STRATEGIC INSIGHT OVERVIEW
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Rule 12b-1: Looking Back, Looking Forward, in the Context of a $12 Trillion Mutual Fund Industry

- On June 19th, 2007, the SEC held a roundtable discussion on the issues surrounding Rule 12b-1 under the Investment Company Act of 1940. Avi Nachmany, Director of Research at Strategic Insight, an investment management industry think tank and data resource, was one of the panelists on the roundtable's final session, *Looking Ahead: What Are Our Options?*

- Mr. Nachmany, who has studied the mutual fund industry since he co-founded Strategic Insight 21 years ago, suggests in this 20-page paper that radical changes to Rule 12b-1 are likely to be harmful, especially for small investors.

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Executive Summary

Competitive Forces are Reducing 12b-1 Fee Use

- **"B" Shares Going Away, Slowly**: The use of high 12b-1 fee "B" share classes has been shrinking rapidly, and such share classes are likely to largely disappear in the coming five years. Of all stock and bond fund sales through financial advisors in recent years, "B" share classes possibly accounted for just 3%. Minimal new sales, naturally occurring redemptions, and automatic conversions to "A" shares with lower-12b-1 fees, led assets in "B" shares to fall to about $240 billion, or roughly 2% of the industry's total. In aggregate, "B" share classes lost nearly 20% of their assets due to net redemptions in each of 2005 and 2006, and such liquidations have accelerated in 2007.
- **"A" Share Sales Less Often Involve Payment of Point-of-Sales Commissions**: In parallel with the decline in the use of "B" shares, fewer investors today pay point-of-sales commissions ("loads") when buying "A" shares. It is estimated that 80-85% of "A" share sales today are at NAV. With lower commissionable "A" share sales and hardly any "B" share sales, only one-fifth of fund sales today generate point-of-sales compensation for the financial advisor, implying that most advisors selling mutual funds today receive fee-based compensation, either through 12b-1 fees, or "externalized" fees paid outside the fund.
- **"C"** shares, which charge and pass on to the financial advisor 12b-1 fees equal to about 1% of the fund's assets, account for possibly one-tenth of fund sales through financial advisors today. "C" shares are often used as an alternative to account-based fees (such as within mutual fund wraps that charge more than 1%, or in Registered Investment Advisors' (RIAs) fee-based accounts).
- **Other competitive forces have also been reducing the use of 12b-1 fees** among mutual funds. In an increasing number of mutual fund "platforms", more lower-fee institutional share classes (without 12b-1 fees) are being used, replacing "A" or "Adviser" shares (purchased at NAV but carrying 0.25% 12b-1 fees). And among mutual fund "supermarkets," which service self-directed investors, as well as RIAs managing mutual fund investments for their clients, the fastest expansion has been observed at the "transaction fee" platforms, where lower-fee and no-12b-1 fee funds are sold.
- **Overall, mutual fund total fee ratios** (combining advisory, operational, and distribution fees) **have declined significantly in recent years**. Notably, for investors using mutual funds in their Defined Contribution (DC) plans, fund fee ratios in aggregate have not only been significantly lower than fund fees elsewhere, but have been falling too.

Most Fund Accounts Small and Most Households' Total Fund Ownership Modest

- Given the extraordinary growth of the mutual fund industry, which is already responsible for $12 trillion in assets, and investment management capacity limitations at many funds today, **closing funds to some investors is at times advisable**. Such "closed" funds, however, are rarely truly closed, as they continue to be open to existing individual and institutional investors, and therefore, maintain sales and ongoing services to existing investors. Our study suggests that, among such "closed" funds, the continuation of 0.25% 12b-1 fees post their "soft" close has been well within the industry's best practices and regulators' recommendations.
- One reason to keep some access open to "closed" funds is to help the smaller fund accounts grow. Most fund accounts are very small and quite expensive to administer. Industrywide, the average stock fund account size is about $20,000, suggesting that possibly half of all equity fund accounts are smaller than $10,000 or $12,000 (the likely median value). Funds with too many small accounts can become much more expensive for all shareholders. (Our discussion shows that such additional costs (due to "mutualization") can annually reach 0.30% of assets in some cases.)
- **Modest ownership of mutual funds pervasive**: The dollar value of mutual fund ownership among most investors remains modest, reflecting the middle-income characteristics of most fund shareholders. For

example, in 2004, half of all American households investing in mutual funds owned less than $48,000 in total across all of their funds' accounts; among fund-owning households, half owned four funds or fewer.

- Only 14% of fund-owning households have mutual fund assets in excess of $250,000; another 13% have mutual fund assets of $100,000 to $250,000; thus, about 70% of fund-owning households held mutual fund assets of less than $100,000 (2004 data).

Fund Investors Expect Advice, but "Externalized" Models are Expensive

- **Most fund investors expect personalized advice**: Roughly four out of five fund investors seek personalized advice.
- Should fees for financial advice be "externalized" by replacing 12b-1 fees taken out of a fund's value with fees charged directly to investors' accounts? To examine the impact of such "externalization," we analyzed a number of areas of the investment management industry where such practices have been in place for many years, and looked at the price being charged there for advice.
- **Separately Managed Account (SMAs)**: Many financial advisory firms offer SMAs to their wealthier investors. While SMA account minimums are often $100,000 (twice the median mutual fund holding of fund-owning households), many SMA accounts are of a much larger size. The **average SMA** ("subadvisory separate account consulting program") **account held $336,000** (in 1Q 2007), according to Cerulli Associates.
- "Externalized" fees charged in **smaller SMA accounts are generally 2.5-3% of assets.** For all SMAs, large and small, Cerulli estimates that the average **effective fee** (asset-weighted, thus adjusted for the greater contribution of the lower fees charged to the very large accounts, such as those holding $250,000 or $500,000 or more) was **1.69%** (2Q 2006). Cerulli also suggests that such fees have not declined much since 2002 (despite the more than doubling of assets managed in SMAs).
- **SMA investors are among the wealthiest, most informed, and most able to negotiate the cost of financial advice. Yet, the fees they are charged (which also include investment management fees) have been set at an economic equilibrium much higher than the advice cost to fund investors embedded in the form of 12b-1 fees** (and fund investors generally have fewer financial assets, sophistication, and bargaining power than SMA investors).
- **Mutual fund advisory "wrap" programs** charge an additional fee on top of the underlying mutual funds' expenses. Mutual fund wrap accounts held an average $143,000 during 1Q 2007. Here again, the average account size is many times the size of most households' aggregated mutual fund holdings within a single financial institution. Cerulli estimates the average wrap fee at 1.17% of assets.
- **Cost of "externalizing" fees for advice**: Comparing the equilibrium cost of financial advice under the "externalization" option, to paying for such advice through 12b-1 fees, suggests that repealing Rule 12b-1 and "externalizing" fees paid for advice could result in a dramatic increase in the cost of advice to low-balance investors.
- **Loss of tax benefits:** Another inevitable cost of "externalization" is the loss, in many cases, of the tax-benefits of paying for advice through 12b-1 fees. (Fees based on a fund's value result in a reduction in taxable fund distributions and in the shareholder's reported taxable earnings, and thus, lower tax payments.) In comparison, when fee for advice is paid in out-of-pocket cash, tax benefits are generally available only when the investor is able to report such expenses under "miscellaneous itemized deductions" subject to the 2% of Adjusted Gross Income (AGI) limitations. Yet, less than 5% of all households are able to deduct such expenses.
- While the tax disadvantage of "externalizing" varies by circumstance, **even a small annual shortfall becomes meaningful over a 20-30 year investment horizon, and can cumulatively exceed 5% of the original investment value.**

Externalizing Advice is Likely to Create Operational Issues and Related Costs

- **"Externalization," disclosure, and transparency**: Beyond funds' fee tables, 12b-1 fee ratio data is already instantly available on many web sites (e.g., on the free site Morningstar.com, **four clicks are all that's needed to observe any fund's fee data**.) No such transparency will be available post-"externalization."
- **Other issues to consider**: Operational costs of "externalization", both for initial conversion and ongoing; operational problems when each FA becomes a "collection agent" (and not all FAs have superior technology). Will FAs transition from mutual funds to other, less transparent yet more expensive investments? Will the elimination of 12b-1 fees reduce availability of small DC plans or significantly increase their costs, especially considering the opportunities and expectations from the Pension Protection Act of 2006?
- **Competition and consolidation:** Since December 2002, more than 150 fund management companies have either been merged with others or have chosen to exit the fund business. About 2,000 individual funds have been merged away. Structural changes reducing access for fund investors may accelerate the industry's consolidation, especially during the inevitable down markets in the coming decade. (Even today, a small number of fund managers account for a very large percentage of the industry's incremental cash flows.)
- **High fee funds and risk management**: Do some funds with multiple share classes, including some classes with high 12b-1 fees, take higher investment risk to overcome the additional expenses? Given that "B" share sales have declined significantly, and that a majority of multi-share class funds' assets are in low- / no-12b-1 fee share classes, the incentive to reach out into the risk spectrum is uncertain today. For example, of 652 very large funds, each with $1 billion-plus in assets, that offer "C" shares as one of their pricing classes, just four have more than 50% of their total assets in "C" shares. Thus, taking undue risk to stimulate the ranking and sales of some share classes, but at the expense of the risk-adjusted ranking of all share classes, appears imprudent. Even in the bond fund area, where there is a greater focus on "total returns" today (and not just on yields) and with ranking services zeroing in on risk-adjusted returns, such investment approaches may be rare.

Externalizing Advice Costs Could Hurt Small Fund Investors

- **Who can afford to advise the small investor?** Eliminating 12b-1 fees and their tax-related and operational efficiencies in paying for advice would force many financial advisors (FAs) to rationalize and limit access to any investor with limited wealth (a process already in evidence at the larger financial institutions). Many FAs who find themselves unable to efficiently service 200-300 relationships (averaging at least $200,000-$300,000) in fee-based assets will not to able to maintain their employment; thus, such FAs will have to dismiss some existing low-wealth relationships and curtail, or eliminate, new lower-wealth accounts.
- **"Externalizing" mutual fund fees charged for advice would result, over time, in a significant increase in what the average mutual fund investor would pay for advice. It would, in our view, most likely end up doubling the annual cost, and even more than double the out-of-pocket costs, when also accounting for the tax benefits lost as compared to charging 12b-1 fees through the mutual fund.**
- **Over a lifetime of investment, such higher costs could add up to a penalty, in some circumstances, of 20-30% of the account's current value**. Furthermore, many lower income and wealth investors using mutual funds would be shut out completely from access to affordable personal advice.
- **In summary: "Externalization" of fees for advice has been in place for many years, with such fees transparent to wealthier, more sophisticated investors with much greater economic negotiating power. Yet, the equilibrium fees for advice in these circumstances are much higher than fees embedded in Rule 12b-1.**

Through Their Actions, Fund Investors Show a High Level of Satisfaction

- U.S. mutual fund assets have reached $12 trillion. Mutual funds are increasingly adopted by investors throughout the world, and fund assets outside the U.S. already exceed $13 trillion. In the 18 months since the beginning of 2006, worldwide mutual fund assets have expanded by roughly $5 trillion.

- Purchases of U.S. stock and bond funds this year are running at the highest pace ever (see long-term fund "new sales" in chart on next page).

- Fund redemption activity is at its lowest level in 20 years, suggesting increasing satisfaction with the mutual fund vehicle (see equity fund monthly outflow rates in chart on next page).

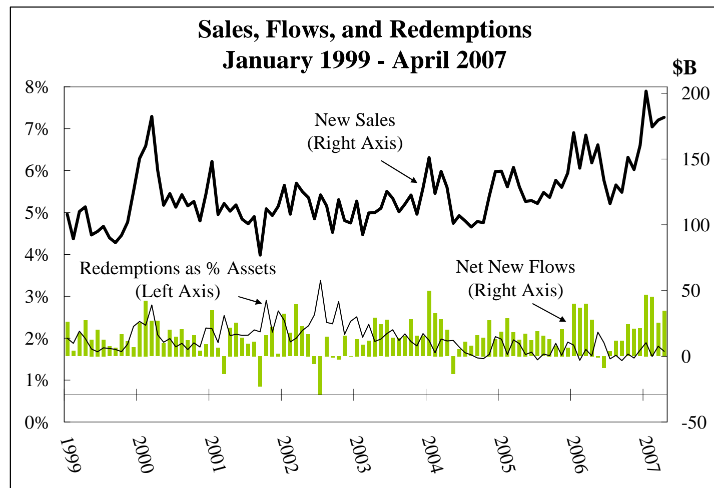
- Investor demand for actively-managed stock and bond funds in 2007 (measured by net flows to such funds) could exceed, by a wide margin, the pace in any year over the past decade. In just the first four months of 2007, active long-term funds have amassed over $150 billion; for comparison, in prior years, they generally garnered $200 - $240 billion for the entire year, see below. In parallel, demand for ETFs and index funds by institutional and individual investors is also high.

- Sixty two percent of stock and balanced fund assets are in retirement accounts; over the past decade, equity / balanced fund net flows totaled $1.7 trillion, of which three-quarters originated in retirement accounts (less than one-quarter of the flows were captured by taxable accounts held by individual investors).

- Stock fund investments are used for very long-term retirement savings, with 20-30 year investment time horizons; with such long planning horizons, the buying of stock funds is advisable independent of recent stock price trends (it is prudent to invest more in a down market…). Recognizing and benefiting from such a truism, fund investors emphasize stock fund purchases even during bear markets. (Stock funds controlled over 60% of stock and bond fund sales during the depth of the 2000-2003 bear market.) Mutual fund investors buying stock mutual funds both support and stabilize the U.S. capital market system, in times of falling as well as rising stock prices. Further interest in retirement investing through mutual funds is certain to come from the Pension Protection Act of 2006.

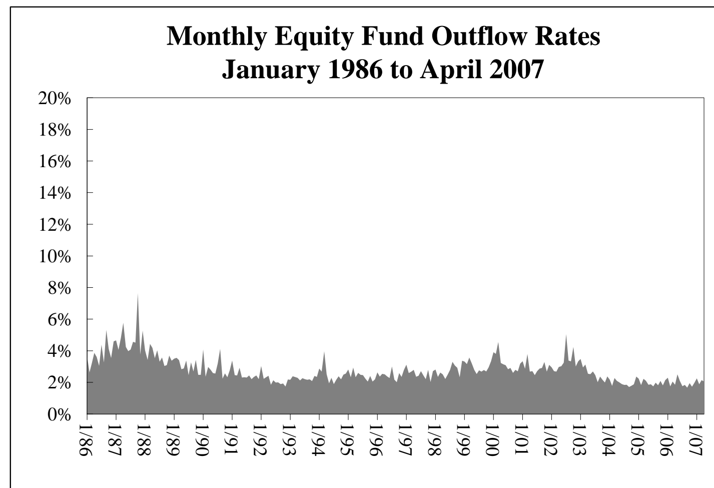
- Overall, the extraordinary acceptance of the mutual fund vehicle by investors, as suggested above and illustrated below (graphs based mostly on data from the Investment Company Institute), suggests that **any structural changes to the mutual fund regulatory framework, including those affecting Rule 12b-1 fees and fund distribution, should center on strengthening access to fund investments, especially for low- and middle-income households searching for convenient and cost-effective ways to save for retirement.**

Lately, new sales of stock and bond funds have been at their highest-ever monthly pace.



Source: ICI Trends Data (Reported by Strategic Insight Simfund MF)

Equity fund redemption activity has been at its lowest level in 20 years.

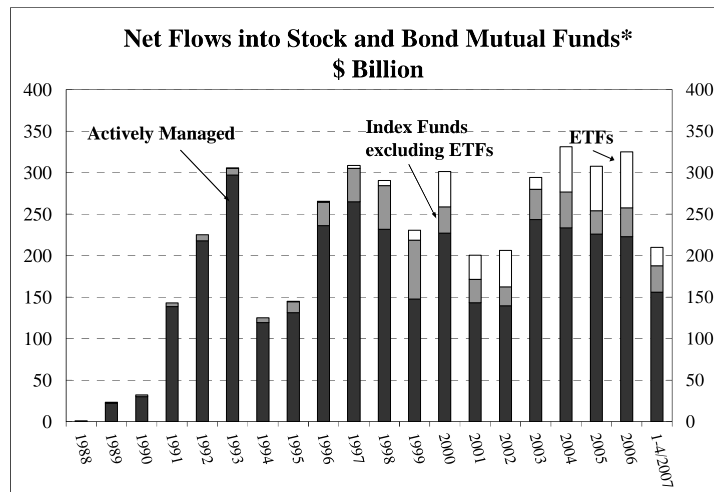


Outflows Rate = (redemptions out of the fund + switching to another fund within the same management company) as a percentage of the fund's average assets. The data suggests that in each month lately, about 2% of all equity funds assets have been switched. Source: ICI Trends Data (Reported by Strategic Insight Simfund MF)

Clearly, fund investors today show a high degree of satisfaction with the mutual fund vehicle. Four in five fund investors are choosing to be helped and guided by financial advisors (for funds held outside DC plans), and these advisers are often compensated by 12b-1 fees. Thus, advisor acceptance and advocacy of mutual funds has encouraged investments in the nation's capital markets, increased access to investments among middle-income investors, and supported innovation and competition.

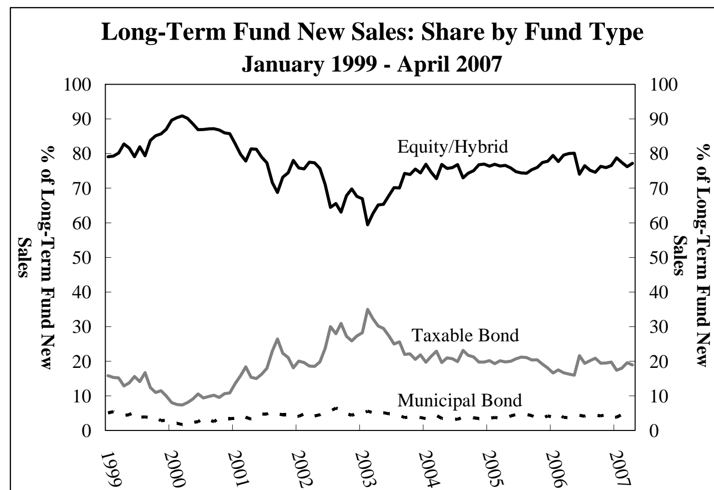
During the first four months of 2007, net flows into actively-managed stock and bond funds exceeded $150 billion; for the first half, such flows may have reached $200 billion. Assuming capital market stability during the rest of 2007, net flows into actively managed funds could significantly exceed their all-time records, and may reach a volume significantly higher than in any single year during the past decade. Thus, while fund investors are

aware of, and have access to, attractive and efficient index funds and ETFs, they are also increasingly selecting actively managed stock and bond funds.



*Open-end, closed-end, and variable annuity funds.
Source: Strategic Insight Simfund MF / VA

Most stock fund investments are used for very long-term retirement savings, with 20-30 year investment time horizons. Given such long planning horizons, buying stock funds is advisable independent of recent stock price trends. Recognizing and benefiting from this truism, mutual fund investors emphasize stock fund purchases even during bear markets. Partly benefiting from dollar-cost averaging within retirement accounts, stock funds controlled over 60% of stock and bond fund sales even during the depth of the 2000-2003 bear market. **Thus, mutual fund investors buying stock mutual funds both support and stabilize the U.S. capital market system, in times of both falling and rising stock prices.**



Source: ICI Trends Data (Reported by Strategic Insight Simfund MF)

Mutual Fund Investors' Profile and Expectations for Financial Advice

- An Investment Company Institute (ICI) survey in 2004 of households owning mutual funds found that $48,000 was the median value of household fund holdings, i.e., half of all American households investing in mutual funds owned less than $48,000, in total, across all of their fund accounts. The typical mutual fund-owning household owned four mutual funds. Average holdings were naturally higher, as a small number of wealthier investors own much more in both dollar amount, and at times, in number of funds. (The average mutual fund-owning household had $142,000 invested in seven mutual funds in 2004.)
- The average stock mutual fund account held by individual investors holds about $20,000 (Source: Strategic Insight Simfund). This suggests that the median account size may not be much greater than $10,000. Account size averages are somewhat larger for bond funds, especially for tax-free bond funds, which tend to be held by wealthier investors.
- Only 14% of fund-owning households have mutual fund assets in excess of $250,000; another 13% have mutual fund assets of $100,000 to $250,000. Thus, about 70% of fund-owning households held less than $100,000 in 2004 (market appreciation and new investment have improved this statistic somewhat since that time).
- Many households choose to have a number of financial services relationships, and prefer not to have all their investments in one place, so their 'perceived' risk is reduced. Consequently, mutual fund investments held in any single financial institution are even smaller than suggested above. This further reduces the ability of a single institution to offer economy-of-scale discounts.
- Outside their defined contribution plan accounts, roughly four out of five investors seek advice from a financial planner, Registered Investment Adviser (RIA), or securities broker; ICI research suggests that financial advisors are used more often by wealthier or older investors; more often by women; and more often during periods of financial turmoil. Thus, most investors, when searching for both a convenient and cost-effective way to invest and save for retirement, as well as guidance on how to use their accumulated wealth in retirement, most often work with and pay for personalized advice. Advanced technology or Internet financial tools do not appear to lessen the desire for a personal adviser.
- Many financial advisors have transitioned in recent years to holistic, thus more complicated, financial planning, and away from their past focus on "discovery" of great investments (stock or funds) and "rebalancing." (Increasingly, fund screening is done today by a dedicated and specially trained unit within the brokerage firm or retirement plan administrator, often referred to as Investment Analysts / Fund Selection Unit. In parallel, advisors are less involved with the periodic re-allocation and rebalancing of portfolios; this is more often guided by the firm's Investment Committee.) Thus, the financial adviser skill sets needed to serve today's investors have become more complex—specialized advice, trust, real estate, multi-generational wealth management, taxation, educational savings, income-at-retirement management, etc.

Paying for Advice: When Charged Directly to Investors, Fees for Advice are Higher than When Paid through 12b-1 Fees

- As discussed before in this article, most investors (maybe four in five) seek personalized advice. According to research by the ICI in 2004, of the investors owning fund shares outside defined contribution retirement plans, more than 80% owned fund shares through various types of professional financial advisers, including full-service brokers, independent financial planners, insurance agents, bank or savings institution reps, and accountants. **Nearly half owned funds solely through advisers**, while another third owned funds purchased from advisers as well as directly from fund companies, fund supermarkets, or discount brokers. **Only 14% solely owned funds bought directly from fund companies. ICI research suggests that in 2006, only 11% of stock and bond fund sales were direct to individual investors** (half as much as a decade ago).
- While many mutual fund investors pay for financial advice through 12b-1 fees taken out of their fund's value, other investors (in funds or individual securities) pay for it through fees charged directly to their account. A number of observers have suggested that 12b-1 fees should be replaced with similarly charged direct-out-of-one's-account fees (i.e. "externalizing" advice fees unlike the current practice of having such fees embedded inside the fund.)
- To examine the impact of "externalization," we look at a number of personal advice relationships where such a practice has been in place for many years: Separately Managed Accounts (SMAs) held by individual investors, as well as mutual fund "wrap" programs (multiple funds are held within an advisory program that charges a fee on top of the mutual fund expenses).
- **Separately Managed Accounts**: Many financial advisory firms offer SMAs to their wealthier investors. While account minimums are often just $100,000 (yet twice the average of total mutual fund investments of most fund shareholders), many SMA accounts are much larger. Data compiled by Cerulli Associates, a Boston-based research firm that has tracked the SMA industry over the past decade, suggests that the average SMA ("subadvisory separate account consulting program") **account size was $336,000** (1Q 2007). Cerulli estimates the average **effective fee** (asset-weighted) charged to SMA accounts to be 1.69% of account assets (2Q 2006). For comparison, in 2002, the comparable effective fee was 1.77%. Thus, despite the more than doubling of assets managed in the SMA segment over the five-year period, fees charged to investors barely changed.
- **SMA investors are among the wealthiest, most informed, and most able to negotiate the cost of financial advice. Yet, the fees they are charged, which also include investment management fees, have established an economic equilibrium at a higher level than the highest 12b-1 fees charged to mutual fund investors**, almost all of whom have much smaller financial assets, sophistication, and bargaining power.
- **At the low end of SMA investment sizes**, fees are actually higher than the averages mentioned above. For SMA investors holding just the minimums stipulated (often $100,000 to $250,000) and within just one organization, the costs (of investment management plus advice) **are set most often at 2.5-3.0% of the account's value**.
- These 2.5-3% fees for SMAs are at the account level, transparent and easily understood, yet the portion of such fees paid for advice has remained dramatically above 12b-1 fee levels charged, for example, within mutual funds' "C" share level-load accounts (1%).

- **Mutual fund advisory "wrap" programs**: Cerulli surveys suggest that mutual fund wrap accounts, which charge an additional fee on top of the underlying funds' expenses, had an average size of $143,000 during 1Q 2007. This investment size is many times the size of most fund-owning households' aggregated mutual fund holdings within a single financial institution. The average wrap fee charged was estimated by Cerulli at 1.17% of assets. Thus, despite being significantly larger, on average, than the typical aggregated household mutual fund holding at a financial advisory firm, wrap program accounts charge advice fees that are higher, not lower, than fees for similarly-owned mutual funds.
- Comparing the equilibrium cost of financial advice when such cost is "externalized", to paying for the advice through 12b-1 fees, suggests that repealing Rule 12b-1 and "externalizing" fees paid for advice could result in a dramatic increase in advice costs. Furthermore, many financial advisors may simply reject any investor with less than $100,000 in assets, regardless of such an investor's willingness to pay more. Such under-serving of smaller accounts is already in evidence.
- **Loss of tax benefits:** Another inevitable cost of "externalization" is the loss, in many cases, of the tax-benefits of paying for advice through 12b-1 fees. The 12b-1 fee results in a reduction in reported taxable earnings. In comparison, when fee for advice is paid in out-of-pocket cash, tax benefits are generally available only when the investor is able to report such expenses under "miscellaneous itemized deductions" subject to the 2% of Adjusted Gross Income (AGI) limitations. Yet, less than 5% of all households are able to deduct such expenses.
- While the tax disadvantage of "externalizing" varies by circumstance, **even a small annual shortfall** becomes meaningful **over a 20-30 year investment horizon**, and **can cumulatively exceed 5% of the original investment value.**
- Eliminating 12b-1 fees and their tax-related and operational efficiencies in paying for advice would force many financial advisors (FAs) to rationalize and limit access to any investor with limited wealth (a process already in place among the larger financial institutions). Many FAs who can not efficiently service 200-300 relationships (averaging at least $200,000-$300,000) in fee-based assets will not to able to maintain their employment; thus, such FAs will have to dismiss some existing low-wealth relationships and curtail, or eliminate, new lower-wealth accounts.
- **In summary: "Externalization" of fees for advice has been in place for many years, used by wealthier, more sophisticated investors having much greater economic negotiating power. Yet "externalized" advice fees are much higher than fees charged pursuant to Rule 12b-1.**
- **"Externalizing" mutual fund fees charged for advice would result, over time, in a significant increase in how much the average mutual fund investor would be paying for advice.** Most likely, in our view, it would double the annual cost, or even more than double the out-of-pocket costs, when also accounting for the tax benefits of charging 12b-1 fees through the mutual fund. In some cases, **over a lifetime of investment, such higher costs could add to a penalty of 20-30% of the account's current value**. **Furthermore, many lower income and wealth investors would be completely shut out from access to affordable personal advice.**

Market Forces Have Already Been Reducing the Use of 12b-1 Fees

- **“B” shares slowly disappearing**: As mentioned before, “B” shares are slowly liquidating as a category. Ten years ago, “B” shares held $277 billion, or 8.5% of all open-end mutual fund assets. Today, their share of industry assets has collapsed to 2.4%. While the mutual fund industry more than tripled its size in the past decade, “B” share assets had fallen to only $244 billion by April 2007. “B” shares at one time accounted for one-quarter of all fund sales through financial advisors. In the past two years, they accounted for less than 5% of all sales, likely less than 3%.
- **“C” shares and “breakpoints”**: To help investors benefit from point-of-sales “breakpoints” offered in “A” shares, many fund companies will not permit sales of such high-fee classes if the investors’ household has already amassed a large portfolio (generally $1 million, sometimes less) and will instead direct such investors to “A” share classes. Financial advisory firms impose even more restrictive rules to ensure “breakpoint” compliance and investor awareness. One example:

  > *“…Restricts sales of “C” shares to purchases under $1 million. Brokers can not place trade orders of “C” shares if the transaction will bring a client’s total “C” share assets within one fund family above $1 million within (our Broker-dealer). An order that would bring a client’s single-fund family “C” share assets up to $250,000 can be placed only for those investors who expect to hold this investment for six years or less. Only orders that specify the expected holding period will be considered. They must also indicate that the client wants a non-transaction-based relationship with the broker that is placing the trade. Broker must advise the client that “C” shares may be more expensive over time than other share classes. For orders bringing customers’ fund family assets to $1 million in that share class, clients must specify that they expect to hold the investments for only three years or less.”*

  Another leading national broker-dealer also introduced a $1 million “C” share restriction, but unlike the example above, the ceiling takes into account *all* “C” shares held, not just those held within one fund family.
- **From “A” to no-12b-1 “I” share class**: A trend gathering steam among an **increasing number of mutual fund “platforms”, is the use of more lower-expense institutional share classes** (without 12b-1 fees), replacing “A” or “Adviser” shares (purchased at NAV but carrying 0.25% 12b-1 fees).
- **From “NTF” to no-12b-1 “Transaction Fee”:** Another factor causing a decline in the use of funds with 12b-1 service fees (generally 0.25% of assets) is a trend in evidence at **mutual fund “supermarkets”**, which service self-directed investors or Registered Investment Advisors (RIAs) managing mutual fund investments for their clients. **The fastest expansion in such “supermarkets” is being noted in their “Transaction Fee (TF)” segment**. In TF platforms, investors pay trading commissions or wrap fees (often 1% of assets) to their RIAs. Because funds participating in the TF segment do not have to share much of the costs of operating this platform with the sponsoring firm (such as Schwab or Fidelity), their managers can afford to use funds without 12b-1 fees. (Among the most successful such managers participating in TF platforms are Dimensional Fund Advisors (DFA), whose mutual funds are available primarily through RIAs that charge a fee for advice (outside the fund), as well as Dodge & Cox, whose assets have expanded nearly ten-fold over the past six years.)

12b-1 Fees: A Competitive, Transparent Marketplace at Work

- **In 2006-2007, funds that charge 12b-1 fees garnered only a quarter of the aggregate net flows into all stock and bond mutual funds**; funds that do not charge 12b-1 fees accounted for about three-quarters. (This observation excludes ETFs, as they are mostly used by institutional investors or "stock traders"; when ETFs are included, the flow proportion of funds charging 12b-1 fees drops even lower, to 20%.)
- 12b-1 fees are often used within pricing class alternatives to recoup front-end sales commissions, or to compensate brokers for ongoing shareholder services and initial sales assistance. (A February 2005 ICI *Fundamentals* research brief suggested that only 2% of 12b-1 fees are used for promotion and advertising.) Retirement plan record-keepers and discount brokerage firms are also recipients of 12b-1 fees.

Mutual Fund Assets where 12b-1 Fees Are Charged (Exc. VA Funds)

	Assets $B 4/07	Effective 12b-1 Fee Ratio %*	Net New Flows $B (Estimated) 2004	2005	2006	Ytd-4/07
Equity Funds						
Front Load ("A"), Today Mostly Sold at NAV	1,817	0.26	75	58	44	**20**
No / Low Load	350	0.23	31	28	27	**16**
Level Load ("C")	310	0.96	25	21	19	**9**
CDSC / Back Load ("B")	201	0.96	-28	-41	-42	**-14**
Bond Funds						
Front Load ("A"), Today Mostly Sold at NAV	370	0.22	-7	4	12	**10**
No / Low Load	73	0.25	2	3	4	**4**
Level Load ("C")	67	0.89	-1	0	3	**3**
CDSC / Back Load ("B")	38	0.92	-14	-13	-12	**-3**

Excludes passively managed funds (index funds and ETFs); also excludes closed-end mutual funds and variable annuity mutual funds, both of which have somewhat different expense structures.
**Weighted by latest assets. Source: Strategic Insight Simfund MF*

Not shown in the table above are some money market funds held within brokerage accounts, and funds underlying variable annuities that also, at times, have a share class carrying 12b-1 fees. Most commonly, a 0.25% 12b-1 fee is charged in such cases. (Source: Strategic Insight Simfund MF / VA.)

As the Fund Industry Expanded, Mutual Fund Fee Ratios Declined

Mutual fund fee ratios have been steadily declining. The table below shows average total expense ratios, including 12b-1 fees, charged to fund investors, **based on the size of the funds, or asset-weighted** (and not the oft-used, but misleading, simple-average expense ratios, which assign identical weights to expense ratios of tiny $1 million funds, and those of funds more than a thousand times larger).

The table below excludes passively managed funds (index funds and ETFs). It also excludes closed-end mutual funds and variable annuity mutual funds, both of which have somewhat different expense structures.

Expense Ratios Paid by the Average Fund Investor: Actively-Managed Funds

Mutual Fund Expense Ratios: Actively Managed Funds Only
Excludes Index Funds, ETFs, Closed-End Funds, VA Funds

	Average Total Expenses, Asset Weighted, %						Assets $B	
	2002	2003	2004	2005	2006	'02 to '06	12/01	4/07
US Equity / Hybrid	1.06	1.05	1.00	0.95	0.92	**-14%**	2,471	4,045
International Equity	1.25	1.25	1.20	1.14	1.10	**-15%**	409	1,387
Taxable Bond	0.80	0.78	0.77	0.75	0.71	**-9%**	561	985
Tax-Free Bond	0.68	0.68	0.67	0.66	0.65	**-3%**	300	380
Taxable Money Market	0.47	0.44	0.43	0.42	0.43	**-3%**	2,001	1,986
Tax-Free Money Market	0.50	0.47	0.45	0.42	0.41	**-8%**	261	376
Total	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	***6,002***	***9,158***

Source: Strategic Insight Simfund MF; n.m. not meaningful (as the number would average the results of completely dissimilar investment styles).

Even Excluding 12b-1 Fees, Fund Investors' Fee Ratios Are Falling

As suggested before, there are many competitive marketplace trends reducing the industry's use of 12b-1 fees. To remove the impact of declining 12b-1 fee use industrywide on mutual fund total expense ratio trends, we look at expense ratios excluding 12b-1 fees—see table below. (Source: Strategic Insight Simfund.)

Mutual Fund Expense Ratios Excluding 12b-1 / Distribution Fees
Excludes Index Funds, ETFs, Closed-End Funds, VA Funds

	Average Total Expenses, Exc. 12b-1 / Distribution, Asset Weighted, %						**Assets $B**	
	2002	**2003**	**2004**	**2005**	**2006**	**'02 to '06**	**12/01**	**4/07**
US Equity / Hybrid	0.81	0.81	0.78	0.73	0.71	**-12%**	2,471	4,045
International Equity	1.00	1.02	0.97	0.92	0.89	**-11%**	409	1,387
Taxable Bond	0.60	0.58	0.57	0.55	0.54	**-10%**	561	985
Tax-Free Bond	0.51	0.51	0.50	0.49	0.48	**-7%**	300	380
Taxable Money Market	0.36	0.34	0.34	0.33	0.32	**-10%**	2,001	1,986
Tax-Free Money Market	0.41	0.39	0.38	0.35	0.35	**-16%**	261	376
Total	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	***6,002***	***9,158***

Source: Strategic Insight Simfund MF

Fund Fee Ratios Charged to Investors in their Defined Contribution Plans are Lower than Average, and Falling

Increasingly, Defined Contribution (DC) investments in mutual funds, now totaling $2.3 trillion, are held in lower-fee share classes (or in portfolios with a single, low-fee share class). At most 2% of 401(k) plan assets are held in "B" or "C" share classes (see second table below). And many owners of "A" shares within DC plans never paid a "sales commission" but instead purchased the funds at NAV.

Asset-Weighted Average Total Mutual Fund Expense Ratios

	1996 (ICI)		2005 (ICI)		2007 (SI)		
	401(k)[1]	Industry[2]	401(k)[1]	Industry[2]	401(k)[3]	Industry[4]	Industry Above 401(k)
Stock Mutual Funds	**0.84**	**1.02**	**0.76**	**0.91**	**0.73**	**0.87**	**20%**
Domestic Stock	**0.82**	0.97	**0.72**	0.87	**0.68**	0.82	**21%**
Foreign Stock	**1.14**	1.32	**1.01**	1.10	**0.95**	1.04	**9%**
Hybrid	**0.78**	0.95	**0.65**	0.82	**0.58**	0.73	**26%**
Bond Mutual Funds	**0.71**	**0.92**	**0.58**	**0.71**	**0.54**	**0.66**	**22%**
High Yield and World Bond	**1.08**	1.17	**0.89**	1.00	**0.79**	0.89	**12%**
Other Bond	**0.64**	0.82	**0.55**	0.64	**0.52**	0.61	**16%**
Money Market Mutual Funds	**0.43**	**0.52**	**0.42**	**0.41**	**0.42**	**0.41**	**-2%**

[1]The 401(k) average expense ratio is measured as a 401(k) asset-weighted average; [2]The industry average expense ratio is measured as an asset-weighted average. [3]SI estimate reached by applying an identical 2007 vs. 2005 percentage decline as in industrywide average expense ratios. [4]The industry average expense ratio is measured as an asset-weighted average. SI 2007 data excludes ETFs.
Sources: ICI, Strategic Insight Simfund, SI estimates.

401(k) Mutual Fund Assets by Share Class
Percent of assets[1],1996 and 2005

	1996	2005
Share Class	**41%**	**26%**
A Shares/ others	37%	21%
B Shares	3	1
C Shares	(*)	1
Retirement Shares	(*)	3
No-Load	**59**	**74**
Institutional	14	19
Retail	45	51
Retirement Shares	(*)	4
Total	**100%**	**100%**

[1] May not add to the total because of rounding; (*) = less than 0.5%.
Source: ICI

Reflecting on the importance of DC plans in seeding the investment process, we note that over the past decade, fund investors net purchased $700 billion within their DC accounts; in addition, they earned about $1 trillion due to appreciation. A majority of mutual fund shareholders are introduced to mutual funds via DC plans. Afterwards, many expand their investment portfolios, for both retirement savings and other purposes.

Partly "Closed" Funds and 12b-1 Fees

Funds "Closed" to New Investors: Generally, Still Open to Many

Among the many reasons, some inter-related, that funds temporarily close are:

- Investment capacity constraints, especially among smaller cap or specialized strategies;
- A portfolio management team's persistent inability to find new investments priced within the fund's valuation model;
- A large and growing cash hoard;
- Inflows that come in too large and too quickly to be invested;
- Too many investors flocking to a fund at the wrong phase of its investment cycle;
- Organizational "stress" due to "hyper-growth" throughout a management company, not just in one of its funds (companies where fast growth within mutual funds is often paralleled by large institutional investments within the same style).

Since many attractive funds may experience a surge in new accounts and investments once their future closing is announced, some funds exercise a sudden, "hard" close, where no additional investments are permitted after the "closing" announcement. Such "hard" closes can be very disruptive, though, especially for investors focusing on prudent dollar-cost averaging; retirement plans; and financial advisors using the fund to manage their clients' ongoing, dynamic asset allocation needs.

Thus, most "closed" funds remain open for many of their existing shareholders or other types of investors. This is typified by the language used by some "closed" funds, which nevertheless remained open to certain clients, such as:

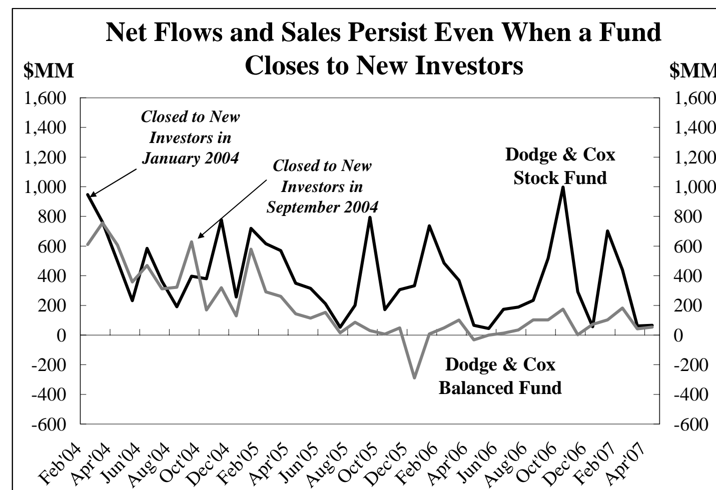
- *"Existing shareholders of the Fund may add to their accounts, including through reinvestment of distributions.*
- *Financial Advisors who currently have clients invested in the Fund may open new accounts and add to such accounts where operationally feasible.*
- *Participants in retirement plans utilizing a Fund as an investment option on (this date) may designate the Fund, where operationally feasible.*
- *Employees of (our company) and their family members may open new accounts and add to such accounts.*
- *Existing separate account clients of (our company) may open new accounts in either Fund and may add to such accounts.*
- *The Fund reserves the right to make additional exceptions or otherwise modify the foregoing closure policy at any time and to reject any investment for any reason."*

Some funds, instead of "closing" to new investors, may slow down new sales by drastically increasing the minimum size of new investments from, say, $2,500, to $10,000 or $20,000.

Some steady inflows into the "closed" funds are actually often to the advantage of existing shareholders, since they balance regularly occurring redemptions, running at roughly 1%-3% of fund assets each month. Such balancing inflows lessen the need to liquidate securities to meet redemptions, as well as allow some opportunistic buying without the need to liquidate attractive stocks and needlessly realize capital gains.

Overall, even a "soft" close continues to necessitate some ongoing marketing and sales efforts. And since a large share of the assets of "closed" funds (whether they exercised a "soft" or "hard" close) is held in omnibus accounts, at Schwab or Merrill Lynch, for example, **most 'closed' funds continue to require ongoing service expenses for the majority of their assets, and the sharing of the costs of such services, and these needs do not decline or 'disappear' once a fund's closing is announced.**

To illustrate the "open" nature of "closed to new investors" funds, we note two highly-rated funds that closed to new investors three years ago, and remain closed. The **Dodge & Cox Stock fund** closed to new investors in January 2004. **Since then, and through April 2007, it has drawn $15.5 billion in net cash flows** (gross sales to existing investors were even higher). **Since its closing, from January 2004 through April 2007, this highly respected "closed to new investors" fund increased its assets (through appreciation and net flows) by $38 billion**. A sister fund, **Dodge & Cox Balanced**, closed to new investors in September 2004; the fund **added $3.1 billion in net cash flows and increased assets by $10 billion since its closing and through April 2007**. Monthly flows to these two well-liked funds, during the three years after closing to 'new investors', are charted below; the persistent additions to their holdings (especially, to the Dodge & Cox Stock fund), month after month, are evident.



Source: Strategic Insight Simfund MF

The Treatment of 12b-1 Fees among Funds "Closed" to New Investors

For the many reasons detailed above such as satisfying ongoing service needs, 12b-1 fees continue to be implemented and charged among "closed" funds. The following discussion summarizes Strategic Insight's prior studies of 'closed' funds and their application of 12b-1 fees.

Funds that closed to new investors in the past four years and on closing reduced their 12b-1 fees were, with hardly any exception, funds that prior to "closing" charged a 12b-1 fee ratio of over 0.25% (generally 0.30% or 0.35% in class A). Once closed to new investors, they reduced fees to the 0.25% typical of service fees among such funds open to new investors. Note that even among 'closed' funds, 12b-1 fees for certain share classes have not changed (e.g., 'B' or 'C' share classes, where 12b-1 fees need to continuously be paid to financial advisors, or to amortize previously incurred distribution costs.) (Of course, not all of these 'closed' funds charged a 12b-1 fee before closing.)

Examples of 12b-1 Fee Reductions:

Company A: Three funds (European Small Company, International Small Company, and Real Estate) closed to new investors on [date]. *"During this limited offering period, the Rule 12b-1 fees for Class A shares will be reduced from 0.35% to 0.25% of the fund's average daily net assets attributable to Class A shares. 12b-1 fees charged to other share classes did not change."*

Company B: Small Cap Value fund and Special Values fund, which closed to new investors on [date] reduced the 12b-1 on Class A shares from 0.30% to 0.25%. *"Shares in the Small Cap Value Fund, Special Values Fund, and VA Special Values Fund will only be available for purchase after [date] by existing shareholders, including qualified retirement plans and their successor plans. Members of a Fund's portfolio management team may open new accounts after [date]. Shareholders may be required to demonstrate eligibility to purchase additional shares of these Funds. This restriction may be eliminated at any time in the future, without prior notice to shareholders, and it may be waived by the Trustees of the Funds at any time for any purchaser or class of purchasers. During the period when this limitation on the offering of a Fund's shares is in place, Rule 12b-1 fees for the Class A shares of the Fund will be paid at a rate of 0.25% of the Fund's average daily net assets."*

Company C: Eight funds reduced the 12b-1 fees in their Class A shares from 0.35% to 0.25%. Of these, the Bond fund liquidated, and the others closed to new investors. *"The Board of Directors recently approved certain changes to Class A shares effective on [date]. All upfront sales charges have been eliminated, the 1.00% contingent deferred sales charge on redemptions made within the first 24 months of purchase has been eliminated on shares purchased after [date], and the annual 12b-1 distribution and service fee for (fund list) has been reduced from 0.35% to 0.25% of average daily net assets attributable to Class A shares."*

The Special Case of Closing an Entire Share Class

Some managers have permanently closed their "B" share class to both new and existing investors, and others may follow. **As noted before, "B" shares are sold only minimally throughout the industry at present, with possibly less than 3% of sales through financial intermediaries conducted through such share classes today. Strategic Insight projects that within five years, much of the existing assets in "B" share funds, currently adding up to roughly $240 billion, or just 2% of the mutual fund industry's total assets, will be transferred out of these share classes, either by their automatic, mandated conversion to lower-12b-1 fee "A" shares, or through natural attrition.** But even when "B" shares are no longer sold, 12b-1 fees that are charged to recoup originally-paid sales commissions remain in place, as exemplified below:

"Refers to Class B shares…Existing shareholders of Class B shares may continue to reinvest dividends into Class B shares and exchange their Class B shares for Class B shares of other funds… For Class B shares outstanding… ***all Class B share attributes, including the associated Rule 12b-1 fee, contingent deferred sales charge and conversion features, will continue."***

Some Regulatory Developments Relating to the Charging of 12b-1 Fees by "Closed" Funds

A few years ago the NASD Mutual Fund Task Force issued a report to the SEC with suggestions and observations on 12b-1 fees. It was the opinion of the task force that fund firms should be allowed to keep 12b-1 plans, but that they should increase disclosure about the fees' purpose. In short, the funds should be explicit about the fees being used to pay for distribution and shareholder servicing costs, rather than for marketing or advertising to attract new investors.

Two key areas that the task force identified as potentially being appropriate for regulatory consideration were:

- ***"Guidance on when a closed fund may no longer charge distribution related Rule 12b-1 fees.*** *When a mutual fund closes to new investors, it may continue to charge Rule 12b-1 fees in order to recoup its up-front distribution costs, or to support the continued bank financing of those costs. It also is appropriate for a closed fund to continue to charge Rule 12b-1 fees if the fees are charged for shareholder servicing or ongoing advice to existing fund shareholders. It is inappropriate for a closed fund to charge Rule 12b-1 fees or distribution-related expenses in other circumstances, and regulatory guidance on this issue may be needed.*
- *This issue generally affects Class B shareholders only. Class A shares typically pay a Rule 12b-1 fee for shareholder servicing only, and Class C shareholders may pay a Rule 12b-1 fee that covers ongoing, well-defined advisory services. Neither of these payments should be affected if the fund closes to new investors. For example, service fees, which may not exceed 0.25% of the fund's average net asset value under NASD Rule 2830, are intended to pay for personal service and the maintenance of existing shareholder accounts.*
- ***Limitations on the length of time before a holding of Class B shares convert to A shares.*** *The higher Rule 12b-1 fees associated with Class B shares generally permit a mutual fund distributor to recoup the up-front distribution costs that it has incurred. The Task Force does not believe that a mutual fund should continue to charge an investor the higher Rule 12b-1 fees after it has recouped its up-front distribution costs. Regulatory guidance on when conversion from Class B to Class A shares should take place may be appropriate."*

Closed funds and 12b-1 fees have been the subject of a number of lawsuits. In one, a federal district judge dismissed plaintiff's claims against the manager that the latter violated fiduciary duties by continuing to authorize and receive distribution and service fees during a period when the funds were closed to new investors. In a memorandum dated May 9, 2005, the judge said,

- *"SEC Rule 12b-1 permits fund-advisory firms to recover certain sales-related expenses previously paid out when distributing the fund's shares. Compensation for past distribution services are considered payments made 'in connection with' the distribution of a fund's shares. Plaintiffs, therefore, cannot entirely confine their claim for excessive distribution fees to the de minimis sales-related services provided when the funds were closed to new investors. At a minimum, plaintiffs must also allege that the distribution fees are disproportionate and unrelated to the sales-related services actually provided when shares of the funds were marketed and sold to the general public. Because the amended complaint does not contain this fundamental claim, or any facts that would support such an allegation, Plaintiffs fail to state a claim for breach of fiduciary duty in connection with the payment and receipt of distribution fees. Plaintiffs also fail to state a claim with respect to the 0.25% service fees. In the amended complaint, Plaintiffs do not allege that the service fees exceed the ongoing expenses associated with maintaining shareholder accounts. Plaintiffs allege no facts that, if true, would indicate that the service fees are unrelated to the shareholder services provided by broker-dealers."*

In summary, the growth of the mutual fund industry coupled with investment management capacity limitations at many funds today, has necessitated at times the closing of funds to new investors. Such closed funds' 12b-1 fee policies have become a common question.

Our study suggests that the continuation of such 12b-1 fees is well within the industry's best practices and regulators' recommendations.

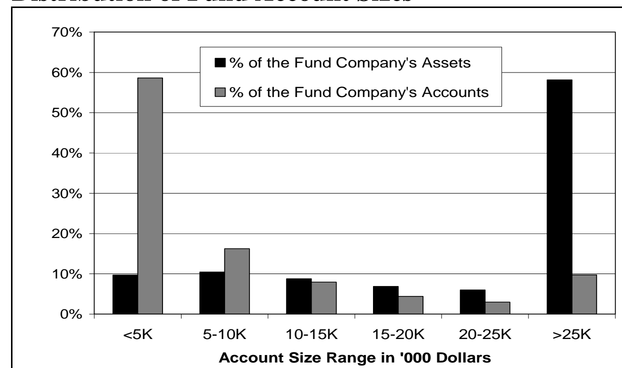
The "Mutual" in Mutual Funds: When Small Account Costs are Subsidized by Big Accounts, Including through 12b-1

Some funds, and some management companies, experience a high proportion of small shareholder accounts. A few of the many reasons for this:

- Narrow sector-based funds (technology, financial services, Latin America, international real estate, etc.) or funds that experienced temporary "hot" performance triggering a single "exploratory" purchase but with no additional investments subsequently.
- Affinity distribution (minimum purchase amounts for affinity groups are generally low, and initial purchases are not followed up too often) or high dependency on insurance agent sales (at times accommodating small deposits with no follow-through).
- Funds serving as building blocks for lower-end mutual fund wrap programs (where multiple funds are used to seed a relatively small $25,000-$50,000 wrapped portfolio).

Sometimes a management company has a shareholder account profile like the one depicted below, with over half of accounts being of a tiny size, and those tiny accounts controlling just about 10% of aggregate assets. Inversely, in this example, only about 10% of all accounts of this fund manager were of a size greater than $25,000, yet those larger accounts controlled, in aggregate, the majority of dollars managed.

Distribution of Fund Account Sizes



Source: Strategic Insight Research

A fund with a high proportion of small accounts ends up being more expensive for those of its shareholders holding larger accounts, **as transfer agent (TA) fees, which often run at $20-$25 per account, due to "mutualization", are apportioned based on each account's assets, with larger accounts subsidizing smaller ones.**

The following two tables show TA fee ratios for US Large Cap Equity and US Small Cap Equity funds with the smallest average account sizes. (Source: Strategic Insight Simfund; estimated based on funds' N-SAR filings with the SEC that disclose the number of accounts at fiscal-year end.) In the example below, transfer agent fee ratios for funds with the smallest retail-type accounts could be 0.30% (or more) higher than among funds enjoying much larger average account sizes.

Large Cap Equity Funds, Active	
Average Account Size	Median TA Fee Ratio %
Up to $5,000	0.396
$5-10,000	0.285
$10-15,000	0.210
$15-20,000	0.184
$20-30,000	0.138
$30-50,000	0.102

Source: Strategic Insight Simfund

Small Cap Equity Funds, Active	
Average Account Size	Median TA Fee Ratio %
Up to $5,000	0.409
$5-10,000	0.285
$10-15,000	0.232
$15-20,000	0.157
$20-30,000	0.122
$30-50,000	0.117

Source: Strategic Insight Simfund

Initiatives to reduce the occurrence of an excessive number of tiny accounts and thus lower TA costs for other shareholders may include "small account fees" compensating for small accounts' high TA costs. For instance, Vanguard charges $20 annually for accounts under $10,000 (except when the account is not held at Vanguard) or if a household's aggregated accounts at Vanguard exceed $100,000, or if the investor has more than $10,000 at Vanguard and receives all communications electronically, etc.; for the very small accounts, such account fees translate to a large increase in the effective "cost ratio." Other funds may raise account minimums, or implement initiatives to aggregate multiple smaller accounts held by the same investor into a single fund-of-fund account, etc. Such efforts, while reasonable, sometimes meet with shareholder resistance, especially when there is little understanding that some of the costs of small accounts are borne by other shareholders of the fund.

Every fund has many small accounts. As aggregate TA fees are proportionately allocated based on assets, subsidization (of small accounts) due to the "mutualization" of fees occurs. **This is one example of how the mutual fund structure allows small shareholder accounts, some with only $3,000, $5,000, or $10,000 to benefit from the pooling of costs inherent in "mutual" funds. "Mutualization" results also in the pooling of advisory fees across all share classes, where large or institutional shareholders—sometimes with their $1 million-plus accounts held in an institutional share class—provide cross-subsidization to small retail accounts.**

In the same way, **the pooling of 12b-1 fees across all shareholders within one pricing class works to benefit small shareholder accounts. Despite the extraordinary expansion of the mutual fund industry, the majority of shareholder accounts are still very small, with probably half still under $10,000 or $12,000.** (529 plan growth and the Pension Protection Act of 2006 are two past and future sources of many tiny accounts.)

Economies of scale are not yet meaningful at the account level, and Rule 12b-1 fees are important as a cross-subsidization mechanism for small accounts.