



12b1 transcript

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1 P R O C E E D I N G S

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

5 To many of you who are seated here, or who are  
6 listening on the Internet today, Rule 12b-1 has a special

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7 meaning, and a long history, as least as far as mutual fund  
8 regulation is concerned. To others, Rule 12b-1 is merely an  
9 obscure reference to one item in a thick book of rules.

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

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

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

24 Now, with nearly three decades of experience under  
25 our belt, it's time that we take serious steps to re-evaluate

1 the rule. Today, we have gathered an impressive group of  
2 panelists to help us take a fresh look at Rule 12b-1. I  
3 expect that they will express a wide range of views on the  
4 history and on the future of the rule.

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

9 The first panel will discuss the history of Rule  
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10 12b-1. What were the circumstances that led the Commission  
11 to adopt it back in 1980? What was the original purpose of  
12 the rule, and how did the use of the rule evolve and change  
13 over the intervening years? We will hear from individuals  
14 who were intimately familiar with all of these developments.

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

21 After the lunch break, the third panel will discuss  
22 the costs and benefits of Rule 12b-1. Sometimes we think of  
23 cost benefit analysis as applying to new rules and  
24 amendments. But it also applies to rules that have been on  
25 the books for years. On this panel, we will hear from

1 experts who can speak to the economic effects of Rule 12b-1,  
2 from an academic, as well as a business perspective.

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

13 issues, with regard to mutual funds, broker dealers, and  
14 investors.

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

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

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

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

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

13 I am pleased to see the interest that Rule 12b-1  
14 has generated among our panelists and audience members, and  
15 those who are joining us by webcast from their homes and

16 offices. I have a personal interest in the rule, as well,  
17 because I have lived with the rule throughout its existence.

18           When I began my career in 1975, mutual funds had  
19 \$50 billion in assets under management. During that decade,  
20 in 7 of 8 years between 1972 and 1979, funds experienced  
21 significant net outflows. At the time, the Commission  
22 generally prohibited funds using fund assets to pay for the  
23 sale of its shares, out of concerns about the inherent  
24 conflicts of interest in such arrangements.

25           In view of the market conditions of the time,

1 however, some petitioned the Commission to reverse its  
2 long-standing position, and permit funds to use a small  
3 portion of fund assets to pay for advertising and selling.

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

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

17           In addition, there was some recognition that small  
18 12b-1 fees could subsidize the marketing and advertising

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19 expenses of the growing legion of no-load funds, and thereby  
20 promote healthy competition between no-load funds and  
21 broker-sold funds.

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

25           Admittedly, this is not a very nuanced description

1 of events, but I shall leave it to the first panel to give us  
2 the inside story on how and why 12b-1 was adopted. I raise  
3 the subject, only to show that we have come a long way from  
4 1980.

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

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

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

19           In the early 1980s, shareholders paid a few million  
20 dollars in 12b-1 fees. In 2006, they paid almost \$12 billion  
21 in 12b-1 fees. The use of 12b-1 fees also has shifted from

22 the limited marketing and advertising purposes that were  
23 originally envisioned.

24 Now, the nearly \$12 billion that shareholders pay  
25 annually in 12b-1 fees are used primarily as a substitute for

1 a sales load, or to compensate brokers for servicing their  
2 clients, uses that are much different from what the  
3 Commission originally intended when adopting the rule.

4 Although there is much room for debate on Rule  
5 12b-1, which will be made abundantly clear today, most  
6 observers agree that there is a disconnect between how the  
7 rule is supposed to operate, and how it used today. As I have  
8 said before, one would be hard-pressed to believe that Rule  
9 12b-1 wouldn't benefit from at least a tune-up.

10 As Chairman Cox previously remarked, when the  
11 Commission adopted Rule 12b-1, it noted that it would monitor  
12 the operation of the rule, and be prepared to address the  
13 rule if the circumstances or experience warranted. In view  
14 of the changes in the mutual fund market, and the role of  
15 12b-1 in fund distribution practices, the Commission is  
16 re-examining the rule, to evaluate whether it continues to  
17 benefit mutual fund shareholders, or whether it would profit  
18 from re-consideration.

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





2 on historical circumstances that led to the adoption of  
3 12b-1, the original intended purpose of the rule, and how the  
4 use of the rule evolved over time.

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

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

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

20 Dick Grant served as a special counsel to the  
21 director of the division of investment management, and he  
22 served as an associate director in the division in the late  
23 1970s and early 1980s. He was a principal architect of Rule  
24 12b-1.

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

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

3 We will start our panel today with Joel Goldberg,  
4 who will begin the discussion of the historical circumstances

5 that led to the adoption of 12b-1. And Joel will cover,  
6 among other things, how the distribution of fund shares was  
7 financed before Rule 12b-1, what the historical position of  
8 the Commission was towards the use of fund assets for  
9 distribution.

10 And so, Joel, take it away.

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

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

24 And Armstrong Associates came in for a no-action  
25 letter, asking for permission to use half of their advisory

1 fee to pay broker-dealers what we would now call a trail.  
2 They didn't call it that then, but pay half of their advisory  
3 fees to broker-dealers to get them to sell shares of a  
4 no-load fund, and keep shareholders invested.

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

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

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

16 About a year later, the sponsors of two newly  
17 formed money market funds were casting about for ways to  
18 incent broker-dealers to place customers' cash in their  
19 funds. One of these funds, called "Mutual Liquid Assets,"  
20 requested no action permission to give half of its advisory  
21 fee to broker-dealers who sold shares of the funds. You  
22 know, the staff obviously recognized the similarity to  
23 Armstrong Associates. The only material difference was,  
24 Mutual Liquid Assets was a newly formed fund. So you  
25 couldn't be sure that the advisory fee would have been the

1 same if they weren't giving up half of it. But the fee was  
2 in the range of what other money funds were charging at the  
3 time, which was 50 points.

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

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



































































































































































































































































































































































































































