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Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Rule 12b-1 Roundtable – File Number 4-538

Dear Ms. Morris:

On behalf of Smith Barney,[1] I want to express my gratitude for the opportunity to be a panelist on the U.S. Securities and Exchange Commission's ("SEC") Rule 12b-1 Roundtable. Through the leadership of Chairman Cox, the SEC is taking a fresh look at a long-standing rule that in certain ways has become one of the cornerstones of the mutual fund industry. Changes to this cornerstone, however, can have a significant impact on various parties that comprise the industry and investors. Therefore, we appreciate the SEC's approach in seeking the views of interested parties and industry experts to assist the staff as it considers constructive and effective modifications to the rule.

We believe the Commission's paramount consideration, which we share, should be: Do what is best for investors. We believe the rule, with SEC guidance over time, has been a true success story that has maximized benefits to investors. The rule has helped facilitate the proliferation of new funds and investment choices and the creation of a range of fund share classes with alternative pricing and deferral of fees in line with investor demand. Moreover, since the rule's inception, there has been a reduction in fund costs and expense ratios. The rule also has made possible the offering of bundled distribution services through intermediaries. Firms like Smith Barney are able to provide professional, quality service to investors due in part to fees we and our sales force receive under Rule 12b-1.

Because of the rule, investors receive real value and services from broker-dealers and other financial services providers. Firms like Smith Barney have invested significant resources necessary to offer the distribution, recordkeeping and servicing functions paid only in part by Rule 12b-1 fees. With the increased number and complexity of fund investment choices, investors now are more in need of quality services and related advice over the life of the investment.

It is important to keep in mind that mutual funds are unique, long-term investment products, distinct from equity and bond investments. Mutual fund sales, processing and recordkeeping services are more complex and expensive than, for example, secondary market equity trades. Given that funds are designed to be long-term investments, broker-dealers have continuing service requirements and investors expect brokers to follow and service their fund investments over time. Fund-compensation structures, including 12b-1 "trails," provide payment options to customers and compensate firms and their representatives for the ongoing nature of services they provide.

[1] Smith Barney, which is a division of Citigroup Global Markets Inc., distributes mutual funds and offers a range of sales, marketing and back-office services to funds and investors.

I. Themes and Misconceptions - Rule History and the Role of the Intermediary/Distributor.

There has been much commentary suggesting the rule was adopted for funds to use temporarily to address specific issues, such as permitting some fledgling fund companies to use fund assets for marketing and distribution expenses when experiencing net redemptions. Given that these circumstances no longer exist, some suggest that rule should be eliminated. We believe this is an over simplified and narrow summary of the origin and purpose of the rule. Rather than outliving its purpose, the rule continues to successfully serve investors and support the growth and health of the industry.

Moreover, distribution and servicing functions are key to fund sales and the investor experience. We believe comments surrounding the rule and potential changes have failed to give adequate attention to the valuable services broker-dealers provide to investors. Changes to the rule could have a profound negative impact on the quality and breadth of services provided by intermediaries and result in fewer choices and increased expenses incurred by investors -- particularly smaller investors.

A. History and Purpose of Rule 12b-1.

1. Original Purpose was to be Proactive and Evolving. At the time Rule 12b-1 was proposed, the primary debate revolved around potential conflicts of interest if a fund paid for distribution costs out of the assets of the fund, as well as the use of "excessive" expenses or similar abuses.[2] The Commission resolved that debate when it adopted the rule and confirmed distribution compensation was a legitimate and beneficial use of fund assets. In the rule's adopting release, the preamble states: "The Commission is today adopting rule 12b-1 to permit open-end management investment companies to bear expenses associated with the distribution of their shares."[3] The release further provides that "Section 12(b) was intended to permit the Commission to regulate the use of mutual fund assets to finance distribution," and its purpose was "to protect the funds 'against excessive sales, promotion expenses and so forth.'"[4] The adopting release even clarified that advisers can use a portion of their advisory fee to supplement distribution, in addition to 12b-1 distribution-fee payments.[5]

Rather than making a limited rule to be used only for funds in dire straits or for no-load funds, the SEC designed Rule 12b-1 to be proactive and evolving, enabling all funds to experiment with various distribution arrangements. The adopting release stated: "Recognizing that new distribution activities may continuously evolve in the future, and in view of the impracticality of developing an all-inclusive list, the Commission maintains that the better approach is to define distribution expenses in conceptual terms (*e.g.*, financing activities primarily intended to result in the sale of fund shares.)"[6] In addition, the SEC stated that: "Rule 12b-1 does not restrict the kinds or amounts of payments which could be made."[7]

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[2] Historically, the SEC had been concerned with undisclosed, indirect use of fund assets, *i.e.*, "whether funds are paying for distribution in substance and not with the form of particular arrangements." *See* Investment Company Act Rel. No. 11414 (Oct. 28, 1980), 1980 WL 20761 (Oct. 28, 1980) (*hereinafter*, "Adopting Release").

[3] *Id.*

[4] *Id.* at *8.

[5] *Id.* at *9. Indeed, the Commission also considered whether fund boards should consider investment adviser "profits" used to pay for marketing or distribution when considering whether to authorize a 12b-1 plan using fund assets to pay for marketing and distribution costs. The Commission decided that, assuming an adviser's compensation in a board approved advisory agreement is reasonable, the adviser can use its profits as it wishes. *Id.* Such "revenue sharing" was as common then as it is today, and the Commission did not view such revenue sharing presumptively as indirect use of fund assets to pay for distribution, in addition to distribution expenses authorized in a 12b-1 plan.

[6] *Id.*

[7] *Id.* at *11.

Most persuasive was the commentary of former senior SEC staff members during the SEC Roundtable.[8] They quickly and effectively dismissed the "myths" surrounding recent public commentary that the rule was intended to provide a temporary solution to problems as they arose or to deal with a net redemption problem. They noted that the rule, its history and staff briefings to the Commission all clearly contemplated that the rule was intended to pay for distribution costs, including those distribution fees related to broker-dealers and other intermediaries.

In adopting the rule and resolving the debate, the Commission provided clear endorsements that it is appropriate for fund assets to be used for distribution and for compensation to brokers over the life of an investment to facilitate fund share sales. This decision remains equally valid and useful today.

2. Subsequent SEC Actions Helped Expand Distribution and Investor Choices. The rule's legislative history and subsequent SEC action confirm the rule was intended to grow along with industry developments. As noted, the rule anticipated that funds and intermediaries would experiment with new fee structures to facilitate distribution, subject to fund-board oversight. Given this mandate, mutual funds, with SEC review and approval, evolved to provide a range of share classes, pricing structures and Rule 12b-1 fees that now offer investors more types of mutual funds and more pricing structures suited to investor choice and preferences.

For example, soon after the SEC adopted the rule, funds submitted and received exemptive relief from the SEC staff to experiment with alternative pricing structures, in addition to Rule 12b-1 fees.[9] Funds adopted share classes with contingent deferred sales charges that declined as investors remained invested in the fund for the long term.[10] Each share class, with different load and 12b-1 fee structures ("spread loads"), was created with different investor choices and investment time horizons in mind. These were important pro-investor changes as they enabled investors to choose to avoid front-end sales charges.

In addition, in the 1980's, the SEC improved prospectus and fee disclosures in response to public criticism. It also worked with the NASD to impose a regulatory ceiling on the amount of asset-based fees a fund may charge shareholders. The SEC approved amendments to NASD Rule 2830(d)(2)(E), which prohibits the offer or sale of fund shares with an asset-based sales charge in excess of 75 basis points, and NASD Rule 2830(d)(5), which prohibits the offer or sale of fund shares with a service fee (*i.e.*, payments by a fund for personal service and/or maintenance of shareholder accounts) in excess of 25 basis points.

In the 1990's, the SEC adopted additional rules to facilitate use of alternative share classes and backend loads. For example, the SEC adopted Rule 18f-3 and Rule 6c-10, which permitted funds to adopt multiple share classes and contingent deferred sales loads, respectively, without the need to obtain an exemptive order.[11] The SEC also adopted changes to Form N-1A to consolidate 12b-1 fee expenses data in a fee table.[12]

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[8] *See generally* Comments of Joel H. Goldberg, Partner, Willkie Farr & Gallagher LLP, and a former Director of the SEC's Division of Investment Management at the time the rule was adopted, and Richard W. Grant, Partner, Morgan Lewis & Bockius LLP, and an Associate Director of the Division of Investment Management at the time the rule was adopted, during SEC Rule 12b-1 Roundtable, Jun. 19, 2007.

[9] *See* Report of the Working Group on Rule 12b-1, Submitted to Investment Company Institute Board of Governors (May 2007) at Appendix II, p. 40 (*hereinafter*, ("ICI Report")).

[10] *Id.*

[11] Investment Company Act Rel. No. 20915 (Feb. 23, 1995), 1995 WL 75247 (Feb. 23, 1995), 1995 WL 82082 (Mar. 2, 1995); Investment Company Act Rel. No. 22202 (Sept. 9, 1996), 1996 WL 508754 (Sept. 9, 1996).

[12] Investment Company Act Rel. No. 23064 (Mar. 13, 1998), 1998 WL 107729 (Mar. 13, 1998).

The Commission staff helped facilitate all these changes, consistent with the original purpose of the rule, and let market forces respond to investor demand for alternative compensation and pricing structures and for streamlined disclosure of fund distribution expense in a fee table.

B. Financial Intermediaries Add Value – They are Vital to the Distribution and Servicing Functions.

1. Rule 12b-1 Fees Help Financial Intermediaries and their Brokers Provide Significant Benefits to Investors. Investors obtain significant benefits from financial intermediaries and their brokers/representatives, paid for in part from Rule 12b-1 fees. Broker-dealers like Smith Barney provide excellent professional marketing, sales and recordkeeping/administrative services – all part of the "distribution" process for which 12b-1 fees are tailored.

Firms like Smith Barney incur significant expenses to offer and sell mutual funds, such as performing due diligence on fund companies and funds; providing research, portfolio analysis, tools and website functionality; reviewing and updating fund sales literature and performance data; training sales force on new mutual fund developments; delivering consolidated statements and tax-reporting efficiencies; delivering prospectuses; and other services. Over the past 25 years, the number and types of funds, strategies and share classes offered to investors have increased dramatically. Various features (such as breakpoints, letters of intent, householding, exchange features, etc.) differ from one fund company to another. With this rapid rise in the number and complexity of funds and changes to fund prospectuses each year, broker-dealers also incur increased expenses in offering and maintaining so many funds.

Indeed, due in part to the costs associated with adding funds to its mutual fund platform and the ongoing maintenance, diligence and prospectus updates, Smith Barney does not sell all mutual funds. We sell over 100 fund families, and offer about 2,500 funds out of close to 9,000 publicly registered funds. As part of our due diligence, we screen fund companies and funds for appropriateness for our customer base. Distribution costs make it prohibitively expensive for even large full-service firms like Smith Barney to review and evaluate all open-end funds for sale to our clients even with 12b-1 fees used to cover some of those costs. Without Rule 12b-1 fees to subsidize some of these costs, and in order to maintain our due diligence standards, we would likely be forced to offer investors fewer investment choices.

Smith Barney Financial Advisors ("FAs") independently spend significant time reviewing prospectus changes, fund performance data, fund pricing changes, breakpoints and other data for their clients to determine if the mutual fund remains a suitable investment given costs already incurred. FAs provide clients with information such as performance updates, reports on the underlying mutual fund portfolio, reports on the manager of the fund, personnel changes in the fund, information about upcoming and past capital gains distributions, size of the embedded capital gains at the fund level, the impact of market changes and of world events on the mutual funds they own. Clients regularly call FAs for updates.

Sales of mutual funds involve significantly more work and training than an equity or debt security. As professionals, FAs are obligated by SRO rules to know various features of competing fund products, their alternative share class and cost structures, and potential benefits to investors, such as breakpoint discounts for larger transactions, rights of accumulation, account aggregation preferences, householding features of various funds, and exchange privileges. Because fund investments are considered longer term, fund shareholders benefit from and have a reasonable expectation that their FA will continue to monitor the performance of an investment over time and the availability of breakpoints or other benefits.

The SEC also should consider the impact that financial intermediaries and Rule 12b-1 fees have had on the retirement/401(k) industry. Broker-dealers and other intermediaries may provide sales, marketing, education, administrative and recordkeeping services to companies and their 401(k) participant employees. Many of these intermediaries rely on 12b-1 service and administrative-fee components to subsidize and customize their services to plan sponsors. With alternative fee choices, plan sponsors as fiduciaries have a range of choices to pay for plan administration, and 12b-1 fees help pay for these services.[13]

In sum, broker-dealers and other financial intermediaries provide valuable services to investors, and Rule 12b-1 fees are a primary reason investors enjoy the broad selection of investment choices and receive integrated financial services.

2. Broker-Dealers have Efficiently Internalized all "Distribution" Functions Envisioned by Rule 12b-1 to Reduce Fund Expenses. Rule 12b-1 was designed to enhance "distribution," and the rule itself identifies "distribution" activities as including: 1) advertising; 2) compensation of underwriters, dealers and sales personnel; and 3) service activities, such as printing and mailing of prospectuses and sales literature. In other words, "distribution" encompasses the entire sales process following a company's issuance of securities, including marketing, prospectus delivery, sales/advice, confirms, statements and shareholder servicing. Investors get consolidated reports of all fund holdings and tax reporting from their broker, something they would not get if they bought funds directly from separate fund companies.

Funds and broker-dealer intermediaries realized that integrated brokerage firms could provide this package of distribution services, disclosed separately in funds' 12b-1-expense category, more efficiently than separate service providers. Loads and fund expense ratios also have decreased since the adoption of Rule 12b-1. Broker-dealers, therefore, have become efficient and cost-effective "distribution" agents for funds, providing competitive, integrated financial services to cover the entire marketing, sales and administrative/servicing functions.

Because funds have authorized 12b-1 fees for this package of integrated services, broker-dealers have been able to compete with each other. Broker-dealers can choose to allocate their 12b-1 fees by paying their sales force, increasing marketing activities, or investing in infrastructure to enhance the client experience with the firm, such as with enhanced statements, web-site access, asset allocation tools, and consolidated statements. In order to encourage competition for pricing and servicing among broker-dealers, we believe it is preferable to let broker-dealers decide how to best allocate such assets, rather than have funds or the SEC dictate specific percentages or amounts eligible for compensation, marketing or servicing functions. Funds can monitor use of 12b-1 fees to see that intermediaries are using them to enhance distribution consistent with a Rule 12b-1 plan.

II. Benefits to Investors Outweigh Costs and Alternatives.

On balance, we believe Rule 12b-1 has created significant benefits to investors that greatly outweigh alternatives being considered.

A. Benefits to Investors. The following discussion summarizes some of the main benefits investors receive at least indirectly from Rule 12b-1 fees.

- **Lower Loads and Expenses.** Prior to the rule, investors could purchase mutual funds only with an upfront load (putting less money to work up front) or pay external advisers to obtain advice and services. Loads were as high as 8.5%, as compared to the highest loads of 5.75% today. Some commentators assert that Rule 12b-1 fees may negatively impact shareholder returns by using a portion of fund assets to subsidize distribution expenses, rather than to make investments. Mutual fund expenses, however, have trended downward since the rule was adopted in 1980. In 1980,

[13] The SEC staff reportedly is working with the DOL to streamline disclosures to plan sponsors and/or participants, including fees paid for administration of 401(k) plans. Speech by SEC Staff: Keynote Address at the Practicing Law Institute Investment Management Institute 2007 by Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, New York, NY (Apr. 12, 2007).

investors in stock funds, on average, paid fees and expenses of 2.32 % of fund assets; by 2006, that figure had fallen by more than half to 1.07 % of fund assets.[14]

- **More Investor Choices – Putting More Client Assets to Work**. The rule and SEC guidance helped fund companies offer a menu of no-load, front-end load or contingent deferred load choices tailored to an investor's anticipated investment period. In response to investor demand, funds have tailored 12b-1 fee "distribution" charges (which subsidize and lower loads), so investors can defer (or avoid) commissions and put the full amount of their investment assets to work immediately while getting servicing and incidental advice for the duration of the holding.

- **Integrated Distribution Services – Professional Assistance**. As noted, the rule facilitated downward pressure on loads and fund expenses because broker-dealers have been able to deliver low-cost, integrated "distribution" services in a manner more efficiently than if funds or investors paid for such services separately. In addition, these intermediaries provide incidental advice to investors regarding the imposing array of choices of available funds. Changing the rule to limit the use of 12b-1 fees to compensate these intermediaries may cause them to turn their attention to other investment products and services.

- **Alignment of Long Term Investing**. Mutual funds are long-term investments, and 12b-1 fees align the interests of investors, brokers and fund management. First, with stable assets, portfolio managers can take better advantage of investment opportunities and reduce instances in which they need to sell attractive positions in order to meet redemptions. Fund companies have experimented with different pricing structures and share classes to encourage longer-term investment. Stable, long-term assets, therefore, enable fund managers to reduce transaction costs and maximize investment performance. Second, compensation to brokers, paid in part over the life of the investment, encourages brokers to follow the fund over the long-term investment period. This long-term investment structure also reduces potential conflicts that could encourage churning of mutual-fund investments if investors separately paid for distribution in the form of commissions. Eliminating Rule 12b-1 fees and the "trail" component would take away significant incentives for brokers to continue to monitor client accounts, particularly smaller investors. Finally, with the addition of new share classes, investors can choose to pay for servicing and incidental advice with an upfront load or can put the full amount of investment at work with "spread load" combinations. In this way, investors can spread out the cost of a mutual-fund investment.

- **Elimination of 12b-1 Fees Will Likely Raise Costs and Result in Less Transparency.** Since total fund costs are already constrained today by competitive forces (*i.e.*, funds compete on total expense ratios as well as loads), repealing 12b-1 fees would likely cause funds to shift distribution costs to other cost components – some combination of higher non-management fees, management fees and loads. This could in turn lead to higher overall costs to investors. In addition, if these costs were shifted, funds would compensate financial advisors out of other charges, such as non-management fees, which are not transparent to investors.

In the end, investors care most about their risk-adjusted return on their investment, after accounting for fees. It's all about performance. If a mutual fund charges high fees and, as a result, has a low return net of fees, investors will flee the fund and go to a fund that provides a better net return.

B. Alternatives do not Enhance Investor Choices or Benefit Investors. Some have suggested it would be preferable to separately charge investors for distribution, instead of using fund assets. Investors currently can purchase mutual funds without Rule 12b-1 fees or pay a separate commission. Many funds do not have Rule 12b-1 plans and attempt to compete with lower expense ratios and without a distribution network. Investors can purchase closed-end funds and ETFs in the secondary market and pay a commission. Certain investors also can purchase load-waived or institutional share classes in advisory

[14] *See* ICI Report, at 6.

accounts. Even with these choices, investors have voted in favor of using intermediaries. As of 2003, more than 80% of all shareholders owning fund shares (outside 401(k) or other employer-sponsored pension plans) acquired them through financial advisers.[15]

In the end, Roundtable panelists generally agreed that it is reasonable for investors to pay for the services they receive, whether distribution, advisory, recordkeeping, administrative, etc. Indeed, the staff of the SEC's Division of Investment Management issued a report in 1992 on issues related to mutual-fund distribution; the report recognized that regulation of one method of distribution necessarily affects each other method, meaning that elimination of 12b-1 fees will increase other distribution fees that shareholders might pay.[16] Proponents of change, therefore, do not advocate getting rid of fees; rather, they advocate mandates to shift costs directly to investors, which has its own drawbacks, such as adverse tax consequences and probably fewer choices. Firms would incur costs to develop systems and make other changes to accommodate significant changes to the rule. These changes would likely be passed on to investors.

III. Proposals for Change

Changing Rule 12b-1 has been proposed several times over the past several years. During the Roundtable, the SEC staff proposed several possible solutions for change, including repeal. Rather than repealing the rule -- which we believe could result in harm to investors -- most panelists and industry groups believe the rule has worked to the benefit of investors. They recommend making constructive changes to the rule, and we believe the following changes would be the most useful.

A. Enhanced/Simplified Disclosure. Most industry groups studying Rule 12b-1, including the ICI, SIFMA and the NASD, all agree that investors could still benefit from simplified disclosure.[17] We agree that most concerns with Rule 12b-1 and its focus on payment for distribution expenses can be addressed with tailored disclosure. For example, the SEC could permit funds to offer their shares using a short-form disclosure document that provides key information about a fund, including the fund's fee table. The prospectus or the short-form disclosure could describe the general purpose of the fees, use a glossary of terms and list fees in a table format.

At Smith Barney, we already provide a separate disclosure document to mutual-fund investors entitled "Mutual Fund Share Classes and Smith Barney Compensation." This document describes how mutual funds work and the various share classes, loads and 12b-1 fees. The document provides numerical examples of how a typical investment may work in an A share, and provides similar comparisons to B and C shares and related 12b-1 fees. We provide examples of how 12b-1 fees and loads affect returns and note that investors should carefully consider their investment objectives and time horizon to ensure they select the most appropriate load and 12b-1 fee cost structure. Fund prospectuses also provide similar disclosures describing distribution and servicing (or 12b-1) fees and for different share classes.

While most funds and firms provide a range of disclosure to investors, investors may benefit from disclosures that are standardized and provided in a simplified, short-form format that all could use.

B. Greater Clarity on Fund Expenses and 12b-1 Fee Terminology. "Rule 12b-1 Fees" as a term is often used inaccurately and increasingly in a derogatory sense. We agree with suggestions by others to delete references to Rule 12b-1 in fee table or other disclosure requirements and simply refer to such fees as "Service Fees" or "Distribution and Servicing Fees" or something similar. Again, greater

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[15] ICI Report, at 4, n. 18.

[16] DIVISION OF INVESTMENT MANAGEMENT, UNITED STATES SECURITIES AND EXCHANGE COMMISSION, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (May 1992), at 296-97.

[17] *See* ICI Report; Responding to Mutual Fund Investors' Changing Needs, Mutual Fund Distribution and Shareholder Servicing Practices, White Paper, Securities Industry and Financial Markets Association (Jun. 13, 2007); Report of the Mutual Fund Task Force: Mutual Fund Distribution, NASD (Apr. 2005).

clarity and consistency on the use of fund expenses would dispel misconceptions about the use of Rule 12b-1 fees.

C. **Revising Factors for Board Consideration.** We agree that the non-mandatory factors articulated for fund board consideration of Rule 12b-1 fees are outdated and should be revised. The requirement to approve such 12b-1 plans annually also should be reassessed, particularly for plans covering share classes with contingent deferred loads. As pointed out during the Roundtable, it is unrealistic to expect fund boards to terminate plans when they are being used to recoup fronted commissions for funds paying deferred loads (B and C shares), but funds are free to revise their plans and can do so going forward. Clearly fund boards have used and modified Rule 12b-1 plans over time to accommodate innovation in the industry with share class and front and deferred load arrangements to convey greater investor choices.

While some have proposed that fund boards should be out of the business of assessing distribution or 12b-1 fees, we believe the Commission was correct when it placed such burdens on fund boards when adopting the rule. Fund boards, and independent directors, are best suited to assess use of fund expenses, and they currently assess such expenses when reviewing advisory contracts, transfer agent expenses, etc. Not all funds have a Rule 12b-1 plan to pay for distribution and administrative expenses; however, many do and correctly determine that such fees are well spent to the benefit of investors.

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Once again, on behalf of Smith Barney, we thank the Commission and its staff for organizing this Roundtable and seeking input from interested parties. Even though the Commission and the securities industry have continued to study this issue since 1980, this Roundtable has probed deeper and has produced more constructive consideration of the competing issues and interests. In the end, we are all driven by investor protection and "Client First" considerations, and we strongly support Commission initiatives that improve rules to help and protect investors.

Thank you, and we remain open to assist the Commission and its staff in any way as it further deliberates constructive change in this area. Please feel free to contact us if we can be of assistance.

Sincerely,

Michael J. Sharp

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Roel C. Campos, Commissioner
The Hon. Annette L. Nazareth, Commissioner
The Hon. Kathleen L. Casey, Commissioner
Andrew Donohue, Director, Division of Investment Management
Erik R. Sirri, Director, Division of Market Regulation