just a moment -- it's not this panel -- to underline a few comments made in the previous panel about the factors, the nine factors that were adopted in 1980.

I think those of you who have a chance to go look at those, I think you will find that all or substantially all of those, are badly outdated, and need to be reformed, either in a generic blueprint, or in a new list.

I think, from my director's view, I would suggest that some generic guidance there, that each fund group figure out the facts and circumstances that are relative to itself. I think that is very important.

Second of all, several people have discussed disclosure today. I would certainly be with that group that suggested that this industry could do a much better job, in terms of disclosing either where it is, or in different places, what is happening with 12b-1. Paul's comment that 12b-1 should be disbanded, it sounds like a couple of tax people talking about tax sections. You can't follow a conversation, the average person. I think we can do a lot better, in terms of plain English, and explaining what it is that's here, in a robust but simple way.

And then, finally, I would say there are really four words that enthused me here. One is "advice," one is "choice," one is "scale," and one is "mutualization." And the advice is the one that I think about the most these days. I think Mr. Donohue suggested, in his opening remarks, that half of America now owns these products.

I think most of us view that, and say, "What percentage of that half of America do we think is financially literate, in terms of either the experiences they have had, the education, the economic background, personal finance?" And I suspect we may all think that, "Gee, it's a pretty small part."

And so, the question is, since we have now entered the brave new world of moving retirement assets, among other assets, from defined benefit to defined contribution here, who will provide these people that are not financially experienced, the advice and counsel, so that they make the right decisions, in terms of the right mix of assets, so that when they get to be 60-something, then, in fact, there is enough money so that they can live in a retirement mode, somewhat similar to what their parents did under defined benefit.

Well, that worries me a lot. MFS has millions of shareholders, and I know all those millions of shareholders are not consistent with a deep, financial knowledge.

So, the 12b-1s, it seems to me, provide the opportunity not just at the outset to figure the suitability of the investments for those individuals, but also the mid-course corrections, in terms of their life experiences, and in terms of the change of markets, in terms of reallocating their assets amongst domestic and international and fixed, et cetera, et cetera.

And then, also, as they get later in life, people like me here, they worry about whether you are going to outlive your assets or not, in terms of -- again, what's the component, what's the draw-down, et cetera. It seems to me there are multiple points in your life that you need advice and counsel. And it seems to me that 12b-1 allows that to happen.

The other points I talked about, choice, I think we heard from the first panel, from Ms. McGrath for example, and that's consistent with my own kind of observations, is that people don't like front-end loads, and they don't like loads, and they like to have something kind of over time. And I think that's right, and I think that 12b-1 has offered them a choice.

And we haven't talked much today about the proliferation of share classes, but there are an awful lot of share classes out there, in many, many load groups.

Finally, scale -- my penultimate point -- scale, I think if we look around in the capitalist world, and we look at the trends of what has happened in modern times here, people realize scale is important in every industry, to drive down cost and deliver value. I think 12b-1 has allowed a lot of scale to happen in this business, as it's moved from -- I think Mr. Donohue said it was $50 billion when he came into the business, and it's now something on the order of $12 trillion.

There are a lot of reasons why that happened, but I think, personally, one of the components is 12b-1, which has allowed a lot of advice and counsel for people to get it.

And my final point is mutualization. We could dismantle all the expenditures in a fund, and put them all outside the fund, and my guess it that wouldn't be in the best interest of anybody, it would create confusion.

And so, my thought is pulling 12b-1 out isn't any more valid than pulling custody out, or shareholder accounting, or anything else. I think the mutualization of 12b-1 is important, and I think it's served this industry well. This industry still can put product on the street in a less expensive expense ratio than virtually any other segment of the financial services.

And so, it's okay with me, the way it is. Concentrate on disclosure, and concentrate on the advice. Kind of that's where I am.

MR. PLAZE: Thank you. Mr. Morris?

MR. MORRIS: Yes. We feel that 12b-1 fees need a slight upgrade, not a major overhaul. We do, as well, support removing the jargon 12b-1 fees, and providing a more descriptive, plain-English way of describing these fees, so that investors are really better able to understand their purpose.

We also support the ICI recommendation, to include a glossary of terms used in the prospectus, really clearly defining these fees.

With respect to any proposed change in Rule 12b-1, we should be very, very thoughtful about the potential for creating unintended, adverse consequences for individual investors. We believe that the benefits of supermarkets to investors are so important, that the SEC's overarching goal in examining 12b-1 should be preserving this remarkably democratizing way of ensuring that investors have access to thousands of different funds.

MR. PLAZE: Thank you. Ms. Hobson?

MS. HOBSON: I have three points to make in my summary.

First, we believe that 12b-1 fees really give smaller mutual fund companies a fighting chance against the big guys, and that's not a small task for us on a daily basis. It allows us to sit side-by-side on the shelf of supermarkets, brokerage firms, or 401(k) plans against bigger mutual fund companies.

It also allows us to offset -- and I want to put the emphasis there -- the cost of marketing the funds. But it is not a profit center, as I said before.

Second, we would argue that, in our case, 25 basis points is a low price for the ongoing advice and service that our 1.6 million shareholders get. And when you really put that 25 basis points in context, a $1,000 account is paying $2.50 a year for a lot of support, from our perspective. That's everything from the web site to the phone access, to many of the other things that we provide, regardless of where the fund was sold, regardless of if the broker was a good broker or not. That support still exists, and is there.

Last, but not least, we would argue that the issue -- and I would argue -- the issue of disclosure is something that is extraordinarily important. It clearly has been highlighted here. But I do think that there is the risk of peeling the onion a little too far, when it comes to this issue.

And it gets confusing for everyday people who, at the end of the day -- and I think one of my colleagues already said this on the panel -- should be, and are, most concerned with the bottom line of what they're paying.

Service and distribution is a cost of anything that you buy in this country. And we know that from higher energy prices, those costs have been passed on, in terms of higher prices, right now, in terms of lots of products.

But the mutual fund industry is really one of the only industries that breaks this cost out, so that people can see it in real time, which I think is terrific, but I also think can be confusing.

So, at the end of the day, is there a better way to do this, that still allows us to have all of this, all of these benefits? Perhaps there is. But I would also -- and is there potentially a better name for this, that provides more clarity? Maybe that's the way to go. But at the end of the day, we think the actual essence of what this rule provides for the millions of shareholders who are out there of all mutual fund companies is unarguable.

MR. PLAZE: Mr. Haaga, you get the last word. But the price of that is it's got to be a short one.

MR. HAAGA: Okay, thank you. I sure will. Let me thank, again, the Commissioners for having us and me.

I have heard this, once again, mutual funds compared to products. I think I heard automobile, refrigerator, sofa so far today. They're not products; they're services. They are ongoing relationships, they're not something that gets sold and walked away from. And the more we try to deal with these issues by analogizing consumer products, the harder time we're all going to have.

There is a lot of complexity here. I apologize, in some ways, for this. But, you know, choice is the enemy of complexity. So, unless you're complex, you don't have many choices. And we try to balance it out, and have the right amount of choice, with a reasonable amount of complexity, and that's what got us to this number of classes.

I am just going to focus on one part of this. And you notice I haven't said those words I said I wouldn't say. And that's the service fees, the 25 basis points on the A shares, 80 percent of our assets are in A shares, 80 percent of our expenditures, pursuant to the rule are on service fees on A shares.

Our average account size is $25,000, and 60 percent of our accounts are under $10,000. So that's the person I am thinking about when I talk about making these distinctions.

I think Tom Selman had it right. This is not a question about whether -- I don't think it's a question about whether brokers, advisers, provide services to shareholders. And I don't even think it's a question of how they ought to be paid. I think most people agree that payment over time is better than payment only for transactions.

And I think most people would be willing to concede that some services are being provided to shareholders. The question we're dealing with today is just should those be externalized or mutualized. And let me give you the case for mutualization.

We're buying in bulk, in effect. We set the fee at 25 basis points that will be paid to the advisers. We don't get any of it. And, moreover, it gets deducted from our reported investment results. So we have an incentive to set it as low as we can, to still get the job done.

There is also a tax advantage, that some people have mentioned. There is also a simplicity to it, and I don't want to overlook that, that our being the paymaster is a lot easier than asking each adviser to go out -- remember, on a $25,000 account, that's $62, I think it is, a year -- it's a lot easier for us to pay it, and us to credit to the firms, than it is for the advisers themselves to go out and collect it. So it's going to be lower, just because we have borne the administrative burden.

I think there are a lot of things to like about the mutualization of these fees, just like there is to like about the mutualization of transfer agent fees, advisory fees, and others.

And, finally, I am terribly sorry about the guy who wrote the letter, but let's not solve this problem anecdotally. We will fix him, but let's not unfix things for another -- for 50 percent of American families, just so we can deal with the poor guy who never calls his broker. I bet he doesn't go to the dentist, either.

(Laughter.)

MR. HAAGA: So, I will leave it at that. Thank you.

MR. PLAZE: Thank you very much. This concludes our second panel. There will be a break, now, for lunch.

I would like to thank the panelists very much for their participation. I thought it was a good panel. We will resume again at 2:00 this afternoon for a panel entitled, "The Costs and Benefits of Rule 12b-1 Plans." I know that's my favorite part of every SEC release. So I'm sure you will be back to listen to it.

(Whereupon, at 12:30 p.m., a luncheon recess was taken.)

A F T E R N O O N   S E S S I O N

PANEL THREE -- THE COSTS AND BENEFITS OF 12B-1 PLANS

MR. SIRRI: All right. Why don't we get started? Welcome back from our lunch break. This panel will be about the costs and benefits of Rule 12b-1 plans. My name is Erik Sirri, I am the Division Director from the Division of Market Regulation.

We're pleased to have a distinguished panel with us to discuss this topic. Let me introduce them. Starting from your right, on the far right of the table, is Brad Barber, who is a professor of finance at UC Davis.

Next to him is John Hill, who is the independent chairman of the Putnam Funds.

Next to him is Jeff Keil. Jeff is the principal in his own firm, Keil Fiduciary Strategies.

Next to him is Joseph Russo, who is the chairman and chief executive officer of Advantage Financial Group.

Next to him is Michael Sharp, who is the general counsel of Citi Global Wealth Management.

And on the far end of the table is Shannon Zimmerman, who is an investment analyst at the Motley Fool.

So, let me thank you all for joining us here today to talk about this topic. We will follow, broadly, the same scheme we had last time. We will go through the panel, we will leave about, oh, I would say about 10 to 15 minutes at the end for closing statements of 2 to 3 minutes each. We will go down the line for that. I will try to get you in for comments. Just signal to me, raise your hand, do something like that. I will try and call on you, to keep a reasonable amount of order here, if we can.

So, why don't we start? I think what's a little different about our panel is that we're going to cover a few things that haven't been talked about yet. Obviously, as the title suggests, it's going to be about economics, in some sense. We're going to talk about the cost and benefits of 12b-1 plans.

And, in particular, I think we're going to pay some attention to the individual investor, what their role is, and what the information set is that they have, and how they think about the various kinds of fee charges they face.

So, let me start us off. And let me start, Michael, with you, if I could. 12b-1 plans, why are they so popular with the fund industry? Is the story really that this is just a cost-effective way of paying for distribution and shareholder services? Or, in fact, is this a method to obfuscate charges and costs of funds?

MR. SHARP: I think it's clearly the former, and I think it's important that you pointed out that we will focus on investors. Because I think, with this dialogue, we need to think about what's right for investors, and what's in investors' interests. And I think 12b-1 fees are in investors' interests.

In fact, at the earlier session, when we heard the letter from the disgruntled client, I was sitting down and fidgeting, and I wanted to raise my hand and say, "I know the answer, teacher."

There are many, many services that are given to clients. And they're given to clients in a way that is sort of in an integrated way that neither the funds nor the individual investors could pay for more efficiently or more cheaply on their own.

And it's not just -- it's hard to define exactly what the services are. I could give you a list of -- I had one of my guys put a list together of things that we do for clients, and the list is over 70 items long. It's the web sites we provide, it's the asset allocation information. It's the information that goes into statements educating them about mutual funds. It's the incremental advice that is given on any given time about mutual funds. It's introducing them to the whole panoply of the share classes that are out there. It's introducing them to the differences between the share classes.

There are many, many things that happen, not only at the time of sale, but throughout the entire duration of the investment, and into the next investment. And I think that having the 12b-1 fees out there puts the client and the FA on the same side of the table, because it gives the FA the ability to have an ongoing interest in the client. And likewise, the client has the FA looking out for his or her interests. And I think that's a crucial thing, and I think it has worked.

I think, when you look at 12b-1, and you look at the way the industry has grown over the past 27 years since 12b-1 has been out there, I think it's a clear success. I think the SEC has done a great job in the way it formed this in the beginning, and the way it continues to look at it even now. And I commend the Commission for looking at it, even now. It's a strong rule, but it needs to be looked at.

MR. SIRRI: So, just so folks have some sense of who receives 12b-1 fees, could you describe, in just two sentences, what your business looks like?

MR. SHARP: Say that again, I'm sorry.

MR. SIRRI: You receive 12b-1 payments. What does your business look like? What does your brokerage business look like?

MR. SHARP: Yes. The overall business, we have a large business. We have about 13,000 FAs out there, and probably slightly more than half of our business is fee-based, usually advisory, but some non-advisory fees. And the rest is transactionally based.

And on the mutual fund side of the business, it is a combination of front loads and 12b-1 fees that are used to compensate the FAs. And depending on how much production you have as an FA, you will have somewhere between -- you will get 25 to roughly 42 percent of those fees, as they come in.

MR. SIRRI: Thanks. Joe, you run a slightly different business model. I wonder if you could talk about your view of 12b-1 fees, and if you would preface that by talking about what your business looks like.

MR. RUSSO: Sure. My business is much smaller than Michael's, and it's, frankly, tough to add to what Michael has said, in terms of the value of 12b-1, or that section which allows ongoing service, ongoing relationships. My business is an OSJ, an office of supervisory jurisdiction. I have 28 branches, 81 partners, a couple of billion dollars that we manage.

And the long and the short of it is we have 33,000 clients that we have been building relationships with for 35 years. And those relationships, over the last 20 years, to a great degree, have been paid for, financed, by the very effective, tax-efficient, 12b-1 fee.

And that is a mutual trust relationship that is built between middle America, the small and moderate-sized investor, and the financial community. That mutual trust relationship lasts until you die, in most cases.

I'm a big advocate for this. I believe that we're doing right to look at it again. And somebody did very right

20 years ago, when they established this in the first place, because it works. There was $50 billion in mutual funds, and now there is $7 trillion in mutual funds.

And, largely, that's because you have financial advisors looking for the best interests in clients, who need that ongoing service, ongoing education, tax advice, the support that comes as part and parcel of what the independent adviser does.

MR. SIRRI: Shannon, I think of you as having a sort of investor advocacy lean. Would you agree with what you just heard?

MR. ZIMMERMAN: No. With all due respect to all of my panelists, I think I will have a slightly different take on the issue of 12b-1 fees.

And just to pick up on one of the themes of our panel, and a comment that Paul was making earlier, too, you know, there is a lot of conversation in the industry about customers and products, and not nearly so much as there should be, I think, about investors and investment vehicles.

And, on some level, you can kind of understand why that's the case, right? There is a host of services that are, indeed, provided. People enjoy receiving consolidated, quarterly statements. They also like state-of-the-art web sites, it makes it easy for them to check out their personal returns.

To my way of thinking, those are ancillary to the investment vehicle that is the mutual fund. And the problem that 12b-1 invites is that it conflates those charges, it puts the charges for the services in the context of the investment vehicle, and the investment vehicle becomes worse, the higher the expense ratios become.

At the end of the day, what people are investing in are the returns those investment vehicles can deliver for them, and they are necessarily worse than they would be, as a result of higher expense ratios.

Just to speak to the latter point, there is a -- conflict of interest may not be the right word, but there is a tension between the fact that 12b-1 fees are used for marketing and distribution to pump up fund assets, and the performance of those mutual funds for the individual investors. It isn't the case that the larger the asset base, the better the fund. In fact, it's the opposite.

One of two things tends to happen, right? If it's a large cap fund, it morphs over time -- as it receives more and more assets to put behind fewer and fewer compelling investment ideas, it morphs over time into an index hugger, right? An over-priced index hugger.

And then, if it's a small cap fund, there is frictional costs, because the more assets the small cap manager has to put to work, it becomes more and more difficult for that manager to move in and out of the kinds of investments they like, without moving prices in the wrong direction.

So, setting aside the question of whether or not 12b-1 fees pay for services that investors need and want -- I believe that they do -- my view is that those services should not be paid for in the context of the investment vehicle itself.

MR. SIRRI: Brad?

MR. BARBER: Well, I guess I'm going to sort of -- I'm the lone academic today; what happened to all of my profession?

Let me just say that I will sort of bring a somewhat different perspective to this, based upon the research that me and many of my colleagues in the academic profession have been taking on.

And I think one of the things that has been lost so far is that, in surveys, 80 percent of investors do not know what they're paying, and what their expense ratio is for the largest mutual fund they hold. That's from a study by Alexander Jones in 2001.

And in addition, I think there has been a secular shift in the industry away from front-end loads towards sort of 12b-1-type fees, or the multiple class of shares.

In 1962, 91 percent of fund assets were in load funds. In 1999, 35 percent of equity fund assets were in funds that charged front-end loads. So, clearly, there has been a secular shift away. And I think what you hear from the industry -- and the message I hear over and over again -- is that investors do not like front-end loads.

There is a simple psychological reason for that. It's an in-your-face fee. When you pay a load fee, it comes immediately out and off the top. Whereas, if you pay a spread fee over time, it's less obvious and less salient.

The question is whether most investors who are not financially literate can do the calculus to make choices that are optimal for them. And I think there is evidence that that is a very difficult thing to do.

To be clear, I think the advisory services to be provided by the profession are extremely important and valuable to what is largely a financially illiterate populous, unfortunately. However, I think that should be transparent and communicated effectively.

And let me repeat that, because I think it's the most important message that I have today is that I would like to see transparent and effective communications of what the fees for those services are, and I simply don't think that the 12b-1 fees are, the label alone is obscure, "12b-1."

I'm not suggesting the fees are not justified; they very well may be justified. But I think that it should be communicated that these are fees for ongoing service to be provided to clients, and the web sites, et cetera. Many investors would choose to pay for those services. But I think it's important that it's transparent that they do so.

MR. HILL: Yes, I guess I share some of my colleague's on my left, here, point of view on this topic. I was listening to the panel this morning, and some of the comments earlier.

I think I may be looking at a different 12b-1 than a lot of people look at. It sounded earlier like it was the best thing since sliced bread, and it makes me wonder why we have, on our board, all these issues with it, why this commission is even holding this hearing, if it's that good.

I think it's disingenuous to say these are some important services, ergo we need 12b-1. There is no question that investors need services. And a variety of investors need different services for different abilities. And it has to be paid for. But to sort of move from that position to, ergo, let's don't touch 12b-1, as I said, I think that's disingenuous.

I think if it is that good, we ought to be telling investors about it every chance we get, when they purchase a share, what the 12b-1 charge was. It ought to come out of their account, it ought to be on their annual statements. If it really is that good, they ought to know about it, and it ought to be spelled out.

Secondly, I think it's the only way they will know they're paying for services which they may not be getting. So I think it really begs the question to go from services to this type of thing. There has got to be a much more economically fair way.

MR. SIRRI: And, to be clear, could you describe Putnam's use of 12b-1s?

MR. HILL: Our 12b-1 fees are much like the rest of the industry. I think it's clear to us, at least, that if Putnam didn't have a program, a lot of brokers wouldn't sell our funds. The answer is always the same, it's got to be an industry solution. I'm getting less of that today, because B shares are on the decline. We're seeing less and less of them. But we use them, but it's actually turned out to be quite a small percentage in recent years.

MR. SIRRI: Mike?

MR. SHARP: No, I think that -- just going to respond to the B share point. I think B shares are, indeed, on the decline.

But I think that when we're talking about 12b-1 fees, there are two sides to 12b-1 fees. There are the fees that are kept to finance B shares, and there is the 25 basis points that goes to the distribution point for the servicing and advice, and I think those are two different things we need to distinguish.

MR. KEIL: I think, certainly to echo my fellow panelists' points about there are certain benefits to 12b-1 plan expenditures, whether it be plan administration, supermarket payments, or what have you, there are obviously pricing options. So there is no question there.

I would like to address Mr. Zimmerman's point about the expense load and the reduced performance. I think that what's minimized in that discussion is that the -- if -- the investor, left to their own devices, what performance would they have realized, versus what they get with advice from a financial advisor? And, obviously, was that service fee covered by the excess -- if you want to call it that -- performance? Presumably, excess performance. So I think it's not as simplistic as you may have us believe.

MR. SIRRI: If I listen to what you said, it seems like you've divided the world -- there are two pieces to this. There are the services the broker provides, and then there is a question of how you pay for those services.

What is your -- thinking about the investor side of things, is there any sense that brokers aren't providing the right basket of services today, because of the way we price those services? Shannon?

MR. ZIMMERMAN: If I can say a word on my own behalf, I certainly don't mean to suggest a simplistic rationale for the line of argument I was making before, and I really do want to emphasize that I am not saying that the services that are provided for and that are paid for by 12b-1 fees are not worthwhile services. Clearly, they are.

And if you're working with someone who is knowledgeable, and has your best interests at heart, it stands to reason that, over time, you would have greater returns than you would if you were just sort of winging it and throwing darts. I don't mean to suggest that at all.

My question has to do with whether or not the 12b-1 is the most appropriate way to pay for those services. I don't feel that it is. And just if I could, just to speak to Brad's issue about transparency, I am a big fan of greater transparency and disclosure.

My concern, though, is that that isn't sufficient. You can know if your fund is paying a 12b-1 fee, and you can

know what your fund's expense ratio is. Are you motivated by that? I don't know.

There was a study last year, put together by some professors at Wharton and Harvard and Yale that -- it was with Harvard and Wharton students, presumably a smart group of kids, and they were offered a choice of S&P 500 index funds.

And as a group, they failed to choose the least expensive of those identical options, and based their decisions on things like performance since inception, which, of course, has no bearing on the fund's forward-looking performance. That's going to be determined by exactly two things: the performance of the S&P; and the cost that they are paying to invest in those funds.

So, greater transparency is a wonderful thing. I am concerned that it's not sufficient. I think the industry has to take the lead in helping folks to understand the impact of the fees that they pay, over the life of their investment.

MR. SIRRI: Joe?

MR. RUSSO: I surely agree with that. And might I say that mutual fund companies communicate with my clients all the time. They send all kinds of information. But they never speak to my clients, they never dialogue with my clients. That ongoing education that the client needs, in order to understand the relevance of a 12b-1 fee, or a management fee, or an administrative fee, or an operational fee -- you know, I'm all for transparency, I think we should have as much of it as possible, as much education as possible, so that there is a clear, concise understanding. That's a powerful incentive for the client to maintain a relationship with that mutual fund and that adviser.

So, transparency is great, but it takes ongoing education in order to get the job actually done.

MR. SIRRI: Brad?

MR. BARBER: Yes, I just wanted to follow up. First of all, the study that Shannon was referring to was a study by Jim Wilcox in the "Journal of Business" in 2003. It was an experimental study of 50 subjects, and 46 of the 50 failed to make a choice that was optimal for them, giving their holding period, which again suggests that folks need advice on making and navigating these choices.

Even MBA students seem to need the advice after they graduate from MBA school, unfortunately.

The other point I wanted to make is I completely agree that it is not just disclosure, it's two parts: transparency and effective communication. I think that latter part is often lost, because putting another disclosure on page 12 of the prospectus is not going to do any good in this arena. These costs need to be effectively communicated

to investors in a way that is simple to understand.

And I guess from my -- some would call it -- ivory tower of academe, what I would like to see is sort of a simple disclosure to investors, "This is the total amount you paid to fund managers last year, and of that amount, this amount went to sales and distribution, this amount went to advertising, this amount went to investment research, et cetera."

There are allocation issues with that, which were raised before. But, for gosh sakes, corporations have accounting allocation issues every day and every year, in how they have to allocate their expenses among different items. So I don't think that's a necessarily overly onerous burden there.

But at the end of the day, I would just like to see effective communication, along with the transparency.

MR. SIRRI: John?

MR. HILL: Yes, I think the issue of transparency is a key one, and disclosure. The problem is, so much disclosure gets made in the prospectus documents, and so some people feel the more disclosure you have, the less you have.

To me, the best disclosure of any fee that an investor pays is what is charged to his or her account that year for that service that was performed. And you don't have to write any verbiage, you just have to say, "You paid a B-share fee of X coming out of your account," and it's quite clear. Doesn't take any words.

MR. SIRRI: So, given the way fee disclosure is, from the prospectus you've got two or three numbers, three or four numbers, that add together to a final fee.

Do folks here believe that if, instead of taking that 100 basis points, 25 basis points, whatever it was, for distribution -- and instead, I think what you're saying, is I translate that to dollars, and put it -- not necessarily charting it, in terms of disclosure -- put dollar disclosure on the account statement, you think we would get a different outcome for people's purchase decisions? Mike says no.

MR. SHARP: I don't think you will. I think what we were thinking, what we're talking about here, presumes that this is an inefficient market, that it's not a competitive market, and that people don't want to pay what they're paying.

And I think if you put that dollar figure on somebody's confirmation, you put it on their monthly statement, you put it on their annual statements, you will see little to no change in behavior.

MR. SIRRI: Is that a difficult thing to do today? Since you're in the business, is that a difficult thing to do, to get -- not to charge there, to get a dollar disclosure there, on an account statement? Is that hard?

MR. SHARP: It is not hard to do, if you do it in the aggregate. To get to Brad's point about saying how much is research versus servicing versus advertising, that would not be easy to do, for all the reasons you can imagine. My business guys are probably cringing right now. It's probably a doable thing, it will probably cost money to do, but it is a doable thing.

MR. SIRRI: But would you say this is one of the costs of increasing transparency of 12b-1, then?

MR. SHARP: Yes, I think I would certainly advocate this is -- and if you looked at our confirmations right now, on other parts, we have a two or three-page mutual fund confirmation right now, for all of the different fees that are charged for clients.

Now, we could tack on the next line, which would be 12b-1 fees on your account base equals X dollars.

MR. BARBER: Let me say, Michael, that I view myself as an economist, and I clearly see that there are costs to these disclosures. And the question is -- which I have no clue about -- is how large those costs are.

And, clearly, that requires a lot of investigation, to see whether mandating these disclosures, or encouraging them, is sensible or not.

MR. KEIL: Yes, it begs the question, would it change the outcomes if they had this information.

MR. HILL: I think that's almost impossible to answer that question. That's kind of a metaphysical question.

I think what it would do, though, is give trustees a great deal more comfort when they approve these plans, if there was clear information there on the investors' confirmation statement. And that would just -- it would be nice to have that comfort, something simple they could look at.

MR. KEIL: My sense is that investors, who tend not to be very cost-sensitive, probably wouldn't change the decision. I think that they are more focused on service. Several studies have born that out, that they're willing to pay for service, they like service, it helps their decision, it gives them comfort. Investors certainly like comfort. And it's not likely to change.

MR. SIRRI: We note that there have been a lot of proposals about how to package pricing for funds. One of the more recent ones is actually to go the other direction. We're talking about deconstruction. It's actually aggregated up into a unified fee, to have just one price that includes everything.

When you listen to the language about it, some of the commentators have said it will be easier to understand, and folks don't necessarily -- investors don't necessarily need to understand what is in all of that -- call it 150 basis points, whatever it is -- then there will just be one price, and that includes everything. Is that a sensible way to go, here?

MR. SHARP: It depends. It depends on the client's choice. I say that not in jest. I mean, clients have spoken. We, right now, sell probably between 45 and just under 50 percent A shares. We sell the rest either in mainly C's or primary shares, and a very small amount of B shares.

But we also have clients who want to go into a fee-based brokerage account. We have clients who want to go into wrap accounts. I think that the important thing is to keep investors in mind, and what it is they want from the account. And clients have spoken.

Clients have the options right now. They see A's, they see B's, they see C's, they understand. We inundate them with information about what all this stuff is. And, quite honestly, it is a lot of information to get, which is why they need the advice.

But I think clients have spoken, and I think that, if you went to one pricing, some clients would use it, and some clients would not.

MR. ZIMMERMAN: The study that Brad and I both referred to, the title of the study is, "Why the Law of One Price Fails." It's because people don't have a strong enough grasp on the issue of expenses, in terms of the impact of those expenses, over the life of an investment.

And to the extent that additional fees that are now currently broken out are baked into a single fee, I think that probably paves the way for additional confusion around what folks are paying for, and whether or not they are choosing to pay for those services that they may or may not be receiving.

So it goes to the point that was made earlier. In addition to greater disclosure -- if disclosure is not going to be sufficient, because people -- there is plenty of disclosure now, there can always be more, and there should be -- but ongoing, effective communication about what the expenses entail, that would be a necessity, as well.

MR. RUSSO: And could I just add to that, since we're talking about the disclosure, and educating the public so that they understand the real nature of these fees.

We should add, supposedly, no-load mutual funds into these, to the conversations, because, as we all know, no-loads are full of loads, and they have administrative expenses, and operation expenses, and management expenses, and they may not have a 12b-1 fee -- or they may -- but they're full of loads.

And so, I think we're all in agreement here, in one fashion or another, that we want to educate the public in such a fashion that they fully understand, and can make a valid decision, based upon that information.

My sense is that an all-in-one fee may, indeed, be the answer, and may, indeed, drive prices to the lowest possible competitive level. And I would have to hire Brad to do a study on that to tell you for sure.

MR. KEIL: I am going to take a little different perspective. I think that what the unified fee does is remove the benchmarking process of all the component pieces, so that the trustees don't have to -- or the adviser doesn't present information about the competitiveness of the services provided under the custodial contract and transfer agency, et cetera, et cetera, to the point where the board is satisfied that all those fees are priced reasonably, and the fund, in total, is priced reasonably, I think you lose that.

MR. HILL: I think the notion of a unified fee has merit. I'm in the private equity business, and it seems to work, everybody seems to buy into it.

But to me, it really suggests what we're hearing here is that there ought to be flexibility, there ought to be a variety of options. There ought to be choice. If some people want a unified fee, there ought to be that available. Some people want to pay over time, that ought to be available. If somebody wants to pay up front, that ought to be available.

The key is, when they're making that choice -- and I think when they're making that choice they need to know specifically what it costs. They don't do that now.

MR. BARBER: So, let me ask you a question, Erik. When you say "unified fee," does that mean that there would be one fee disclosed, and all expenses would be wrapped under that fee?

MR. SIRRI: That's the context. There would be one number.

MR. BARBER: There would be one number. So, I guess the issue is, then, can you communicate to investors effectively what they're paying for the different services provided by a mutual fund?

And so, I guess I'm not opposed to there being one fee -- in other words, wrap the 12b-1 into the one fee, or all the stuff into one fee, as long as the underlying services, or cost of those underlying services, are transparently and effectively communicated to investors.

I think the issue, though, is mutual funds can compete on a lot of different dimensions. They can compete on service, they can compete on investment research, they can compete on price.

And in order to compete on those dimensions, prices of each of those dimensions have to be clearly disclosed to investors, because some investors may choose high service, low investment research. Some may choose high service, high investment research. And unless they know what they're buying with a mutual fund, one fee may not communicate that to them.

MR. SIRRI: Well, listening to what you're saying, there is something unusual about mutual funds, the mutual fund business. Because you have this security, the mutual fund. It sits there. And you have something that normally goes along with it, at least for a lot of purchases, which is advice.

We have selected a regime where the pricing of the two is often bundled together. So you get one versus the other, and then you get a 12b-1, administrative fees packaged together.

Is there any reason to believe it is efficient to package them together, whereas -- forget how you do it for a moment -- it is sensible to break them apart? Is there a reason why we should have those all rolled up together?

MR. ZIMMERMAN: If you're talking about the efficient use of investor capital, I think the answer is clearly no, right? I mean, to the extent that people are paying an ongoing fee, and their investment results are worse as a result of that, then no, it's not an efficient use of their capital. Whether or not it makes sense on the business side is a completely separate question.

MR. SHARP: Again, that answer presumes that the market is not efficient. It presumes that there is no competition in the mutual fund industry. And it presumes that if you do away with 12b-1 fees, you do away with that 25 basis-point cost. And you don't.

So, if it's not in the 12b-1 fee, it will show up in the management fee, it will show up in the administrative fees. And if efficiency means you're paying for what you're getting, I think there is efficiency now. And I think if you change to unified pricing, or to something else, you would pay pretty close to what you're paying right now.

MR. SIRRI: We're obviously thinking hard about these kind of questions. As we grapple with sort of the status of how we pay for servicing and distribution, and the manner by which it's disclosed, what should be our objective, as the public policy makers here? How should we think about whether or not, based on outcome, we have done a good job?

MR. HILL: I think the -- as I look at that issue, your objective ought to be to have a policy that, in effect, pays for services that investors need, but which does so in an efficient manner. And I'm talking about an economically efficient manner for the investor, not for business, if you will.

And an economically efficient -- at least to pass the criteria on economic grounds, it's got to be one where there is full information. Otherwise, you're not getting an efficient decision, an efficient choice.

Secondly, I think it's got to be fair. One of my biggest concerns with the B shares is that they're not fundamentally fair to all the investors in the individual funds. We have investors who have bought in on day 1 who are actually now subsidizing investors who bought in on day 350, depending on performance. So you get tremendous cost subsidies here that are unfair. And, again, that, to me, is a criteria of public policy: fairness.

MR. SIRRI: But isn't that just the nature of the mutual part of a mutual fund?

MR. HILL: Well, like I'm saying, if investors paid that fee up front, and paid it over time, he wouldn't be subsidized; he'd be aware of it anyway. It's the hidden nature of the subsidy, day in and day out, without them really understanding that subsidy -- it goes into hundreds of millions of dollars.

MR. SHARP: You know, you had asked what you should do now. And I think it gets back to the earlier point that you made that I picked up on, is that we have to do what's right for investors. And I think acting just for the sake of acting makes no sense. Because no matter what we do, it's going to cost something, whether it's going to Brad's point of doing research, going to an account-based thing, any of that is -- account-based or doing research on this stuff, exactly what each facet of the fee is, is extremely expensive.

I think this has been a wild success. When you look at 12b-1 fees, and you look at the way it's built into the system, when you look at what it's done for the industry, what it's done for investors, getting back, 25 years ago, only 6 percent of people invested in mutual funds, you now have 48 percent of the people investing in mutual funds, that's a good thing.

And I think that we need to be real careful about what we do here, because acting just for the sake of acting makes no sense.

MR. BARBER: I have to jump in. I have heard this throughout the day.

As far as I know, there are no studies that link the 12b-1 fees to the growth of the mutual fund industry. And I think there is a lot of other conflating effects. For example, the movement from defined benefit plans to defined contribution plans probably comes first and foremost to my mind.

That's speculation on my part, not backed by scientific evidence as well, but I think it's probably a better conjecture than that 12b-1 fees have led to the growth of the mutual fund industry.

Let me also add that the 1990s witnessed the biggest bull market in history, and investors tend to chase performance with their asset allocations. So it wouldn't be too terribly surprising to me if that also had something to do with the growth of the mutual fund industry. I just had to throw that in.

MR. SHARP: And I would agree completely, but I wouldn't ignore the fact that 12b-1 has made it easier for people to invest in mutual funds, whether it's doing away with what used to be an 8.5 percent front-end load, or giving people the option of A shares, B shares, or C shares, it's made it easier.

MR. RUSSO: And the way that that charge comes out of a mutual fund is tax efficient. If -- there are unintended consequences if we make a change in this. And the first unintended consequence is going to be we're going to lose a tax preference item.

Because if I have to charge my client 25 basis points, and send him a bill for that, that is not going to be deducted from his total return of the mutual fund, it's going to be a bill that he cannot deduct in his taxes, unless it exceeds 2 percent of his adjusted gross income, which it never will.

And so, you lose a tax efficiency when you start meddling with the current structure.

MR. SIRRI: John?

MR. HILL: Yes, I think it's just not right to say that 12b-1 has done these wonderful things for the mutual fund industry. I think, clearly, the last 20, 25 years since we have had B shares, 12b-1, we have had an explosion in economic growth in this country, and tremendous creation of wealth that happened during this period.

Secondly, you had the demographics of the Baby Boomers starting to retire, and people have generated these assets, they have to do something with it, the mutual fund industry was smart, to be there to help these people with their needs.

But it wasn't 12b-1 that created the booming economy demographics, it really was other factors. And mutual funds just happen to be there. If we hadn't had B shares, they would have been buying A shares. They needed someplace to invest their money.

MR. SIRRI: Jeff, let me ask you something. As I understand your business before -- your current business -- when you were at Lipper you provided data to the 15(c) process, the process of creating the review of board materials. I presume you sat in on some board meetings.

What do you think of the board review of the materials that support 12b-1 decisions? How do you think about that, the factors they consider, versus the practices you see out there? You must have seen a lot of that.

MR. KEIL: I would have to echo what was said earlier, that it's a non-decision -- it's a necessity, it's a recoupment of outlays. It's a competitive posturing, meeting the standard payouts of the business, et cetera.

At the risk of using an overused term, it's a bit of a rubber stamp, frankly. It's a necessity. It's not a, "Gee, let's do a real analysis, the correlation of the expenditures versus the benefits," it's, "No, we have to have it, it's a necessity, end of story."

MR. SIRRI: When trustees -- in your experience, when trustees consider these things, are they thinking, "This is going to help the fund grow larger and pass on economies of scale?" Is that what they're thinking? Or are they thinking, "We've committed to these financing arrangements for distribution," or are they thinking, "This pays for servicing to shareholders, and we want that to happen as part of the product attribute?"

MR. KEIL: They are thinking all of the above, and they have to think of all those component pieces, there is no way around it.

What I don't think does exist, the disaggregation -- at least not that I have seen -- the disaggregation of all the different component pieces of the 12b-1 fee, looking at those individually for correlations, let's say, of advertising, for example. I am not aware of that happening. Or maybe in very rare cases.

MR. BARBER: I will say that there has been some study -- actually, my own study with Terry Odean and Lu Zheng -- about 12b-1 fees. And in that study -- it was published in the "Journal of Business" in 2005 -- we found that 12b-1 fees actually attract money, that flows tend to increase following 12b-1 fees, which makes sense, right?

I mean, these 12b-1 fees partially are for sales and distribution. You charge the fees and you distribute them, but I think one of the issues that -- and let me be clear, that I am not laying any accusations, I am merely asking the question, which is: are these fees to promote the sale of the funds, or to service?

And, to what extent are investors aware of those two buckets, the promotion and sales side of the 12b-1 fee, and the service side of the 12b-1 fee?

MR. SIRRI: Shannon, you probably have the greatest contact with investors, day in and day out, and what they know. How would you describe what they understand about package of services they're paying for, what the various line items are on the prospectus, and whether they care, in fact?

MR. ZIMMERMAN: In my experience, investors have lives, and so they don't spend a lot of time poring over prospectuses. Maybe the annual reports that are especially well written, they spend more quality time with.

But in terms of drilling down, actually paying attention to the anatomy of an expense ratio, and understanding the various component parts of it, I'm not sure that that's sort of something they race home to do, to see if the prospectus has arrived at the mail box to figure out what's under the hood.

I do think that good things have happened in recent history. People have become much more aware of the impact of fees. Look at the growth of the index fund industry, or the low-cost providers, like Fidelity and Vanguard. They have done a tremendous job of gathering assets, in large part because they have been able to offer low-cost solutions to practical investment problems.

But in terms of this being a burning issue, unless -- except insofar as it affects the performance, the return that investors are earning or not earning as a result of the fees, I don't know that there is a great level of awareness, or even interest in that.

MR. SIRRI: Thank you. Brad, you had mentioned earlier, when you were talking, I think you described American investors, I think, as a financially illiterate populous. I don't know whether that's right or not.

But I was thinking back to the first panel, when

Kathie McGrath made reference to a point of sale document, which was some kind of a document that gets distributed when the mutual fund decision gets made, so that information passes at that point that would contain something -- at a minimum, say, pricing information.

This might be an alternative to, say, account-level disclosure. Any sense of whether that would be effective at what you all are thinking about? I know there is differences of opinion, but is that a direction we should be thinking about, that is, forcing that information at the point of sale?

MR. BARBER: Erik, I think that that's something worth exploring, and I think it's actually something that, if the Commission devotes some resources to -- and it wouldn't be exorbitant -- if you would get an experimental economist to run some of these surveys with the two, you might be able to ascertain whether those sorts of disclosures would make a difference.

And, by the way, I'm not an experimental economist, so I'm not looking for work, here. You could get some indication of whether those sorts of disclosures would change outcomes in a positive way, again, referring back to the study that both Shannon and I talked about before, choices have not been optimal when they're put to folks.

And so, the question is, if you provide clear disclosures about, "This is what you would pay with the A shares, this is what you would pay with the C shares, given your holding period, this is what the present value of those costs are, what do you want to do," see if their outcomes would change, I think that would be worth pursuing and seeing. We don't know the answer to that question.

MR. SHARP: I think you all now are in the middle of working with the Rand Corporation to do a study like that, or at least having that as part of the study.

The one thing I would say is that if there is going to be point-of-sale disclosure, it can't be in writing, because it just won't work. And even oral disclosure at the point of sale, to the extent that Brad is talking about, clients will not want to hear it.

MR. SIRRI: I want to be clear. What is it that clients wouldn't want to hear at the point -- let's say it's oral. What is it that they wouldn't want to hear at the point of sale?

MR. SHARP: The level of disclosure that you have been talking about, with respect to, "Okay, you are buying an A share, you are buying a B share, you are buying a C share. The present value of the cash flows is so-and-so." That will not play well with clients.

And that -- I can be disproved by the Rand Corporation when the time comes, but I think you will find that out. And I think, in fact, that one of the problems you

all had with the point of sale disclosure that you came out with before was it really sounded great, a lot of information, and for really financially savvy people.

Fell flat on its face, because the people don't want to hear that kind of information. They want to buy advice, they want to buy guidance. And that's what they're doing.

MR. RUSSO: I spent a week reading statistical summaries of these kind of modelings. And, frankly, I came away saying, "Nobody models the behavior of the client." This is not a zero sum game. You do certain things, you get certain responses.

You want something -- you want to prohibit an event? Tax the heck out of it. You want to encourage it? Drop the tax on it. And the same thing goes with the fees that we're charging in these mutual funds.

So, I question whether or not we can actually model a study that's well enough done so that we can come away and say, "We should structure it in this fashion or in this fashion." I think we should underscore the fact that it has been very successful in the manner and mode in which it is delivered to the clients today.

MR. HILL: I guess the thing I struggle with is why mutual funds are in a unique category all by themselves, they don't need to have point of sale disclosure.

When I buy a stock, I get a point of sale disclosure what the commission was. When I get my tax returns done, I get a point of sale disclosure of what they charged me to do my taxes, broken out between his own advice, his own time, and his printing press, if you will -- just a whole array of things I do in life, there is point of sale disclosure.

But, for some reason, mutual funds are considered to be different, and it would be bad. It would be --

MR. SHARP: I'm not sure we're saying that.

MR. HILL: You're saying disclosure problems.

MR. SHARP: And if you look at -- I mean, that's another thing. We have spoken all about a lack of transparency with 12b-1 fees.

I would ask all of you to look at the prospectus. There is enormous disclosure about exactly how many basis points are being paid on management fees, administrative fees, 12b-1 fees, and every other fee in the world.

There is a ton of disclosure out there. Now, is it at the time of the sale, when I'm on the phone with a client? No, it is not.

MR. HILL: And it's not by the client, it's by the fund.

MR. RUSSO: It may be by the adviser, John. In fact, when you look at the multiple vehicles that advisers are putting in front of the client, insurance products -- try and get good disclosure out of insurance products, in terms of what expense is involved, and what return of the client is actually there.

Less so with a variable annuity -- but very much in the same fashion, everybody agrees transparency and disclosure is a good thing. And that's why I think when we hit upon the unified pricing of these costs, to actually give somebody something that they can compare.

Mike is probably right, in that we have an efficient market now, so it probably won't drive prices down, but it will sure let my client, with a high-school education, be able to look at that and say, "Hmmm, 150 basis points, that one is 175 basis points, so this one may be better."

MR. BARBER: I doubt they will know what basis points are.

MR. RUSSO: I will educate them, I promise.

MR. SHARP: And just one other point is that financial advisors do give this kind of -- they just don't get into the level of detail we're talking about on this panel.

Our guys literally have to -- when they're entering an order, they have to attest to the fact they have had these conversations with clients. Those conversations are followed up by our branch managers, not on a call-by-call basis, but on a sampling basis. We do this because it's the right thing for clients. It happens.

MR. RUSSO: And one of the unintended consequences of not doing it in this fashion is that you have the stampede of 100,000 independent security professionals moving to the investment advisory arena, so that they can avoid a lot of the complexity, or continue their ongoing fee structure. And that provides not only additional costs, but a huge burden to the regulatory arena, I would think.

MR. ZIMMERMAN: Just to ask a question of folks who are proponents of the 12b-1 fee as it stands now, or maybe only slightly modified.

I feel like -- and I'm sure this is the case for everyone who is here -- that we're hearing the best case scenario for the way in which the 12b-1 fee is used.

What about the dark side? I mean, to the extent that these fees incentivize people to put their clients in funds that may not be appropriate for them, when cheaper funds might be the better way to go, how do you speak to that? At least as a potential concern, and probably a practical one, as well.

MR. KEIL: I think you hit on sort of why I support the point-of-sale disclosures. I think it should be clear to the clients where the conflicts of interest are, what the specific dollar amounts a financial advisor or intermediary gets for selling one product versus another product.

And if he or she selects the product that is not the cheapest, but let's say one on the upper end of the scale, that some reasonable justification should go on for that -- the fund has better servicing, the fund has lower risk -- or good risk adjustments, or what have you.

I think that's a necessary part of the process. And I think, understanding of course, that you can go crazy with the documentation on a point-of-sale disclosure if it's done in a written form -- and I think there needs to be a balance between oral and written, something reasonable on the record, but not overwhelming.

MR. SHARP: But, again, this presumes it's not happening right now, and it is. The stuff you're talking about happens right now. There is disclosure at the time of sale, there are rules and regulations that are imposed on us on suitability that has to go to the exact issue of whether one fund is cheaper or more expensive than the other.

My firm, a lot of firms in the industry, have gotten rapped for that. And because of that, there have been changes in practices. We are not operating in a vacuum. This is not the first discussion we have had about mutual funds and 12b-1 fees. Built into the sort of fabric of the industry are all the rules and regulations that apply right now. It works.

MR. KEIL: I have no question that groups the size of Citigroup, and other ones of that magnitude, certainly get a lot more scrutiny than the rest of us. I think that the challenge is that you create a regulation not for the Citigroups of the world, but for some of the smaller groups, where this kind of thing isn't happening. And I think that's the issue.

MR. RUSSO: Everybody who is registered with the National Association of Security Dealers is functioning under the same premise and the same guidelines on disclosure.

And I daresay none of Michael's 17,000 brokers, nor none of my 81 brokers, has a client who expects you to work for nothing. They all expect to pay for this, and it's just a question of making it understandable to them.

MR. SIRRI: But, Mike and Joe, in your support of 12b-1 you pointed out that you give very clear disclosure to clients, either in writing, orally, and in all sorts of parts of the process.

But if we asked the question the other way, and I went to your clients and said, "Do you pay for advice? Did you pay for distribution? How much did you pay?" Would they have a sense of that?

MR. SHARP: I think they would know they were paying. Would they know how much was split between distribution and advice? No, I don't think they would know.

I don't think they can tell you that, to be honest with you, because there is a fine line between distribution and servicing and advice. And I will be darned if I could figure it out. But they do know they're paying. They know they're paying.

MR. SIRRI: Part of what we're dealing with here is whether or not it's important that investors understand -- whether it's beforehand -- and you made it clear to them beforehand; I think that's your point -- or after the fact, that they have a comprehension of the various bits, the management costs, the distribution/servicing costs, and so forth.

Is it important that they comprehend those for their purposes?

MR. SHARP: I think it's crucial that they be told. I think it's crucial, because it's good for investors, and it's good for us.

MR. SIRRI: That's a different question.

MR. SHARP: I know. But the fact of the matter is, it gets back to these MBA students. You know, there is a big difference between being financially savvy and financially illiterate. I don't think our clients are financially illiterate.

In many cases, they are not financially savvy, which is why 70 percent of mutual fund investors go through intermediaries like us to do this. They are looking for advice, and they're looking to pay for that advice.

So, will it help clients to see it? Yes. If we can do it in some way that we can put a dollar value on it, it's a doable thing. Will it make a difference? No, because I think the market is very efficient right now. And I don't think -- and if anything, if you take it the wrong way, it could -- it certainly won't drive prices down, and it could drive them up.

MR. RUSSO: Another way to express that, Erik, is to say, yes, it's important to us that the client understand it, that it's fully disclosed. No, it's not important to the client.

I shared with you over lunch the global positioning satellite system. That project was managed by a client of mine. He's a brilliant, brilliant guy, who cares not one twit what I am charging him for this service or that service, even though it's fully disclosed, even though I beg him to listen to me, as I make those full disclosures.

The long and the short of it is he has a mutual trust relationship that spans 30 years, and he is not interested in reading the prospectus.

MR. SHARP: And that mutual trust is backed up by arbitration and litigation and regulation. There is a system out there, and it works.

MR. RUSSO: The audits that occur every year in the National Association of Security Dealer branches would be reduced to perhaps once every three to five years. That's one of your unintended consequences if you move this from the securities realm into the investment advisory realm.

MR. SIRRI: Well, let me turn the question around then a little bit, and ask Brad and Shannon. If this is so important, this deconstructive sort of pricing and clear disclosure, then why don't we have it today?

After all, there is nothing that stops people, stops companies, from breaking this down. There is nothing that stops a broker from disclosing this kind of information. They could invest in the systems. They might be expensive, but they could do it. And if this is such a great idea, they may garner assets and have a very successful business.

So, I don't see anything that causes the market not to do this.

MR. BARBER: Seach costs. Oh, you have written on this, Erik. So Erik Sirri and Peter Tufano wrote one of the first papers on search costs in the mutual fund industry. What do I mean by that?

If you create a complex landscape for trying to figure out which mutual funds investors should be in, you can support an intermediary business that, essentially, solves that search problem for investors. So it's a very difficult problem for an investor to come to, and solve that problem.

And so, I think that's one of the reasons you don't see it now, is the intermediaries have no incentive to eliminate or minimize that search cost, because it supports their activities. I think that's the economic equilibrium that we might be in. That's speculation on my part.

I think that -- will changing this, making transparent, effective communications change that landscape? I don't know. But I think it's movement in the right direction, to try to communicate these costs effectively to consumers.

MR. ZIMMERMAN: And, again, just to sort of reiterate, I also think that greater transparency would be a movement in the right direction.

I don't know, though -- in the same way that maybe we're not interested in the kind of enamel that our dentists use whenever they work on our teeth -- maybe when you look under the hood of an expense ratio, the various component parts, if they're broken out better, I'm not so sure that that's going to represent a competitive advantage for one mutual fund company over the other, given the level of interest that investors have.

And one of the reasons they're going to mutual funds is for the sake of convenience. They do not have to do the kind of research that would have to be involved, necessarily, in investing in a particular stock.

To the extent that they do do research, there are probably things that they are focused on that are more core to the investment side of it, the manager, who is the manager, what's his track record, what are the strategies -- how has the fund fared in that market, what are the risk measures? But the fee component, I think, is not going to be a big selling point.

MR. HILL: Yes, I don't think the issue of cost is a real issue. When you think about a statement you get from your broker, or you get from your manager, or Citibank, they lay out all kinds of data, specific to your account, that you were charged that period. And at the end of the year, they give you a complete data run on your taxes, capital gains, income, et cetera.

It cannot be that expensive, just to put a code in there that says, "And you paid this 12b-1 charge," trail charge or up-front charge. That's got to be simple. And when I look at the things these computer people are doing today on derivatives, if they can create those little monsters this is certainly a simple, cost-free case, I would think.

MR. SHARP: Or, they could pay a lot more for derivatives.

(Laughter.)

MR. SIRRI: We look at the way we distribute funds today and the way they're priced, we have share classes that differ by distribution charge, fundamentally. And there are a lot of reasons for that. One of them, I think as we all know, is section 22(d) of the Investment Company Act, that is essentially the resale price maintenance structure.

You know, we've been talking about 12b-1, but maybe we're talking about the wrong issue. Maybe we should, in fact, be talking about changing that aspect of the framework. That is, taking 22(d) away, and let brokers compete, on a broker-by-broker or adviser-by-adviser basis, for the distribution of fund shares.

And then -- let's just go that way, and be very direct about it. Is that something -- are we focusing on the right problem, here?

MR. SHARP: We've done that. Fee-based brokerage. And, not surprisingly, average fee-based brokerage fees are between 95 and 105 basis points. I don't think it's an accident that's similar to where 12b-1 fees are for deferred back-end load fees.

MR. SIRRI: Could you just explain, in pricing, why you think that fits that model, for people who don't know?

MR. SHARP: For those of you who don't know, fee-based brokerage is instead of paying a commission for your business -- this started back in the late 1990s, and may or may not be coming to an end -- the notion was to put clients and FAs on the same side of the table, to avoid situations in which FAs would have to trade the account in order to get paid. The notion was to provide fee-based brokerage, where you would get paid a percentage of what -- how many assets were in the account.

And in the top five or six firms in the industry, there are about $300 billion worth of assets in those accounts, where the average fees are somewhere between 95 and 105 basis points, where only an incremental part of that is paid for advice, because it is fee-based brokerage. That notion, I know, is open to question, in terms of the advice part of it.

But the fact of the matter is, it's a brokerage account. You don't have the protection of being protected by the advisers, you're not dealing with a fiduciary, you're dealing with a broker. And those fees are roughly 100 basis points.

And I think that part of the reason that that has grown, some people wanted that choice. They wanted the choice to go in and pay one fee, no matter what they did in the account, including for mutual funds.

MR. SIRRI: And the fund shares sold through those accounts, are they -- what's the pricing on them? How are the --

MR. SHARP: No load. I'm sorry, that's what you were asking -- I missed it.

MR. BARBER: Well, the other part of this that, you know -- and Shannon raised this earlier, and I guess it's something I would encourage the SEC to look at -- is the extent to which investors do end up in vehicles that perhaps were not appropriate for them. And I don't know to what extent you're able to look at that issue, but I think that that's one issue that there is not a lot of evidence out there on.

And if what the industry claims is true, that there is not pushing of the investment vehicles to maximize the payments to the intermediaries, then you should see very little misplacement of investors. So one key element of this is whether that is widespread or trivial, or non-existent.

MR. HILL: I think there is merit in your notion of 22(d) and moving in that direction, because it would push everything to the client and the broker, in terms of costs and discussions.

It would get boards out of these annual reviews, trying to make judgements about whether or not these fee costs are reasonable, and how do you ever know that -- maybe for some investors, not for others.

It would get trustees out of trying to make decisions about whether or not the right investor bought the right funds or whether there are controls in place. These are just enormous problems.

If you go the 22(d) route, it gets us out of that game all together, and I don't think the outcomes are going to be any worse. They might be better.

MR. ATKINS: I wanted to sort of follow up on that, what Mr. Hill was just talking about. Since you're the only trustee on the panel, I don't want to necessarily pick on you.

But earlier in the day, we talked about some of the factors built into 12b-1, whether they are still relevant today. And I just wanted, since you are voting on a 12b-1 plan year in and year out at Putnam -- I assume you have one.

MR. HILL: Obviously.

MR. ATKINS: You know, do you find these factors still relevant? And if not, how do you analyze the 12b-1 plan, from your perspective?

MR. HILL: That's a fair question. I think that, by and large, the original rules are -- some still have validity, but a lot of them are outdated and outmoded.

I think there is a broader set of issues and questions we asked today that are not on the original list, some are ones we devised, when we were trying to come up with our own criteria to try to determine what was reasonable and fair. How do we get at that answer?

So, I think there is a need to update that list, and particularly with all the new options, platforms, and SMAs that you have to look at, it is outdated.

MR. KEIL: Excuse me. The theme that kind of resonates through those is sort of the temporary phenomenon of 12b-1, and the reassessment of it on an annual basis, where I think that, really, that doesn't go on any longer.

MR. HILL: Right.

MR. ATKINS: And then one other just follow-up, I'm sorry, but your firm was sort of a poster child for scandals a few years ago, when you had a huge number of redemptions.

MR. HILL: Right.

MR. ATKINS: And I was just curious, with respect to some of these brokerage fees, 12b-1 or whatever, what your experience was in that you think you all benefitted by having this sort of program in effect. How did you make changes to rescue your firm?

MR. HILL: Well, I'm not sure I can answer that. We really -- we've made a lot of changes to 12b-1 before we had two of our employees market-time their funds, which was the issue at Putnam. And we have taken hundreds of millions of dollars out of the 12b-1.

It is a very profitable program, notwithstanding what we heard this morning, because if you look at it on its own, under the NASD rules, it's quite profitable.

Now, to the extent that managers take money to spend on distribution and declare it unprofitable, that's their choice of how they're spending the profit from that activity. It has nothing to do with profitability of 12b-1.

But we had taken steps just to take the profit out, because we looked at it as part of our annual fee discussions and negotiations about how much money we thought should be left at the manager.

I don't -- I think the 12b-1 is operated pretty well there. We have even had discussions, and we have even had brokers come in and talk to us. We have gone out and visited brokers in their offices and around the country, in their home offices, to understand how they sell shares, to get comfort.

So, I don't think that was a -- I thought the B shares operated fine, and it had nothing to do with these two portfolio managers who timed their funds.

MR. SIRRI: Let me turn -- ask one last question, in terms of something that was raised in one of the earlier panels, I think the second panel. There was a point raised that having 12b-1 funds may make it easier for small, young funds to enter the business, that it levels off some of the competitive space.

I wonder what folks thought of that, whether they thought that this was a pro-competitive measure, that having this sort of a structure was helpful, and in fact, did improve the competitive landscape, or whether, in fact, as sometimes is the case, you become -- which way -- how should we look at the pure competitive/funds entering the business space question, with regard to 12b-1?

MR. KEIL: I think there is some validity to that argument. But at the same time, I think what does happen is that -- and was alluded to earlier -- you've got a -- you know, if it isn't in the form of a 12b-1 fee, distribution finds its way into the management fee, or there is some way to finance it some other way. It's a reality, period. But I think just the existence of the 12b-1 -- there is a little more flexibility in the model, and that's positive.

Of course, there is also the question of sort of that bouying inefficient players in the market gives them a little extra resource to play with. But I think that if you're truly inefficient, you're a marginal player, you kill yourself.

MR. ZIMMERMAN: Is the implication of that question maybe that 12b-1 could be modified in such a way that it would benefit funds that were still in base building mode?

MR. SIRRI: It's possible. I mean, funds can do all sort of things. They could waive fees, they could do many things.

MR. ZIMMERMAN: Right. I guess my position on 12b-1 is probably pretty clear by now, but I guess I'm open to persuasion as to whether or not it could benefit in the form of greater competition, as funds are up and coming.

Because -- and I know that we learned earlier today that the dwindling assets, net redemptions, that wasn't so much one of the motivating forces behind 12b-1. But to the extent that a fund can raise its asset base, and have more shares to distribute its cost across, that benefits shareholders in the form of a lower expense ratio.

So, I guess I could see, if it was carved out carefully, maybe tied to a program with expense ratio reductions along the way -- but then that gets into a regulatory thicket that maybe we wouldn't want to try to navigate.

MR. BARBER: I guess, from an economist's perspective, the question is whether there is any barrier to entry in the mutual fund industry, and whether you have to encourage entry through providing some sort of incentive, et cetera.

And I guess I don't view there to be huge barriers to entry, given my sort of observation of the fund.

MR. SHARP: I would agree with that. I don't think there is a barrier there. In fact, I think, quite to the contrary, entry is relatively easy. And the think that keeps small or large fund players in is performance.

MR. ATKINS: Just one point here, I guess my two cents would be that a huge barrier to entry would just be the huge costs of getting geared up to be able to comply with the rules. It is easy for those who are already established, but when you talk to folks who try to set up smaller funds, compliance costs are something we struggle with to maintain a balance.

MR. BARBER: If there are economies of scale, maybe you shouldn't encourage for there to be small funds neccesarily. In other words, if compliance is an important part of the landscape, then maybe it's not efficient to have the smaller funds. There are still plenty of folks out there who are willing to finance a competitor if it's a profitable industry.

MR. ATKINS: Well, everybody starts small, and if you want innovation, you'd probably take exception to that.

MR. SIRRI: I think we're getting to that time. I would like to go give all the panel an opportunity for some closing remarks. And I would ask you -- feel free to say what you will, but I would like to ask you if you would answer one question along the way.

And the question is this, that, given our structure of how we pay for distribution and services through 12b-1, are investors, through that method of pricing, getting the right package of services? Or, if you want to flip it around, are they paying the right amount for the package of services they're getting? And if not, which way should we go?

MR. BARBER: I wasn't sure which end you were starting on.

So, I guess let me just iterate a couple of things that I have said throughout the discussion this afternoon. First and foremost, I think the expenses should be transparent, and effectively communicated. I think the point has been made that many of these expenses are, to some degree, disclosed in the prospectus. But I don't think they are effectively communicated.

And I think some discussion of that -- for example, what sort of point of sale document might be the most effective communication -- is worth noting.

To reiterate some of the points I have made today, surveys indicate that 80 percent of investors are not aware of the expenses they pay for their largest mutual fund holdings, so there are clearly many who do not know what they are paying.

The experimental evidence that both Shannon and I have talked about suggests that investors don't necessarily make the right choices when choosing among funds.

And let me also add there is the curious example of index funds. So, Ed Elton, Marty Gruber, and Jeff Busse, in

2004, did a study of index funds. And there were 52 S&P 500 index funds that they looked at, from 1996 to 2001. Some of these funds charged front-end loads, many charged 12b-1 fees. And the expense ratios on these index funds, which were all tagged to the S&P 500, scored greater than 99 percent for the statisticians in the audience.

But their expense ratios ranged from 10 basis points to 1.35 percentage points per year. The expense ratios explained all of the variation in performance. And the question is, how can those vehicles survive in a competitive landscape?

And I think part of the answer that you have to think about is whether some investors are being put into the high-expense funds inappropriately.

Another solution might be that they are put there because they get high levels of service, when, in fact, the study looked at that issue, and there was not a lot of evidence of variation in service.

And so, I think it is important -- this study, I think, sort of concludes that the index funds investors hold have higher 12b-1 fees, higher loads, and higher expenses in the best portfolios, and funds used almost all 12b-1 fees and loads and part of the expense ratio to reward sales persons and market funds. Apparently, this marketing effort produces the desired effect.

I think there is some question as to whether that sort of push in the industry leads folks to a bad outcome. We have no evidence on that. All we can observe is what the landscape looks like. And I think that the incentives right now are sort of, "Here are the fee structures," and I would like to see that made more transparent, to reduce the search costs, so investors know precisely what they're getting.

MR. HILL: Yes, I guess the -- just a few points. One, I think it needs to be said and resaid that investors buy performance first, they buy performance second, they buy performance third. And when performance is not good, they look at their expenses. That is when expenses become an issue.

Having said that, I think that, given the costs of these services, which I think are necessary -- I think we do varying degrees of service, some a little, some a lot -- I think it's important that we break out the costs of various options, what the costs are to an investor when they buy a fund, just like when they buy a stock, or any other service. I don't find differences here that justify a separate category for mutual funds.

They still need this product. So, to me, the best way to go is to try to push this towards the broker and the investor, give the broker and the investor lots of flexibility on how this service gets paid for.

I actually have a lot more confidence in investors making smart decisions about cost, anyway. Nobody can make a good decision about performance. It always turns out to be not quite as good a fund as it was the last three years.

But I think the more you can push it there, and have it clearly laid out, the better off we will be. And we will also get trustees out of trying to make judgments that are metaphyscially impossible.

MR. KEIL: I think a number of recommendations, or considerations, I think, should be undertaken.

In contrast to Mr. Uek and Mr. Haaga's comments earlier, I think I would like to see the distribution fees -- and I mean the loads and the asset-based sales charges and the service fees -- charged at the account level, rather than at the fund level through the 12b-1 payments. I think it's clear for the shareholder. I think it enables a more direct total expense ratio comparison.

And I think -- and I'm sure it happens in very rare cases, but there is the potential to have a service fee charged at the fund level, and also some level of all-inclusive or wrap fee at the account level, where you've got a double counting, potentially.

Now, I can't say I know how often it happens, but closing that loophole may be useful.

MR. RUSSO: What's your answer on the tax angle?

MR. KEIL: I'm not a tax accountant. I know that that's been one case that has been made, and I also heard from people that the estimates have been overblown. And I don't know, honestly. I would rather not speak to that.

I think I would like to echo the sentiment about not using the term "12b-1." I think 12b-1 is very confusing. It sounds like some kind of plastic explosive, or something, so let's get rid of that.

Obviously, modernizing the board considerations, I think that's useful.

I think one thing that has never been done -- and I understand that, originally, when the rule was crafted, the ultimate flexibility was sort of the goal, that we didn't want to box people in to having different kinds of distribution models, let them sort of be creative, and kind of figure out where they want to go, what worked and what didn't work, et cetera, and if someone got out of line, you know, we would slap them, but up to that point, let them be creative.

I think acceptable distribution expenditures should be defined in some way, shape, or form, or say what's not a distribution expenditure. I think that would be useful. I think the language that had driven me crazy for years is "Payment is an intended result of the sale of fund shares."

Well, that is the goal of the mutual fund companies, to sell shares. I mean, anything from beefing up the portfolio management staff, to a number of things, are designed to do that. But they don't fall in the realm of distribution, per se.

Another sort of loophole I think needs to be closed, or needs to be brought under purview of 12b-1 is there is a number of funds that have what I referred to as the non-12b-1 service plan. Basically, it smells like, looks like, operates like a servicing plan under 12b-1, but it's outside of 12b-1. I think that should be brought under the rule, and sort of defined more clearly.

The other piece that happens also is there is a level of personalized servicing that goes on under the guise of the transfer agency fees under sub-transfer agency. Again, that needs to be defined clearly, so that needs to be under the 12b-1 purview, as well.

One other issue -- and it was brought up in the paper I sponsored a number of years ago -- and that is the issue of compensation versus reimbursement plans. I think that's the key here. And some guidance, as far as what's acceptable, as far as how those operate, might be useful, as well.

And maybe one last point. I think with any modification of a rule, it's unlikely you're going to get it perfect. No offense intended, obviously, but a regular review of the rule, henceforth -- assuming, of course, it's modified -- is certainly useful.

MR. RUSSO: Without sounding terribly corny, and without advocating this position 100 percent, "If it ain't broke, don't fix it." And that has some relevance, given the fact that this has been a very successful way of delivering not only the investment vehicle, but also a level of service that is tough to quantify.

This panel is called, "Cost and Benefits." Well, costs can be generated pretty reasonably, accurately, through the kind of studies that my colleagues have undertaken. So we have a good handle on what the costs are.

The benefits, on the other hand, are much more esoteric, and perhaps far greater -- just a short list is in the investment optimization that goes on in the relationship between the adviser and the client, reducing the turnover of mutual funds, believe it or not, telling a client when a market is down, that they should not be selling their funds. As silly as that sounds, folks, that happens all the time. And maintaining those clients in those positions is in their best interests. It's also in the best interest of the fund.

Managing the expectations of clients, also in the best interest of the client, the best interest of the fund. Reallocating the resources through life. You meet annually with a client, it's unlikely that there are no changes in that client's life every year. Something has changed.

There is more of them, there is less of them, their health is better, their health is worse, they are retiring, something is changing. And these investment packages need to change with them. The only way we can do that effectively is with a one-on-one relationship.

There is also tax preparation that goes on, and sometimes it's simply supplying all the data to a professional tax preparer. Other times, there is tax preparation and filing that is happening, all on the basis not of a fee that is being charged, but on the 12b-1 fee that is being accumulated by that investment professional over the year.

And in answer to the question that you posed, Erik, is this a right package for the client, and the answer is yes and no.

And, again, I call our attention to the fact that on no-load funds that are full of loads, have no investment counsel other than what they're reading in a prospectus. And it's sad, for me, to believe that the small clients, the most vulnerable, will be reduced to reading a prospectus, and trying to make heads or tails out of that for their investment counsel.

So, clearly, this system has worked. And whatever minor changes are made to it in order to encourage transparency are good, decent efforts that should be undertaken. But any major alterations I think would result in unintended consequences that we would all regret.

MR. SIRRI: Mike?

MR. SHARP: Yes. On behalf of Citigroup and Smith Barney, I want to thank the commissioners and Chairman Cox and Erik and Buddy for having me here. We very much appreciate that.

I think I am a lot more positive than people are about this. You know, we think it's commendable that the Commission is look at this right now, and deciding about whether there are any things that need to be done with 12b-1 fees.

But I think, just to sort of strike the same note I struck at the beginning and in the middle, don't lose sight of investors, and don't lose sight of investors' interests. We think 12b-1 serves those interests.

When the Commission adopted 12b-1 in 1980, it talked about the fact that there would be a continuous evolution of the way distribution would work, and the way 12b-1 would work. And we have seen that evolution, and we have seen it work.

You know, the rule has facilitated a downward pressure, both on loads and fund expenses. And on the fund expenses side, because the intermediaries can do this better across a larger client base, with respect to integrated distribution services, and they can do it in a way that is more efficient than if the funds paid for it on their own, and certainly if clients paid for it on their own.

The rule has also helped fund companies offer a menu of no-load, contingent deferred sales loads, and front-end load funds, to give clients more choices. And it has worked. And clients have spoken, they have demonstrated a preference, and not only for the professional adviser working through the array of funds that are out there -- and we sell close to about 100 fund families, and up to 3,000 funds -- but also with respect to the servicing that goes on after they buy the mutual fund.

And as I mentioned earlier, it is -- when you look at the mutual fund industry back in 1980, we were looking at front-end loads of 8.5 percent. And right now, I think the highest is about 5.75 percent on front-end loads, and the lowest is about 4.75. But it's not only the front-end loads. It's mutual funds expenses, in general.

Back then, expenses were about 232 basis points, 230 basis points. And they're more than half lower now, down to 107 basis points. And I think that 12b-1 has worked. Now, is 12b-1 responsible for all that? Of course not. But it has facilitated all of that. And I think that we need to be very careful in how we change it now.

And I think, also, that we need to be careful about the question about eliminating 12b-1 fees. I am not an economist, I don't even experiment as one, but I think that we need to be careful here. Because if we repeal 12b-1 fees, there is nothing that I have ever seen, heard, or sensed that says that fees are going to go down. I don't think they will.

I think that if you go to an account basis for services, and advice that people pay, there is mass bargaining power out there right now with 12b-1 fees that gets capped by the NASD. You lose that mass bargaining power, and you lose that cap, and I am convinced that the small investors will be paying more than they're paying now. I'm just convinced of that.

And there is that part of the mutualization. That's why they're called mutual funds. And I think we can't lose sight of that. We can't forget the investor.

But I also think we should be a little bit more self-congratulatory, in particular, the Commission. I think that this experiment started 27 years ago. There has been scrutiny on it over the years, and I think there should be continued scrutiny. I think now that scrutiny will result in better communication on disclosure, or whether it's giving fund board members the ability to make an easier decision, rather than being locked into a 27-year-old set of factors that people aren't sure what to do with.

But I think we should not lose sight of the fact that 12b-1 has been a success. Tweak it, make it slightly better, but don't throw the baby out with the bath water.

MR. SIRRI: Shannon -- the last word.

MR. ZIMMERMAN: I'd also like to thank the commission and my fellow panelists, too. I don't necessarily agree with everyone. I have learned a lot about the industry point of view, as well. My mind has not changed, however.

And just to illustrate why that's the case, I want to take you back to the distinction that we made earlier between customer and product, and investor and investment vehicle, and then ask a question.

In what way is a mutual fund not like a toaster oven, right? A toaster oven, the more you pay, the more bells and whistles you receive. Unlike any other product under the sun, a mutual fund does not work in that way. The fee is a feature of the fund, itself. And to the extent that the fee is higher, the product, which are the investment returns, are necessarily worse, right?

And so, I think that is a distinction, and it gets papered over when we regard mutual funds as products, rather than investment vehicles. And that sets aside the whole question of the services, the important services, that lots of folks provide.

What I hope it does is it foregrounds the way in which those services can be paid for. So, that's the first point I would like to make.

The second is I think that, to the extent that a 12b-1 fee incentivizes folks to put clients into particular funds, and it fuels industry asset bloat, because it pays for marketing and distribution of those funds, the fees are particularly odious, because they ask shareholders to oversee the process by which their investment becomes worse.

Again, just to go back to the point that I made earlier, as a fund's asset base grows, one of two things tends to happen. If it's a large cap fund, it morphs over time into an expensive index fund, and if it's a small cap fund, the manager's ability to pursue the strategy that they have had success with is impeded.

And so, if 12b-1 fees are behind the problem of asset growth, then that's another problem.

And then, we really didn't speak -- we sort of touched on this, but we didn't delve into it quite that deeply. I am concerned to know -- to pick up on Brad's point -- whether or not the financial incentives that exist for folks to put their clients into pricier funds that have 12b-1 fee versus cheaper funds that could serve their interest better, what kind of effect that has, in terms of the investment performance that those folks receive over time?

So, as the Commission continues to look at these questions -- and they do so with the needs of individual investors, front and center -- I hope that those are some of the issues that you will consider, as well. Thanks.

CHAIRMAN COX: Well, thank you to every member of our panel, and, Erik, to you as moderator. This, like the preceding two panels, and I expect our next and last one, was exceptionally illuminating.

You bring, each of you, a very significant bit of wisdom and perspective, and so on, that necessarily none of us can have here, and collectively, you've really done us a great service. So I want to thank you for the extraordinary amount of time and the wisdom that you bring to it, accumulated over many, many years, and, hopefully, your continued commitment to help us work on these problems.

MR. SIRRI: I just want to mention that we will have a 15-minute break, after which we will come back for our final panel on the options we have going forward. Thank you.

(Applause.)

(A brief recess was taken.)

PANEL FOUR -- LOOKING AHEAD: WHAT ARE OUR OPTIONS?

MR. DONOHUE: The fourth panel of the day. Well, we certainly have had an interesting day, having heard from a very experienced, diverse group of individuals about the origin of Rule 12b-1, its current uses, and its costs and benefits. Now, for this final panel, I will be asking them to discuss what should be done now.

We have a very distinguished panel, so let me introduce them. Barbara Roper is the Director of Investor Protection for the Consumer Federation of America, where she has worked for some 20 years. She is the leading spokesperson on investor protection issues, and has served on a number of boards and committees. She is a graduate of

Princeton University.

Mark Fetting is a Senior Vice President for Legg Mason, where he is responsible for the mutual fund and managed account businesses throughout the world. Mark is also on the executive committee, the board of governors of the Investment Company Institute, and is a director of Legg Mason and the Royce Funds. He holds an undergraduate degree from Wharton, and an MBA from Harvard.

Don Phillips is a Managing Director of Morningstar and is responsible for corporate strategy, research, and corporate communications. Don joined Morningstar in 1986, as the firm's first mutual fund analyst, and soon became editor of its flagship publication, "Morningstar Mutual Funds." He holds a bachelor's degree from the University of Texas, and a master's degree from the University of Chicago.

Dick Phillips is a Senior Partner at K&L Gates, where he concentrates his practice in securities regulation, particularly investment management, broker-dealer, and SEC enforcement. Dick has a long and distinguished career, which includes various positions at the SEC, and is the recipient of the William O. Douglas award in 2001. This award was given by the SEC Alumni Association for contributions to the development of securities law, and service to the financial and SEC communities over the years. Dick is a graduate of Columbia University and Yale Law School.

And Avi Nachmany is a Co-Founder of Strategic Insight, a firm founded 21 years ago, as an investment management industry think tank and data resource. Avi guides the research and consulting areas, and contributes to the firm's technologies, including their SIM Fund-mutual fund databases. Avi holds an MBA from NYU's Stern School of Business.

I want to thank the panelists who are here. I am Buddy Donohue, and I am the Director of the Division of Investment Management. Now, let's get started. Our job is to pull this all together, guys and ladies, so let's get at it.

Barbara, why don't we start with you? We have heard a lot today about 12b-1, and why it's good for investors. But we really haven't had much from the investor perspective, and that's what you do for a living. So why don't you give us a little bit of help here.

Do investors understand 12b-1s? Do they know what they are? Do they have a sense about them, and does it matter?

MS. ROPER: Thank you. We have never tested, specifically on knowledge of 12b-1 fees, so I won't start there. We do know they don't know what loads are, so I suspect 12b-1 fees are even farther down the list of what they know and don't know.

There have been some things said about what investors want and don't want today, and a lot of them are true. Clearly, investors want advice. We did a survey that looked at mutual fund investors, purchase practices and information preferences, and the channels through which they purchase.

And, of course, their desire for advice is demonstrated not just by the fact that they choose to make their purchases outside of retirement plans through a variety of different kinds of investment professionals, but when you ask them about how they want to interact with that investment professional, what they tell you -- over a quarter of them, 28 percent say -- they rely exclusively on the recommendations that they get from that professional. They don't look at a single other piece of information.

And then, you have another -- I think it's 36 percent -- who say that they rely very heavily on that recommendation, but they looked at something. They don't like prospectuses, particularly in this distribution channel. They have not only low positives, but high negatives, in terms of something that they value, or considered important in their investment decision.

And we had done -- when we started this survey, we started by looking at what the experts said investors should know when they purchased mutual funds. And we found almost universal agreement -- whether you're looking at regulators, investor advocates, personal finance writers, industry -- when you look at what they think investors should know when they make that purchase.

And then, we asked investors what they wanted to know. Very high on the list of what every expert says investors should know is they should have an understanding of the fees they pay.

When you look within this particular distribution channel of those who purchase through a professional, you have a majority who say that the fee was at least somewhat important to them. But you have 45 percent who don't even rank it as "somewhat important."

And I think that's important in this context, because if you're trying to convey something to mutual fund investors about the costs that they pay, the fees that they pay, you're overcoming a certain resistance to having that information. You are providing that in a context where many of them really don't make an investment choice, in the sense that we conceive of an investment choice.

They are not weighing factors. They are not carefully reading disclosure documents. There is a wealth of information available to mutual fund investors. Much of it is presented in very innovative ways that makes it quite accessible. Much of it isn't, but for someone who is looking for it, it's there. They are not using it.

So you have a real challenge, when you're conveying something as complex as this, and that constrains your ability to rely on disclosure, or sort of -- I think, fundamentally transforms the way you use disclosure in this area.

You know, I heard the previous panelist talking about, "We inundate them with information." Well, yes, we do. And we do not present it to them either at a time when it is useful to them in making their decision, or in a form that they are likely to comprehend. It's not simplified.

I actually think less is more. I think what mutual fund investors need to know in this area is what they're paying for the operation of the fund. Maybe they need to know what they're paying for the services of the broker in providing them that fund. And those are two very different things.

And they don't need to know how it all breaks down, and what's the transfer agent getting, and what's for this kind of fee and that kind of fee. That should be available for the, maybe, one percent of mutual fund investors who might want that level of detail -- I say they all work for Don. But it's not something that we need to focus on when we're talking about how we work effectively in this area for the average investor.

One of the things that I have sort of been frustrated about, both as I have listened to the conversation today -- although I found it quite educational -- and as I prepared for these remarks, is we have heard over and over again, or you read over and over again, about how investors have spoken, investors have chosen, the client has spoken, this is a response to investor desire, I'm sorry, I don't buy that.

It does not follow that it doesn't provide a good option for investors. The ability to pay for the services you receive from a broker in some kind of incremental payment is probably a good thing for investors. It certainly is not anything we're interested in getting rid of.

But the idea that that exists because investors demanded it, I think, is a myth. It exists because it provided a distribution channel for brokers, one that was an alternative and has many positive characteristics, but also makes the costs quite non-transparent. And I don't think that is a coincidence.

The growth and use of these funds, at a time when there was a lot of press around no-load funds, I think there was a reason brokers wanted to receive their compensation for the services they provided in a way that did not allow investors to easily put a price tag on those services. And I think that is the glaring weakness of 12b-1 fees -- that it puts something into the shadows and distorts the other decisions that are made.

Also, I don't think investors make a choice about which share class, typically, is in their best interest. They rely on the broker to make that decision for them. And up until the regulators intervened, there is significant evidence that it wasn't always made with their interests foremost.

And even if we take steps to really improve the transparency around 12b-1 things, I think there is a very real possibility that the -- we will still have to rely heavily on brokers to make those decisions for investors, and we will have to rely on regulators to ensure that those decisions are made with investors' interests in mind, unless we're prepared to fundamentally re-evaluate the way we compensate brokers for the services they provide to investors.

MR. DONOHUE: Barbara, thank you. That was very, very helpful.

Mark, one of the points that Barbara just made, do you feel like the costs that are really broker costs, have been wrapped by you, and now you wear them, you're responsible for them, but they're really the costs for the broker?

MR. FETTING: Well, I think that what we're talking about today is the mutual fund and mutual fund investing. And I think, before I can answer that, I would like to lay out what I think is essential about the success of mutual fund investing. It combines three basic services.

It starts with portfolio management, which is the starting engine of the business as several have said -- it delivers performance, which is the essential ingredient of success. That is at the portfolio level.

The next level of service is the client service, advice, -- it enables what Don has studied, in terms of fee performance realization, so that you're not just getting it at the portfolio level. The individual shareholder is getting it in their own facts and circumstances.

And then, of course, the third level of service is the administrative piece, ranging from fund accounting to custody, et cetera. So we're talking about, and for those of

us who have been in the business long enough, the old

Weisenberger kind of compilation, right? Professional management; client service; and administrative efficiency.

Those three things, combined, deliver mutual fund investing, which, today, is where America invests. Almost 100 million shareholders, over 50 million households, 50 percent, are now investing. So, I think we should appreciate the simple combination has been very good for saving and working and investing America. And to try to split out any one, more than another, has its peril.

So, to go specifically to your question, Buddy, and to build on what Barbara was talking about, I think it is important that we recognize that the individual shareholder typically -- I think it's four out of five now -- use some sort of an intermediary. And they have chosen to do that. And that intermediary assists them in matching up that portfolio to their specific facts and circumstances.

I am one of five. My father ran a retail jewelry business. The first thing he did for us, because a customer of his happened to be a financial advisor -- in those days I'm not even sure what they call them, it was certainly a broker, or a client representative, or a customer -- whatever it was, that customer of my father's jewelry business said, "You ought to do this, Jack."

And my father didn't really understand, as much of your research has shown, how it happened, but he felt confidence in this individual, agreed with the recommendations, set up the accounts, and it enabled us, as children, to go on to schools that he was very proud of. And

I think there are a lot of investors that we serve, like my father.

There are a lot of investors who are busy in their other lives, whose accounts, whether it's $50,000, or $100,000 or $200,000 -- they're not necessarily $2 million or $20 million -- but they really do benefit from this combination of services.

And so, my simple question is what's wrong with combining services, when it delivers an efficient, value-added benefit to clients that are willing to pay for it?

MR. DONOHUE: Thank you, Mark. Question for the group. Toss-up. We have heard a lot today about how 12b-1 has really helped facilitate competition.

My question, observation, is if you go within a particular channel, 12b-1 fees tend to be uniform, and tend to be at the NASD maximums. And while you may have -- on one level, you do have choices of share classes. On another level, there doesn't seem to be much competition with respect to, ultimately, what those fees are.

What's the view of the panel? Is 12b-1 facilitating competition? Is it impeding competition? Or, maybe neither of the above? Dick?

MR. RICHARD PHILLIPS: I think that you have to separate, for purposes of analysis, 12b-1 fees into two parts.

First, is the 25 basis-point service fee; second is the 75 basis-point distribution fee, which according to the

NASD, years ago was the economic equivalent of the front-end load. The 25 basis-point distribution fee has been effectively used by no-load funds to gain entry into the mutual fund marketplaces, and other channels. And in that sense, it has enabled those funds to compete for a broader segment of the investing population.

In terms of the rest of the 12b-1 fee, the equivalent of the front-end load, I don't think it has fostered competition. If anything, it has restrained competition in two ways.

Number one, it does not have the transparency of the front-end load. The investor who puts in $10,000 into a class A share knows that he is going to pay $525 to $575 for the services of an intermediary. That investor gets dollars and cents transparency.

That same investor, if the money is put into a 12b-1 class, gets basis point transparency. That's not the equivalent. And, therefore, to the extent it inhibits transparency of charges, it inhibits price competition.

It inhibits price competition in another way. Because it's paid at the fund level, and because the amount of the 12b-1 fee is really set by the intermediaries -- not by the fund, not by the underwriter, not by the directors -- it restrains competition, insofar as the sales charge is concerned.

Unlike individual securities, there is no price competition in terms of the commission, if you will, or the counterpart of the commission. You cannot go to E*Trade, or another discount broker, and get a deal on a load fund that is any different than any other full-service broker.

So, in effect, the 75 basis-point distribution fee paid at the fund level is a restraint on competition in two ways: relative lack of transparency and inability to bargain for it-- to select a low-cost broker if you don't want a full service and get a lower sales charge.

MS. ROPER: I would say that I think the answer is both. I mean, there are clearly aspects of 12b-1 fees that have promoted competition: providing mechanisms for fund participation in retirement plans and supermarkets transforms the marketplace and creates a different kind of delivery mechanism that is a form of competition.

I would say that 12b-1 fees have in common with the entire sort of product-based system for how we compensate brokers is that they foster reverse competition, constrained by regulatory limits. And that funds, like other investment vehicles, compete to be sold, rather than competing to be bought.

It's not clear to me that if you -- and I think there is a very good case for decoupling broker compensation from investment vehicles. You know, one of the things that I worry about, frankly, if we do that, is I think there is a very real likelihood that prices come down for big accounts and go up for small accounts. And so, as an advocate for retail, and average retail investors, I have to be concerned about that.

But on a pure market-based question, I think there is no doubt that the way we choose to compensate for the services we receive from brokers protects those services from competition.

MR. FETTING: Yes, I would like to say on the competition, though, that it's really not -- if the economic benefit is a combination of investing, servicing, and administrative efficiency, then the competition shouldn't be on the pricing of one single element. And I don't think clients think of it that way.

I think the competition should be on the net return delivered to that client, through their facts and circumstances. And if the cost of getting that service enables them to get more of the return realization over the course of their investing cycle, then I think we would all say -- and I think research has shown -- that that is valued.

MR. DON PHILLIPS: I would like to build on what Mark said. I think it's very helpful to break down the cost of a mutual fund into those buckets that Mark used, the portfolio management; client service and advice; and administrative costs. And the issue I have with 12b-1 fees is that it really doesn't help you get costs into those buckets.

As was said earlier today, people were talking about the different uses that they use 12b-1 fees for. And some of the things that were thrown out -- it's an ongoing fee to the advisers who sell funds; also it's the spread load transaction fee, the offset on internal marketing costs, the phone, the advertising, the web site. Well, all of those things would seem to fit under that client service and advice bucket.

But then, also thrown out was paying for supermarkets, and paying for 401(k) plan administrators. And it seems to me that those are administrative costs. And that's the problem I have with 12b-1 fees, is I think it confuses the issue. I think it's almost as if you had your own personal budget, and you invented something you called 37Q fees, that included part of your housing budget, and also part of your entertainment budget, but it didn't include all of either.

And yet, every time you sat down to look at your household budget, you said, "Well, let's think about our 37Q fees." Well, it doesn't make any sense. You break it down into more economic buckets, as opposed to buckets that are a reflection of the historical or legal basis for their being charged.

And that's the way I would like to see the fund disclosure go, to mimic what happens with public companies. You know, if you or I were to buy shares in a business, we would ask for some basic cost accounting, and we would say, "What went into cost of goods sold, what went into sales and marketing, and what went into general and administrative," it would be very basic.

And in the fund industry, that breaks down into exactly the buckets that Mark has proposed: portfolio management; cost of goods sold; client service and advice would be sales and marketing; and then administrative would be the G&A part.

Today, though, it takes a huge amount of financial gymnastics to try to get mutual fund costs into those three buckets. As was volunteered by two fund companies earlier today, the total amount of what they are charging for what they consider to be 12b-1-like fees exceeds the 12b-1 fee that they charge.

In many cases, if you're paying a 40 basis points fee on a supermarket, clearly you can't pay for those fees just out of your 12b-1 fee, it has to come out of the management fee. So, some of what the client sees in the current breakdown of costs that they see as management fee is really going to sales and marketing.

You also have the case of soft dollars where something that clearly would be a management fee is not even in the expense accounting. And I think if the Commission could clear this up, and just get those costs into those three buckets, that would do investors a world of good, and would do a lot to promote competition, because then you could look and see, with two different funds, how have they allocated your dollars, the dollars that flow through to the fund, into these three basic services.

And then you could decide, do you favor a firm that is spending more on client services, or more on investment management. And you could also have some debate over are some groups inefficient, in the aggregate amount that they're paying for administrative costs, relative to others. That, I think, is what would inspire competition.

MR. NACHMANY: Let me take it for a couple of minutes. First, I disagree with the original premise that there is homogenity in this pricing, and how it works. We had two broker-dealers today, and one of them, level-load, fee-based is 60 percent of retail sales, and the other one, A share, is the majority of the fund sales. So, clearly, there is even when you look at very similar organizations.

But the way I look at this issue is other marketplace forces -- because at the end, we are very confused about this issue. But to some extent, the question is, are the marketplace forces trying to fix all those places that we have been confused, or perceived to be ultimately wrong for the investor?

And I will just show you a couple of places that were not discussed today. B shares is where most of the anxiety around 12b-1 fees has been. And clearly some of that came out today. B shares today are, maybe, three percent of sales for brokers. It's a category that is in the process of self-regulation, losing about 20 percent of its assets due to net redemptions in each of the last 3 years.

And from a practical perspective, it's no longer an issue, it's no longer a problem to try to fix. We talked a little bit about front-end loads and 22(d). The discussion that we have with an organization, 80 to 85 percent of A shares today are sold at the NAV. Ultimately, the business has transitioned to fee-based pricing everywhere you look.

There are many other subtle changes in the business. More and more of the business is done through platforms where funds are aggregated. And in some of those platforms, there are expectations to shift from A shares, which generally have 25 basis points, to institutional share classes. So we use that.

We had this discussion from Schwab, that Schwab has two main platforms. One is called NTF -- no translation fee -- and one is called transaction fee. Usually, in a transaction fee, they are funds that are less expensive, and have no 12b-1 fees. The transaction fee piece of Schwab, to my knowledge, is going much faster than the others.

So, the marketplace is working to figure out those things that we all have been confused about. And to me, trying to find a different way to fix that problem that the marketplace is not yet addressing -- is not clear what will be the outcome of that.

MR. DONOHUE: Dick, you made a comment before that I would like to follow up on where you pointed to the position that directors are in now, where they effectively are price takers, not price determinants of 12b-1.

And as I was preparing for the roundtable, I went back and read all of the Commission releases, and it was quite clear that the Commission relied -- was relying quite heavily on directors, particularly independent directors, to have a role, and a very crucial role, in determining when, where, to what extent 12b-1 fees will be used.

You fast forward now 27 years, and you hear from many, including many members on boards, that it's the marketplace that is determining that, not the directors. And that directors are in a position of really being unable to fulfill the role, I think, that had been envisioned for directors, back when the rule had first been adopted -- is that something that the Commission should be concerned about at this point?

MR. RICHARD PHILLIPS: With all due respect to the historians on the first panel, I don't think the Commission envisioned that 12b-1 would be so widely used as a substitute for the front-end load.

And the Commission factors that directors should consider reflects the fact that they did not have that vision. They viewed 12b-1, if you look at the factors, as something that would be temporary and limited, a subsidy, if you will, to funds that need help in their distribution system.

That is not the way 12b-1 is used today. It's used for two purposes. Number one, to pay for various kinds of services, including no-load funds, services on the marketplaces, services on pension fund platforms. It's used to incentivize salesmen to follow up on customers, and maintain a relationship. That's the function of the 25 basis-point service fee.

The rest of it, the 75 basis-point distribution fee, is used as a substitute for the front-end load. And that price, as well as the price of all intermediary services in the 12b-1 area, is set by the intermediaries.

And if there is one thing the Commission should do, that I think, above all else, cries out for doing, is to reform the role of directors, not only with respect to 12b-1, but with respect to oversight of the distribution system. As the Commission's more recent enforcement proceedings show, distribution is a source of tension and conflict within the fund industry. And it's been the source of more enforcement action in recent years than any other area of fund operations.

And it calls for directors' oversight of the entire distribution system, an understanding of how funds are distributed, what kind of money goes into the distribution, where does it come from. No one here, for example, this entire day, has mentioned revenue sharing, a very important component of the financing of the distribution of fund shares.

Directors should understand how distribution is financed, where it comes from, the manager or its affiliates, the fund, or the shareholder. Directors should understand who gets it, how much they get, what are the conflicts. Okay?

And 12b-1 is just a small piece of that understanding. And 12b-1, in terms of the role of directors, ought to be converted into a duty of oversight with respect to distribution, not with respect to simply the small piece of distribution that funds pay.

And so, I urge the Commission to take a good look at the role of directors, in connection with the distribution function, and be realistic, in terms of recognizing that, A, distribution is necessary and inherent to the operation and development of the mutual fund, complex of the mutual fund industry and of each mutual fund.

It's in the interest of the shareholders, because a fund that doesn't keep pace with its market is not going to be able to retain and recruit the talent that it needs to maintain good performance, both in operations and in investment performance.

And directors have a responsibility to understand the operations of distribution systems, the financing of it, and to make a judgement whether or not the manager is devoting sufficient resources to distribution, and whether or not there are conflicts in the distribution system that need monitoring and oversight by the directors. And that is how the duty of directors ought to be reformed, in terms of 12b-1 -- much broader than it is today.

MR. FETTING: I would like to build on that, if I can, because the working group that we formed at the ICI, which included independent directors -- and we have a working paper on our site -- really tried to get exactly at Avi's and Dick's, Don's, Barbara's comments.

This sounds like a sound byte issue, but it's not. This is a very complicated issue, because of the pervasive use of 12b-1, beyond what the original intention was. So, let's go through kind of the things that have come up today.

Retirement investors, which is a big chunk of that

50 million households. Almost 40 percent of those plans use 12b-1s in one form or another, to kind of deliver the benefit of retirement investing, in one form or another.

The individual investor, which is still very important -- and that 75 basis points is actually a minority in the total dollars, because of what Avi said, which is -- what is it, Avi, 80 to 85 percent of A shares are NAV, right? So that means they're only getting the 25, not the 75, et cetera.

So, as the Commission looks at this, we totally support the notion of looking at its current use, and marrying good board oversight with good disclosure, relative to its current use, in such a way that it continues to be a good benefit.

Yes, there should be some changes, absolutely should be some changes in disclosure, in board oversight. But it being a fundamental part of delivering good service, which is part of the kind of trinity, if you will, of value that is delivered, I think is important.

So, I really think this -- I really feel good about, that at the end of the day, we're coming to, hopefully, it's not a sound byte issue. It's a complicated issue, with multi-factors because of its usage, and we ought to look at it, accordingly.

MR. DONOHUE: Mark, the day is not over yet.

(Laughter.)

MR. DONOHUE: Barbara, how do you feel about disclosure as the solution?

MS. ROPER: Well, I mean, obviously, we're in favor of improved disclosure. But, as I said, I think you need to think creatively about when that happens and how that happens. It's not necessarily about more information. It can be about simpler presentation of information, or different information.

I don't have a lot of confidence that, even if we really get the disclosures just right, a lot of investors will make the use of it that we would like to see them do.

And the other thing I think, I have a fair amount of confidence that if we get the disclosures just right, and really bring some of these broker compensation costs out into the open, that they will shift into a less transparent form. As Dick was saying, revenue-sharing payments, for example.

If you bring certain things out into the open and leave certain things hidden, or relatively hidden, you're creating an incentive to shift costs into a place where they can be hidden.

I also have a concern -- and perhaps it's unusual for this to be brought up by the investor advocate, rather than some of the industry people -- but by dealing with this as a mutual fund issue, by dealing with this as a 12b-1 fee issue, or a mutual fund issue, instead of a broker compensation issue, sort of more holistically, you run the risk that you make mutual funds less attractive to sell. And I think that would be a very bad thing.

I think it is very important that we do a better job around the entire issue of broker compensation questions.

But I don't think that is a product-specific issue.

And, obviously mutual funds have, in some ways, been well served by the distribution services that have been provided by broker-dealers. But there are other ways in which they have been very badly served.

What we refer to as mutual fund scandals in recent years, some of them are mutual fund scandals, the timing, market timing. A lot of them are broker-dealer sales abuse scandals. And they get classed as mutual fund scandals, because we have made this linkage between the product and the provider. I understand why the brokers would want to hang on to the star of mutual funds, and use that as the way that they represent themselves to the public.

But I do think there is -- when you tie these two things together, mutual funds have, in some cases, been sullied by that relationship. And I think compensation is almost always at the heart of those issues, when that has been the case.

MR. NACHMANY: Yes, I want to touch just quickly on this issue of disclosure and confusion, just a couple of points, and maybe the other side.

As I was preparing for this exercise the last few days, I tried one thing, I went to Morningstar.com and tried to figure out how complicated it is to figure out what's the expense structure of a fund. How long will it take me? It's four clicks. It's four clicks. Morningstar has done a terrific job. Four clicks.

On the top of the page is the 12-month fees, then the whole breakdown the maximum sales load, the redemption fees, the maximum fees, and the cost projection for 3, 5, and 10 years. It's four clicks for every fund. So, is this hard to understand? Yes, it is. But there is so much disclosure, and it's there.

Just on a point of confusion, and I think it came up a lot today, I think most investors -- and something I did not fully understand until last week -- what is the "mutual" in mutual fund? What is the mutual in mutual fund? Because, when you think about this, those small investors, the 50, 60, 70 percent of investment accounts that we have, are small. Almost everything in a mutual fund for those small investors, they are being subsidized by large investors. That's the "mutual" in mutual funds.

Investment management fees are subsidized, shareholder servicing fees are subsidized. And sometimes, the 12b-1 thing is merged into that. Very small investors are somewhat subsidized by the very large investor. That's the deal that we have made here, to create a product that has cross-subsidization everywhere.

And the 12b-1 is just one aspect of that. And just focusing on that, saying it's not always perfect, the product is not perfect. But, clearly, it has been accepted very, very well, despite its imperfections.

MR. RICHARD PHILLIPS: You know, I question some of what Avi says -- and I do so hesitantly -- because I think you have got to separate the 25 basis-point service fee from the 75 basis-point sales compensation fee, or broker's compensation fee. And the two things are very different.

I think it would be foolhardy, on the basis of the information that the Commission has today, to mess with that 25 basis-point service fee. It's used in too many different ways for too many worthwhile purposes. No-load funds use it to gain access to the marketplace, to retirement fund platforms. It serves -- it should serve as an incentive for salesmen who sell class A shares and class B shares.

Before the Commission passes judgement, maybe it ought to find out whether, in fact, the 25 basis-point service fee in class A is working somewhat as intended. Are there many letter writers like the one that was highlighted earlier today, or is that an isolated incident?

Is there something that the NASD and/or the Commission can do, A, to find out whether there is a problem there, in that the service fee is not working as intended, to provide continuing service to shareholders, or is that an isolated case?

Is there something that the NASD and the Commission can do to make sure that any laggards among the brokerage community are properly reminded of their responsibility to work for that 25 basis-point service fee?

The 75 basis-point substitute for the front-end load, on the other hand, is pure sales compensation. And there is no reason why that shouldn't be made as transparent as the front-end load, and no reason why you can't introduce some modicum of price competition at the broker level for those investors who don't want servicing, who prefer dealing with a discount broker, as they do in the case of individual

securities.

So, I would separate the two. The 25 basis-point service fee, I would recognize it as a very important factor in the maintenance and development of the fund industry in many different ways. Indeed, I would almost regard it as a necessary cost to the open-end structure of the mutual fund industry.

The 75 basis-point sales load substitute is also a necessary cost for those investors who want that kind of service. But I think it ought to be made more transparent, as to what they're paying for. And that's a dollars and cents disclosure.

MR. NACHMANY: The 75 basis-point on B shares is finished, because B shares are not selling anymore. It's 2 percent of assets going away, and not a need to focus on that anymore, and the 75 basis-point level of funds, just very clearly articulated, is a fee-based, very well accepted substitution to other ways to pay fee-based.

And, incidentally, all the other ways are generally higher in costs than the level load. So I think the marketplace has sort of clearly --

MR. RICHARD PHILLIPS: Why are we ignoring C shares? Don't C shares have a salesman's compensation component, as well as a servicing component? Indeed, I would hope that C shares provide more servicing, more advice than, say, a B or an A share, because after all, over the term of a longer-term investment, the broker gets better compensation for it. And, in return, the broker ought to have incentive to give better service.

But I would not ignore C shares. I don't think B shares is the only issue. Moreover, B shares is suffering from the problems of suitability exposed by the more recent NASD enforcement actions. And in five years, they may be back.

MR. FETTING: Let's probe this issue. Because, to me, it's kind of an extension of choice, which the industry has been able to deliver, partially due to the structure of the funds, partially due to what 12b-1 allows.

But if you think about today, the investor that doesn't want to go through an intermediary is currently doing that, whether it's through Schwab, dealing directly with the fund complex that is largely traditional no-load; through their retirement plan, where they're getting it at pretty low value, in terms of cost and efficiency, et cetera.

But there still is a large group of investors that want to take advantage of advice. They're willing to pay for it. Now, if we were to say that the funds shouldn't do that -- assume you improve disclosure, and the funds should -- then what they're going to do is they're going to go to other places, as exists right now.

One of the fastest growing segments of the mutual fund business right now, are mutual fund wrap programs. And the brokers tend to charge a higher fee than what is embedded in the fund. They have that choice right now, they're pursuing it. They're pursuing it, presumably, because they're being disclosed at the account level that it's being charged, et cetera, et cetera.

So, here again, if you look at the widespread choices that are available, if the fund really does deliver an efficient approach -- we improve the disclosure, we improve the board oversight and the factors -- isn't that progress, while still allowing multiple choice, across the board?

MR. RICHARD PHILLIPS: I think we should allow multiple choice, but I would hope that a wrap share program, for most investors, gives them more service and more investment management or advice than they get from A shares or B shares. If they pay more for it, they should get more service.

And I assume that, on the whole, investors are rational in that respect, as long as they know what they're paying for. And in the case of wrap programs, I think, by and large, they do know.

MR. FETTING: And therein lies the mission of the SEC, to protect all investors. The average account size of a wrap program is $250,000. The average account size of a mutual fund program is $20,000. So, if we get the right disclosure in a more efficient format to a mutual fund structure, isn't that beneficial to this larger, smaller-balance investor?

MR. NACHMANY: Mark? $336,000.

MR. DONOHUE: Thank you.

MS. ROPER: Can I just say? I don't understand why mutual fund companies have to dictate my choices for getting broker-dealer services. And, in fact, I have a multitude of choices for getting advice -- whether it's from asset management, fee-only financial planner, fee and commission financial planner -- all of the various different mechanisms for charging for brokers that do not have to go away, just because we stopped running those fees through the products themselves.

And so, I don't think it's an automatic assumption that the choice diminishes if you stop choosing to compensate through this mechanism.

The other thing I would just like to point out, having listened to today's discussion, this advice we're getting doesn't sound remotely like anything I would call solely incidental to product sales. And these fees sound a lot like special compensation for advice.

And I am just suggesting that, in light of the recent court decision, it is an interesting discussion.

MR. DONOHUE: Well, Dick, you broke up the two components of the 12b-1 fees. And let's go a little bit with that, let's talk about them a little differently. And we will take service fees and put them to the side for a moment.

And for a moment, let's not try and come up with hypotheticals about what would happen to fees if they were externalized. The one thing that kept fees constrained inside the funds was not because the fund companies -- Mark, it wasn't because your firm kept them down -- it's because the NASD kept them down. And the NASD regulates brokers. So, we will put that aside for a moment.

How do people feel about externalizing the 75 basis points? In other words, say that that's not really a fund's responsibility, to collect a load on behalf of the broker -- what if you wanted some competition to take place -- and put aside, maybe for a moment, 22(d), or maybe talk about 22(d).

But why not let Barbara go to a financial advisor and say, "Well, I will pay you 50 basis points," or, "I will pay you 25, but take it out of my account." What's wrong with that?

MR. RICHARD PHILLIPS: Well, I think there are four things wrong with it. Number one, it --

MR. DONOHUE: I mean, let the record show only Dick can speak in terms of four things.

MR. RICHARD PHILLIPS: I want to say that the views I express are my own; they are not the views of my colleagues at Kirkpatrick; they are not the views, necessarily, of clients. Any resemblance between their views and mine is purely coincidental. They reserve every right to brand it as pure heresy.

Having said that, I see four problems with internalization, and two problems -- four problems with internalization, or mutualization, as it is labeled here --

and two problems with externalization.

The four problems are: it inhibits transparency, number one, compared to front-end load standard of transparency; number two, it increases the complexity of what, in concept, is a relatively simple concept of a mutual fund -- a collective investment vehicle -- it produces different classes, makes it difficult to compare performance and expenses; number three, it puts directors in a very uncomfortable role, they have to exercise responsibility over 12b-1 fees that is really outside their control; and, number four, it inhibits competition, because the fund has to pay what the intermediaries charge -- and there is no effective shopping around, or negotiation, and no effective cost lowering, price competition. There is lots of competition on performance, there is competition on service, but not on price, with respect to that 75 basis-point sales charge.

Those are four problems. Externalization would deal with those problems in a meaningful way. It would provide dollars and cents disclosure, hopefully at the point of sale and the confirmation, and in account statements over the period of time, shareholders would know what they're paying for. And if it's for service on a continuing basis and they aren't getting it, they may ask questions, and suddenly they may get it.

Or, they can -- next time they buy mutual fund shares, they will try and shop around, and if they don't want service, they will try and get a lower sales charge. Very healthy.

Secondly, directors would not have responsibility for determining whether a charge is reasonable. That doesn't mean they won't have responsibility over distribution. In particular, whether funds ought to be distributed in a particular channel, as well as what are the conflicts, what are the problems, what are the costs to the funds, to shareholders.

But not for determining whether a fee is reasonable, and that's what makes them uncomfortable. And not to make a yearly determination whether it's in the best interest of shareholders to keep paying that fee, even though the fund may be closed.

Number three, externalization would reduce complexity. Funds would not have to have all those different classes. May have to have more than one, but usually not more than two, if that much.

And four, they could be shopping around.

And five, in a sense most importantly of all, you would eliminate what I think is probably the most persistent and misguided criticism of the fund industry, which does a great deal of damage to the industry reputation. Even some very, very sophisticated observers do not seem to understand that 12b-1 fees are really a substitute, in large part, for the front-end load. They condemn it as a hidden subsidy. And that's simply misguided.

It ain't true, the way 12b-1 is used today, and yet I am shocked at the sophistication of people who continue to repeat that mantra, particularly with respect to the payment of 12b-1 fees for closed funds, when they simply refuse to recognize that the 12b-1 fee paid today is for yesterday's sale, for the most part.

MR. DONOHUE: Yes, I --

MR. RICHARD PHILLIPS: So, I think that the industry would be a lot better off with externalization. Are there problems? Yes, there is some cost. Whenever you have to make changes to your systems to accommodate each shareholder account, it's costly and it's complicated.

On the other hand, is it more complicated than instituting a dividend reinvestment program, which has to be done periodically with very small amounts? I don't think so. And people I have talked to kind of laugh at arguments that it involves very substantial costs. The mutual fund industry, at least in the United States, is technologically very sophisticated, and it can handle it. Tax is a problem that it's not going to be able to handle.

MR. NACHMANY: Yes, let me take -- you have a list, and I have a list. I have five things wrong with externalization.

(Laughter.)

MR. NACHMANY: The first one, it's going to drive the cost, the effective cost, to an investor, my guess, double what it is now. It's going to double the cost, especially for small investors.

Why do I say that? Because when you look at other places where externalization is in place -- let's take separately managed accounts -- the average account is

$300,000. The average fee on the very large accounts averaging with small accounts is, right now, about 1.7 percent. But if you look at the low end of the market, it's somewhere from two to three percent. Our sophisticated investors, they have bargaining power. There is transparency, it's somewhere from 2 to 3 percent.

So, as you think through these issues in externalization, the cost of advice in externalization, the economic equilibrium, has been set. It is significantly higher than the highest 12-month fees today --

MR. RICHARD PHILLIPS: Avi, implicit in your statement is that the mutual fund investor, for the 25 basis-point service fee, gets precisely the same level of service as a separately managed account investment. I don't believe it, and I don't think you do.

MS. ROPER: Plus, that separately managed account includes the investment advice and the fund management fee, and it includes --

MR. NACHMANY: It's about 30 or 40 basis points --

MS. ROPER: -- you know, personalization.

MR. NACHMANY: -- or 3 percent. So it is not the --

MS. ROPER: So, I mean, it's not -- and it requires a certain volume, in order to be functional. So I don't think it is at all the same vehicle.

MR. NACHMANY: Well, it is -- you know, I can argue the case -- so, anyway, there is a cost.

Then this whole tax, we haven't talked a lot about the tax. You lose the tax issue. And if you look at the 10 or 20 or 30 years time horizon, and you lose 20 basis points a year, this is a complicated issue, but the simplest way -- most people don't get it, but it's like buying a subway card out of your salary -- getting a salary reduction by a New York City subway card, versus paying cash. There is an advantage to paying before tax, and it adds up, it is significant over time.

You also have the issue of transparency. For the life of me, I don't understand why, if Merrill Lynch has it externalized, and you try to compare how much you pay to Merrill Lynch, and how much you pay to Smith Barney, Don Phillips at Morningstar will not be able to show me those numbers on the web site. So I think it will actually reduce transparency, not increase transparency.

And I think once you break the pricing rules, then brokers will say, "Why am I doing business with $10,000, $20,000 accounts? Why am I doing business? I have a limited amount of time. I will do business only with the high end."

So, I think there is a problem with accessibility at the low end of the markets. The cost is going to be much higher, significantly higher, you lose the tax benefit, you lose transparency, and you lose accessibility with externalization. So I don't get it.

MS. ROPER: I just want to say this model exists. I use it. I have a family financial planner, my payments are very transparent, and I implement through no-load mutual funds.

And I would argue that my costs are probably lower, when you combine my fees for advice and my fees for the operation of the fund, than they are in most or many brokerage accounts. And there is research that certainly supports this notion, that part of what you get, the benefit you get in paying 12b-1 fees, or loads purchasing through that channel, is higher cost funds, absent the distribution costs.

And we were talking about this last night, and one person said, "But that's not a fair comparison, because they don't have access to those funds, those lower-cost funds." But that's the point. You have chosen to pay for advice in a way that denies you access to investments that may be in your best interest.

I think there are two -- in the interest of arguing against myself -- the two biggest concerns I see about externalization, or say the one biggest concern I see about externalization, is this issue of what happens to small investors. And I think there is a very real issue about whether, as I say, costs come down for big investors but go up for small investors, or access for small investors is lost.

I actually have a fair amount of faith in the industry's ability to figure out a new way to deliver to that market, if they view that market as worthwhile, so I don't --

MR. RICHARD PHILLIPS: I don't get that.

MS. ROPER: -- necessarily think it is a lost cause.

MR. RICHARD PHILLIPS: I don't get that. I am not suggesting -- unless transparency has some effect -- I am not suggesting that fees be lowered. I am suggesting that they be made more transparent.

Do you think that the effects of transparency would be such that the brokers couldn't justify it? And, therefore, they would abandon the field? I never thought -- if so, then there is something wrong with the field.

But if, in fact, transparency would have no effect, as Avi says, and others say, then there should be no impairment of the profitability to the broker-dealer, except for the cost of ink and paper for one more line on a confirmation account statement.

MR. DON PHILLIPS: Dick, which fees are you talking about being externalized? I thought you had said, initially, that the 25 basis point you would leave internal --

MR. RICHARD PHILLIPS: I would leave it.

MR. DON PHILLIPS: So, A shares, as they exist, would continue to exist.

MR. RICHARD PHILLIPS: Would be unaffected.

MR. DON PHILLIPS: An organization like Ariel, where Mellody talked --

MR. RICHARD PHILLIPS: Right.

MR. DON PHILLIPS: -- about the importance of having -- that would continue to exist. So, really, what we're doing is debating C shares, since Avi has told us that B has gone away.

MR. RICHARD PHILLIPS: That's right. So all we're talking about is C shares, which is really another way of charging a separate account fee, because you're talking about one percent over a period of time.

Now, maybe you don't get the same services as a separate account, because you don't have the same amount of money, but that's to be expected. But I have difficulty understanding, unless transparency will really have devastating effects on brokers' compensation, I have difficulty understanding why costs will go up, except for the ink in adding a line to a confirmation, and an account statement. It's expensive, but not that expensive.

MR. DON PHILLIPS: Yes, Avi's numbers on how B shares have fallen from favor are illuminating. A lot of discussion has come up today about how investors don't look at expenses, and I think that's true. They don't look at expenses. But there is an army of people out there who do look at expenses.

And financial advisors, like Joe, who was on the last panel, they list expenses as the number one thing that they look at. So a lot of that is filtering through to investors, and influencing their decision-making. I have lost my train of thought.

MS. ROPER: Well, in direct answer to Dick's point -- because on almost all of this I agree with him -- the reason I am concerned that investment costs could come down for large accounts and go up for small, is that when you charge on a percentage of assets basis, large accounts right now are subsidizing smaller accounts.

They are paying the same percentage, but they're paying a lot more cash. And they also are those investors who will have the most ability to negotiate their fees with the broker, because they're attractive clients.

I am not saying this is a reason it shouldn't be done. I am just saying it is the one thing that gives me pause about the issue of externalization.

MR. RICHARD PHILLIPS: Yes, I have questions about the business judgement of that broker. If I were a broker, if I didn't see any other -- if I was losing money on a small account, I would get rid of it, and raise my profitability, except that I may want small accounts because the marginal cost is not that much.

And number two, small accounts grow into big accounts, particularly if they have a good investment experience with me.

MS. ROPER: Yes, watching investors' interest in small accounts is like the old watching hemlines go up and down. I mean, one decade we're about accumulating assets, and the next day we're about sending the small investors off to call centers.

They make a business judgment. They have a right to make a business judgment about how much service that they want to give those accounts. But it's not always the same decision.

MR. DON PHILLIPS: I see what we were talking about earlier, B and C shares, not a whole bunch of issues. You know, the retirement share classes, I think I am certainly in agreement that paying additional fees to service those accounts, and having that run through the fund, just seems like an appropriate usage of that. Paying for being on supermarkets seems like an appropriate usage of the fund.

The real issue comes down to the B and the C shares. And I said earlier, investors don't look at expenses. But what they do see is the long-term impact that high fees have on expenses. And I would argue that that's the way, or the reason that the B shares have fallen from favor, is that they developed 10, 15-year records, and people saw the scarring of that record by the inflated expenses.

And I think it's a very easy prediction to make, that the same thing will happen to C shares, once investors see the 10-year impact of paying a 1-percent load on C shares, especially if you get into areas like short-term bond and see just the debilitating impact that has.

The question is how much damage do you want to have happen to investors, before you step in and look at that? But I would think, on the externalization or internalization the major thing is does it apply to all 12b-1 fees, or just this spread load factor, which I think, as Richard has pointed out, are very different debates.

MR. DONOHUE: Don, if the investment performance was the reason why B shares were falling off, C shares would have fallen off sooner. Once you get beyond that period of conversion, the performance for C shares, long term, is worse than B shares.

MR. DON PHILLIPS: But C shares, for the most part, don't have 10-year records yet.

MR. DONOHUE: That's not --

MR. DON PHILLIPS: You know, most of them are newer, they have shorter histories.

MR. DONOHUE: That is not --

MS. ROPER: There -- regulatory action --

MR. NACHMANY: Don, the C shares started in 1990 --

MS. ROPER: -- is what happened to B shares.

MR. NACHMANY: They only have 17 years, and the big, big evolution of C shares in the marketplace was, like, in 1992 or 1993. So we have 14 years of tenure. I don't think that is --

MR. DONOHUE: Okay, we have 15 minutes left. What I would like to do, I would like to reach closure, have an answer, be able to package it, hand it to the Commissioners.

(Laughter.)

MR. DONOHUE: But that is not something that we are going to be able to achieve today. So what I would like to do is, first, I would like to invite Chairman Cox and the Commissioners to -- I know they're not shy, but if there are questions for this group, we've got them here, they can't leave for another 15 minutes. And then I would like to leave some time for closing statements by the panelists.

CHAIRMAN COX: Well, Buddy, I don't see why we couldn't put a question somewhat like the one that you just put, possibly make it a little more susceptible of actually being answered by asking you to take two forks.

Alternatively, first, imagine that all we are doing is leaving the status quo, but improving transparency. And then, second, imagine that you can do anything you like. What would be your favorite way to wrap this thing up?

MS. ROPER: If what you want to do is improve transparency, then I think you have to figure out what you want to accomplish by that.

And if the goal is particularly with regard to that portion of 12b-1 fees that goes to compensate brokers, to give investors the information they need to know what they're paying for and how much they're paying, then I think one of the approaches that you can take is account statement disclosure.

If that's the goal, then that can be a post-sale disclosure, and you can -- the investor can then take that information, and decide whether they're getting services that are worthwhile, given what they're paying. And that could be a good thing to do.

If what you want to do is arm investors to make better decisions, so that they can evaluate for themselves which share classes are appropriate for them, what's the best way for them to pay for the services they get from brokers, then I think that disclosure has to occur pre-sale. And, in fact, I think it has to occur at point of recommendation.

And I think it has to be fairly simple and straightforward. It has to say, "This is what you're going to pay for the operation of the fund, this is what you're going to pay for the services of the brokers."

I don't have a huge amount of confidence that that will change investor behavior. That doesn't mean it's not a worthwhile thing to do.

If I could do anything, I would change the topic from 12b-1 fees to broker-dealer compensation issues, and have the Commission look holistically at these issues, to ensure that, one, it doesn't create incentives to simply move to a different form of non-transparent compensation within the mutual fund context, but more importantly perhaps, to ensure that it doesn't create a disadvantage for the sale of mutual funds, which I think we can all agree has been one of the great innovations for investors from recent decades.

MR. FETTING: I would go down the path of modification of transparency, but also board oversight, pulling those things together, and talking about in comprehension the things that we have been talking about now.

And I would like to leave with the thought of we at Legg Mason have had what people call C shares -- it's Primary Shares -- since inception of our funds and the Value Trust is our flagship fund. We have really strived to align the investment manager and the financial advisor together, to deliver this return realization for the client.

It's not easy. It takes years of working together. It means kind of servicing counter-intuitively, not buying at the peak, but just the opposite. And that can happen. And so, I would like to point out that this so-called distribution fee can be viewed by the client as a service fee, and good value.

And I would really urge that, when you look at this, the possibility that many of us inside Washington and related areas are informed, because we might choose personally to invest differently, but there are a lot of folks out there, so long as we respect them, are getting good value, and don't see this as the raging issue that some of us might.

MR. DON PHILLIPS: Within the context of how things are today, I think the vast majority of what happens under 12b-1 fees is something that is a legitimate investment cost. It is paying for additional services that you might get in a supermarket, it is paying for ongoing counsel from a financial advisor.

And I think it is truly a benefit, to move from the incentive for the adviser being to sell something to generate a commission, or encourage a trade, to doing the hand-holding during tough times, when the markets get tough, and staying with the adviser. And that shift to an ongoing compensation is appropriate.

And I do think that the vast majority of investors would prefer to have that fee be internalized. You know, if you were to break out the cost of Vanguard running their web site, and myself as a Vanguard shareholder would have my mutual fund, and some of the expenses would be in there, but then I would get a separate itemized bill on my account for the ads that they ran in different magazines, or the cost of

the web site, I would not see that as a step forward.

So, with the way things are, I would say if you wanted to externalize fees, or you wanted to look at one thing differently, you would look at maybe the B and the C shares. And, as Avi pointed out, the B shares are maybe 2 percent of the business, the C shares 10. It's really only the 12 percent of the industry that you're talking about, not the vast majority.

Now, if I had my druthers, and could do whatever I want, what I would like to see is the industry stop reporting to shareholders their fees being management fees, 12b-1 fees, administrative fees, and other.

Because, as I said earlier, those buckets really don't align. Some of what is going on in the 12b-1 fee is clearly an administrative fee. You know, some is a sales fee. In some cases, part of your distribution fee may be in the management fee from extra money that the fund management company is giving to different distribution or administrative platforms.

And I would work to get mutual fund expenses into those three basic buckets, which would be: portfolio management cost; client service and advice; and administrative costs. And then, let the market debate what's the appropriate amount for each fund to have.

And if I could make one final point on this, it was brought up earlier about the unified fee. I would argue strongly against that. I think it is important to have these broken down, in a sense. And the analogy I use is if you were looking at, say, a pharmaceutical company, and one was spending a whole lot on sales to sell the current lineup of drugs, and the other was spending a lot on R&D to develop the next generation of drugs, you would look at those two businesses as having very different prospects.

And I think the same applies to a mutual fund company. You know, a lot of people are worried, is my fund manager not going to be competitive, or the top portfolio manager is going to be hired away to a hedge fund. Well, one thing to look at is how much of their cost goes to paying for investment professionals, and how much goes just to paying for access to be on different platforms.

And I think the investor has the right to look at that. Maybe not every investor will, but I know that financial advisors would look at that. I know that 401(k) trustees would look at that, and they would like to see where their money is ultimately going, whether it's going to portfolio management, client service and advice, or administration.

MR. RICHARD PHILLIPS: Even members of the same family sometimes have to part company. And on this point, I do disagree with my brother Phillips, in that I think, in

terms of effective communication, simple is better. And a unified fee is much simpler. And I think, for the great mass of investors, it will be better understood, and more susceptible for competitive comparison.

That doesn't mean you don't make available to those investors, and certainly to the Morningstar analysts, the different buckets of expenses, and allow those who want to, to analyze further. But a uniform fee has a lot of merit to it, in terms of the ability of the average investor to appreciate, evaluate, and compare.

Having said that, I also think that effective communication in the area of 12b-1 fees means dollars and cents communication. More is less. We have had enough words in prospectuses. You really need to tell investors, on an individual basis, how much their investment is costing them for sales charges.

It probably is not feasible, as Barbara's suggestion, to make that disclosure in advance of the sale. I think you're going to find that it simply is not workable, and investors don't want to hear five minutes of verbal disclosure over the phone, when they want to get off the phone and back to their business, and on to doing what they want to do.

But, over the longer term, if you had that disclosure in the confirmation in dollars and cents terms, if you had it in the account statements, over the longer term I think you would get a mutual fund investing public that is more sensitive to the issue of sales charge. And, over the long run, it would have a competitive effect by a more informed investing public.

MR. NACHMANY: Yes, let me -- Dick and I have been doing this for a while. It has to be simpler.

Now, I don't think any of us understand how we ought to do it so that Barbara's client, that our client, is actually going to get it. Just to do something new, add something new, that will not influence anyone's decision is not the solution. We need to make it clearer, but make sure we understand how to do that, that it gets to people.

So, that is on the disclosure and clarity of -- maybe we should call it, instead of 12b, call it b12, people can see it as something that will help them.

But I think externalization is a terrible idea. Over life -- that's my judgment -- over lifetime of investment, it will cost a person, relative to mutualization, 20 or 30 percent of their investment, in many cases, especially at the lower end. If it's not 20, it's 15. It's a terrible idea.

And to me, closing out, it's one of those things, a couple of days ago, it's Father's Day, and I am working on a paper, 12b-1 fees, and my kids are trying to understand what's behind my effort. So I was reflecting on some of these issues.

You know, I grew up on a chicken farm, and one of the things you learn is when you drop an egg, you can't fix it. You can't put it together. This is sort of -- 12b-1 is one of the elements of the house that we have built. It's part of the cement. And let's not break it and see, "Well, maybe it's going to work this way, maybe it's going to work that way." We don't know how it's going to work.

Clearly, it is working. Fine-tuning, clarity, better understanding is needed, but let's not drop the egg and hope for the best.

MR. DONOHUE: I have never thought of 12b-1 as a chicken egg. But I think that's probably a good point for us to end.

And I want to thank the panelists. You put a lot of effort into this, and provided a lot of help to all of us. I want to thank everyone in the audience for sticking with us through a rather long day, and particularly those on webcast.

And I don't know if the Chairman has any closing remarks, but --

CHAIRMAN COX: Well, I thank you, Buddy, for doing an excellent job, and also the moderators that preceded you -- Erik and Doug -- and to all of our panelists, particularly this last panel. You did an excellent job in setting the table for us closing.

We have got, as the Commission, a lot of work ahead of us. We hope we can continue to have the benefit of your advice. But thank you very much for all of the work and the preparation that you did to get us to this point.

And with that, Buddy, I think we can call it a day. Thanks to everyone.

MR. DONOHUE: Thank you.

(Applause.)

(Whereupon, at 5:13, the conference was adjourned.)