Ms. Nancy M. Norris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Ms. Morris:

I appreciate the opportunity to provide comments to the Commission and hope these are beneficial to your review of Rule 12b-1.

Thank you,

Mike Mulcahy
Bridgeway Funds, Inc.
Bridgeway Capital Management, Inc.

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Introduction

Mutual funds are a great investment option for both large and small investors. As asset managers, we participate in a highly competitive industry supported by a comprehensive set of professional intermediaries, all working together to provide investors access to a diverse range of investments and services. This will remain true independent of the decision the Commission makes in regards to Rule 12b-1. Nevertheless, I am in support of the review of the current Rule. I see the task before the Commission as not to ask "What is in the best interest of the asset managers, mutual fund companies or the intermediaries?" Instead, the question to be addressed is: "Is Rule 12b-1 in the best long-term interest of investors in mutual fund products?"

When viewed from this perspective, it becomes clearer that the time has come for Rule 12b-1 to be either substantially revised or eliminated. I realize that this perspective deviates from a large portion of the industry, so I have focused these comments on my most significant concerns. In addition, I have listened to and read many of the arguments for the continuation of this Rule and therefore offer rebuttals (or even support) to some of these perspectives.

In summary,

1. The use of 12b-1 fees to pay intermediaries introduces the potential for conflicts and biases in the financial service distribution and servicing channel.
2. The application of 12b-1 fees leads to inequitable cost-sharing across channels and discourages valuable (and necessary) service-level competition.

3. 12b-1 fees are complicated for investors and costly to the industry and shareholders.
4. Rule 12b-1 potentially threatens the long-term competitiveness of the mutual fund industry versus alternative investments (such as individual stocks and ETFs).

Finally, I will quickly describe some alternatives to the current fee structure which could address some or all of these issues.

Problems with Current System

While I have many concerns with Rule 12b-1, I will focus on what I feel are four key issues with 12b-1 fees as they are structured and used today.

1. **The use of 12b-1 fees to pay intermediaries introduces the potential for conflicts and biases in the financial service distribution and servicing channel.**

   Investors should be able to ask their financial adviser, *"What is the right mutual fund for me?"* and expect an unbiased answer. If financial advisers only present funds which offer payments in the form of 12b-1 fees versus funds that do not, then financial advisers may have biases (real or perceived) for their own well-being over that of their clients'. This is a difficult conflict to manage. Advisers should be seeking investments that are in the best interest of their clients. This is what investors are looking for, and expect. While I am sure most financial advisers disclose the fees, are they also presenting funds that don't offer such fees? And, do clients really grasp the nature of these fees as well as the range of options that do exist?

   This bias/conflict is also true with many retirement platforms, mutual fund platforms and third-party administrators who select funds available for their clients. Instead of selecting funds based on the appropriate investment measures, the primary selection could become what fees are paid *to me,* the intermediary, and not what funds are best for the investor.

   Based on data from Morningstar, as of June 30, 2007 the average returns of all actively-managed, domestic equity retail mutual funds without 12b-1 fees beats the average returns of those with 12b-1 fees over 1-year, 3-year, 5-year, 10-year and 15-year periods. This seems to indicate that funds without fees are better performing and should not be overlooked in fund presentation or selection.

   For illustration purposes, suppose your doctor prescribed a medicine that was not necessarily best for you but was from a drug company that paid him fees on each prescription filled. Which medicine would you want the doctor to recommend?

   While we have chosen not to use load structures at Bridgeway Funds, some positive aspects of front-end loads are transparency to investors and clarity of

compensation structure to the intermediary for services rendered. Rule 12b-1, however, blurs such clarity.

2. The application of 12b-1 fees leads to inequitable cost-sharing across channels and discourages valuable (and necessary) service-level competition.

Investors should be able to ask their intermediary *"What service do you provide for me and what does it cost?"* so that they can make informed decisions when choosing between any marketplace or any financial intermediary. The underlying asset management service an investor can get from Fund Company A is the same whether through Intermediary X or Marketplace Y or Retirement Plan Z. What an investor should ask is "what is the cost and value of using these different channels, and is it worth it?"

Mutualization of these fees inhibits an investor from having the necessary information on price vs. value to make economic choices across service providers. This distorts fundamental, free-market economics and restricts valuable competition in the intermediary channel. In the end, it is the investor that is being harmed.

Let me use another example:

Today, if you are looking to buy a digital camera, you can choose to go to a technology store where you can touch, tryout and analyze various brands and functions, and get assistance on selecting a digital camera. Alternatively, you can shop the Internet where you will mostly likely find a lower price (but without the same level of service.) You get to make the choice of price and service of the different distribution and servicing channels because the final prices reflect the value of the camera plus the service provided. In fact, the camera's core value is the same; it is the value of the service-level that is reflected in the price difference and a key driver of the decision-making process.

However, given mutualization of 12b-1 fees, free market economics are distorted in the service side of the industry, and when over 90% of all mutual fund assets are held through intermediary service providers, this is concerning. If platform A (a full-service mutual fund marketplace) charges 40 basis points to participate and platform B (a low-cost, internet marketplace) charges 10 basis points, the current method for charging 12b-1 fees to shareholders averages these costs across assets. (The cost of the "digital camera" is same in each channel, irrespective of the services delivered.) The shareholders of platform B who may have thought they were shopping around to find a "low-cost" option are in fact paying the same price as the "high-cost, high-service" option as they subsidize the shareholders of platform A.

This practice of mutualization has several negative impacts. First, it discourages competition among service providers since the costs of these services cannot be

reflected in the final price paid by the shareholders who choose different channels. Second, platform A realizes this "mutualization subsidization" occurs and has the incentive to raise its fees as increases in costs are spread across all assets and are not directly reflected through their channel. Third, it discourages the low-cost marketplace from innovating and pursuing a low-cost strategy because this lower-cost model cannot necessarily be passed on in the form of lower prices in an effort to gain customers.

Instead of encouraging competition (which lowers costs and/or increases services), Rule 12b-1 and its current application does the opposite.

3. **12b-1 fees are complicated for investors and costly to the industry and shareholders.**

The presence of 12b-1 fees has led to a proliferation of share classes with certain share classes created for retirement platforms, mutual fund marketplaces, mutual fund wrap programs, etc. This proliferation complicates investors' ability to comprehend the prospectus and other related documents. It would certainly be simpler if there were only one share class and the associated service fees were "externalized." Even the sales process for intermediaries would be simplified by eliminating the need for explaining the various fees and the classes.

Moreover, this increase in share classes increases the fund's cost of accounting, filings, shareholder servicing (e.g., prospectus review, drafting, printing, mailing), blue sky registration, transfer agency, board review, etc. These costs are a drain to shareholder returns.

Ironically, a fee that is designed to help mutual funds gain scale rarely reflects economies of scale themselves. While it is true that Directors/Trustees must review and approve 12b-1 fees, contractual terms with intermediaries generally are asset-based without breakpoints and require payment by the fund and/or adviser as long as the assets remain in that channel – irrespective of higher or lower continuing levels of service subsequent to the original sale.

Simplification of Rule 12b-1 would be beneficial to all parties: investors, fund companies, intermediaries and fund directors.

4. **Rule 12b-1 potentially threatens the long-term competitiveness of the mutual fund industry versus alternative investments (such as individual stocks and ETFs).**

Let me note two interesting market happenings and explain their potential implication on the mutual fund industry.

First, it has been very exciting to watch the increased competition on transaction fees for security trades at various marketplaces and brokerage firms. Intense

competition on price and service is creating new service options and driving down trading costs (and increasing returns) for investors. Why has this happened? Transparent pricing versus services rendered.

Second, the ETF market has emerged with exuberance. These products also have highly competitive transaction fees and marketplaces/brokerages are competing for investors' business in this space. Once again, transparent pricing versus services rendered.

Concerning to me as an industry participant is the following: I fear 12b-1 fees (and other service/distribution fees) are actually subsidizing competitive investments since companies whose individual stocks can be purchased through these intermediaries do not have to make these servicing payments. While it may be just a coincidence, I am observing declining costs and increased competition for individual stock (and ETF) trades at various intermediaries, while observing increasing costs for mutual funds to participate. The long-term impact of this could be quite dangerous to the mutual fund industry.

Objections to the Modification of Fees

Here are some of the most notable objections to modifying the fees and some counter arguments, or supporting points.

1. *"Advisers and Platforms Must Get Paid."*

Sure they do. After all, they provide an invaluable service for the industry. However, financial advisers first need to be unbiased in their selection and delivery of investment options. When an adviser recommends an individual stock like "XYZ" it is not because company XYZ makes a payment for services. And the financial adviser certainly doesn't sell XYZ or not service the client because he didn't get a fee. They recommend XYZ because the financial adviser believes it is the right investment for the client.

Some advisers today avoid 12b-1 fee paying funds because of the mere appearance of bias. Instead, they charge their clients either asset management fees or hourly rates or commissions or loads. These costs are very visible so clients can assess the cost they pay for the service they receive. There is also a rather large contingent of service providers that use load-based funds. Again, very transparent pricing for clients in the decision-making process.

Economics and free markets flourish when clear information is provided to consumers. Eliminating these fees will increase the transparency of cost vs. benefit enabling investors to make better choices and encouraging the industry to increase the quality of service and/or decrease costs.

2. *"Small funds or new fund companies won't make it. They need it to compete."*

There may be some truth to this given the current structure and use of fees. Since most mutual fund companies are "price takers," fees are oftentimes necessary to get the attention of the intermediary. This is particularly true for new funds or small fund complexes. Unfortunately, they may also have to offer *higher* fees since they don't have the track record or reputation, which in turn hurts their competitiveness in the long-term. Conversely, if these fees did not exist, asset management competition would be based on the investment product, strategy and objective and not 12b-1 payment streams. A more customer-centric approach to competition.

On the other hand, I look at Bridgeway Funds where we don't use 12b-1 fees and yet we have grown to over $3 billion in assets from less than $500 million five years ago. Fees may be helpful but they certainly aren't necessary.

3. *"Service levels will decline without payments" or "Shareholders need education and assistance."*

Will marketplaces, advisers and broker/dealers not service their clients because they are not being paid 12b-1 fees? Not likely. Some advisers don't use 12b-1 fees - or mutual funds at all - and they still provide clients with education and assistance. In addition, financial advisory services existed before Rule 12b-1 and they will exist after. Individual financial advisers can be successful as long as they provide a legitimate and valued business service. If they don't provide a service that clients value (or they provide a service that clients think is over-valued) then either the service level will increase, prices will decline or clients will move elsewhere. Like objection #1 above, the elimination of these fees will increase the transparency of cost vs. benefit enabling investors to make better choices and encouraging the financial services industry to increase the quality of service and decrease costs.

4. *"I have built my business on 12b-1 fees, and need the future stream."*

I am sympathetic to this argument. If an intermediary has sold mutual funds with the anticipation of a future stream of payments, then we certainly don't want a hard cut-off. Any change would need to be managed so that businesses can transition effectively. (Perhaps a reasonable transition period, or a sunset period.) The beauty of the current structure though is it can provide a nice revenue stream as they shift to a fee structure paid for by clients who can make rationale economic choices.

Possible Solutions

As I see it, the Commission has several options for impacting Rule 12b-1. Here are some ideas that I have heard and initial thoughts:

- "Leave it alone." Obviously, I am not a proponent of this.
- "Externalize the fee." I agree with others that this is very complex. In addition, it fails to introduce competition at the service level.
- "Direct charge backs." In this option, a fund complex would be permitted to charge the distribution and service fees incurred from the intermediary back to the investors in that particular channel. The advantage to this model is that the investors pay the service and distribution costs associated their intermediary. This model is "externalization" would increase competition at the service level. The challenge would be determining and communicating NAVs and final price.
- "Elimination." Unless all service and distribution fees and not just 12b-1 fees are addressed, I am concerned that the fees will just shift to another format. However, if "fee shift" can be prevented, this model will likely lead to a more competitive and lower-cost mutual fund industry. This option also appears simplest to implement (systems et al), but certainly creates the biggest change in the intermediary channels and therefore would need to be managed with great care.

Conclusion

Given the near ubiquity of mutual funds, it is time to move to increased competition throughout the entire business system. Competition based on performance, risk management, and investment objectives for mutual funds managers is essential and quite intense today. Fees for client servicing and distribution need to be separated and/or removed to generate similar, strong competition. When consumers are offered clear choices between services and costs, they will make decisions that lead to more efficient and more competitive markets.