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July 27, 2007

RECEIVED
JUL 30 2007
OFFICE OF THE SECRETARY

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: File No. 4-538, SEC Request for Comments Re Rule 12b-1
John P. Freeman, *The Mutual Fund Distribution Fee Mess*, 32 J. CORP. L. 740 (2007).

Dear Ms. Morris:

I have long been interested in matters relating to the distribution of mutual fund shares, including particularly the SEC's rule-making in this area. I enclose page proof copies of a scholarly article I have written dealing with the subject which I ask you to please include in File No. 4-538.

I also ask that you please forward the enclosed copies of the article to the Commissioners listed below and to Mr. Donahue.

Sincerely yours,

John Freeman

John P. Freeman

cc: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Kathleen L. Casey
Commissioner Annette L. Nazareth
Andrew J. Donahue, Dir. Division of Inv. Mgm't

The Mutual Fund Distribution Expense Mess

John P. Freeman*

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I. INTRODUCTION

Holding more than $10 trillion in assets,[1] the mutual fund industry is a powerful financial force in this country. Ninety-one million individual shareholders own mutual funds, representing about one in every two American households.[2] The vast majority of Americans who invest in the equity markets do so through stock mutual funds; fewer than half of the nation's equity investors own stock directly.[3] The mutual fund industry's stunning growth led one government official to muse: "Could mutual fund assets surpass

1. Daisy Maxey, *Mutual Funds Pass $10 Trillion Mark*, WALL ST. J., Nov. 30, 2006, at C11. The industry's asset base was up from less than $7 trillion in 2000. *Id.*

2. INV. CO. INST., 2006 INVESTMENT COMPANY FACTBOOK 46 (2006), *available at* http://www.ici.org/statements/res/2006_factbook.pdf. According to John C. Bogle, a fund industry pioneer, "on average during 1999-2001, our families—the very backbone of the U.S. economy—saved $385 billion per year . . . and placed $320 billion of it in mutual funds." John C. Bogle, Founder and Former CEO of The Vanguard Group, The End of Mutual Fund Dominance, Speech Before the Financial Planning Association (April 25, 2002), *available at* http://www.vanguard.com/bogle_site/sp20020425.html.

3. INV. CO. INST., 2003 MUTUAL FUND FACT BOOK 43 (2003), *available at* http://www.ici.org/pdf/2004-_factbook.pdf.

> A January 2002 study conducted by ICI and the Securities Industry Association (www.ici.org/pdf/rpt_02_equity_owners.pdf) found that 89 percent of U.S. equity investors owned stock mutual funds while 49 percent owned individual stock directly. Furthermore, 51.5 percent of equity investors held only stock mutual funds, 11 percent held only individual stock, and 37.5 percent held both stock mutual funds and individual stock.

INV. CO. INST. & SEC. INDUS. ASS'N, EQUITY OWNERSHIP IN AMERICA 2002, at 3 (2002), *available at* http://ici.org/pdf/rpt_02_equity_owners.pdf.

the value of all U.S. public companies? Probably yes, and in the not so distant future."[4]

Though it was singled out by Congress for special legislation in light of serious fiduciary duty abuses uncovered in the aftermath of the 1929 stock market crash,[5] the investment company industry prospered following enactment of the Investment Company Act of 1940.[6] Captained by lavishly compensated mutual fund sponsors and their powerful trade association, the Investment Company Institute (ICI), the fund industry enjoyed six full decades of growth and scandal-free operations. Lately, however, both the fund sponsors and the ICI have experienced a fall from grace. For both leadership groups, the decline is traceable to a common failing: conflicts of interest.[7] The fund sponsorship industry revolves around accumulating assets in separate mutual funds, selling advisory, distribution, and administrative services to those funds, and thereby extracting fee income. More dollars in fee income for the sponsor translates into fewer dollars of assets for the mutual funds being served. Fund sponsors' dealings thus epitomize a classic conflict of interest.[8] We shall see that it is this nettlesome conflict of interest that explains fund managers' penchant for improperly draining assets from funds to generate greater income for the managers at fund shareholders' expense.

The sea change in how fund leaders are viewed occurred suddenly. Not too long ago, hubris was the order of the day when fund industry leaders held forth. As recently as February of 2003, the ICI's president was writing Congress extolling the industry's embrace of "transparency and accountability principles" and proclaiming that the "mutual fund industry's governance and investor protection standards 'read like a blueprint for the guidelines publicly traded companies are only now being urged to follow.'"[9] Three

4. Barry P. Barbash, Director, Div. of Inv. Mgmt, SEC, Mutual Fund Consolidation and Globalization: Challenges for the Future, Remarks at the Mutual Funds and Investment Management Conference (Mar. 23, 1998), *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch208.htm.

5. *See* Richard H. Farina et al., *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME L. REV. 732, 781-808 (1969).

6. Investment Company Act of 1940, ch. 686, 54 Stat. 789 (1940) (codified as amended at 15 U.S.C. §§ 80a-1 to -64 (2000)).

7. *See, e.g.*, Kathleen Day, *So Sweet and Sour: Investor Fees Finance Interests of Lobbyists*, WASH. POST, Jan. 11, 2004, at F1; Paula Dwyer et al. *Breach of Trust*, BUS. WK., Dec. 15, 2003, at 98.

8. On its web site, the ICI proclaims that it seeks simultaneously to "advance the interests of funds, their shareholders, directors, and advisers." INV. CO. INST., 2005 INVESTMENT COMPANY FACT BOOK, at b (2005), *available at* http://www.ici.org/pdf/2005_factbook.pdf. However, clear-cut financial conflicts of interest even contaminate fund sponsors' lobbying activities. The fund sponsors' leading spokesman, Paul Schott Stevens, President of the ICI, has conceded that its lobbying efforts on behalf of fund sponsors are financed with millions of dollars taken from fund shareholders. In a burst of candor, the ICI's president admitted publicly that the ICI does not "represent fund shareholders." Paul B. Farrell, *Fund Lobbyists Put Wicked Twist on Shareholder Interest*, MARKETWATCH, Oct. 18, 2005, http://www.marketwatch.com/News/Story/Story.aspx?guid=%7BC32EE3AF-B1D9-48F3-A7CD-EF214407E1F7%7D&siteid=google&dist=. David Ruder, a former SEC Chairman, called the ICI's admission "startling," noting that the Institute's leadership "was straight for once." *Id.* According to the Mutual Fund Directors Forum's Allan Mostoff, when it comes to money issues, "[y]ou can't have it both ways . . . where interests diverge, ICI represents the interests of management." *Id.* Through its practice of taking funding directly from fund shareholders, while advocating the interests of shareholders' adversaries when it comes to controversies over fund fees and expenses, the ICI epitomizes the conflicted, self-serving structure of the money management industry it purports to represent.

9. Letter from Matthew Fink, President, Inv. Co. Inst., to Michael G. Oxley, Chairman, H. Comm. on Fin. Servs., and Richard H. Baker, Chairman, Subcomm. on Capital Mkts., Ins. & Gov-Sponsored Enters. (Feb.

months later, on May 22, 2003, ICI Chairman Paul Haaga lamented that the fund industry's supposedly shining examples of rectitude and faithful stewardship had not been unanimously praised.

> Like younger siblings, the mutual fund industry has benefited from numerous and effective critics over the years—but they've never been more active than in the recent down market. Former SEC chairmen, members of Congress and their staffs, academics, Bards of Omaha, journalists, television talking heads, competitors—even a saint with his own statue—have all weighed in about our perceived failings. We've heard high-level rebukes, mid- and low-level rebukes, and rebukes where we couldn't even figure out what they wanted us to do. *It makes me wonder what life would be like if we'd actually done something wrong.*[10]

Fund industry leaders' smugness and arrogance is less evident today, with good reason. Fund sponsors today find themselves called to answer for business practices that formerly went undetected or unchallenged by regulators and plaintiffs' lawyers. These practices all revolve around a single subject and a single crucial weakness in fund industry governance. The subject is money being diverted from the holdings of fund shareholders into the pockets of those who advise, sell, or service mutual funds. The weakness relates to the governance model that is both the fund industry's hallmark and its

21, 2003), *available at* http://www.ici.org/issues/fserv/arc-leg/03_house_sec_ltr.pdf. For a much different view of fund industry practices in comparison with the rest of corporate America, see Neil Weinberg, *Fund Manager Knows Best*, FORBES, Oct. 14, 2002, at 220 ("As other corporations come clean, mutual funds still gloss over costs, hide top-dog pay and keep secret how they cope when self-interest conflicts with duty."). The General Accounting Office does not buy into the industry's self-congratulation over supposedly excellent disclosure, either. Consider the title of a report the agency issued recently: GEN. ACCOUNTING OFFICE, MUTUAL FUNDS: GREATER TRANSPARENCY NEEDED IN DISCLOSURE TO INVESTORS (2003) [hereinafter 2003 GAO REPORT]. As an example of the fund industry's lack of transparency and overall weirdness when it comes to how money flows, consider these two industry practices. First, it is accepted behavior in the fund industry for fund advisers to overpay for fund brokerage charges in order to receive from brokers doing the fund portfolio trades services in the form of research. This so-called "soft dollar" trade is buried as a brokerage expense—the dollar cost of which is not disclosed to the public—instead of as an advisory expense directly charged against assets, which is disclosed. Second, at the same time as the soft dollar sleight of hand, fund advisers are electing through a second sleight of hand to "share their profits and pay for expenses incurred by the distributing broker-dealers, such as advertising or marketing materials that are used by the distributing broker dealers." 2003 GAO REPORT, *supra*, at 37. This funneling of advisory expense (or profit) money to fund sellers is said to be a "major expense for fund advisers." *Id.* at 38. This "major expense" is one that "most fund advisers are not willing to publicly discuss. . . ." *Id.* at 38-39. An industry where the leaders are not willing publicly to discuss a major expense item is one with defective "transparency and accountability principles." *Id.* In summary, in the fund industry we find, simultaneously, neither an explicit, informative disclosure that the fund industry features brokers kicking back brokerage "profits" to advisers in the form of advisory services, nor that advisers are kicking back advisory profits to brokers as "revenue sharing arrangements." *Id.* at 39. Because both practices are hidden, it is impossible to say for sure how much money is secretly changing hands. The number is high. For revenue sharing payoffs, the number is estimated to be as much as $2 billion, and is said to be growing. 2003 GAO REPORT, *supra*, at 38. For soft-dollar brokerage kickbacks of fund money to the adviser in the form of supposed services, the number is estimated at around $1 billion annually. *Id.* at 49.

10. Paul G. Haaga, Jr., Chairman, Inv. Co. Inst., Remarks at the 2003 ICI General Membership Meeting (May 22, 2003) (emphasis added), *available at* http://www.ici.org/statements/remarks/03_gmm_haaga_spch.html#TopOfPage.

stigma—conflicted fund management by separate external advisers.[11]

Conventional fund distribution fees, in the form of front-end sales loads and other direct payments for sales effort, tend to be disclosed to fund purchasers and shareholders, though the quality of this disclosure is poor.[12] These distribution fees, and others that are less visible, are the focal point of this article, and for them the legal questions are many and serious. Orchestrating and supervising the fund industry's disclosure and marketing practices is the Securities and Exchange Commission (SEC). The SEC has publicly proclaimed, "We are the investor's advocate."[13] As we shall see, the truth of that bold proclamation is open to question.

The agency's efforts to provide quality disclosure to investors have been desultory, unfocused, often ineffectual, and sometimes counter-productive. The SEC routinely has found itself out-maneuvered by well-financed fund industry lobbyists and their service-provider allies, including many lawyers formerly on the Commission's payroll.[14] Worse, and more demoralizing, an SEC rule promulgated in 1980[15] has generated huge wealth for fund sponsors and distributors at fund shareholders' expense. The rule in question is the Investment Company Act Rule 12b-1.[16] It entitles mutual funds in certain circumstances to require existing shareholders to subsidize sales-related distribution or marketing to pay for compensation of sales personnel,[17] administrative services,[18] and advertising and other sales-promotion activities.[19]

11. According to one Congressional report:

> Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

S. REP. NO. 91-184, at 5 (1969).

12. *See infra* notes 314-340, 419-423 and accompanying text.

13. *E.g.*, Jack Ciesielski, *The New SEC: Investor Advocate or Market Watchdog?*, SEEKING ALPHA, Jan. 31, 2007, http://usmarket.seekingalpha.com/article/25663.

14. In June of 2003, the author made a Freedom of Information Act (FOIA) request on the SEC for the names of all persons employed by the SEC's Division of Investment Management in a senior capacity from 1970 to the present, specifically, all persons employed as Division Directors, Associate or Assistant Division Directors, Division General Counsel, or Deputy or Associate Counsel. Of persons so employed who were not still employed by the SEC and not deceased, over 80% were either employed in-house by investment companies or advisers, the ICI, law firms, or accounting firms that provided services to mutual funds and fund sponsors. A copy of the FOIA request and the report prepared therefrom is available from the author.

15. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11,414, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,678 (Oct. 28, 1980).

16. 17 C.F.R. § 270.12b-1 (2006).

17. Compensation payments account for about 60% of 12b-1-financed distribution expenditures. *Use of Rule 12b-1 Fees by Mutual Funds in 1999*, FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Apr. 2000, at 2. Included in the compensation payment category are direct payments to broker-dealers, reimbursements to the fund's distributor for advances made to broker-dealers for selling shares, and compensation of in-house marketing personnel. *Id.* at 1.

18. This includes payments for recordkeeping and other services provided to current shareholders. *Id.* These payments account for about one-third of disbursements paid for out of 12b-1 fees. *Id.* at 2.

19. Among the charges covered by this category are printing prospectuses and sales material for prospective investors. *Id.* These 12b-1 charges are a minor item, accounting for only 5% of 12b-1 outlays. "There are no prescribed standards as to what are appropriate promotional, distribution and advertising

Rule 12b-1 thus allows various selling costs to be passed on to shareholders through charges against fund assets instead of being borne by the fund's manager or by incoming shareholders directly at the time of sale through sales commissions or "loads." As an order in one SEC disciplinary case observed, "In essence, it permits existing shareholders to pay for bringing new shareholders into the fund."[20] As we shall see, it is debatable whether this is a good thing. Fund marketing costs borne by shareholders are costs that handsomely compensated[21] fund managers escape paying out of their own wallets. In contrast with fund shareholders, fund managers indisputably benefit financially when fund assets grow. Rule 12b-1 thus presents an odd legal situation where investment managers operating as fiduciaries are permitted to pass costs benefiting them on to investors who realize no net gain from the bargain. Obviously, the process by which shareholders are caused to bear distribution-related costs is one in which external fund managers have a financial conflict with the pecuniary interests of their fund shareholders.

Rule 12b-1 is a big money generator, accounting for $11.8 billion in fees in 2006.[22] There is no doubt that fees generated by Rule 12b-1 have functioned to boost fund sales. The SEC's adoption of the rule ignited a period of unparalleled fund industry growth. In 1980, the industry's 564 mutual funds held assets totaling $135 billion[23] compared to more than $10 trillion today.[24] During the 1990s, "funds became the primary investment vehicle of the average American investor."[25] By 2002, the share classes of nearly all load funds were sporting 12b-1 fees.[26] While its ability to fuel fund sales is unquestioned, Rule 12b-1's legitimacy as a regulatory device calculated to benefit the investing public

expenses chargeable under a Rule 12b-1 plan." *In re* Coxon, Initial Decisions Release No. 140, Adm. Proc. File No. 3-9218 (Apr. 1, 1999), *available at* 1999 SEC LEXIS 662. The Administrative Law Judge in *In Re Coxon* found that Rule 12b-1 had been violated where the fund sponsor had improperly included in 12b-1 costs transfer agent fees, custodial fees, auditing fees, accounting fees, officers' salaries, and other expenses where the fund's prospectus and advisory contract called for the adviser to pay all of the fund's "ordinary operating expenses" and defined those expenses to include the same costs improperly charged as 12b-1 expenses.

20. *In re* Flanagan, Ronald Kinaschi & Spectrum Administration, Inc., SEC Release No. 29-315, 71 SEC Docket 1415 (Jan. 31, 2000).

21. A former SEC official, once in charge of the SEC division that regulates the fund industry, recently suggested that perhaps one reason that the fund industry has not been beset by massive scandals is that funds are "enormously profitable" to fund sponsors, with the result that those in control see no need to loot fund assets. Joel Goldberg, Remarks at the SEC Historical Society Roundtable on Investment Company Regulation 33 (Dec. 4, 2002), *available at* http://www.sechistorical.org/collection/oralHistories/roundtables/investmentCoRegulation/INV1204Transcript.pdf. *See also id.* at 81 (remarks of Allan Mostoff) ("When you look at the profitability figures . . . in at least several of the cases [where advisers have been sued for taking allegedly excessive advisory fees] . . . profitability is rather high.").

22. INV. CO. INST., 2007 MUTUAL FUND FACT BOOK 56 (2007), *available at* http://www.ici.org/stats/res/2007_factbook.pdf.

23. INV. CO. INST., 2002 MUTUAL FUND FACT BOOK 61 (2002), *available at* http://www.ici.org/pdf/2002_factbook.pdf.

24. *See supra* note 1 and accompanying text.

25. Paul F. Roye, Dir., Div. of Inv. Mgmt, SEC, Remarks Before the 2002 Mutual Funds and Investment Management Conference, Mutual Fund Management: Taking Responsibility, Maintaining Trust and Influencing Positive Change (March 25, 2002), *available at* http://www.sec.gov/news/speech/spch546.htm.

26. Sean Collins, The Effect of 12b-1 Plans on Mutual Fund Investors, Revisited 5-6 (Mar. 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=522442. For no-loads, the number was less than 20%. *Id.* at 6. "12b-1 fees are primarily an attribute of load funds." *Id.*

is dubious.

This article focuses principally on the load fund segment of the mutual fund industry where selling abuses are most prevalent. It is here that we find sales made to unsophisticated investors through the broker-dealer channel. In this fund marketplace segment, price competition is muted, if it can be said to exist at all.[27] Instead, investors are led to pay premium prices in the form of higher selling fees or "loads" to buy shares in mutual funds with high operating fees or expenses;[28] in other words, in the fund industry's load fund segment, the public tends to pay the highest prices or fees to get the worst products. This weird result occurs because, rather than competing on the basis of price, load mutual fund sponsors operating in this market segment compete instead for the loyalty of selling brokers, which is available for a price to those load fund sponsors willing to pay the highest sales compensation.[29]

In this article, we find that nearly everything about mutual fund distribution expenses and Rule 12b-1 is open to controversy and dispute. The article first examines Rule 12b-1's origin, its mechanics, and the evolution of industry payment for distribution via Rule 12b-1 and otherwise over time. Proceeding from that discussion, the article considers the impressive collection of data establishing that, from a fund shareholder's perspective, Rule 12b-1 payments are at best a dead weight cost[30] borne by fund shareholders. Scrutiny is then given to industry efforts to evade Rule 12b-1's disclosure and annual approval requirements, and to the vital issue of whether the rule as presently configured and employed actually is operating in the public interest. The article then examines the need to repeal or revise Rule 12b-1 in light of the evidence that the rule's requirements have become disconnected from how the rule functions in practice. The article concludes that 12b-1 fee payments are out of control and that major changes are needed to eliminate shareholder abuses.

27. *See* GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 62-65 (2000) (finding mutual funds generally do not try to compete on the basis of costs).

28. *See* Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. UNIV. L.Q. 1017, 1034 (2005); MERCER BULLARD & EDWARD S. O'NEAL, THE COSTS OF USING A BROKER TO SELECT MUTUAL FUNDS (2006), *available at* http://www.zeroalphagroup.com/studies/113006_Zero_Alpha_Group_Fund_Democracy_Index_Funds_Report.pdf (finding that via the broker-dealer channel load fund, shareholders are induced to pay the highest commission costs in order to buy the worst index mutual fund products).

29. Thus, one national brokerage firm features a "preferred list" of eight mutual fund sponsors it pushes. Every one of these funds is a load fund. In 2005, over and above sales commissions and 12b-1 fees, those eight fund families and one other load mutual fund complex paid that brokerage firm additional cash in distribution-related "revenue sharing" payments in a sum that exceeded half the brokerage firm's net income for the entire year. *See infra* note 293 and accompanying text.

30. *See, e.g.*, William P. Dukes et al., *Mutual Fund Mortality, 12B-1 Fees, and the Net Expense Ratio*, 29 J. FIN. RES. 235, 236 (2006) (presenting findings suggesting "that the detrimental impact of 12b-1 fees on expense ratios has been understated, that funds with 12b-1 fees have higher expense ratios above and beyond the impact of the 12b-1 fee, that the effect on shareholders is becoming more widespread over time, and that 12b-1 fees are a contributing factor to the failure of mutual funds"). That a portion of the payment may constitute a sales commission in disguise does not change the fact that the outlays are a drain on shareholder wealth.

II. INDUSTRY HALLMARKS: CONFLICTED MANAGEMENT AND REDEEMABLE SECURITIES

Typically, companies are "internally managed" in that the managers are full-time employees working for the benefit of the company's owners, not independent contractors owing their primary allegiance to an outside entity. The typical American business thus has managers and boards of directors who operate with their eyes focused on doing what is best, within legal constraints, to serve the pecuniary interests of the entity and its owners. Most mutual funds are different.

Funds typically have their own boards of directors or trustees, but when it comes to the crucial tasks of investment management and marketing fund shares, the norm in the fund industry is "external management" of the enterprise.[31] A mutual fund is normally created and managed by an outside entity. It is this outside entity's control that gives rise to the fund industry's predominant external management governance structure.[32] The fund's sponsor or an affiliate functions as the fund's investment adviser, managing the fund's investment portfolio, and as the fund's principal underwriter, handling sales and marketing or "distribution" activities involving the sale of fund shares.[33]

31. Two key exceptions are the Vanguard Group and TIAA-CREF. Vanguard fund boards occasionally hire external managers but since the hiring is done on an arm's-length basis the external adviser's charges are low compared to industry averages. *See* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of the Conflict of Interest*, 26 J. CORP. L. 609, 637-39, 649 (2001). In the case of TIAA-CREF, it uses the same non-profit strategy used by Vanguard to keep costs low for the benefit of its fund shareholders. *See* Anne Tergesen, *The Biggest Fund You Never Heard of: Pension Heavyweight TIAA-CREF Is Retailing Mutual Funds*, BUS. WK., Sept. 13, 1999, *available at* http://www.businessweek.com/1999/99_37/b3646168.htm.

32. The Vanguard Group is a notable exception.

33. *See* Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir. 1977), *cert. denied*, 434 U.S. 934 (1977).

> A mutual fund is a "mere shell," a pool of assets consisting mostly of portfolio securities that belongs to the individual investors holding shares in the fund. The management of this asset pool is largely in the hands of an investment adviser, an independent entity, which generally organizes the fund and provides it with investment advice, management services, and office space and staff. The adviser either selects or recommends the fund's investments and rate of portfolio turnover, and operates or supervises most of the other phases of the fund's business. The adviser's compensation for these services is a fee, which is usually calculated as a percentage of the fund's net assets, and thus fluctuates with the value of the fund's portfolio.

Id. The court went on to note: "Control of a mutual fund . . . lies largely in the hands of the investment adviser, an external business entity whose primary interest is undeniably the maximization of its own profits." *Id.* For further discussion of the external adviser's control over fund operations, see Role of Independent Directors of Investment Companies, Securities Act Release No. 33-775, [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,212 n.10 (Oct. 14, 1999). In the words of one of the industry's earliest and most vociferous critics:

> Now, this is about the birds and the bees of the American corporate scene. . . . The fund is conceived by a bunch of people whom we call advisers or managers. . . . This group gives birth to the fund. The fund is manned by the advisers. If I may carry this figure of speech, the umbilical cord is never cut after birth, as would be true in ordinary biological life.

Statement of Abraham Pomerantz, *in* University of Pennsylvania Law School Conference on Mutual Funds, 115 U. PA. L. REV. 659, 739 (1967). As former SEC Commissioner Manuel Cohen once remarked when referring to testimony by fund investment advisers:

> They also made the point that the investment adviser creates the fund, and operates it in effect as a business. Many of them stated that "It is our fund, we run it, we manage it, we control it," and I don't think there is anything wrong with them saying it. They were just admitting what is a fact of

This phenomenon means that the investment decision making for most funds is not done by fund employees operating under the oversight of the fund's board of directors or trustees.[34] Indeed, usually the mutual fund itself, as a freestanding entity, has no full-time employees on its payroll. The fund's sponsor or an affiliated entity generally contracts with the fund to supply the fund with key services, ranging from rendering investment advice, to handling fund sales ("distribution" and "underwriting") and record-keeping. Sometimes the sponsor contracts with an outside entity to provide for transfer agent or custodianship services. Workers who serve the fund customarily are supplied by and often employed by the adviser or an affiliate.[35]

In short, contrary to the Biblical aphorism,[36] the conflicted mutual fund sponsor/investment adviser is serving two masters: the shareholders of the management company and the shareholders of the mutual funds to which the adviser sells services.[37] It is the mutual fund industry's chronic conflict of interest affecting the vital governance function, and a documented record of abuses flowing therefrom, that caused Congress to single out investment companies for special regulatory treatment when it enacted the Investment Company Act of 1940.[38]

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life. The investment adviser does control the fund.

Investment Company Act Amendments of 1976: Hearings on H.R. 9510, H.R. 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce, 90th Cong. 674 (1967) (statement of Manuel Cohen, Comm'r, SEC).

34. The industry norm of external management has been described and justified as follows:

> The day-to-day operation of the mutual fund is charged to the fund's various third party service providers. This external management arrangement stems from the mutual fund's purpose as a conduit for the investment adviser's services. With the primary service of investment management provided externally, it would make little sense for the related secondary services necessary to support the fund's investment activity to be provided internally by employees and with tangible assets. Thus, the fund hires other independent contractors to perform management functions required in addition to investing. In some cases, the other fund service providers' functions support the adviser's service roughly the same as they would for individually-managed accounts of the adviser. In other cases, they perform tasks created by the use of the mutual fund form as a pooled conduit for the adviser's services. The fund custodian is an example of the former, while the fund transfer agent is an example of the latter.

David E. Riggs & Charles C.S. Park, *Mutual Funds: A Banker's Primer*, 112 BANKING L.J. 757, 768-69 (1995). *See also* Role of Independent Directors of Investment Companies, SEC Release No. IC-24816, 66 Fed. Reg. 3734, 3735 (Jan. 16, 2001) ("Unlike most business organizations, however, mutual funds are typically organized and operated by an investment adviser that is responsible for the day-to-day operations of the fund.").

35. There are two major exceptions. *See supra* note 31.

36. *Matthew* 6:24 (King James) ("No man can serve two masters: for either he will hate the one, and love the other; or else he will hold to the one, and despise the other.").

37. One of external management's harshest critics is John Bogle, who founded the internally-managed Vanguard Group. According to Bogle, "The ownership structure in the mutual fund business, with the fund company rather than the shareholders owning the funds is lunacy." Eric K. Tyson, *Mutual Fund Visionary Still Going Strong; Vanguard Group Founder Offers New Ways of Managing Investments*, S.F. EXAM'R, Dec. 26, 1993, at E3.

38. It was with such abuses in mind that Congress drafted section 1(b)(2) of the 1940 Act, 15 U.S.C. § 80a-1(b)(2). Section 1(b)(2) provides in part that:

> [T]he national public interest and the interest of investors are adversely affected . . . (2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons

The fund adviser's financial conflict of interest with fund shareholders is troublesome because the adviser is paid under an advisory contract approved by the fund's board, a number of whose members typically are affiliated with the adviser.[39] The advisory fee typically is calculated as a percentage of the fund's net assets, sometimes with a performance bonus,[40] meaning that as new sales generate asset growth, they also generate more income for the adviser. As a rule, the bigger the size of the fund, the bigger the fund adviser's revenues. The adviser thus has a pecuniary interest in seeing increasing sales, particularly where the costs for generating those sales are paid by someone else, such as the fund's existing shareholders.

This money drain goes to the heart of fiduciary management principles and fund shareholders' welfare. Expenses are a drag on fund shareholders' investment performance.[41] A dollar of unwarranted compensation for the fund's adviser, distributor, or administrator is a dollar taken wrongfully from the fund and its shareholders. As one fund industry pioneer has explained, when it comes to mutual fund financial returns for mutual fund shareholders, "*You get what you don't pay for*."[42] For mutual fund shareholders, the cost drag is large. The number runs into billions of dollars per year.[43] In early 2004, a U.S. Senator complained: "The mutual fund industry is, indeed, the world's largest skimming operation, a seven trillion dollar trough from which fund managers, brokers, and other insiders are steadily siphoning off an excessive slice of the nation's

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> thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders . . . ."

Id.

39. *See supra* note 33 and accompanying text. Most funds have "independent directors" holding a majority of the board seats. The simple reality is that a mutual fund's independent directors are essentially men or women approved by the fund's management company. They may seek to be conscientious, and for the most part they have an independent counsel, but they are not people who have been selected by fund investors to represent investors' interests.

40. Performance fees are not popular. *See* Alistair Barr, *Mutual Funds Shun Performance Fees*, MARKETWATCH, Mar. 6, 2006, http://www.marketwatch.com/News/Story/Story.aspx?guid=%7BC4C8EEA2-D78D-4352-8F5D-3DEE45718294%7D&siteid=mktw.

41. Consider the following facts:

> Over the past two decades, and even after the recent decline, the stock market provided an annual return of 13.1 percent compared to a 10.0 percent return reported by the average equity fund. For the full period, therefore, $10,000 invested in the market grew by $105,000, while the same $10,000 invested in the average equity fund grew by $57,000-just half as much. That 3.1 percentage point difference is largely a reflection of the costs that investors incur.

Hearing before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprise of the H. Comm. on Financial Services, 108th Cong. 8 (2003) (testimony of John C. Bogle). Oddly, research shows that the vast majority of fund shareholders believe, incorrectly, that higher fund operating expenses reflect better performance. *See* Neil Weinberg, *Fund Manager Knows Best*, FORBES, Oct. 14, 2002, at 220-21.

42. John C. Bogle, Founder and Former Chairman, The Vanguard Group, Remarks at The World Money Show: In Investing, You Get What You *Don't* Pay For (Feb. 2, 2005), *available at* http://www.vanguard.com/bogle_site/sp20050202.htm.

43. *Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprise of the H. Comm. on Financial Services*, 108th Cong. 8 (2003) (testimony of Gary Gensler). Another industry observer puts the figure at $100 billion annually. *See* Weinberg, *supra* note 41, at 220.

household, college, and retirement savings."[44] Since that observation, the fund industry has accumulated another three trillion dollars of trusting investors' assets.[45]

Another fund industry oddity relates to funds' capital structure. Mutual funds issue redeemable equity securities,[46] entitling shareholders to demand that their issuing mutual funds cash in tendered shares at net asset value, less any applicable redemption fee. Because they issue redeemable securities, funds that do not continue sales risk being redeemed out of existence as existing shareholders withdraw and cash in their shares.

The external management phenomenon and the ramifications of share redeemability are both relevant to the discussion of mutual fund distribution expenses. Fund investors purchase funds shares to make money for themselves, not for the adviser or anyone else. Fund investors seek "investment performance," i.e., investment value appreciation, through whatever means may be appropriate (such as interest, dividends, appreciation of portfolio stocks) in light of the specific fund's makeup (money market, bond, balanced, equity, etc.) and its investment objectives. Once they have invested in a viable fund, fund shareholders have little reason to care whether the fund grows substantially through sales to new shareholders. This is so because new sales bring in money at the fund's then net asset value and produce no financial gain whatsoever for shareholders already in the fund. Fund asset growth is beneficial to fund shareholders only if it yields economies of scale translating into lower fees. Thus, fund shareholders are entitled to be indifferent to new sales, at least so long as net economies of scale are not available and their fund is not redeemed out of existence.

For fund sponsors and distributors, the picture is different. For them, fund asset growth achieved by portfolio appreciation or through cash inflows derived from new sales provides welcome income since fees within the industry generally are calculated as a percentage of assets under management.[47] Money belonging to fund shareholders is taken by fund sponsors and distributors through four main types of fee payments: advisory fees used to pay the manager for professional investment advice,[48] brokerage commissions used to pay for execution of fund portfolio trades, sales loads or distribution charges taken to pay for selling effort, and administrative fees charged against fund assets

44. *Hearings Before the S. Comm. on Governmental Affairs*, 108th Cong. (2004) (remarks of Sen. Peter G. Fitzgerald).

45. *See supra* note 1 and accompanying text.

46. *See* MODEL BUS. CORP. ACT § 6.03 cmt. (1985) (observing that, by allowing unlimited redemptions of shares at net asset value, mutual funds represent a "specialized class of corporation"). At the federal level, fund shareholders' redemption right is provided by section 22 of the Investment Company Act, 15 U.S.C. § 80a-22 (2000). *See also* Section 2(a)(32) of the Investment Company Act, 15 U.S.C. § 80a-2(a)(32), defining the term "redeemable security" to be a security that, upon its presentation to the issuer or to a person designated by the issuer, entitles the shareholder to receive approximately his proportionate share of the issuer's current net assets or the cash equivalent of those assets. This *de facto* put right is unknown in normal corporations' capital structures.

47. The SEC has identified five different types of management contract compensation systems used in the fund industry: "1) fee breakpoints based on fund assets (fund breakpoints); 2) fee breakpoints based on portfolio assets plus a performance fee (fund breakpoints-plus); 3) fee breakpoints based on fund family assets (fund family breakpoints); 4) a single, all-inclusive fee (single fee); and 5) at-cost arrangements." Of these, breakpoint arrangements are by far the most common. DIV. OF INV. MGMT., SEC, REPORT ON MUTUAL FUND FEES AND EXPENSES (2000), *available at* http://www.sec.gov/news/studies/feestudy.htm [hereinafter REPORT ON MUTUAL FUND FEES].

48. This assumes the fund is actively managed and not an index fund.

and used to pay for such things as directors' fees, custodial and transfer agent services, and shareholder reports and prospectuses.[49] As we shall see, however, labels do not necessarily control how shareholder money is spent. For example, fund sponsors' advisory income may be used to pay for distribution costs,[50] and brokerage commission payments routinely have been used both to finance distribution charges and to subsidize advisory services.[51] Even mundane expenses like administrative costs have been siphoned off to pay for distribution charges or simply to enrich the fund sponsor who overbilled the fund.[52] That these aberrations take place in the most highly regulated business in the securities field[53] attests to the rogue nature of the fund industry and the SEC's poor work as the industry's regulator.

Contrary to the ICI's assurance that "transparency and accountability" are fund industry hallmarks, evidence exists that neither mutual fund advisory fees nor brokerage commissions are clearly disclosed or fairly priced to fund shareholders.[54] A study

49. *See* SEC, Mutual Fund Fees & Expenses, http://www.sec.gov/answers/mffees.htm (last visited May 5, 2007). Putting aside custodial and transfer agency cost, the price of fund governance is very low. In 1990, one fund industry analyst concluded that "the potential cost savings from eliminating [the mutual fund industry's] governance structure are *de minimis*." DIV. OF INV. MGMT., SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 286 (1992) [hereinafter PROTECTING INVESTORS], *available at* http://sechistorical.org/collection/papers/1990/1992_ProtectInv/. One mutual fund complex estimated that the total governance costs for its mutual funds were under one basis point, 0.01%, per year. *Id.* at 287 n.118. For a recent federal court decision featuring an excellent discussion of the different ways fund sponsors take money out of the "common fund" owned by fund shareholders, see Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2007 WL 760750, at *12 (N.D. Cal. Mar. 9, 2007).

50. *See infra* notes 274-294 and accompanying text.

51. *See infra* notes 262-273, 295-313 and accompanying text.

52. *See infra* notes 385-387 and accompanying text.

53. *See infra* note 364 and accompanying text.

54. Fund advisory fees tend to be mixed with administrative costs, making it hard to calculate how much money is being charged for what. *See* Freeman & Brown, *supra* note 31, at 663-64. As for the availability of information on fund brokerage commissions, see Miles Livingston & Edward S. O'Neal, *Mutual Fund Brokerage Commissions*, 19 J. FIN. RES. 273 (1995):

> Mutual funds pay well over $1 billion in brokerage commissions per year. In spite of the large amounts involved, empirical research on mutual fund brokerage commissions is relatively sparse. This lack of research is at least partially explained by the difficulty in obtaining information about mutual fund brokerage commissions.

Fund brokerage fee disclosures are discussed further *infra* at notes 58 and 355. In evaluating the industry's claim to share the hallmarks of transparency and accountability, consider the following critique of the industry's cost disclosure practices by one fund manager:

> When I worked in the urban mass transit industry, there was uniform data on system expenses, passengers and other very helpful operating data, with enough detail to establish some best industry practices. Twenty years later, there is no similar, easily accessible database for the mutual fund industry. Some information is in the SEC-EDGAR (ph) system, but it is not downloadable, expense categories are not standardized, and it is terribly time-intensive to access information across fund families. While this level of detail is not generally sought by individual investors, use and analysis by academia, authors . . . , media, consultants and fund boards of directors could greatly spur industry competition and efficiency. The federal government is in the best position to take the lead on this disclosure.

Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprise of the H. Comm. on Financial Services, 108th Cong. 11 (2003) (testimony of John Montgomery). Another comparing mutual fund advisory fees with advisory fees paid by public pension funds showed that mutual funds pay around 2.5 times as much for the same investment advisory services.[55] Fund managers have been caught gouging shareholders and deceiving fund boards by inflating such common expense items as brokerage, administrative, and transfer agency costs.[56] A report prepared by the General Accounting Office pointed to evidence that equity mutual funds, which are large purchasers of brokerage services (and thus eligible for huge quantity discounts), pay *on average* commission rates that are *triple* those available to individual investors trading through discount brokers.[57] As we shall see, fund brokerage payments have furnished managers with a handy "off-the-books" means of garnering additional advisory compensation and distribution fees while hiding that cost from fee expense ratios studied by shareholders and the financial press.[58] As for fund distribution payments, Murphy's Law reigns: they tend to be poorly disclosed to investors, poorly understood by investors, poorly regulated

transparency/accountability problem highlighted by Mr. Montgomery was disclosure of manager salaries:

> When we invest in individual companies, we have the right to know the compensation of the company leaders. When we invest in mutual funds, we are in the dark. . . . Compensation level, and especially structure, do affect portfolio manager incentives and fund decisions. Our industry's refusal to disclose it contributes to the aura of withholding important information and misleading shareholders that some shareholders perceive in the current environment. This disclosure would be easy and costless.

Id. Compare this to James Riepe, who contended that:

> [mutual funds'] success . . . is attributable to a number of factors, but most important is the transparency which people have talked about that is inherent in funds, and because of the trust that has been created between these tens of millions of investors and the managers who manage these funds.

Id. (testimony of James Riepe).

55. Freeman & Brown, *supra* note 31, at 636.

56. *See infra* notes 264-273, 295-313, 385-388, and accompanying text.

57. *Mutual Funds: Information on Trends in Fees and Their Related Disclosure Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. (2003) (statement of Richard J. Hillman, Director, Financial Markets and Community Investment, U.S. General Accounting Office), *reprinted in* GEN. ACCOUNTING OFFICE, MUTUAL FUNDS: INFORMATION ON TRENDS IN FEES AND THEIR RELATED DISCLOSURE 17 (2003), *available at* http://www.gao.gov/new.items/d03551 6.pdf [hereinafter TRENDS IN FEES].

58. For an uncomplimentary report on equity mutual fund brokerage commission practices, see JASON KARCESKI ET AL., ZERO ALPHA GROUP, PORTFOLIO TRANSACTIONS COSTS AT U.S. EQUITY MUTUAL FUNDS (2004), *available at* http://www.zeroalphagroup.com/news/Execution_CostsPaper_Nov_15_2004.pdf. Among other things, the authors found that trading costs, which nowhere are disclosed in funds' expense ratios, were, on average, 43.4% as large as the total disclosed expense ratios. *Id.* at 12. Another interesting finding was that commission levels were positively related to disclosed fund expense ratios, a result the authors found "puzzling," since the authors "expected that soft dollar arrangements whereby fund advisers pay for research out of brokerage commissions would cause a negative relation between expense ratios and commissions." *Id.* at 9. The implication is that fund sponsors who tend to gouge shareholders by charging high expenses tend also to gouge shareholders by incurring high brokerage commissions when they trade. *See also* Letter from Mercer Bullard, Founder and President, Fund Democracy, Inc., et al. to Jonathan G. Katz, Sec'y, SEC (Mar. 16, 2004), *available at* http://edgar.sec.gov/rules/concept/s72903/mbullard03162004.htm#P34_4092 (commenting on the SEC's failure to require reasonable disclosure of mutual fund portfolio transaction costs and noting that in some cases more money is paid for transaction costs than all other costs included in the fund's expense ratio combined).

by the SEC, poorly evaluated by fund boards, and represent a yawning fiduciary duty trap for fund sponsors.

III. THE NATURE AND GENESIS OF 12B-1 FEES

Though 12b-1 fees are not essential to a mutual fund's operation,[59] they are nonetheless very common. More than 60% of the American mutual funds feature 12b-1 shareholder charges.[60] As noted above, in 2006, 12b-1 payments amounted to an amazing $11.8 billion,[61] draining from shareholders' assets almost $1 billion per month.

Despite yielding a truly impressive financial haul for fund managers, dealers, and sales representatives, the fund industry's twenty-plus years of Rule 12b-1 usage has failed to generate any tangible, positive financial benefits to fund shareholders. However, the rule has worked beautifully for fund sponsors and sellers who collect Rule 12b-1-generated money. Still, it is not clear why, as a legal matter, the rule should exist at all given the absence of compelling evidence that the payments made under it create or foster shareholder wealth. A government-sponsored levy yielding dubious, if any, benefits for shareholders in an extremely highly regulated industry[62] is a topic that deserves serious study, particularly when the levy approaches $1 billion per month.

Even in the face of some recent lackluster stock market performance, times are still flush in the fund industry. Attached to the fund industry's $10 trillion in assets is a weighted average expense ratio for all mutual funds of around 0.91% annually.[63] This combination of size and fee structure generates a huge yearly payout, more than $90 billion in fee payments annually, and does not include amounts paid at the time of purchase by fund investors who buy "load" funds or amounts paid by the funds themselves in brokerage commissions to buy or sell portfolio investments. The mutual fund management business was not always so lucrative.

A. The 1970s—Marketing Problems Plague the Fund Industry

Thirty-some years ago the fund industry was a small fraction of its present size. Its total assets stood at only $55 billion.[64] The industry was in trouble. It was suffering net redemptions, meaning it was shrinking.[65] Prompted by the phenomenon of fund sales not keeping pace with redemptions, the SEC commissioned a special study of fund

59. JOHN C. BOGLE, BOGLE ON MUTUAL FUNDS 198 (1994).

60. Aaron Luchetti, *Fund Fees Get SEC Scrutiny*, WALL ST. J., May 28, 2002, at C1.

61. *See supra* note 22 and accompanying text.

62. *See infra* note 362 and accompanying text.

63. Rebecca Knight, *Making a Success Out of Simplicity*, FIN. TIMES, June 20, 2006, at 10.

64. WILLIAM J. BAUMOL ET AL., THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION 19 n.1 (1990).

65. Between February 1972 and July 1974, ICI-member funds suffered net redemptions in 26 out of 30 months. DIV. OF INV. MGMT. REGULATION, SEC, MUTUAL FUND DISTRIBUTION AND SECTION 22(D) OF THE INVESTMENT COMPANY ACT OF 1940, at 19 (1974) [hereinafter MUTUAL FUND DISTRIBUTION]. With the exception of 1977, the fund industry's equity, bond, and income funds were in net redemption status from 1972-79. INV. CO. INST., 1998 MUTUAL FUND FACT BOOK 15 (1998). On a percentage basis, redemptions set a record for equity funds in 1979, when redemptions equaled 12% of equity fund assets. John Waggoner, *2002 Was Ugly, but Investors Didn't Flee Funds*, USA TODAY, Dec. 30, 2002, at B1. In contrast, in 2002, a year in which the average equity fund lost more than 21% of its value, redemptions were only 1% of fund assets. *Id.*

distribution problems.[66] Drawing on written submissions and testimony from industry participants, the SEC staff reached various conclusions. Those findings are worth noting because they affirm the SEC staff's understanding that the sales push was linked to compensation and its appreciation that fund assets (under the euphemism of "advisory profits") were already being used to pay for distribution in the fund industry. The SEC staff findings stated:

- [I]t is clear that price inelasticity and the concomitant premise that load funds shares are sold, not bought, are still key characteristics of the mutual fund merchandising approach.[67]
- Fund distribution, seldom profitable in and of itself in the best of times, seems to have become even less profitable (or more unprofitable) lately, thus requiring greater subsidization of distribution from advisory profits.[68]

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66. MUTUAL FUND DISTRIBUTION, *supra* note 65, at 19. According to the ICI, fund sponsors' trade association, the SEC was willing to consider abandoning its opposition to allowing funds to bear distribution costs because it viewed the fund industry as faced with:

> "altered circumstances," circumstances that raised fundamental concerns about the continuing vitality of the traditional load/no-load system and the Commission's authority to prevent funds from using their assets to promote distribution of their shares.
>
> First, the traditional load system had become so unprofitable that many funds had been forced to subsidize the sale of their share through their investment advisory fees. Thus, the Commission was forced to consider whether the use of advisory fees to support distribution systems that "consistently operate[d] at a loss" was "the practical equivalent of the fund bearing selling expenses."
>
> Second, the mutual fund industry began to face stiff competition from sellers of alternative investment products who were not limited in the manner in which they paid for distribution.
>
> Finally, the Commission was forced to confront the fact that its authority to restrict use of fund assets for distribution was dubious at best.

Comments of the Investment Company Institute on Amendments to Rule 12b-1 Proposed by Investment Company Act Release No. 16,431, at 6-7 (Sept. 19, 1988), *reprinted in* Mary S. Podesta, *Current Developments Involving Rule 12b-1, in* INVESTMENT COMPANIES 129, 207, 236-37 (PLI Course Handbook Series 626 PLI/Corp 1988).

67. MUTUAL FUND DISTRIBUTION, *supra* note 65, at 19 (footnote omitted).

68. *Id.* at 20. The staff later amplified on this point:

> The notion of a distribution system which is, in itself, not profitable seems to have become accepted as a fact of life by the mutual fund industry, and more and more complexes have been forced to finance essential wholesaling service and the sale of fund shares out of investment advisory fees:
>
> > "The economics of this business is such that distribution is not a means of making a profit, not to a company such as IDS nor to most underwriters in this business. It is really an adjunct or a method of marketing your money management services for which you charge and out of which you make a profit . . . .Our distribution organization is essentially nothing but a mechanism by which to market those services out of which we make a profit to bring money into the house." (quoting Testimony of Robert M. Loeffler, on behalf of Investors Diversified Services).
>
> Indeed, some fund complexes have from time to time offered dealers the *entire sales load* on certain of their funds.

- [M]utual funds are subject to vigorous competition for the investor's dollar with different investment media, many of which offer similar features, can be more easily sold on the basis of current yield, and also offer attractive compensation to dealers and salesmen.[69]
- The mutual fund distribution system is being influenced by forces over which it has little or no control. . . . [T]he fund industry's ability to retain the loyalty of retailers becomes more uncertain as the percentage of fund sales made by large broker-dealer firms, to whom such sales are relatively unimportant source of income, rises.[70]
- In response to this combination of forces, fund underwriters have surrendered greater portions of sales commissions to dealers, to the point that underwriting profits have all but disappeared. More than ever, fund advisers are subsidizing distribution out of advisory profits.[71]
- In other words, the industry is not prospering with the marketing strategy which was so successful in past years. Hence changes in the pattern of fund distribution seem inevitable . . . .[72]

B. The SEC's Move Toward Liberalization

Proceeding from the foundation laid in the SEC staff's study of fund sales and marketing activity or "distribution," the SEC moved to loosen restrictions on fund marketing in order to foster a "more competitive environment."[73] In the course of that effort, under the guidance of Allan Mostoff, Director of the SEC's Division of Investment Management,[74] a study began in the 1970s on the legal issue of funds' abilities to subsidize distribution by paying out fund assets. In November 1976, the Commission held hearings on the use of fund assets for distribution.[75] In 1978, the SEC

Id. at 31. The staff concluded:

> The willingness of major fund complexes . . . to forego any share of the selling compensation from one of its mutual funds, albeit for a limited period of time, dramatically underscores the fact that fund sponsors may regard the underwriters' spread as negotiable and look instead to advisory fees, rather than distribution profits, for their compensation.

Id. at 33.

69. *Id.* at 30.

70. MUTUAL FUND DISTRIBUTION, *supra* note 65, at 43.

71. *Id.*

72. *Id.*

73. *See id.* at 10-11, 84-135.

74. This is presently known as the Division of Investment Management.

75. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 9470, 41 Fed. Reg. 44,770 (Oct. 12, 1976) (announcing hearings). In calling for comments, the Commission identified a number of issues, including: whether it can be demonstrated that additional sales of shares could benefit shareholders, and if so, the nature and extent of such benefit; whether the mutual fund industry's use of sales loads placed mutual fund distributors at a disadvantage vis-a-vis distributors of other investment products; the anticipated competitive effects within the mutual fund industry were the Commission to allow assets to be used to subsidize distribution costs; and whether it would be more desirable for investors to pay distribution expenses by means of periodic charges against assets rather than by a one time sales load levied at the time of sale. *Id.* at

announced its intention to "explore whether the use of mutual fund assets to pay distribution expenses could benefit fund shareholders under some circumstances, and, if so, what conditions could be designed to protect the interests of investors."[76] By this point in time, the Commission was reassessing in earnest its long-standing opposition to allowing fund sponsors to tap assets as a source of marketing fees.[77]

The SEC's opposition to allowing fund assets to be drained to pay for marketing costs was inconsistent. Direct, fully-disclosed payments were forbidden, though indirect payments were permitted, so long as the money was classified as an allocation of "advisory profits," that is, net income earned by portfolio managers, rather than a direct payment out of fund assets.[78] In other words, allowing advisers to use a portion of their

44,771. Copies of the transcripts of the hearings and written submissions made in connection with the hearings are filed in SEC File No. 4-186. *Id.* at 44,770.

76. *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10,252, 1978 SEC Lexis 1501, at *1 (May 23, 1978). The release presented as the chief reason for possibly considering a policy change allowing fund shareholders to bear distribution costs was that in the late 1970s, "mutual funds, as a group, at that time were experiencing significant net redemptions of their shares." *Id.* at *3.

77. This is subject to limited exceptions. First, no-load funds by definition had to use fees derived from fund assets to pay for distribution, since there were no sales loads to pay for selling costs. The SEC explained away this reality as permissible because the selling costs were being borne by the no-load funds' investment advisers. PROTECTING INVESTORS, *supra* note 49, at 321. Efforts by no-load fund managers to gain permission were generally rebuffed, as were pleas by load fund managers for relief. *Id.*

78. *See, e.g.*, Letter from Sydney H. Mendelsohn, Assistant Dir., Div. of Inv. Mgmt. Regulation, SEC, to Hoch Reid, Esq., Counsel for the Axe-Houghton Funds (pub. avail. Nov. 15, 1973). In that no-action letter, the staff objected to the payment of continuing fees to a fund's principal underwriter and the sharing of those fees with dealers that had distributed fund shares. The staff contended that this practice could constitute a breach of fiduciary duty under section 36(a), 15 U.S.C. § 80a-35(a) (2000), and might also be inconsistent with the fiduciary obligations of fund directors under section 15(b), 15 U.S.C. § 80a-15(b) (2000) (relating to continuation of the fund's underwriting contract). *Id.* On another occasion, the staff took the position that, in view of the potential conflict of interest present where the fund bears distribution expenses, "it would be necessary to consider particularly the possibility of a violation of Section 36(b)" of the Act, 15 U.S.C. § 80a-35(b) (2000). *See* Carl L. Shipley, Esq., SEC No-Action Letter, 1975 WL 11039 (pub. avail. June 29, 1975). In a subsequent analysis, the Commission justified its opposition to the use of fund assets for distribution:

> [O]n the potential conflict inherent in the fact that, given the structure of mutual funds, most decisions relating to the use of fund assets are made by the fund's investment adviser, who directly benefits from increased sales of fund shares because its compensation is based on a percentage of fund assets. The Commission also was concerned about whether using fund assets for distribution would in fact benefit existing shareholders in a fund. The Commission's opposition reflected a concern that if fund assets could be used for distribution, decisions of whether to do so and how much to spend might be made or influenced by the fund's investment adviser, who might be inclined to spend excessive amounts in an attempt to increase fund assets and, as a result, the level of its compensation, to the detriment of existing shareholders.

Memorandum from Kathryn B. McGrath, Dir., Div. of Inv. Mgmt., SEC, to John S.R. Shad, Chairman, SEC, *n.2 (Sept. 12, 1986), *available at* 1986 WL 67356. For other evidence of SEC opposition to allowing fund assets to be used to pay for distribution, see, e.g., SEC, Statement on the Future Structure of the Securities Markets (Feb. 1972), *reprinted in* Sec. Reg. & L. Rep. (BNA) No. 137, pt. II, at 7:

> [T]he cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment and not, even in part, by the existing shareholders of the fund who derive little or no benefit from the sale of new shares. To impose a portion of the selling cost upon existing shareholders of the fund may violate principles of fairness which are at least implicit in the Investment Company Act.

advisory income from the fund to generate money for distribution was acceptable; allowing fund shareholders or directors overtly to approve distribution payments in the same amounts for the same purposes was forbidden.[79] This seemingly contradictory stance was driven by the SEC's fear that overtly allowing fund assets to be diverted to bolster sales could lead to a stampede of fund sponsors being enriched at the expense of fund investors.[80] As one key participant in the adoption of 12b-1 noted, "for years . . . the Commission and the staff took the position that mutual funds shouldn't pay for distribution; that there was an unacceptable conflict of interest, but they never could quite find a section of the Act saying that."[81] According to the same lawyer, Joel Goldberg, "[t]he real impetus for adopting Rule 12b-1 was the . . . lack of any intellectual basis for preventing payments for distribution. . . . And to mix the metaphors, you couldn't get the genie back into the bottle."[82]

Id.; *see also* Investment Company Act Release No. 9915, 1997 SEC LEXIS 945 (Aug. 31, 1977). Among the legal theories advanced over time against the practice of using assets for marketing were "payment of a portion of a fund's management fee to sales personnel constituted an illegal 'assignment' of the advisory contract under Section 15(a)" of the Act, 15 U.S.C. § 80a-15(a)(4) (2000), resulting in automatic termination of the contract and the necessity of new approval by shareholders; assessing charges against assets for marketing costs resulted in "hidden sales loads" violative of section 22(d), 15 U.S.C. § 80a-22(d); and loads borne by shareholders based on length of time of shareholder status are unfairly discriminatory and also in violation of section 22(d). *See generally* John P. Freeman, *The Use of Mutual Fund Assets to Pay Marketing Costs*, 9 LOYOLA L.J. 533, 543-48 (1978). For further discussion of SEC policy (and vacillation) on the use of fund assets to pay for distribution, see id. at 538-43. *See also* Payment of Asset-Based Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16,431, 53 Fed. Reg. 23,258 (June 13, 1988) [hereinafter Payment of Asset-Based Loads].

79. Indeed, a major mutual fund complex has taken the position that distribution fees inevitably come from fund assets, either extracted as 12b-1 fees or as advisory profits. *See* Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Release No. 34-30,897, 1992 SEC LEXIS 1631, at *n.36 (July 7, 1992) ("Vanguard . . . contended that all funds incur sales-related expenses and pay for them directly out of disclosed Rule 12b-1 fees or indirectly out of the advisory fee.").

80. *See id.*

81. SEC Historical Society, *supra* note 21, at 86 (remarks by Joel Goldberg). Mr. Goldberg was Associate Director of the Division of Investment Management when Rule 12b-1 was adopted. He proceeded to explain what, in his view, provided the impetus for promulgating Rule 12b-1:

> Nobody [at the SEC] really wanted to say . . . there wasn't anything illegal about funds paying for distribution until the pressure to increase sales became so great that some in the industry effectively challenged the Commission's position. You had several money funds organized where they were saying in their prospectus that they would share half of the advisory fee with dealers who sold their shares. And obviously, it's a very small step from that to saying, "[w]ell, we'll just only charge half the advisory fee and we'll have the fund pay what would have been the other half directly to the sales person." It had become clear that the sort of in terroram statements about it being generally inappropriate or immoral to pay for distribution were not going to hold back the tide forever. And I think that's what prompted . . . the staff to recommend to the Commission that they regularize and limit the practice. That was done, as [Allan Mostoff] suggests, by adopting a rule under Section 12(b) of the act.

Id. at 86-87.

82. *Id.* at 88.

C. Facts and Arguments Motivating Change

Helping to drive the SEC's interest in facilitating fund distribution were several factors ranging from undeniable fact to more speculative claims. For one thing, the legal support for government-enforced prohibition was shaky. Section 10(d) of the 1940 Act[83] established a unique type of mutual fund, requiring only a single disinterested director, provided the fund bore no promotional expenses. Arguably, the Act's drafters believed it either was permissible for funds to bear promotional expenses, or that no other provision of the Act barred such expenditures. Regulating distribution expenses was a statutory option available to the Commission, and it exercised that option when it adopted Rule 12b-1.

A practical reality driving the SEC's interest in freeing assets for use in financing fund marketing is that for most of the 1970s mutual funds were becoming harder to sell. Load funds, those that levy sales charges at the point of sale (resulting in less money being put to work as an investment), were encountering stiffer competition from no-load funds (which financed sales out of annually collected expenses),[84] and, as noted above, the fund industry was shrinking due to net redemptions. Freeing up assets for use in generating sales held promise from a marketing standpoint, at least for the load fund segment of the marketplace.

Less clear was the likelihood fund shareholders would receive net benefits in return for diversion of their assets to pay for distribution or sales effort. Representations were made to the Commission by fund industry leaders that boosting sales, even through using fund assets, made good economic sense due to beneficial economies of scale that would be generated for fund shareholders,[85] not to mention that cash inflows would make for

83. 15 U.S.C. § 80a-10(d) (2000). For background concerning section 10(d), see Letter from John L. Casey, Senior Vice President, Scudder, Stevens & Clark to George A. Fitzsimmons, Sec'y, SEC (Feb. 29, 1980) (regarding SEC File No. S7-743).

84. In 1970 load funds held more than 94% of the fund industry's assets. A decade later, no-loads, principally led by the money market funds, accounted for 61.6%. The next year, the no-loads claimed 83%. WILLIAM J. BAUMOL, ET AL., *supra* note 64, at 45 tbl.1.14. For a basic discussion of the differences between load and no-load funds, see Load vs. No-Load Funds, http://biz.yahoo.com/funds/ir_mf2.html (last visited Apr. 1, 2007). In general, no-load funds are better investments. All other things being equal, it is highly likely that no-load funds will be the better choice. *See id.* (reflecting a 29.5% three-year net return on investment for a no-load investment as opposed to a 21.2% return for a fund with a 5% front load, each assuming a 9% annual return after post-investment expenses).

85. *See* Freeman, *The Use of Mutual Fund Assets to Pay Marketing Costs*, *supra* note 78, at 554-55 (advancing economies of scales as an argument for lesser expenses); CHARLES TRZCINKA & ROBERT ZWEIG, AN ECONOMIC ANALYSIS OF THE COST AND BENEFITS OF SEC RULE 12B-1, at 9 (1990) [hereinafter TRZCINKA & ZWEIG]. The economies of scale argument, like the existence of the Loch Ness monster, has been fervently urged, but has never been proved. This reality has not stopped the fund industry from making it prior to the adoption of 12b-1 or subsequently. For an example of this argument post-12b-1's adoption, consider the ICI's claim made in 1988, after the adoption of 12b-1:

> Rule 12b-1 plans are equitable . . . . Long-term shareholders, in particular, stand to profit by additional growth in fund size that produces greater economies of scale and other benefits for them. . . . Rule 12b-1 fees produce benefits for funds and their shareholders (such as economies of scale, better fund management, and increased investment opportunities).

Podesta, *supra* note 66, at 207, 267-68 (quoting from Comments of the Investment Company Institute On Amendments to Rule 12b-1 Proposed By Investment Company Act Release No. 16,431 (Sept. 19, 1988)).

more efficient portfolio management.[86] Indeed, according to the ICI, Rule 12b-1 was adopted because "[t]he Commission recognized . . . that the sale of fund shares can benefit funds and their shareholders in numerous ways—e.g., by providing economies of scale, greater portfolio diversification, and better performance."[87] In a nutshell, the idea was that spending existing shareholders' money to bring new investors into the fund would prove, ultimately, to be cost effective. Other reasons put forth by industry representatives to justify using assets to aid distribution were that barriers to entry in the fund industry would be lowered, increasing competition and lowering costs, and that funds better able to bring in cash from new investors were easier to manage since there would be less risk the manager would have to sell good investments prematurely in order to raise cash for redemptions.[88] As we shall see, in the 25-plus years since Rule 12b-1 was adopted, none of these reasons, advanced to justify a levy that now generates billions annually for fund sponsors, has been proved valid.[89]

D. The SEC's Real Worry: Waste of Fund Assets

The SEC's opposition to allowing fund assets to be used for distribution made more sense for the load funds then dominating the industry. In that market segment, sales commissions or "loads" reflecting distribution costs were assessed against the shareholder at the time of sale. Obviously, a shareholder required to pay a "front-end load" would have less cash available on which to earn a return. This drawback did not apply to investors purchasing shares in the industry's "no-load" funds. There was no sales charge levied for them, though there were distribution costs. Due to the lack of commissions charged at the point of sale, those costs had to be and were picked up by the fund sponsor. The SEC's refusal to allow no-loads to allocate assets to pay distribution costs exalted form over substance, since payments for marketing efforts to attract fund shareholders necessarily had to come from somewhere other than from the purchasing shareholder, i.e., out of fund assets.[90]

In September of 1979, the SEC proposed to adopt a new Rule 12b-1, governing mutual funds' bearing of distribution expenses.[91] In its rulemaking proposal, the SEC made clear that its new rule would not undercut or erode the statutory fiduciary responsibilities owed by fee recipients.[92] The message sent was that fund directors called on to approve 12b-1 allocations would have to determine that any use of assets to pay distribution costs would likely benefit the funds' shareholders, as well as comply with

86. PROTECTING INVESTORS, *supra* note 49, at 321.

87. Podesta, *supra* note 66, at 216 (quoting from Comments of the Investment Company Institute On Amendments to Rule 12b-1 Proposed By Investment Company Act Release No. 16,431 (Sept. 19, 1988)).

88. TRZCINKA & ZWEIG, *supra* note 85, at 9-12. *See* BOGLE, *supra* note 59, at 199-201, for a critique of the arguments that 12b-1 fees are needed to enable the fund to grow to an economically viable size, facilitate economies of scale, and enable the fund to avoid having to liquidate portfolio securities.

89. *See infra* notes 143-256 and accompanying text.

90. One no-load complex bluntly admitted to the SEC in 1979 that mutual fund sponsors use advisory fee income to pay distribution costs. *See* Letter from John C. Bogle, Chairman, Vanguard Group, to George A. Fitzsimmons, Sec'y, SEC, at 2 (Nov. 24, 1979) (regarding SEC File No. S7-743).

91. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10,862, 44 Fed. Reg. 54,014 (Sept. 17, 1979).

92. 15 U.S.C. § 80a-35(b) (1994).

specific SEC rules. The Commission also identified conditions calculated to improve funds' disinterested directors' ability to make distribution decisions free from the adviser's influence.[93] One year after the SEC announced its proposal, and 40 years after the Investment Company Act was adopted, Rule 12b-1 became a reality.[94]

IV. RULE 12B-1'S REQUIREMENTS

Rule 12b-1 classifies as a "distributor" of securities a mutual fund that pays distribution expenses for selling its shares out of its own assets; it then regulates when and how such payments can be made by the fund. A fund functions as distributor by financing any activity primarily intended to result in the sale of fund shares. The rule thus reaches every mutual fund that uses fund assets for such things as advertising, underwriter compensation, payments for dealers and sales personnel, the printing and mailing of prospectuses to non-shareholders, and the printing and mailing of sales literature.[95] Stated differently, "rule 12b-1 under the 1940 Act is the *exclusive means* by which a fund may bear the cost of selling, marketing, or promotional expenses associated with the distribution of its shares."[96]

The rule sets forth a number of requirements relating to the adoption and renewal of 12b-1 plans. In general, funds are barred from paying for distribution unless all fund distribution expenses are made pursuant to a written plan adopted in accordance with the rule (a "12b-1 plan"). Rule 12b-1 aims to make sure that a fund's financially independent directors are (1) not unduly influenced by the external adviser, (2) fully informed, and (3) able to exercise a reasonable business judgment. In an effort to protect against the fund's adviser using undue influence to extract fees, the rule provides that a 12b-1 plan and any related agreements must be initially approved by a majority of the fund's shareholders, and by both a majority of the fund's board of directors, and a majority of the fund directors who are not interested persons of the fund and who have no direct or indirect financial interest in the operation of the plan or in any related agreements. Directors are expressly required to collect and study relevant data before voting.[97] In particular, the directors have a duty under the rule to request and evaluate the information reasonably necessary to making an informed decision of whether to adopt or continue a 12b-1 plan.

The rule also requires that each 12b-1 plan and any related agreements contain certain terms. The plan and agreements are each required to continue in effect for more than one year only if annually re-approved by the fund's board of directors and its disinterested directors. Importantly, Rule 12b-1(e)[98] demands that, in voting to adopt or

93. Among the possible safeguards mentioned by the SEC were requiring funds bearing their distribution expenses to have boards consisting entirely of disinterested directors, or requiring the disinterested directors as a group to review the asset allocation proposal initially and to have independent legal counsel (or other independent experts) assist them in their decision. *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10,862, 44 Fed. Reg. 54,014 (Sept. 17, 1979).

94. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11,414, 21 SEC Docket 324 (Oct. 28, 1980).

95. ABA Task Force, *Fund Directors' Guidebook*, 52 BUS. LAW. 229, 253 (1996).

96. *Id.* (emphasis added).

97. For a report on suggested procedures for fund directors to follow in order to discharge their obligations under the Investment Company Act of 1940 and other legal requirements, including Rule 12b-1, see id.

98. 15 U.S.C. § 80a-2(c) (2000).

continue a 12b-1 plan, the directors must conclude, in the exercise of their reasonable business judgment, and in light of their fiduciary obligations under state and federal law, that the 12b-1 plan is reasonably likely to benefit both the fund and its shareholders. Although the rule does not set forth any particular factors directors must consider when evaluating plans or related agreements, a note to the rule referring to the SEC Release adopting the rule presented various factors pertinent to the decision to adopt or continue a plan.[99] The plan and agreement both are subject to termination by a vote of a majority of the fund's disinterested directors or of the fund's outstanding voting securities.[100]

Rule 12b-1's adoption reflects a big step in the direction of de-regulation of mutual fund governance. By agreeing to defer to fund directors' business judgment, albeit grudgingly, the Commission surrendered its role as the principal decision maker over distribution expenses paid out of fund assets. What tilted the balance was a combination of two factors: the Commission believed the industry needed a marketing boost, and it concluded that it lacked a principled legal basis for denying fund directors the right to attempt to generate the benefits they swore would accrue to funds and their shareholders, if only the SEC would oblige by allowing assets to be tapped to foster sales.[101]

In one sense, this evolutionary change in the direction of de-regulation was long overdue. After all, the norm in this economy is that directors of business entities are trusted to lead by exercising their best judgment. On the other hand, liberalizing sponsors' access to fund assets posed risks in light of the fund industry's inherently-conflicted management structure.

99. The Commission's release adopting the rule directed readers seeking a discussion of factors which may be relevant to a decision to use company assets for distribution to an earlier release. *See* Bearing of Distribution Expenses by Mutual Funds, Bearing of Distribution Expenses by Mutual Funds, 17 C.F.R. §§ 239, 270, 274 (1980) (adopting a rule to permit open-end management investment companies to bear expenses associated with the distribution of their shares if they comply with certain conditions). The earlier release was Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10,862, Fed. Sec. L. Rep. (CCH) ¶ 82,201, at 82,262 (Sept. 7, 1979). Set forth below are the eight factors which were set forth in the 1979 release and discussed in Release No. 11,414: the involvement of independent legal counsel or experts; the nature and causes of the fund's specific distribution problems or circumstances; the manner in which the 12b-1 plan addresses problems or circumstances; the merits of possible alternative plans; the inter-relationship between the plan and activities of other persons; possible benefits of the plan to any other person relative to those expected to inure to the fund; the effect of the plan on existing shareholders; and evaluation of success of the plan. 17 C.F.R. §§ 239, 270, 274 (1980).

100. The plan is subject to termination by the disinterested directors at any time. Rule 12b-1(b)(3)(iii), 17 C.F.R. § 270 (2006). Agreements relating to the plan are subject to termination on 60 days notice. Rule 12b-1(b)(3)(iv)(A), 17 C.F.R. § 270 (2006).

101. *See* Memorandum from Kathryn B. McGrath, Dir., Div. of Inv. Mgmt., SEC, to John S.R. Shad, Chairman, SEC (Sept. 12, 1986) (Response to Letter from Chairman Dingell Concerning Rule 12b-1 Under the Investment Company Act of 1940), *in* Arthur Z. Gardiner, Jr., *Distribution Of Investment Company Shares Under Rule 12b-1, in* INVESTMENT COMPANIES 223, 230 (1987) (PLI Course Handbook Series 548 PLI/Corp 1987) (referring to industry reports to the SEC staff that use of fund assets confers benefits, "including the economies of scale that can be achieved through fund growth and the generation of a positive cash flow through sales of fund shares so that redemption requests can be satisfied without liquidating fund investments").

V. RULE 12B-1 IN PRACTICE

A. The Early Days

Immediately following Rule 12b-1's promulgation, the rule was used infrequently.[102] 12b-1 fees were low, typically 0.25% or less, and payments were commonly used to pay such distribution expenses as advertising costs or sales literature mailings.[103] These results were "consistent with the SEC's expectations in adopting the rule."[104] Then the pace of adoption began to pick up and the landscape changed radically. By 1986, the number of funds featuring 12b-1 plans had ballooned to nearly 600, and average fees had risen from "a token" 0.25% to, in some cases, more than 1% annually.[105] During 1987, 390 more funds adopted 12b-1 plans, triple the number of adoptions three years earlier.[106] What began life as a measure calculated to address specific problems facing individual funds,[107] evolved from a targeted, limited response into a large, enduring, and controversial expense fixture within the industry.[108]

B. Rule 12b-1 Nourishes a Potent Marketing Tool—CDSCs and Fund Classes Arise

When Rule 12b-1 was adopted in October of 1980, fund investors seeking to buy shares had two options. They could buy shares of a load fund through broker-dealers or other professionals, paying a "front-end" sales charge of up to 8.5%, or they could buy shares in a no-load fund offered primarily through advertisements.[109] After the rule's adoption, radical change transformed the fund industry's marketplace. Load fund sales began to zoom.

Spurring adoption of Rule 12b-1 plans during its early years was a development not anticipated by either the SEC or the industry[110] when the rule was adopted: use of 12b-1

102. As of 1984, only around ten funds had adopted plans. Gretchen Morgenson, *Tracking Those Loathsome Loads*, MONEY, July 1986, at 145.

103. Joel H. Goldberg & Gregory N. Bressler, *Revisiting Rule 12b-1 Under the Investment Company Act*, 31 REV. SEC. & COMMODITIES REG. 147, 148 (1998). Between 1980 and 1984, about 30% of the funds in the industry had adopted 12b-1 plans. TRZCINKA & ZWEIG, *supra* note 85, at 6.

104. TRZCINKA & ZWEIG, *supra* note 85, at 6. *See also* SEC Historical Society, *supra* note 21, at 91 (remarks of Joel Goldberg) ("[T]he rule really assumed . . . you would have a payment of maybe 20 points, 25 points tops, and it would cover advertising or training of sales personnel, or that kind of thing."). There is some evidence that when it adopted the rule, the Commission expected 12b-1 fees to approximate those being sought by the Vanguard Group under a requested SEC order. TRZCINKA & ZWEIG, *supra* note 85, at 15 n.18. For the Vanguard Proceeding order, see Investment Company Act Release No. 11,645, 22 SEC Docket 238 (Feb. 25, 1981). Vanguard's distribution fees approved by the Commission were only in the range of 0.05% to 0.10%. TRZCINKA & ZWEIG, *supra* note 85, at 15 n.18.

105. Today 12b-1 fees are capped at 1%. *See infra* note 128 and accompanying text.

106. TRZCINKA & ZWEIG, *supra* note 85, at 7.

107. In a 1986 no-action letter, the staff stressed the importance of 12b-1 as a problem-solving measure, admonishing fund directors to pay special heed to the specific "problems or circumstances that purportedly make implementation or continuation of [a 12b-1] plan necessary or appropriate." Colonial Group, Inc., SEC No-Action Letter, [1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,335, at 78,401 (May 21, 1986).

108. *See* Laurie Kulikowski, *SEC to Examine 12b-1 Rule*, FIN. PLANNING, July 1, 2002, at 30.

109. Podesta, *supra* note 66, at 239.

110. Goldberg & Bressler, *supra* note 103, at 150 ("Nowhere is there any indication in the voluminous

fees in connection with fund classes featuring so-called "contingent deferred sales charges," often called "CDSCs" or "CDSLs,"[111] used to market load funds.[112] In contrast with pre-12b-1 days, load funds now routinely offer different classes or series of shares with different attributes. The Class B shares depicted in Table 1 below differ from other classes of shares typically offered by the same load funds. Class A shares, for example, typically bear a front-end load with various "break-points,"[113] with or without an ongoing 12b-1 fee.[114] As reflected in Table 1, Class B shares may feature no front-end

record of the rule-making proceeding that culminated in the adoption of rule 12b-1 that either the SEC or the industry foresaw how rule 12b-1 would make possible CDSCs for regular mutual funds."). It has been suggested by the man who was instrumental in Rule 12b-1's adoption that the SEC did not foresee the use of CDSCs when it promulgated the rule:

> Now, I think if I had it to do over again, or even if I had it to do the first time, the big mistake the staff and the Commission made at the time of Rule 12 b-1 was we did not foresee that payments out of fund assets would be used as a substitute for a sales load, you know, in the form of a contingent deferred sales charge.
>
> And when you think about it, it was so obvious, it's just astounding that we never thought of it. Because the insurance industry had been doing essentially the same thing for years by having contingent deferred sales charges on variable annuity contracts, and then using the mortality and expense charge to cover that. It's astonishing that we never thought that that could be—or we never thought about the fact that that could be easily transferred to the conventional fund industry.

SEC Historical Society, *supra* note 21, at 88 (remarks of Joel Goldberg). However, prior to 1980, the staff specifically focused on this possible use of asset charges in lieu of a front load in advance of 12b-1's adoption, inviting comments addressing whether it would "be more desirable for investors to pay for selling services by means of periodic charges against assets of the fund after they invest, rather than by means of a sales load paid at the time of purchase?" Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 9470, 10 SEC Docket 680 (Oct. 4, 1976), *available at* 1976 WL 162523.

111. This stands for "contingent deferred sales loads."

112. Why the emergence of CDSC should have come as a surprise is not clear. A 1976 SEC release announcing hearings concerning fund distribution, and inviting feedback about using fund assets to pay for distribution, expressly asked for comment about the following "policy issue": "Would it be more desirable for investors to pay for selling services by means of periodic charges against assets of the fund after they invest, rather than by means of a sales load paid at the time of purchase?" Investment Company Act Release No. 9470, 1976 WL 162523 (Oct. 4, 1976). The release predates 12b-1's adoption by four years but refers directly to the CDSC concept.

113. The use of commission breakpoints means that the higher the investment, the lower the rate at which the sales charge is calculated and the lower the payout to the dealer. For example, Class A shares for the AllianceBernstein Growth Funds feature breakpoints as follows:

Amount Invested	Load %
$ 0-99,999	4.25
$ 100,000-249,999	3.25
$ 250,000-499,999	2.25
$ 500,000-999,999	1.75
$1,000,000-and up	0.00

The Alliance Bernstein Growth Funds, PROSPECTUS (Alliance Bernstein Invs., New York, N.Y.), Nov. 1, 2006, at 32.

114. The Class A Alliance Premier shares mentioned in the preceding footnote carry a .50% 12b-1 charge in addition to a 1% management fee. In contrast, Merrill Lynch Fundamental Growth Fund's Class A shares carry no 12b-1 fees, though the initial breakpoints bear slightly higher loads than the Alliance Premier Class A. *Id.*

load, but the broker who sells it is paid a full commission at the time of sale. To pay that commission, these funds carry a 1% 12b-1 fee and a declining redemption charge.[115] They may be convertible into Class A shares some years into the future.[116] Another typical load fund class of shares, Class C shares, often carries a CDSC of 1% if redeemed during the first year, a 1% 12b-1 fee charged yearly, and, in contrast to Class B shares, may not be redeemable into Class A shares.[117]

To appreciate the significance of the CDSCs' development and the competitive pressures CDSCs have exerted, it is necessary to understand how selling effort is compensated for load funds. For a load fund, a sales charge or "load," such as 6% of the amount invested, would be deducted directly at the time of sale and used to compensate the sales representative and the selling organization. The load cuts the investor's equity at the front end, meaning less money is put to work to earn a return. CDSC evolved into a form of sales load that enabled load fund marketers to have their cake and eat it too. This is done by connecting a level 12b-1 fee to a redemption fee, i.e, the CDSC.

The combined use of 12b-1 fees with CDSCs allowed load funds marketers to pay large front-end commissions without appearing to do so. A fund that might have formerly charged a 6% front-end sales load that was visible to the investor became able to compensate retailers at the same rate up front, recouping the cash advanced from the shareholder through a combination of 12b-1 fees and CDSCs. The fund would accomplish this by calling the old front-end fee investment "Class A shares," while branding as "Class B shares" interests in the same portfolio sold by brokers compensated by means of CDSCs. Here, 100% of the investor's money was immediately invested, but with deductions over time via 12b-1 fee charges, coupled with a declining "surrender" charge if the investor left the fund within a certain number of years. Consider the following example illustrating payments for a hypothetical Class B offering:

TABLE 1

Year	**Annual** *12b-1 fee*	**Cumulative** *12b-1 fee*	**Applicable** *Redemption Fee*	**Cumulative** *Sales load*
1	1%	1%	5%	6%
2	1	2	4	6
3	1	3	3	6
4	1	4	2	6
5	1	5	1	6
6	1	6	0	6

As the chart shows, there is nothing "contingent" or "deferred" about sales charges paid to own Class B shares. The CDSC operating in tandem with a 12b-1 charge is a

115. Both the Alliance Premier Class B and the Merrill Lynch Fundamental Growth Class B shares fall into this category. For a report on different options, see J. Julie Jason, *Mutual Fund Share Classes: Uses And Abuses, in* SECURITIES ARBITRATION 2002: TAKING CONTROL OF THE PROCESS 27, 40-59 (2002) (PLI Course Handbook Series 1327 PLI/Corp 2002).

116. Both the Alliance Premier Growth Class B and the Merrill Fundamental Growth Class B are convertible into Class A in eight years.

117. Both the Alliance Premier Growth Class C and the Merrill Fundamental Growth Class C have this profile. Thus, the Class C shares would carry a 12b-1 charge indefinitely.

financing mechanism.[118] A load is paid at the time of sale, and the cash used to pay it either accumulates over time via the 12b-1 charges, or is generated through a combination of 12b-1 and redemption assessments. An ICI report explained how mutual fund 12b-1 fees have come to be used to pay fund costs:

> Although 12b-1 fees can be used to pay for any distribution expense, in practice they are largely used to compensate sales professionals for investment advice and ongoing service to fund shareholders. A survey of fund companies in 1999 found that 63% of the revenue from 12b-1 fees was used to compensate broker-dealers and other sales professionals. This compensation includes payments made to broker-dealers for the sale of fund shares, reimbursements to the fund distributor for financing charges arising from advances to broker-dealers for the sale of fund shares, and compensation of in-house personnel. An additional 32% of the 12b-1 fees was paid for administrative services, including compensation to third parties for recordkeeping and other services provided to fund shareholders. Only about 5% of 12b-1 fees was used for advertising and other sales-promotion activities, including expenses for printing and mailing prospectuses and sales materials to prospective investors.[119]

The combination proved to be a potent marketing tool in the load fund segment of the fund industry using the broker-dealer channel. One fund that pioneered the use of spread loads financed by 12b-1 charges and CDSCs experienced asset growth from $109,000 to nearly $4 *billion* in a single year.[120] The spread load-selling tool presented the fund industry's load fund segment with a handy device to counter downward pressure on prices caused by competition from no-load funds.[121] The SEC lent a helping hand by

118. According to an SEC staff study of fund expenses, "[a] CDSC is 'contingent' because the sales load is paid only if the shares are redeemed before a specified period of time (often 5-8 years)." REPORT ON MUTUAL FUND FEES, *supra* note 47. The SEC view exalts form over substance. Under the CDSC format, a load is paid to the sales representative and the selling organization at the time of the sale. There is nothing contingent or deferred about that payment. The money is then extracted, inexorably, from the buying shareholder through assessments of 12b-1 fees or the CDSC levied at the time the investor redeems the fund shares. An investor who buys fund shares under this set-up does not face a contingent possibility that a load will be paid, any more than a customer who finances a car payment faces a contingent possibility that the car salesman will be paid a commission for the sale. References to a "contingent" load fog the issue and are misleading.

119. Brian K. Reid & John D. Rea, *Mutual Fund Distribution Channels and Distribution Costs*, PERSPECTIVE (Inv. Co. Inst., Washington, D.C.), July 2003, at 19, *available at* http://www.ici.org/pdf/per09-03.pdf.

120. PROTECTING INVESTORS, *supra* note 49, at 322 n.137.

121. Exemption for Certain Registered Open-End Management Investment Companies, 53 Fed. Reg. 45, 276-77 (Nov. 2, 1988):

> Until fairly recently, most of the sales and promotional expenses associated with [a mutual fund] offering were passed on to fund investors in the form of a sales charge or "sales load" paid by the investor at the time fund shares were purchased and expressed as a percentage of the public offering price of the shares. Funds that sold their shares to the public without a sales load formerly represented only a small portion of the industry. However, the number and asset size of so-called "no-load" funds increased dramatically in the 1970's. This increased competition from no-load funds and a perceived resistance among mutual fund investors to products that charge front-end sales loads have prompted load funds to develop alternative methods of distribution financing, such as the imposition of sales loads payable other than at the time of purchase.

issuing 300 orders between 1981 and 1995 authorizing funds to use spread load payment systems.[122] Exemptive orders became unnecessary in 1995 upon the SEC's adoption of Rule 6c-10 of the Investment Company Act,[123] codifying the conditions under which exemptions previously had been granted.[124]

Also playing a role in the evolution of spread load share classes was the National Association of Securities Dealers (NASD), to whom the SEC has de facto delegated a significant regulatory role. In 1993, in an effort to limit marketing deception relating to fund costs, the NASD issued a rule[125] barring sales representatives or their firms from representing a mutual fund as "'no load' or as having 'no sales charge' if the" fund imposes a front-end load, a redemption fee or a CDSC, or a 12b-1 fee exceeding 0.25% of average net assets per year. The NASD's regulatory action treated front-end loads and 12b-1 financed spread loads as different forms of the same thing: sales loads.[126] This is only fair because, as currently used by the fund industry, in many cases, from the investor's standpoint 12b-1 fees principally are a form of hidden or disguised sales load. Under the NASD rule, the maximum 12b-1 fee that a fund can charge is 1% per year consisting of two components: "asset-based sales charges"[127] of no more than 75 basis points and service fees of no more than 25 basis points.[128]

In any event, the rise of CDSC share classes financed by 12b-1 fees, and their embrace by large brokerage firms, led to a complete turnaround of Wall Street's attitude toward mutual funds in the 1970s. Then, large brokerage firms' attitude reflected in the 1974 SEC staff's report on mutual fund distribution was, "we could do without the funds."[129] According to one press report, in 1971 "Merrill Lynch forbade the sale of

Id.

122. Jason, *supra* note 115, at 37.

123. 17 C.F.R. § 270.6c-10 (2006).

124. Exemption for Certain Open-End Management Investment Companies to Impose Contingent Deferred Sales Loads, Investment Company Act Release No. 20,916, 60 Fed. Reg. 11,887 (Mar. 2, 1995), *available at* http://www.sec.gov/rules/final/edsls.txt.

125. NASD CONDUCT RULE § 2830(d)(4) (1998). Additionally, NASD rule § 2830 limits the maximum aggregate asset-based, front-end, and deferred sales charges to 7.25% of total new gross fund sales, plus interest. *Id.* § 2830(d)(2)(B). Additionally, if the fund pays a "service fee," the maximum is reduced to 6.25% plus interest. The rule defines "service fee" to mean payments made out of fund assets that are used to pay "for personal services and/or the maintenance of shareholder accounts." *Id.* § 2830(b)(9). Service fees may or may not be paid under 12b-1 plans.

126. The SEC's *Report on Mutual Fund Fees* noted that "many funds adopt a rule 12b-1 plan as a substitute for or supplement to sales charges or as an ongoing method of paying for marketing and distribution arrangements." REPORT ON MUTUAL FUND FEES, *supra* note 47.

127. "[P]ayments by an investment company for personal service and/or the maintenance of shareholder accounts." NASD CONDUCT RULE § 2830(b)(9). "An asset-based sales charge is a sale charge that is deducted from the net assets of an investment company and does not include a service fee." NASD CONDUCT RULE § 2830 (b)(8)(A) (1998).

128. NASD CONDUCT RULE § 2830(d)(2)(E) & (d)(5). By the time the fee cap was adopted, 12b-1 fees were running as high as 1.25%. Margaret Price, *Fees Come Under Scrutiny*, PENSIONS & INVESTMENTS, July 11, 1990, at 19.

129. MUTUAL FUND DISTRIBUTION, *supra* note 65, at 33. The staff report quoted the President of the National Mutual Fund Managers Association, a group of mutual fund sales managers of New York Stock Exchange member firms:

> Member firms are important to the mutual fund industry as they account for a very large portion of the total mutual fund sales. However, mutual fund commissions are not of too great importance to

mutual funds."[130] In 1976, Merrill Lynch's own funds had assets totaling $50 *million*. Things changed swiftly. A decade later the company was managing 50 different funds with assets of $61.3 *billion* and fee income of $183.2 million.[131]

The emergence of CDSCs operating in tandem with 12b-1 fees completely transformed the economic relationship between the fund industry and the large brokerage firms; in the post-12b-1 world, mutual fund sales became a very big revenue item.[132] Between investors paying up-front load charges or buying CDSC-classes, the fund industry takes in loads approximating $20 billion annually.[133] Fund-generated management and other fees have proven to be unusually lucrative, accounting for 20%-30% of brokerage firms' net profits, though they accounted for only 4% of total revenues.[134]

Today, load fund shareholders face a variety of share class purchase possibilities when deciding how to invest. Deciding which of these options, such as Class A, Class B, or Class C shares, is the better deal for a shareholder can be a difficult puzzle to solve since present value computations and guesswork on the prospective holding period are required.[135] Consider, for example, the following hypothetical fund fee arrangement taken from an ICI illustration[136] that assumes a 10% annual return and an annual fund expense ratio aside from the 12b-1 charges of 0.75%:

- A shares have 5.75% front-end load and 12b-1 fee of 0.25%;
- B shares have a 12b-1 fee of 1.00%, convert to A shares after the end of the eighth year, have an initial CDSC of 5.00% followed by successive levels of 4.00%, 3.00%, 3.00%, 2.00%, and 1.00% over the next five years, and have no CDSC starting in the seventh year;
- C shares have a 12b-1 fee of 1.00%, a CDSC of 1.00% in the first year, and no CDSL thereafter.

Given these parameters, total annual returns for A, B, and C shares can be computed

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> member firms as they account on average per firm for only 3% of member firms' total income. What I am implying is that if mutual funds were deleted from our product mix, we could do without them.

Id. at 34 (testimony of Bradley Baker).

130. Leah Nathans, *Mutual Funds: Wall Street's Cash Cow*, DUN'S BUS. MONTH, Oct. 1986, at 46.

131. *Id.*

132. For example, for the five quarters ending June 29, 2002, Merrill Lynch grossed $1.787 billion in mutual fund commissions, amounting to precisely half of the total commissions of $3.574 billion the brokerage firm earned selling listed and over-the-counter securities. *Merrill Lynch Reports Second Quarter Net Earnings of $634 Million*, BUS. WIRE, July 16, 2002, Attachement IV. For Charles Schwab Corp., funds played an even bigger role. In 2001, gross income from mutual fund service fees and commissions totaled $1.237 billion, nearly equaling the $1.259 billion Schwab grossed in commissions for transactions in listed stocks, NASDAQ stocks, and options. *See* Charles Schwab Corp. Annual Report (Form 10-K), at 3 (Mar. 27, 2002). Five years later, Schwab's receipts from mutual fund service fees totaled $1.516 billion, dwarfing Schwab's trading revenue (commissions and principal transactions) of $785 million. *See* Charles Schwab Corp. Annual Report (Form 10-K), at 19 (Feb. 26, 2007).

133. GREGORY BAER & GARY GENSLER, THE GREAT MUTUAL FUND TRAP 102 (2002).

134. *Id.*

135. *See* Miles Livingston & Edward O'Neal, *The Cost of Mutual Fund Sales Fees*, 21 J. FIN. RES. 205, 206 (1998) (comparing "distribution-related fees" for mutual fund investments using the authors' derived present value calculation).

136. Reid & Rea, *supra* note 119, at 12.

for a particular assumed holding period. This analysis is presented in Table 2 below.

TABLE 2

Hypothetical Total Annual Return on A, B, and C Shares %

Holding Period *In Years*	**A Shares**	**B Shares**	**C Shares**
1	2.64	3.08	7.08
2	5.72	6.21	8.08
3	6.77	7.21	8.08
4	7.30	7.48	8.08
5	7.62	7.78	8.08
6	7.83	7.96	8.08
7	7.98	8.08	8.08
8	8.10	8.08	8.08
9	8.19	8.17	8.08
10	8.26	8.24	8.08
11	8.32	8.30	8.08
12	8.36	8.35	8.08
13	8.40	8.39	8.08
14	8.44	8.43	8.08
15	8.47	8.46	8.08

As shown in Table 2, for an investor holding shares for five years, the annual rate of return over the five-year period would be 7.62% for A shares, 7.78% for B shares, and 8.08% for C shares. If return were all that mattered and the investor knew with certainty that the shares would be held for five years, C shares would be the appropriate choice. The table also shows something that is very telling. Aside from the tie in year seven, Class B shares are *never* the investor's best choice; for years one through six, Class C shares are always the best choice. From year eight onward, Class A shares are the best choice. Nonetheless, Class B shares, which are never clearly the best choice for investors, tend to be popular with those selling load fund shares.[137] Why this is so is discussed below.

C. Recent History: Rule 12b-1 Pads Wall Street's Bottom Line

By 1998, in the midst of the longest bull market in history, approximately 60% of all mutual funds supported 12b-1 plans.[138] The average fee payable under those plans amounted to 0.62% of net assets.[139] From this position of market dominance, the rule's influence has continued unabated. By early 2002, the percentages of both adoption and

137. *See* Pete S. Michaels & Derek C. Anderson, *Class B Mutual Fund Shares: A Primer on Recent Regulatory Activity and Strategies for Arbitration Cases*, *in* SECURITIES ARBITRATION 2004: A RAPIDLY EVOLVING PROCESS 405, 409 (2004) (reporting that sales of Class B shares represent around 18% of fund shares sold by registered representatives).

138. Goldberg & Bressler, *supra* note 103, at 150.

139. *Id.* Today, the asset weighted 12b-1 expense is 0.34%, and the median expense is 0.65%. *See* Carla Fried, *Pressure Builds to Cut Fund Fees*, N.Y. TIMES, Jan. 11, 2004, Business Section at 26.

fee rate had continued to creep upward with nearly 62% of all funds adopting 12b-1 plans, and fee percentages averaging 0.64%.[140] Roughly one-third of the funds with 12b-1 plans are charging the maximum permissible 12b-1 fee,[141] which now is set at 1%.[142]

From its beginning at the reluctant, skeptical hands of the SEC's Division of Investment Management, Rule 12b-1 has reached maturity and today enjoys a life of its own. When the measuring stick is the ability to generate fund sales, Rule 12b-1 stands as an unqualified success story. It has been a very effective tool in fund sponsors' drive to accumulate assets to be managed under advisory contracts. Far less clear is whether Rule 12b-1 delivers any *net* benefits to those figuratively seated at the other side of the bargaining table: the tens of millions of fund shareholders stuck with the 12b-1 bill. The following section identifies the gaps between the fund shareholder benefits that Rule 12b-1 was supposed to generate and the measurable results actually achieved. As we shall see, from the shareholders' standpoint, an overwhelmingly powerful case can be made that Rule 12b-1's impact has been negative.

VI. THE ACID TEST: DOES RULE 12B-1 BENEFIT MUTUAL FUND SHAREHOLDERS?

That the SEC's staff filibustered for years against Rule 12b-1 attests to a deeply ingrained skepticism among a highly knowledgeable group of fund industry experts about the basic precept that fund sales financially benefit existing shareholders. The Commission and its staff greeted with skepticism the industry's purported justifications for allowing assets to be diverted to spur sales.[143] By deferring to fund directors' business judgment, the SEC elected to give fund industry leaders an opportunity to prove their theories worked. The SEC's business judgment experiment has now been running for more than 26 years.

A. The Economies of Scale Argument Is Unsubstantiated

A recurring claim made by the industry prior to Rule 12b-1's adoption was that by generating sales and thereby growing funds' assets, administrative and management costs would fall, allowing fund shareholders to, in essence, realize a net gain on their invested marketing dollars.[144] The idea was that money could be taken from mutual fund shareholders by the fund's adviser or distributor to pay for 12b-1 marketing efforts, with the diverted funds being put to work in a way that would yield savings through economies of scale realized as the fund grew in size. This theory has not panned out. The SEC's staff found in its December 2000 report on fund expenses "that, everything else

140. Jason, *supra* note 115, at 36.

141. *Id.*

142. NASD CONDUCT RULE § 2830(d) (1998). The maximum 12b-1 fee that can be imposed under Rule 2830(d) has two components: a maximum "asset based sales charge" or CDSC fee of 0.75% of average assets, *id.* § 2830(d)(2)(E)(i), and a maximum "service fee" of 0.25%, *id.* § 2830(d)(e).

143. *See supra* note 81 and accompanying text; *see also supra* note 78 and accompanying text.

144. *See supra* notes 85-87 and accompanying text; *infra* note 367 and accompanying text; *see also* Comments of the Investment Company Institute on Amendments to Rule 12b-1 Proposed by Investment Company Act Release No. 16,431, at 14 (Sept. 19, 1988), *reprinted in* Podesta, *supra* note 66, at 244-45 ("[T]he existing shareholders of funds are directly affected by net redemptions since they stand to lose economies of scale . . . .").

equal, funds with 12b-1 fees had total expenses that were higher than those of other funds, but by an amount that was slightly less than the maximum 12b-1 fee."[145] In other words, the SEC found that funds spending more 12b-1 money saw their expense ratios rise by approximately the amount of money diverted. This is a far distance from validating the contention that 12b-1 payments would in essence pay for themselves. More recently, an SEC-employed economist, Dr. Lori Walsh, conducted private research that carefully reviewed data concerning 12b-1 fees, and concluded:

> While funds with 12b-1 plans do, in fact, grow faster than funds without them, shareholders are not obtaining benefits in the form of lower average expenses or lower flow volatility. Fund shareholders are paying the costs to grow the fund, while the fund adviser is the primary beneficiary of the fund's growth.[146]

Dr. Walsh did not mince words, finding that "shareholders do not obtain *any* of the benefits from the asset growth."[147] This finding vindicates opponents of using fund assets to subsidize sales who warned about funds shareholders being exploited by their funds' conflicted managers.[148] The findings made by the SEC staff and Dr. Walsh accord with other similar studies; the evidence is overwhelming that 12b-1 payments do not generate net financial benefits for fund shareholders.[149]

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145. REPORT ON MUTUAL FUND FEES, *supra* note 47. The staff theorized that the difference between expense ratios for 12b-1 and the non-12b-1 funds not equaling the maximum 12b-1 charges was due to some funds not charging the maximum. *Id.*

146. LORI WALSH, THE COSTS AND BENEFITS TO FUND SHAREHOLDERS OF 12B-1 PLANS: AN EXAMINATION OF FUND FLOWS, EXPENSES AND RETURNS 2 (2005), *available at* http://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf.

147. *Id.* at 4 (emphasis added).

148. *See, e.g.*, Statement on the Future Structure of the Securities Markets, SEC (Feb. 1972):

> [T]he cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment and not, even in part, by the existing shareholders of the fund who derive little or no benefit from the sale of new shares. To impose a portion of the selling cost upon existing shareholders of the fund may violate principles of fairness which are at least implicit in the Investment Company Act.

Id.; *see also* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 9915, 42 Fed. Reg. 44,810 (Aug. 31, 1977).

149. *See, e.g.*, Nicolaj Sigglekow, Caught Between Two Principals (May 5, 2004), *available at* http://knowledge.wharton.upenn.edu/papers/1280.pdf (finding, after review of a data set of essentially all U.S. funds between 1992-2002, that 12b-1 has been used to shift costs from fund providers onto fund shareholders); Antonio Apap & John M. Griffith, *The Impact of Expenses on Mutual Fund Performance*, 11 J. FIN. PLAN. 76, 76-77 (1998) (stating that for funds with investment objectives of long-term growth, growth and current income, and equity income, 12b-1 fees do not add to funds' performance); Stephen P. Ferris & Don M. Chance, *The Effect of 12b-1 Plans on Mutual Fund Expense Ratios: A Note*, 42 J. FIN. 1077, 1082 (1987) (describing 12b-1 fees as "a dead-weight cost"); Robert W. McLeod & D.K. Malhotra, *A Re-examination of the Effect of 12B-1 Plans on Mutual Fund Expense Ratios*, 17 J. FIN. RES. 231, 239 (1994) (stating that 12b-1 fees are "a dead weight cost" to shareholders that has been increasing over time); TRZCINKA & ZWEIG, *supra* note 85, at 2-3, 9-10, 66-67 ("We find no evidence that 12b-1 expenses promote growth in total assets. There is no effect of 12b-1 on either the growth of the average fund or on the growth of small funds in any of the years 1986-1988."). For criticism in fund industry literature, see Amy C. Arnott, *The Rising Tide*, MORNINGSTAR MUTUAL FUNDS, Oct. 11, 1996, at S1-S2; Michael Mulvihill, *A Question of Trust*, MORNINGSTAR MUTUAL FUNDS, Aug. 30, 1996, at 51-52.

Another serious problem with the growth begets savings scenario is that asset growth in the fund industry does not guarantee costs will drop at all. A Government Accounting Office report published in 2003 found that a sample of 46 large stock mutual funds which, together, had a growing asset base,[150] also had experienced rising average expense ratios, with costs growing from 0.65% of assets in 1998 to 0.70% in 2001. Meanwhile, the average mutual fund shareholder, until very recently, has tended to find expenses creeping higher.[151] Decade after decade of rising costs casts doubt on the concept that asset growth can be counted on to generate economies of scale for shareholders, however the asset growth may be financed. Moreover, scholarly research has identified "a negative persistence in fund performance [for large funds] supporting the hypothesis that funds can become large and inefficient."[152] Indeed large equity funds sometimes "close to new investors if the fund becomes too large to effectively deploy capital."[153]

The fact that fund asset growth financed by 12b-1 fees fails to yield tangible benefits for fund shareholders has a serious legal ramification. Cost efficiency is Rule 12b-1's touchstone. Prior to adopting or renewing a fund's 12b-1 plan, fund directors are required to consider "whether the plan has in fact produced the anticipated benefits for the company and its shareholders."[154] After all, it would be a breach of fiduciary duty for directors to take and spend shareholder money with no honest, reasonable expectation that spending the money would leave shareholders better off. Twenty-six years of experience with Rule 12b-1 has failed to generate a single competent, objective study concluding there is a positive net financial return flowing to shareholders derived from the 12b-1 marketing investments paid for by those fund shareholders. This cold reality ought to trouble a conscientious mutual fund director called on to approve a 12b-1 plan. So should Dr. Walsh's damning observation:

> Although it is hypothetically possible for most types of funds to generate sufficient scale economies to offset the 12b-1 fee, it is not an efficient use of shareholder assets. . . . Fund advisers use shareholder money to pay for asset growth from which the adviser is the primary beneficiary through the collection

150. Twenty-eight of the 46 large funds grew in size; the assets held by the sample as a whole grew from $835 billion in 1998 to over $1,052 billion in 2001. TRENDS IN FEES, *supra* note 57 (statement of Richard J. Hillman).

151. *See* Russell Kinnel, *Fund Expense Ratios Continue to Fall*, MORNINGSTAR, May 22, 2006, http://news.morningstar.com/article/article.asp?id=164494&_QSBPA=Y (reporting that costs started to trend downward in 2004, possibly in reaction to legal actions taken by N.Y. Attorney General Eliot Spitzer).

152. David A. Volkman & Mark E. Wohar, *Determinants of Persistence in Relative Performance of Mutual Funds*, 18 J. FIN. RES. 415, 423 (1995).

153. Consuelo L. Kertz & Paul J. Simko, *Mutual Fund Investing and Tax Uncertainty: The Need for New Disclosures*, 7 STAN. J.L. BUS. & FIN. 103, 117 (2001); *see also* Samuel S. Kim, *Mutual Funds: Solving the Shortcomings of the Independent Director Response to Advisory Self-Dealing Through Use of the Undue Influence Standard*, 98 COLUM. L. REV. 474, 509 n.58 (1998) ("Fidelity Investments recently closed its popular Magellan Fund largely in response to criticisms from customers that 'the fund had grown too big to be managed effectively and was being kept open to generate higher management fees at the expense of existing shareholders.'") (emphasis omitted).

154. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11,414, 45 Fed. Reg. 73,898 (Oct. 28, 1980).

of higher fees.[155]

Predictably, the fund sponsor's trade association and lobbying organization attacked Dr. Walsh's scholarly effort, complaining to the SEC's Chairman that it "unfortunately presented an unbalanced view."[156] In reality, what was unbalanced was the ICI's criticism, not Dr. Walsh's analysis.

When it promulgated Rule 12b-1, the SEC specifically encouraged directors to evaluate the "possible benefits of the plan to any other person relative to those expected to inure to the company," "the effect of the plan on existing shareholders," and the success of the plan.[157] Lori Walsh's findings are pertinent to each of these factors and ought to be disturbing to any fund board member conscientiously seeking to honor his or her fiduciary duty under Rule 12b-1. Predictably, the fund industry's lobbying organization, the ICI, criticized Dr. Walsh for leaving readers with "a negative impression about the impact of 12b-1 fees on fund shareholders,"[158] which she did, and for disregarding "how 12b-1 fees are currently used,"[159] which she did not do. On the latter point, the ICI attacked Dr. Walsh for not accepting that 12b-1 is today used mainly in ways not envisioned when Rule 12b-1 was promulgated, principally as a means of funding sales of load funds through the spread load mechanism discussed above. This criticism is unfair.

In truth, after finding that the original justifications given for Rule 12b-1's adoption held no water, Dr. Walsh evaluated the use of Rule 12b-1 as a load funding device. She found Rule 12b-1 plans to be "an inappropriate means" for use by investors to pay load fees.[160] First, she criticized the lack of transparency that makes it impossible for a fund shareholder to calculate the load actually being paid via 12b-1 either annually or in the aggregate.[161] Second, she pointed out that, since 12b-1 charges are assessed at the fund level, shareholders with large accounts are assessed higher dollar charges per account than shareholders with smaller accounts.[162] In contrast, under the normal front-end load sales charge system, economies of scale in selling effort are reflected by breakpoints, which reduce the load as the amount purchased increases. Finally, Dr. Walsh noted that the "opacity" of fee charges fostered by 12b-1 makes it difficult for shareholders to monitor or act on the conflict that exists between the fund's adviser and its shareholders.[163] In sum, the ICI's attack on Dr. Walsh's analysis and findings was groundless. While it is true that 12b-1 fees are harvested today for purposes not clearly foreseen in 1980, that does not make current practices legitimate or defensible.

155. WALSH, *supra* note 146.

156. Letter from Matthew P. Fink, President, Inv. Co. Inst., to The Honorable William H. Donaldson, Chairman, SEC (May 24, 2004), *available at* http://ici.org/statements/cmltr/04_sec_12b1_com.html.

157. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11,414, 45 Fed. Reg. 73,898 (Oct. 28, 1980).

158. Letter from Matthew P. Fink, *supra* note 156.

159. *Id.*

160. WALSH, *supra* note 146, at 5.

161. *Id.*

162. *Id.*

163. *Id.*

B. Rule 12b-1 Fees Allow Fund Sponsors to Off-Load Entrepreneurial Risk

Tied into the conflict of interest problem that 12b-1 payouts create is a separate reason for concern over the legitimacy of 12b-1 fees—namely, the annual fee payments collected by the fund sponsor undercut a traditional justification for the substantial advisory fees the fund's sponsors collect for managing the fund. Lush profit margins[164] enjoyed by the industry's investment advisers[165] historically have been justified in part because they are needed to compensate the adviser for the "entrepreneurial risk" incurred in launching the fund[166] and nurturing it through its youth.[167] The concept is that the adviser deserves compensation for risk of failure shouldered in the fund's early days, before it was large enough to sustain the standard operating costs.[168] This justification melts away in the face of the permission Rule 12b-1 gives fund managers to off-load cost and risk on fund shareholders' backs.

That 12b-1 fees call into question sponsors' right to payment for shouldering entrepreneurial risk was foreseen even before the rule was adopted. One of the comment letters received by the SEC in opposition to adoption of Rule 12b-1 came from Dreyfus Corporation Chairman Howard Stein, who predicted adoption would "result in waste and an unnecessary expenditure of fund assets."[169] According to Stein, "distribution is the function of the manager since it is the only one who has a direct economic interest in seeing the money is spent wisely. . . ."[170] A prime failing in the proposed rule, in Stein's view, "is the removal of the elements of risk and commensurate reward. . . ."[171] Stein was half right. The element of risk in financing distribution was moved from the adviser

164. *See* John Waggoner & Sandra Block, *High Fund Performance at Low Cost*, USA TODAY, Mar. 26, 1999, at 3B (quoting John Bogle). Bogle estimated that out of the total gross revenue for fund sponsors, less than 10%—"[m]aybe $5 billion"—actually goes to paying for management of the funds. *Id.* In Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962, 988 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987), the court approved as reasonable an adviser's pre-tax profit margin that had escalated from 57% for the first nine months of 1979, to 59.1% for the entire year, to 66.8% for 1980, and to 77.3% for 1981. *See id.* at 968, 977-79. *See also supra* note 18.

165. *See* JOHN C. BOGLE, COMMON SENSE ON MUTUAL FUNDS: NEW PERSPECTIVES FOR THE INTELLIGENT INVESTOR 368 (1999) ("[T]here are staggering economies of scale in portfolio management and research."); Kathryn M. Welling, *Vanguard's Bogle on a Crusade*, TRADERS MAGAZINE, Aug. 1, 2003 (quoting Bogle for the proposition that: "[d]espite the truly staggering economies of scale in mutual fund management, fund investors have not only not shared in these economies. They have been victims of far higher costs."). *See also infra* note 444 and accompanying text (the fund industry is "enormously profitable").

166. *See* Krinsk v. Fund Asset Mgmt, Inc., 715 F. Supp. 472, 481 (S.D.N.Y. 1988) (listing the adviser's entrepreneurial risk as a factor weighed by the fund's board in setting the advisory fee); *Schuyt*, 663 F. Supp. at 968 n.18 (advice of counsel to the board listed "entrepreneurial risk" as a factor the directors were entitled to consider in setting the advisory fee).

167. For a discussion of the concept of entrepreneurial risk and ways of reaping its rewards in the fund industry, see David E. Riggs & Charles C.S. Park, *Mutual Funds: A Banker's Primer*, 112 BANKING L.J. 757, 766 (1995); James K. Sterrett II, *Reward for Mutual Fund Sponsor Entrepreneurial Risk*, 58 CORNELL L. REV. 195 (1973).

168. A recent study by the General Accounting Office suggested the adviser's break-even point for fund asset accumulation is around $100 million. GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 60 (2000).

169. Letter from Howard Stein, Chairman, Dreyfus Corp., to George A. Fitzsimmons, Sec'y, SEC (undated) (on file with author).

170. *Id.*

171. *Id.*

to the fund shareholders. Lavish rewards continue to be reaped by sponsors through escalating fee payments.

Because 12b-1 enables fund managers to lower their risk exposure, an expected consequence of 12b-1 assessments would be a decrease in management fee profitability levels. No such decrease has been observed. As discussed above, both the SEC staff and its staff economist Dr. Lori Walsh have searched in vain for evidence that growth financed via 12b-1 fees has yielded net economic benefits for fund shareholders stuck with the bill. To date, nobody else has found that 12b-1 payments are a cost-effective means of financing fund asset growth. On the contrary, evidence suggests that instead of decreasing expense levels, 12b-1 has given fund sponsors a pay hike by allowing them to saddle fund shareholders with administrative costs formerly borne by the adviser.[172]

The NASD allows an annual assessment of 0.25% for 12b-1 payments for "shareholder services."[173] According to the ICI, these payments account for 52% of 12b-1 fees assessed.[174] In 1980, total fund assets were $135 billion.[175] In 1980, according to Morningstar, the average equity fund expense ratio was 1.07% of assets.[176] Using this expense ratio figure as a standard would suggest that *total* annual expenses for all mutual funds in 1980 aggregated around $1.44 billion. Hence, it seems that fund shareholders today, purely through shareholder service fees constituting a fraction of their annual 12b-1 payments, are paying *three times more* than the estimated total cost of running the entire mutual fund industry when 12b-1 was promulgated in 1980.

A shareholder service fee of 25 basis points may seem miniscule—"no big deal"—but it actually represents a huge cost allocation. According to one academic study, the weighted average expense ratio for the mutual fund industry's domestic equity index funds was 25 basis points, that is, 0.25%.[177] This is a telling figure, for it represents the true cost, on a weighted average basis, of running a mutual fund. Index funds, after all, actually are mutual funds. Index funds are unmanaged mutual funds and hence lack advisory fees, but that is all they lack. They have shares, daily pricing, boards of directors, SEC regulatory requirements, prospectuses, 800 numbers, shareholder reports, etc. Fund sponsors set them up to make a profit for themselves, so profit to the sponsor is

172. Stanley J. Friedman, *Management Fees*, *in* CURRENT REGULATION OF MONEY MARKET FUNDS INCLUDING RULE 2a-7, 353 (PLI Course Handbook Series 762 PLI/Corp 1991) (noting that rule 12b-1 yields fund advisers an "indirect benefit [that] can be substantial since a Rule 12b-1 plan will *normally* relieve the adviser of expenditures it might make (if they are in fact made at all) from its own pocket") (emphasis added).

173. INV. CO. INST., HOW MUTUAL FUNDS USE 12B-1 FEES 2 (2005).

174. *See id.* at 3-4.

175. John Waggoner, *Greed is Good?*, USA TODAY, Dec. 31, 2003, at 1B.

176. Mark Davis, *Mutual Funds Grab Cash from Investors with Barrage of Fees*, HOUSTON CHRON., Feb. 16, 2004, Business Section, at 4. Some weighted average expense data is available for the time in question. It shows that in the period 1980-84, the weighted average expense ratio for no-load equity funds was 0.80%, and for equity load funds it was 0.72%. For the period 2000-04, the weighted average no-load equity fund expense ratio had dropped to 0.67%, but the ratio for load equity funds, principally driven by 12b-1 fees, had ballooned to 1.17%. Todd Houge & Jay Wellman, *The Use and Abuse of Mutual Fund Expenses*, 70 J. BUS. ETHICS 23, 28 tbl.I (2007).

177. KARCESKI ET AL., *supra* note 58, at 16 tbls.2 & 7. *See* Houge & Wellman, *supra* note 176, at 28 tbl.I (showing the weighted average annual expense ratio for no-load equity index mutual funds during 1995-2005 to be a mere 0.19%, thereby confirming that a mutual fund can be organized and run on a total expense budget of less than 0.25 basis points per year).

included, too, in the all-in cost of 25 basis points. Thus, in the form of the seemingly humble 25 basis point "shareholder service" fee, 12b-1 has given fund sponsors supplemental funding that equals, on a weighted average basis, the true cost of doing business, save outlays for investment advisory services.

C. Rule 12b-1 Fees Do Not Beneficially Affect Fund Portfolio Turnover

Another argument that has been advanced in support of Rule 12b-1 is that increased sales can lead to savings by allowing fund managers to avoid liquidating positions to raise cash for redemptions, thereby making the funds more efficient to manage and profitable for investors.[178] In her study, Dr. Walsh found that 12b-1 fees are associated with increased, not stabilized, flow volatility, and lower gross returns.[179] As for providing a mechanism protecting against net redemptions, Dr. Walsh concluded "[t]here is little evidence that 12b-1 plans lessen net redemptions."[180]

The claim that increased sales decrease costs by decreasing portfolio turnover was debunked in a 1991 study concluding "there are no significant differences between the liquidity or turnover" for funds that adopt 12b-1 plans compared to "an otherwise comparable fund without a plan."[181] A more recent investigation of fund expenses shows that high portfolio turnover is associated with higher, not lower, expense ratios.[182] This study involved analyzing the relationship between portfolio turnover and operating expenses for actively managed[183] domestic equity funds. Another study in 1990 concluded that net returns (returns minus the expense ratio and portfolio transactions costs) were lower for 12b-1 funds than non-12b-1 funds.[184] More recently, an SEC study found that increases in portfolio turnover rates are associated with higher expense ratios, with high expense ratios being a feature common to funds bearing 12b-1 fees.[185] This suggests a willingness on the part of fund sponsors competing for broker-dealers to engage in excessive portfolio trading to generate extra money in order to reward favored (i.e., share-selling) broker-dealers.

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178. "Maintaining continuous sales in sufficient amounts to offset redemptions benefits all shareholders by providing the stability needed for effective portfolio management. It is difficult to manage the portfolio of a fund that is experiencing net redemptions." Comments of the Investment Company Institute on Amendments to Rule 12b-1 Proposed by Investment Company Act Release No. 16,431, at 14 (Sept. 19, 1988), *reprinted in* Podesta, *supra* note 66, at 244-45. This is nonsense. For one thing, the cost of "liquidating portfolio securities would normally be trivial relative to the amount of the 12b-1 fee. In any event, they would certainly be of no greater magnitude that the costs of purchasing portfolio securities if the 12b-1 fee succeeds in bringing additional assets into the fund." BOGLE, *supra* note 165, at 199-200. If the argument is that the portfolio distribution is perfect leaving no weak stocks to be sold off to raise cash, the argument again fails, since the portfolio holdings can be reduced proportionately.

179. WALSH, *supra* note 146, at 17.

180. *Id.*

181. Derwood J. Haskell et al., *The Impact on Shareholders of Mutual Fund Distribution Expenses*, 11 J. L. & COM. 15, 29 (1991).

182. Xiaohui Gao et al., *The Sources of Economies of Scale for Domestic Equity Mutual Fund Fees* 19 (April 2005)(copy on file with *Journal of Corporation Law*) (stating that higher turnover is associated with higher total expense ratios).

183. In other words, not index funds.

184. TRZCINKA & ZWEIG, *supra* note 85.

185. REPORT ON MUTUAL FUND FEES, *supra* note 47.

In sum, academic and government studies agree that 12b-1 fees do not hold down portfolio turnover or trading costs. Instead, the data suggest that fund managers who use 12b-1 to pay for distribution costs tend to run up costs to generate added money to pay for distribution.[186] That high brokerage commissions, turnover ratios, and expense ratios coexist in the load fund segment of the fund industry suggests that the fund industry's mangers operating there, whether advisory firms or distributors, have no trouble seizing on multiple opportunities to charge excessive fees to funds they supposedly serve. If this misconduct is occurring, as the evidence suggests, this behavior would be a flagrant breach of fiduciary duty by fund fiduciaries, since the excessive fees and commissions are costs being generated for ulterior purposes and with no commensurate benefit back to the funds getting stuck with the fee bills.[187] Moreover, fund shareholders injured by excessive turnover also stand to pay higher taxes when their adviser's excessive trading generates capital gains that would not otherwise be realized.[188]

D. Rule 12b-1 Does Not Stop Funds From Disappearing.

One of the arguments advanced in favor of fund sponsor's use of fund assets for marketing purposes is that boosting sales is good for shareholders because it protects against a fund being redeemed out of existence.[189] This argument holds no water. Mutual funds do not deserve immortality. Like other business entities, mutual funds go out of business all the time; there is absolutely nothing wrong with a fund ceasing to exist. In Darwinian terms, only the "fittest" funds, in the sense of the better performers—those providing superior value to their owners—deserve to survive.

In fact, weak performing funds ought to disappear, and usually they do[190] by being merged into healthier funds. In 1979, 195 equity-oriented funds held assets exceeding $100 million; by 2000, despite mounting use of 12b-1 fees by the fund industry, 33 of those funds, one in six, had disappeared.[191] Not surprisingly, the funds that disappeared

186. An increasingly large amount of academic literature tends to point to the same conclusion: funds bearing the highest distribution costs, that is, those most expensive to buy are also the most expensive to own, and hence the worst investments. *See generally* BULLARD & O'NEAL, *supra* note 28; Dukes et al, *supra* note 30; Bergstresser et al., *infra* note 236; Houge & Wellman, *supra* note 176.

187. Suits seeking redress based on excessive, unfair fees are commonly brought under section 36(b) of the Investment Company Act of 1940, 15 U.S.C.A. § 80a-35(b) (West 1997). *See, e.g.*, ING Principal Protection Funds Derivative Litig., 369 F. Supp. 2d 163, 167 (D. Mass. 2005) (asserting a section 36(b) claim); Strigliabotti v. Franklin Res., Inc., No. C 04-00883 SI, 2005 WL 645529, at *3 (N.D. Cal. Mar. 7, 2005) (denying a motion to dismiss where the complaint alleged, inter alia, that "defendants charge plaintiffs much higher fees than other clients for equivalent advisory services . . .").

188. *See* BOGLE, *supra* note 165, at 279 (portraying the "tax issue" created by portfolio turnover as "the black sheep of the mutual fund industry").

189. *See, e.g.*, Freeman, *The Use of Mutual Fund Assets to Pay Marketing Costs*, *supra* note 78, at 555-56 (noting industry concerns over funds being extinguished by net redemptions); Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10,252, 43 Fed. Reg. 23,589 (May 23, 1978) ("Commentators also argued that the use of fund assets to finance distribution activities could lead to increased sales of shares, thereby alleviating the difficulties perceived to result from net redemptions or small asset size . . . .").

190. *See* BOGLE, *supra* note 165, at 128-29 (noting that, depending on the years studied, around 20% of funds disappear over a 15 year time span).

191. DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS 370 (2005) (reporting on a study by Robert Arnott, Andrew Berkin, and Jia Ye).

tended to perform worse than the survivors.[192] More recently, Morningstar reported that between March of 2000 and September of 2002, of the 4074 mutual funds it followed, 414 funds were dissolved and another 556 were merged into other funds.[193] This means that more than 20% of the funds publicly tracked by Morningstar disappeared in less than two years.[194]

Economic analysis of fund growth rates during the 1980s found "no support for the contention that adoption of a distribution plan impacts subsequent asset growth."[195] "[I]n 1988, 12b-1 funds actually experienced much slower growth than non-12b-1 funds."[196] More recently, Dr. Lori Walsh's detailed study found that "12b-1 funds do experience higher annual net inflows than comparable non-12b-1 funds," but that, nevertheless, 12b-1 is not a cost-effective source of marketing payments for shareholders since "it would take decades of sustained growth at typical 12b-1 fund growth rates for a fund to be able to achieve sufficient scale economies to offset 12b-1 fees."[197] Even more recently, academic researchers have found that 12b-1 fees "are a contributing factor to the failure of mutual funds."[198] If this finding is correct, 12b-1 fees are a negative force in terms of fund longevity.

The use of 12b-1 payments to build investor satisfaction is open to doubt. These days, few fund shareholders are anticipated to stick around for decades. Between 1995 and 2000, the average holding period for fund shares dropped from five years to under three.[199] For 2002 the average equity fund holding period was two and one-half years.[200] According to a survey released by the ICI in 2004, 92% of the 12b-1 fees mutual funds collected from investors goes to compensate financial advisers and other intermediaries for assisting shareholders before and after purchasing funds.[201] If the chief use of 12b-1

192. *Id.*

193. John Waggoner, *Mutual Funds Vanishing at Record Rate*, USA TODAY, Sept. 9, 2002, at B1. "About 5% of funds go out of business every year." *Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. (2003) (statement of Gary Gensler, former Under-Secretary of the Treasury).

194. Of slightly more than 30,000 U.S. mutual funds extant since 1961, more than 11,200 are inactive today. *See* Center for Research in Security Practices, Survivor-Bias-Free U.S. Mutual Fund Database, http://crsp.chicagogsb.edu/products/mutual_funds.htm (last visited Apr. 2, 2007).

195. Haskell et al., *supra* note 181, at 30.

196. *Id.* at 29.

197. WALSH, *supra* note 146. A more recent study suggests 12b-1 fees do not result in even slight expense reductions, but rather are associated with higher fund expense ratios even after adjusting for economies of scale. *See* Dukes et al., *supra* note 30.

198. Dukes et al., *supra* note 30, at 236.

199. *See* Mike Clowes, *John Bogle: Turning Over Fund Portfolios At 85% a Year Is Deplorable*, INVESTMENT NEWS, Jan. 11, 1999, at 22 ("The industry's liquidation ratio is 33% to 36% per year. . . . That means the average mutual fund shareholder holds his funds for three years."); Frederick P. Gabriel Jr., *More Funds Charging Exit Fees; Rise in Redemption Charges Sign Companies Are Seeking to Discourage Market Timers*, CRAIN'S CLEVELAND BUSINESS, May 28, 2001, at S7 ("[I]nvestors are growing increasingly less loyal. The average holding period for mutual funds stood at 2.9 years in 2000, down from 5.5 years in 1996, according to a report by Financial Research."). According to one study tracking fund redemptions since 1988, the longest average time span for a mutual fund investor to remain invested in an equity fund was about 3.25 years in 1992. DALBAR, QUANTITATIVE ANALYSIS OF INVESTOR BEHAVIOR 6 (2003).

200. DALBAR, *supra* note 199.

201. *How Mutual Funds Use 12b-1 Fees*, FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Feb. 2005, at 52.

fees is to sell shareholders for the long term and keep them sold, then plummeting fund holding periods show the rule is not working.[202]

Mutual funds, like other companies in the economy, have no special entitlement to grow larger indefinitely.[203] Historical experience counsels that fund assets need not be raided to keep the fund alive. The fund industry pre-dates Rule 12b-1 by many decades. The rule was crucial neither to the industry's formation nor its first half-century of expansion. Logically, the funds most in need of cash to subsidize sales would be the poorest performing, i.e., those hardest to sell, and in a capitalist society, they deserve to fail. A fund that performs poorly, like other poorly run entities in the economy, ought to be shut down.

E. Rule 12b-1 Fees Are Not Essential to "Viable Distribution"

Of all the justifications offered for allowing the use of fund assets to pay marketing costs, the one ringing most true, circa 1978, was the SEC staff's suggestion that a fund marketing system relying on the assessment of high sales loads "is no longer viable because investors are increasingly unwilling to pay a high entrance fee."[204] In other words, in the face of an increasingly sophisticated, price-conscious marketplace, load fund marketers were seeing their customer base eroded by the no-load option. A major SEC objective in adopting 12b-1 was to spur fund sales and stabilize the industry. This goal has been achieved. Rule 12b-1 has provided a marketing boost for fund sponsors.

The SEC staff's original estimate that funds would use the rule to obtain an additional 20 or 25 basis points allocation of fund assets[205] was quickly surpassed, as payments soared[206] with the NASD then capping 12b-1 payments at a maximum of 100 basis points.[207] Use of 12b-1 charges to generate sales by acting as a financing mechanism is the only anticipated consequence of the rule's adoption to actually be realized.[208] But what started as a way to give the industry a relatively minor

202. Pamela Savage Forbat, *Fund Industry Frets About Shorter Holding Period*, REGISTERED REP., Aug. 1, 2000, *available at* http://registeredrep.com/mag/finance_fund_industry_frets/index.html (discussing an increase in redemption rates from 10% "[a] few years ago" to "40%, bringing the average holding period down to about 2.5 years").

203. BOGLE, *supra* note 165, at 200.

204. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10,252, 43 Fed. Reg. 23,589 (May 23, 1978).

205. SEC Historical Society, *supra* note 21, at 91 (remarks of Joel Goldberg) ("[T]he rule really assumed . . . you would have . . . a payment of maybe 20 points, 25 points tops, and it would cover advertising or training of sales personnel or that kind of thing.").

206. *See supra* notes 102-108 and accompanying text.

207. NASD Conduct Rule § 2830(d)(2)(E)(i) bars NASD members from offering or selling mutual fund shares having an "asset based charge" exceeding 0.75 basis points. Service fees exceeding 0.25 basis points are barred under NASD CONDUCT RULE § 2830(d)(5). The NASD manual is available online at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159005052&element_id=115900 0547&highlight=2830%28b%29%289%29#r1159005052.

208. In its release soliciting comments in advance of rule 12b-1 adoption, the SEC expressly recognized the linkage between loads and asset-based distribution subsidies, raising the question "whether a fund's use of assets for distribution expenses should be permitted to supplement revenue from sales loads or be required to replace sales loads partially or entirely." *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10,252, 43 Fed. Reg. 23,589 (May 23, 1978). Rule 12b-1's use as a load-spreading device has been described as the only business reason for adopting 12b-1 plans. *See* Haskell et al., *supra* note

supplemental marketing boost has developed into a full-blown addiction, with serious negative consequences.

No competent, credible data exists proving that Rule 12b-1 offers tangible net (after cost) benefits to the shareholders who pay the bill. The evidence is that 12b-1 fees are nothing but a dead weight cost, and thus a drag on performance.[209] Nonetheless, year after year, directors for thousands of mutual funds[210] go through the motions required by Rule 12b-1(e)[211] and cast votes manifesting their belief that their fund's 12b-1 plan is reasonably likely to benefit both the fund and its shareholders. In these directors' eyes, and in the industry's eyes, the direct use of fund assets to pay distribution costs, a practice banned for the first 40 years following the Investment Company Act's enactment, has become essential if many load funds are to maintain "viable distribution systems."[212] Professed fear of jeopardizing the industry's "viable distribution system" is a standard industry argument in opposition to SEC efforts to address the problems 12b-1 has created.[213]

Thus, speaking for fund sponsors, not fund shareholders, the ICI has argued to the SEC that 12b-1 fees "have permitted the establishment of viable distribution systems which are essential to the continued existence of open-end funds and their shareholders."[214] The industry's implicit message to the SEC is that 12b-1 fees are a crucial means of funding fund distribution without which the fund industry will suffer

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181, at 15:

> [Rule 12b-1] plans offer the benefit of spreading sales costs over time, and hence increase a fund's attractiveness to a broader range of investors. This method of paying distribution charges over time, however, is the sole rationale available to mutual fund directors who, in the exercise of fiduciary duty and reasonable business judgment, must conclude that the plans benefit the fund. Previous business reasons for adopting 12b-1 plans, such as the plans are likely to increase fund size and thereby reduce individual expense ratios, are statistically invalid.

Id.

209. *See* WALSH, *supra* note 146.

210. "At the end of 1999, 56% of the 15,264 share classes of all mutual funds had 12b-1 plans, and 40% of the $6.8 billion of assets in all mutual funds were in share classes with 12b-1 plans." *Use of Rule 12b-1 Fees by Mutual Funds in 1999*, FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Apr. 2000, at 2, *available at* www.ici.org/pdf/fm-v9n1.pdf.

211. 15 U.S.C. § 80a-12b-1 (2000).

212. *E.g.*, Letter from Matthew P. Fink, President, Inv. Co. Inst., to Jonathan G. Katz, Sec'y, SEC (Sept. 9, 1988), *reprinted in* Podesta, *supra* note 66, at 129, 201, 203; Nancy M. Morris, *Investment Company Distribution and Advertising, in* INVESTMENT COMPANIES 9, 14 (1992) (PLI Course Handbook Series 786 PLI/Corp 1992).

213. *See, e.g.*, Morris, *supra* note 212, at 14 (observing that, in response to SEC efforts to tweak 12b-1 in 1988, opponents "argued that the proposal would jeopardize maintenance of viable distribution systems to the detriment of funds and shareholders").

214. Podesta, *supra* note 66. In a follow-up letter, ICI claimed:

> The Commission adopted Rule 12b-1 because it realized that the ability to maintain a viable distribution system is essential to the well-being of a mutual fund and all of its shareholders. . . . The Commission recognized, in adopting Rule 12b-1, that the sale of fund shares can benefit funds and their shareholders in numerous ways--e.g., by providing economies of scale, greater portfolio diversification, and better performance."

Letter from Matthew P. Fink to Jonathan G. Katz, Sec'y, SEC (Sept. 19, 1988), *reprinted in* Podesta, *supra* note 66, at 207, 216. To date, 12b-1 fees have brought about none of the listed benefits.

irreparable injury. Supporting evidence is lacking.

For one thing, the fund industry was "viable" for decades before 12b-1 arrived on the scene.[215] Moreover, even today, prominent fund complexes that do not carry any 12b-1 fees exist and prosper. The Vanguard Group and, for the most part, the T. Rowe Price and Fidelity families of funds do not feature 12b-1 charges[216] and somehow have managed to accumulate between them over one-quarter of the fund industry's equity and bond fund assets.[217] These respected industry giants do not stand alone. Dodge & Cox funds carry no 12b-1 fees. Dodge & Cox's Stock and Balanced Funds zoomed in value from around $10 billion in 2000 to over $75 billion five years later without any boost from 12b-1-financed marketing expenditures.[218] Clearly, marketing success in the fund industry does not necessitate charging 12b-1 fees.

In 1980, the fund industry was relatively weak, with equity funds emerging from a decade in which net redemptions were a frequent problem. Providing a mechanism to boost selling effort arguably made some sense at that time and in those circumstances. Today, things are different. Today, the American public understands what a mutual fund is.[219] It thus becomes questionable whether it makes sense for huge amounts of shareholder money to help fund sponsors explain the concept of fund ownership to non-shareholders, or to keep existing shareholders sold on the funds they already own. Indeed, if "service after the sale" is a primary reason for 12b-1 fees, then that justification rings hollow in the face of plummeting share holding periods.[220]

215. Indeed, it has been argued that it is a "myth" that Rule 12b-1 was adopted because the fund industry was in dire straights:

> [T]he first myth is that Rule 12b-1 allows funds to pay for distribution. The second myth is that it was in response to the net redemptions that were prevalent in the industry, and that there was sort of a desperation attached to it. In fact, by the time the rule was adopted in 1980, the money funds had brought the industry back to unprecedented prosperity, and there were even increasing sales of equity funds.

SEC Historical Society, *supra* note 21, at 87-88 (remarks of Joel Goldberg).

216. Both T. Rowe Price and Fidelity offer some fund classes designed to be sold through financial intermediaries that carry 12b-1 fees.

217. Paul J. Lim, *Two Giants Square Off*, U.S. NEWS & WORLD REP., Apr. 25, 2004, *available at* http://www.usnews.com/usnews/biztech/articles/040503/3invest.htm.

218. On its web site, Dodge & Cox equates the non-assessment of 12b-1 fees with superior shareholder service:

> Dodge & Cox's strategy has always been to focus on servicing our current clients well, and to achieve a steady, controlled growth of assets under management and client relationships. Therefore, we have not advertised, employed sales people, or paid 12b-1 fees to brokers for distribution as a way of increasing the Funds' asset base.

Dodge & Cox Funds, Equity Asset Growth at Doge & Cox, http://www.dodgeandcox.com/about/equity_asset_growth.html (last visited Apr. 2, 2007).

219. According to the ICI's president, "[b]y 2005, 90% of America's equity owners held stock mutual funds." Paul Schott Stevens, Mutual Fund Investing: The Power and Promise of a Simple Idea, Remarks Before the Investment and Financial Services Association's Connect 2006 Meeting (Aug. 2, 2006), *available at* http://www.ici.org/new/06_aust_stevens_remarks.html. *See also* William A. Birdthistle, *Compensating Power: An Analysis of Rents and Reward in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1414 (2006) ("[M]utual funds have thoroughly saturated the investment landscape, insinuating themselves into the entire spectrum of American portfolios.").

220. *See supra* notes 199-202 and accompanying text.

The SEC needs to ponder some pointed questions as it decides whether 12b-1 deserves to survive in a fund industry scene that is radically different from that circa 1980 when the rule was promulgated. If 12b-1 fees make mutual funds viable, then why are numerous funds going out of business every year? What exactly is wrong with weak funds failing? If depleting shareholder wealth through 12b-1 fees is critical to sustaining a "viable distribution system," how does one explain the example of four thriving industry leaders pointing in precisely the opposite direction, namely Vanguard, Fidelity, T. Rowe Price, and Dodge & Cox?

A further problem with the industry's "viability" argument relates to the timing of fee flows. Simply put, when markets are bad and asset values are down, 12b-1 fees, tied to asset size, are in the doldrums, too.[221] In the fund industry, sales of equity funds tend to lag because stock market prices have dropped.[222] It is precisely when the stock market is suffering downturns that asset values are low, with less 12b-1 money being generated in order to subsidize distribution efforts. Conversely, boom times yield bumper crops of 12b-1 revenue precisely when investors are streaming into the market and buying equity funds. Fund marketing financed through 12b-1 assessments is thus prone to throw off the most cash when marketing push is least needed, and the least cash when sales are hardest to come by.[223]

F. Rule 12b-1 Is Not an Acceptable Load Reduction Tool: It Encourages Investor Deception

The ICI claimed that "[t]he substitution of 12b-1 fees for front-end loads contributed significantly to the substantial reduction over the past two decades in the cost of purchasing bond and equity funds."[224] Like virtually all of Rule 12b-1's folklore, however, on close inspection this contention fails. First, the research report cited by the ICI to support the claim fails to provide the needed support.[225] Rather than portraying 12b-1 fees as the cause for declining fund sales charges, the research report said: "The

221. For example, a high yield bond fund may see its asset value and size drop precipitously just as bond funds are most attractive because interest rates are soaring.

222. It was, after all, the industry's net redemption status during the 1970s that spurred SEC interest in Rule 12b-1 in the first place. *See supra* notes 65, 66, 76 and 178 and accompanying text. According to the author's review of Lipper data, the fund industry (exclusive of money market funds) was in net redemptions for only one year from 1985-2000, and that was in 1988, immediately following the large market break in October of 1987. The Lipper data shows that, led by no-load sales, the funds edged back into net sales status the following year, and remained in net sales status through the millennium's end.

223. This same criticism could be leveled at financing distribution activities out of sales loads; for there, too, sales commission income is most easy to come by in times when funds are most easy to sell. Like the 12b-1-financed system, you have a problem when you need sales the most and funds are somewhat out of favor. The difference is that under the commission system, the person actually using the distribution system (the fund buyer) is paying for the cost of the service being used. In contrast, under the 12b-1 approach, the payor is an existing fund shareholder and the net financial benefit to existing fund shareholders from new sales to others is something that has never been proved.

224. *Use of 12b-1 Fees by Mutual Funds in 1999*, FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Apr. 2000, at 1 n.1, *available at* http://www.ici.org/statements/res/fm-v9n1.pdf.

225. The ICI report relied on John D. Rea, Brian K. Reid & Travis Lee, *Mutual Fund Costs, 1980-1998*, PERSPECTIVE (Inv. Co. Inst., Washington, D.C.), Sept. 1999, *available at* http://www.ici.org/statements/res/per05-04.pdf.

decline in distribution cost reflected competition between load and no-load funds. Load funds responded to the competitive challenge of no-load funds by reducing front-end loads."[226] In other words, first and foremost, what has driven price competition for load funds is pressure from no-loads, period.

A second major cause of declining fund load fees relates not to 12b-1 fees and spread loads, but to the changing marketplace for fund shares. Today, sales to individual investors, which can require costly one-on-one sales effort, increasingly take a back seat to retirement plan and institutional purchases. For example, by year-end 2004, mutual funds managed $3.1 trillion through individual retirement accounts and employer-sponsored defined contribution plans.[227] By 2005, that number had grown 10%, to $3.4 trillion.[228] In 2004 and 2005, 64% of the total net new cash inflow to stock, hybrid, and bond mutual funds was invested through retirement accounts.[229] Investors sophisticated enough to use retirement vehicles when making fund investments are likely to be more sophisticated and price-conscious than individuals buying shares with after-tax dollars. "Retirement plan money is viewed as a relatively 'sticky' asset,"[230] meaning it tends to stay invested in the same place,[231] a boon to investment advisers. In fact, sales to retirement plan investors have been a major force in causing fund costs to decline.[232]

Use of 12b-1 fees in tandem with CDSCs was a marketing success, but came with a moral price tag, since charging spread loads involved trading in consumer deception. To begin with, the nomenclature itself is deceptive. There is nothing contingent about the sales charges paid or assessed for Class B shares. Proof that the CDSCs' feature loads are neither "contingent" nor deferred, but merely hidden, comes from the industry's dubious practice of continuing to charge 12b-1 fees for "closed-up" funds, which are mutual funds that cease selling to the public. The following chart is drawn from the January 2003 Morningstar Principia Pro data. The data show 429 mutual fund classes closed to new

226. *Id.* at 8.

227. *Mutual Funds and the U.S. Retirement Market in 2004*, FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Aug. 2005, at 1, *available at* http://ici.org/pdf/fm-v14n4.pdf.

228. *The U.S. Retirement Market: 2005*, RESEARCH FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), July 2006, at 2, *available at* http://ici.org/stats/res/fm-v15n5.pdf.

229. *Appendix: Additional Data on the U.S. Retirement Market*, FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), July 2006, at 1, http://ici.org/stats/res/fm-v15n5_appendix.pdf

230. Kathleen Pender, *401(k) Plans Face Scrutiny*, S.F. CHRON., Oct. 23, 2003, at B1 (quoting John Coughlan of the Litman/Gregory fund group).

231. *See, e.g.*, Frederick P. Gabriel, Jr., *"Conscience" Funds Woo Pension Plans*, INV. NEWS, Sept. 11, 2000, at 16 ("Retirement assets tend to be sticky—that is, people make their allocations and sit back and watch it grow.") (quoting John Shield, President and Chief Executive of Citizens Advisers Inc. in Portsmouth, N.H.).

232. *Total Shareholder Cost of Mutual Funds: An Update*, FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Sept. 2002, at 4-5, *available at* http://www.ici.org/stats/res/fm-v11n4.pdf. The industry's lobbying organization reports:

> By 2001, the cost of distributing equity load funds had fallen to 90 basis points . . ., a decline of 23 basis points from 1998. During this period, an increased proportion of load fund sales resulted from large purchases—such as those through 401(k) plans, wrap plans, and rollovers of 401(k) balances into IRA accounts—where loads were reduced or waived. From 1998 to 2001, the average maximum sales load charged by mutual funds was essentially unchanged. . . . Nonetheless, owing to the relatively high proportion of sales on which loads were reduced or waived [i.e., retirement plan sales], the average of actual loads paid by investors on new sales of front-load mutual funds declined.

investors. Of these, 235 with total assets in excess of $39 billion continued to charge 12b-1 fees. The table below shows the 15 largest closed funds that were charging such fees.

TABLE 3

Fund Name	**Expense Ratio**	**Front Load**	**Deferred Load**	**12b-1 Current**	**Net Assets**	**Fund Inception Date**
Berger Sm Cap Val Inv	1.08	0	0	0.25	1,597	1997-02
Franklin Bal Sh Invmt A	0.96	5.75	0	0.25	2,415	1990-04
Franklin Sm Cap Gr II A	1.21	5.75	0	0.35	818	2000-05
ING International Value A	1.67	5.75	0	0.3	1,330	1995-03
INVESCO Dynamics Inv	1.21	0	0	0.25	3,870	1967-09
INVESCO Financial Svc Inv	1.27	0	0	0.25	821	1986-06
INVESCO Health Sci Inv	1.31	0	0	0.25	965	1984-01
INVESCO Technology Inv	1.37	0	0	0.25	1,086	1984-01
INVESCO Total Return Inv	0.96	0	0	0.25	827	1987-09
Merrill Bond Hi-Inc B	1.37	0	4	0.75	840	1988-10
MFS New Discovery A	1.58	5.75	0	0.35	793	1997-01
PIMCO PEA Renaissance C	2	0	1	1	972	1988-04
Putnam High Yield B	1.74	0	5	1	781	1993-03
RS Emerging Growth	1.37	0	0	0.25	1,310	1987-11
State St Res Aurora A	1.48	5.75	0	0.3	1,585	1995-02
Averages	1.37			0.40	1,334	
Asset Weighted Average				0.35		

We have seen that a standard claim used to justify 12b-1 assessments was that fund sales would benefit existing shareholders by spurring growth through sales and the resultant economies of scale. Obviously, this supposed benefit cannot be available when the fund is closed to new investors, since it is no longer available for new shareholders to buy. Because 12b-1 payments in closed-up funds cannot, by definition, go to pay for generating new sales, the logical justifications for the charges are limited. Aside from the need to amortize advanced B share commissions, a factor in a distinct minority of cases,[233] the most likely justification for the 12b-1 charges in closed-up funds is that some valuable services are being provided to the funds' shareholders who are paying the tab. However, no studies show that investors paying 12b-1 fees in closed-up funds are receiving, on an ongoing basis, services of a quality or quantity superior to those received by either investors in mutual funds with no 12b-1 shares, or closed-end funds that neither constantly offer shares to new investors, nor feature 12b-1 charges.

Anyone who wants to argue that using 12b-1 payments to finance post-sale services leads to happier shareholders has an uphill battle. More than $2 trillion in fund assets are held in money market mutual funds that function as checking accounts for their fund shareholders.[234] Though a significant share of 12b-1 payments take the form of "trail commissions, which are continuing payments made to broker-dealers to encourage them to service shareholders,"[235] just what kind of service money market checking account holders need is not obvious. Seemingly little "post-sale service" would be required for this substantial block of fund shareholders who, on an asset-weighted basis, pay an average of 13.5 basis points in 12b-1 fees yearly.[236] Whatever the level of service, it certainly is lavishly compensated. It is a mystery how money market fund directors can find that draining $2 billion annually from investors' accounts amounts to conferring a benefit on those investors.[237]

Another credibility problem with using 12b-1 fees to compensate for post-sale service is that, as has been noted, the average length of time fund shareholders hold their shares has been dropping, as 12b-1 payments have been soaring.[238] This reality shows that, despite a torrent of 12b-1 money paid for service fees, fund shareholders are increasingly less committed to holding the funds they were induced to buy, a phenomenon that refutes an industry justification for using 12b-1 fees to fund "trail commissions" to brokers.[239] The trail commission money is paid for post-sale tasks performed by the broker in the form of personal services rendered to shareholders and/or maintenance of fund accounts. Increasing rates of investor turnover suggest that such post-sale 12b-1 payments are not leading to greater investor satisfaction. More likely,

233. Note that this justification is applicable to only three of the 15 closed funds listed on the foregoing table.

234. As of January 2007, money market funds held more than $2.379 trillion in assets. *Retail Money Funds Rise in Latest Week*, ASSOCIATED PRESS (Jan. 19, 2007), *available at* Westlaw (search for title in AP news database).

235. Haskell et al., *supra* note 181, at 20.

236. Daniel Bergstresser et al., *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* tbl. 5 (AFA 2006 Boston Meetings, Harvard Bus. Sch., Working Paper No. 616981, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=616981.

237. The math is simple: The asset base exceeds $2 trillion. *See supra* note 234 and accompanying text. The weighted average 12b-1 payment is 13.5 bps for money market shareholders. *See supra* text accompanying note 236.

238. *See supra* notes 199-202 and accompanying text.

239. For a discussion of how 12b-1 relates to trail commissions and service fees, see David A. Shevlin, *Donor-Advised Funds: The Applicability of Rule 12b-1 Fees and Trail Commissions*, *in* Victoria B. Bjorklund, *Choosing Among the Private Foundation, Supporting Organization and Donor-Advised Fund*, *in* CHARITABLE GIVING TECHNIQUES 73, 144 (ALI-ABA 2001).

increased expenses erode net investment returns, leading to increased investor dissatisfaction and increased redemptions.

It is true that 12b-1 does function as a load-financing mechanism, but this is not the same thing as saying it is a low-cost financing mechanism, which it is not. This is particularly true in the use of 12b-1 fees to finance fund sales charges for Class B share offerings, an investment alternative that is nearly always the most expensive (and hence, worst) choice for fund investors faced with a multi-class investment option consisting of Class A, B, or C shares.[240] Rather than driving down costs, Rule 12b-1-financed Class B shares actually operate in the opposite direction, furnishing a marketing tool wielded to mislead unsophisticated investors into believing that they can escape paying a sales charge by buying Class B shares. To a large extent, Rule 12b-1 spread loads have been successful in attracting investors by tricking them. Morningstar's Managing Director, Don Phillips, offers this telling anecdote:

> What I think is right with the negative opinion about 12b-1 fees is this hugely complicated selection process of a mutual fund. And it allowed the fund industry to create or to carry out something that frankly was unfair. The notion that "B" shares were no-load funds. I've talked to thousands of investors literally who came to me and said, "I bought a no-load fund." And then you ask them what they bought, and they bought the "B" shares of a load fund organization. They thought they were getting something for free.[241]

We thus see that a government-engineered marketing advance has enabled what is clearly the high-cost segment of the fund industry, the load funds, to compete effectively and unfairly against the low-cost no-load segment of the market. With the aid of a big helping hand from the SEC, the load fund segment has become adept at exploiting the unsophisticated segment of the fund investor universe.[242] The problem starts with the simple fact that most investors do not know that 12b-1 fees are a drain on fund assets.[243] Investors are apt to stumble into CDSC purchases by assuming that they are in essence getting a form of no-load fund since the sales charge is hidden from view.[244] These

240. See *supra* notes 135-137 and accompanying text.

241. Mercer Bullard, *The Mutual Fund Summit Transcript*, 73 MISS. L.J. 1153, 1187 (2004) (remarks of Don Phillips, Managing Director of Morningstar, Inc.) (panelist answer to question at Mutual Fund Summit). For a lawsuit that attempted to make the argument that Class B shares are improperly deceptive, see Behlen v. Merrill Lynch, 311 F.3d 1087 (11th Cir. 2002), a class action contending plaintiffs were misled when they were "sold the Class B shares . . . *because* those shares were subject to the excess fees and commissions." *Id.* at 1094.

242. *See* Houge & Wellman, *supra* note 176. "Market segmentation to provide different levels of customer service can be beneficial to investors. Market segmentation to extract higher fees from less-knowledgeable investors raises ethical concerns." *Id.* at 31. Promoting the exploitation of less knowledgeable investors raises public policy concerns, too, not to mention concerns over how fund boards are able to find that 12b-1-fostered fee gouging yields a likelihood of benefits accruing to fund shareholders.

243. *See* Walter Updegrave, *Fund Investors Need to Go Back to School*, MONEY, Feb. 1996, at 98, 100 (noting that of approximately 1400 investors surveyed by *Money* magazine and The Vanguard Funds Group, only 22% knew that Rule 12b-1 fees are charged against fund assets to pay for distribution of fund shares).

244. The SEC itself noted in Investment Company Act Release No. 16,431, 53 Fed. Reg. 23,258 (June 13, 1988) that it had received "hundreds of letters that have been received from individual fund investors who characterize 12b-1 fees and deferred sales loads as 'hidden loads'. Many of these investors claim to have been misled by sales literature or salesmen into thinking that a particular fund did not charge for distribution." The SEC was not alone in seeing the no-load deception problem. *See, e.g.*, Jerry Edgerton, *When a Load Becomes a*

trusting, unsophisticated investors are being tricked into believing that by leaving their funds invested for at least five or six years, they can escape a sales load. These investors are being played for suckers: "For funds with back-end loads [i.e., CDSCs], distribution fees [i.e., selling charges] are 51 percent of total expenses."[245]

There is nothing "contingent" about the SC part of CDSCs. The load is *not* contingent any more than death and taxes are. The load is being paid one way or the other, whether the investor withdraws early, late or never. A second problem with using 12b-1 fees to finance CDSCs is that CDSC financing has next to nothing to do with the factors directors are encouraged to weigh in deciding whether to adopt or continue 12b-1 plans.[246]

Investors' comprehension problems have become more acute as funds' capital structures have become more diverse and intricate. In general, for large purchases, say over $50,000, Class A shares are the most cost-effective investments, with Class C shares being best for smaller investments assuming a holding period not exceeding eight years.[247] For load fund investors having holding periods of greater than eight years, Class A and Class B funds tend to be better.[248] However, today fund shareholders, on average, tend to redeem their shares within three years of purchase.[249] According to one authority, "[i]n the vast majority of cases, the B shares are never the most advantageous of the share classes."[250]

Burden, MONEY, July 1985, at 135; John W. Hazard, *Spotting Hidden Costs in Mutual Funds*, U.S. NEWS & WORLD REP., Aug. 5, 1985, at 68; Deborah Rankin, *Loading the No-Load Mutual Funds*, N.Y. TIMES, Jan. 8, 1984, at 11; *Loads of Complexity*, FIN. PLAN., May 1985, at 118; Karen Slater, *Critics Say Brokerage Firms Hide Fees on Their New 'No-Load' Mutual Funds*, WALL ST. J., Aug. 8, 1985, at 25; *Through the Back Door*, ST. PETERSBURG TIMES, Oct. 13, 1986, at 4E; Laura R. Walbert, *Backdoor Loads: Many Mutual Funds that Like to Be Called "No-Loads" Still Soak You for Sales Commission. How Do They Get Away With It?*, FORBES, Apr. 8, 1985, at 168; Laura R. Walbert, *Careful, It's Loaded*, FORBES, Sept. 16, 1985, at 82; *12b-1 Plans: A Revealing Look at Hidden Costs*, BARRON'S, Aug. 12, 1985, at 46.

245. DAVID A. LATZKO, MUTUAL FUND EXPENSES: AN ECONOMETRIC INVESTIGATION 21 (2002), *available at* http://www.personal.psu.edu/~dxl31/research/presentations/bsi.pdf.

246. Goldberg & Bressler, *supra* note 103, at 150-51.

247. *Id.*; *see also* Karen Hube, *Choosing the Right Class of Shares Can Add Up to Savings on Fees*, WALL ST. J., April 6, 1998, at R18, *available at* 1998 WLNR 2159186.

248. *See* Hube, *supra* note 247, at R33 tbl.2; *see also* Miles Livingston & Edward O'Neal, *The Cost of Mutual Fund Sales Fees*, 21 J. FIN. RES. 205 (1998).

249. *See* Mike Clowes, *John Bogle: "Turning Over Fund Portfolios at 85% a Year is Deplorable,"* INV. NEWS, Jan. 11, 1999, at 22 ("The industry's liquidation ratio is 33% to 36% per year. . . . That means the average mutual fund shareholder holds his funds for three years."); Frederick P. Gabriel Jr., *More Funds Charging Exit Fees; Rise in Redemption Charges Sign Companies Are Seeking to Discourage Market Timers*, CRAIN'S CLEVELAND BUS., May 28, 2001, at S7 ("[I]nvestors are growing increasingly less loyal. The average holding period for mutual funds stood at 2.9 years in 2000, down from 5.5 years in 1996, according to a report by Financial Research."); Brian R. O'Toole & Richard E. Steiny, *Behavioral Finance 101: Understanding the Psychological Side of Money Can Help You and Your Clients Make the Right Investing Decisions*, FIN. PLAN., May 1, 2005 (explaining that "the average holding period for mutual funds is a mere 2.9 years").

250. Jonathan Clements, *Why B Shares Deserve to Get an "F": These Broker-Sold Funds Are a Bad Deal*, WALL ST. J., July 2, 2003, at D1 (quoting Professor Edward O'Neal).

> Are there any cases where B shares would outperform? Prof. O'Neal offers one possible scenario: If you're investing a very modest amount for the long term and you buy B shares, you will outperform C shares and your results should rival those on A shares.
>
> "But if you have an investor who can hit that first breakpoint [on the A shares], then A shares are

Given that Class B shares are almost never the most cost-efficient investments from the investor's perspective, it is fair to ask why they are so popular with fund retailers. According to one industry observer, two reasons stand out:

> So why do B shares exist? My contention: They are designed to be sold, offering unethical brokers two great advantages.
>
> First, in flogging B shares, brokers can pitch the funds as being "no-load" or having "no initial sales commission." To be sure, C shares can also be sold as "no-load." But for unscrupulous brokers, B shares are far more attractive. Which brings us to the second advantage.
>
> With C shares, brokers receive a moderate amount of commission every year. But with B shares, they get paid a hefty initial commission, just like they would with A shares. In fact, on big fund purchases brokers can earn more from B shares than A shares.[251]

In May of 1998, SEC Chairman Arthur Levitt spotlighted the multi-share class deception problem in an address to industry executives:

> Where are the pioneers among you who are willing to stand apart from the rest? Consider expenses. Do you really expect investors to understand the alphabet soup of A, B, C, D, I, Y, and Z shares? To figure out what combination of front-end loads, CDSLs, 12b-1 charges, commissions, and who knows what else they're paying?
>
> You've got to do a better job of making sure that those who sell funds also explain the costs of investing. I'm disturbed at the number of investors who don't understand the impact of fees and expenses.[252]

Chairman Levitt is not the only one concerned about fund shareholders' inability to

almost always better," he says.

Id.

251. *Id.*

252. Arthur Levitt, Chairman, SEC, Remarks at the Investment Company Institute (May 15, 1998), *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch212.txt. *See also* Timothy Middleton, *Mutual Funds; Abecedarians, Take Note: Classes Multiply*, N.Y. TIMES, Nov. 24, 1996, § 3, at 8 ("Fund companies have shown great ingenuity in creating share classes that, while legal, may leave buyers baffled."). Today, one fund company, MFS, features no less than 15 share classes for many of its various funds. For example, MFS Emerging Growth Fund, has the following share classes: A, A LW, B, C, EA, EA LW, EB, EC, I, R, R1, R2, R3, R4, and R5. Chairman Levitt's successor, Harvey Pitt, identified "[m]aking financial information comprehensible to the average investor" as a key need if the public is to profit from the opportunities that abound in the marketplace. *Testimony Concerning Financial Literacy Before the S. Comm. on Banking, Housing and Urban Affairs*, 107th Cong. (2002) (statement by Harvey L. Pitt, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/020502tshlp.htm. As is discussed below, lax government regulation has exacerbated investor ignorance in the mutual fund industry. *See infra* notes 257-260 and accompanying text. On the other hand, the fund industry claims that one of the glories of 12b-1 is that investors' pre-12b-1 choice between load and no-load funds has produced "a wide range of choices ranging from traditional load or no-load funds to 'every gradation' in between." Comments of the Investment Company Institute on Amendments to Rule 12b-1 Proposed by Investment Company Act Release No. 16,431, at 10 (Sept. 19, 1988), *reprinted in* Podesta, *supra* note 66, at 240. The choices may be many, but they also are bewildering.

understand the products they buy and own. Though 12b-1 fees are huge in total and ubiquitous in their imposition, investor ignorance in the fund industry is so pervasive that it has been suggested that 12b-1 costs are expenses that "most [fund] investors may not even know they are paying."[253] Investors' inability to understand cost issues enhances fund sponsors' ability to exploit consumer ignorance.

Rule 12b-1 fees are cost items, and sophistication is needed if costs are to be minimized. That sophistication is lacking. According to the SEC's chief economist, "investors do not appear to be particularly price sensitive shoppers. . . . I would not characterize the investing public as being cost conscious."[254] A joint survey by the Office of the Comptroller of the Currency and the SEC reported that fewer than one American in five knows how much his or her funds charge,[255] and, worse, that fewer than one in six investors believed that higher expenses led to lower average returns.[256] Rule 12b-1 thus has developed into a handy tool enabling load fund sponsors to exploit consumer ignorance. As discussed in the following section, the SEC's efforts to cope with the problems its rule has unleashed have been almost nonexistent.

VII. HALF-HEARTED SEC REGULATION HAS HURT INVESTORS

A respected money manager recently condemned the SEC's approval of 12b-1 fees in strong, unequivocal terms steeped in frustration and disappointment:

> In 1980, the Securities and Exchange Commission caused considerable damage to mutual-fund shareholder interests by permitting mutual funds to pay for marketing and distribution expenses directly from fund assets. . . .
>
> Ironically, a December 2000 SEC study on mutual-fund fees and expenses concluded that 12b-1 fees essentially represented a net transfer from the fund shareholders to the fund management company. . . . In other words, mutual-fund advisers who charge 12b-1 fees take nearly the entire 12b-1 fee to the bank.
>
> The SEC continues to allow 12b-1 fees, even while explicitly recognizing the "inherent conflict of interest between the fund and its investment adviser.". . . Without the blessing of the SEC, fund directors could scarcely approve

253. Luchetti, *supra* note 60; *see also* Updegrave, *supra* note 243, at 100 (suggesting most fund investors do not know that 12b-1 fees are levied against fund assets to pay for distribution of fund shares).

254. Letter from Erik R. Sirri, Chief Economist, SEC, to John C. Bogle, Chairman, The Vanguard Group (March 23, 1999).

255. GORDON J. ALEXANDER ET AL., MUTUAL FUND SHAREHOLDERS: CHARACTERISTICS, INVESTMENT KNOWLEDGE, AND SOURCES OF INFORMATION 51 (1996), *available at* 1996 WL 10828970; *see also* Barry P. Barbash, Director, Div. of Inv. Mgmt., SEC, Mutual Fund Consolidation and Globalization: Challenges for the Future, Remarks at the Mutual Funds and Investment Management Conference, *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch208.htm.

256. ALEXANDER ET AL., *supra* note 255. For similar survey results reflecting investor naiveté, see Ellen E. Schultz, *Blizzard of Retirement-Plan Offerings Eases Drought in Mutual-Fund Choices*, WALL ST. J., Dec. 21, 1995, at C1 (reporting on a survey of retirement-plan participants reflecting that more than a third of respondents believed it was impossible to lose money in a bond fund, while an additional 10% were unsure; 12% of the respondents also believed it was impossible to lose money in a stock fund or answered that they were unsure).

something as damaging to investors as 12b-1 fees. . . .

> Shame on the SEC for allowing 12b-1 fees, shame on the directors for approving them, and shame on the mutual funds for assessing them.[257]

Recognizing that 12b-1 reflects a failed policy judgment is one thing, cleaning up the financial waste and legal mess it continues to generate is something else again. It turns out that turning off a spigot pumping nearly $12 billion annually into Wall Street's coffers is a task for which there is no constituency, even at the agency proud to bill itself as "[t]he investor's advocate."

A. The Failed "Clean Up" Effort—Rule 12b-1 Is "Untouchable"

In late 2002, the SEC Historical Society sponsored a roundtable discussion of notable Investment Company Act historical events, including 12b-1's birth and maturity.[258] In the course of those proceedings SEC Investment Management Division Director Kathryn McGrath referenced as "her biggest failure" her largely ineffectual efforts to "tackle and clean up 12b-1," in the 1980s.[259] The reason given for the failure is deeply disturbing, for it had nothing to do with legalities, public policy, or investor protection. It centered on political clout. McGrath lamented, "There was too much money flowing through 12b-1 fees to make it touchable."[260] This is a telling and deeply disturbing admission from someone who sought to reform a glaring problem while serving as a high SEC official. The money flowing to Wall Street through 12b-1 in the 1980s is a pittance compared to the nearly $12 billion generated annually by the rule today.[261] If 12b-1 was "untouchable" in the 1980s, one cannot be optimistic about reform today. All signs are that Rule 12b-1 has become politically sacrosanct. In Rule 12b-1 we have an "untouchable" rogue rule drafted and sponsored by the SEC, the so-called

257. DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS 228-29 (2005) (internal citations omitted).

258. SEC Historical Society, *supra* note 21.

259. *Id.* at 108. The SEC staff's 1988 "clean up" proposal, Payment of Asset-Based Sales Load, Investment Company Act Release No. 16,431, 53 Fed.Reg. 23,258 (June 13, 1988), "[w]as represented to the Commission in public session, . . . [to be] nothing more than a 'mid-course correction' in the development of Rule 12b-1." Comments of the Investment Company Institute on Amendments to Rule 12b-1 Proposed by Investment Company Act Release No. 16,431, at 10 (Sept. 19, 1988), *reprinted in* Podesta, *supra* note 66, at 210. Had the staff's proposed amendments been adopted, they would have curtailed the use of spread load plans. The proposal would have: (1) prohibited compensation plans, paying a specific amount to a fund's distributor not linked to any promotional program; (2) required that 12b-1 plans pay only for sales or promotional activities described in the plan; (3) limited the ability of funds to reimburse distribution expenses more than one year after they were incurred; (4) required annual shareholder approval of 12b-1 plans; (5) required disclosure in fund prospectuses whether and under what circumstances shareholders would pay more than is permitted under NASD rules relating to sales loads; (6) required that fund directors consider additional factors and perform other duties when approving the implementation and continuation of a 12b-1 plan; and (7) required the 12b-1 plan to state the maximum amount that could be spent annually for distribution. Podesta, *supra* note 66, at 140-144. The staff's proposals were bitterly opposed by the ICI. Comments of the Investment Company Institute on Amendments to Rule 12b-1 Proposed by Investment Company Act Release No. 16,431 (Sept. 19, 1988), *reprinted in* Podesta, *supra* note 66, at 215-26.

260. SEC Historical Society, *supra* note 21, at 108 (remarks of Kathryn McGrath).

261. According to data derived from Morningstar, 12b-1 fees from 1980 through 1989 totaled $2.32 billion, less than one-quarter of the current $11 billion-plus *annual* cash harvest 12b-1 supplies to fund sponsors and advisers.

"investor's advocate," that annually is draining close to $12 billion from American investors, and there is no help in sight.

B. The SEC's Equivocation Over Directed Brokerages Payments for Distribution

When it adopted Rule 12b-1, the SEC took pains to make clear that both direct and indirect uses of funds assets to pay for distribution costs were covered by the rule.[262] This requirement has been honored in the breach. Over the years, the SEC turned a blind eye to various means used by the fund industry to evade the 12b-1 principle requirement: fund assets may be used to pay for distribution only if embodied in 12b-1 plans approved by fund board after a finding of likely benefit to the fund and its shareholders.[263]

In 2003, Congressman Richard H. Baker zeroed in on the fund sponsors' practice of padding funds' non-distribution expenses to generate cash to use to compensate brokerage firms for giving a preferred distribution sales push used to sell fund shares. Congressman Baker demanded information from the SEC relating to directed brokerage, soft dollar payments, and revenue sharing.[264] He sought information about "how these arrangements work, the impact of these expenses on investors, the legal issues raised by such arrangements with respect to Rule 12b-1, directors' obligations with respect to these arrangements, and the transparency of these arrangements and their associated costs."[265] Following the ensuing investigation, the SEC staff conceded that 12b-1 fee payments, though lush, still left the industry hungry for additional sources of funds to finance selling efforts:

> [F]unds intensely compete to secure a prominent position in the distribution systems that selling broker-dealers maintain for distributing fund shares. Over the past decade, selling broker-dealers have increasingly demanded compensation for distributing fund shares that is *in addition to the amounts that they receive from sales loads and rule 12b-1 fees.* To meet this demand, fund investment advisers have increasingly made revenue-sharing payments to the selling broker-dealers, which may be a "major expense" for some investment advisers. Further, the allocation of fund brokerage to "supplement" the advisers' payments to broker-dealers for distribution generally is bundled into the commission rate and not separately identifiable or reported as 12b-1

262. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11,414, 45 Fed. Reg. 73,898 (Nov. 7, 1980). In its release proposing Rule 12b-1 for comment, the Commission did not mince words in specifying that improper "indirect" usages of assets to pay for distribution would arise "if the advisory fee was inflated in order to provide the adviser with funds for that purpose," or "if the directors [were to] make allowance for the adviser's distribution expenses in setting the advisory fee." Bearing Distribution Expenses By Mutual Funds, Investment Company Act Release No. 10,862, 18 SEC Docket 271 (Sept. 7, 1979).

263. *See* ABA Task Force, *Fund Director's Guidebook*, 52 BUS. LAW 229, 253 (1996) ("Rule 12b-1 under the 1940 Act is the *exclusive means* by which a fund may bear the cost of selling, marketing, or promotional expenses associated with the distribution of its shares.") (emphasis added).

264. Letter from Richard H. Baker, Chairman, Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, U.S. House of Representatives, to William H. Donaldson, Chairman, SEC (Mar. 26, 2003).

265. *Id.*

fees.[266]

An SEC investigation completed in 2004 confirmed that various fund sponsors were inflating brokerage expenses to generate cash to pay fund sellers in order to boost sales.[267] Specifically, the Commission's staff "found that the use of brokerage commissions to facilitate the sale of fund shares is widespread among funds that rely on broker-dealers to sell their shares."[268] The potential for abuse was so obvious and serious that three securities industry groups, the ICI, the Securities Industry Association, and the Mutual Fund Directors Forum, each supported eliminating arrangements whereby fund brokerage payments are diverted to reward brokers for selling fund shares.[269] Concern over the practice culminated in the SEC amending Rule 12b-1 to make clear that fund managers were prohibited from using fund brokerage to compensate broker-dealers for selling fund shares.[270] Interestingly, the SEC's 7800-word release outlawing directed brokerage conspicuously failed to attack sponsors participating in the banned practice for breaching their fiduciary obligations to fund shareholders.[271]

266. Letter from Paul F. Roye to The Honorable William H. Donaldson, Chairman, SEC (June 9, 2003) (emphasis added).

267. One form of directed brokerage involved simply demanding that the selling broker route a share of the commission to another brokerage firm in return for the receiving firm's having sold fund shares. Sometimes these directed brokerage dealings took the form of "step out" arrangements because the adviser would demand that the executing brokerage firm "step out" of the brokerage fee collection in order to pass on a share of the commission to another firm having no connection with the brokerage transaction's execution, but who took the payment as a reward for selling fund shares. For SEC enforcement proceedings involving directed brokerage allegations with a step out transaction payoff, see *In re* Am. Express Fin. Advisers, Admin. Proc. File. No. 3-12115 (Dec. 1, 2005), *available at* http://www.sec.gov/litigation/admin/33-8637.pdf; *In re* Franklin Advisers, Inc., Investment Advisers Act Release No. 2337, 2004 WL 2884102 (Dec. 13, 2004).

268. Prohibition on the Use of Brokerage Commissions to Finance Distributions, 69 Fed. Reg. 9726 (proposed Mar. 1, 2004). The Commission found alarming abuses driven by sponsors' hunger for sales:

> Pressures to distribute fund shares (or to avoid making payments for distribution out of their own assets) have caused advisers to direct more fund brokerage (or brokerage dollars) to selling brokers. The directed brokerage has been assigned explicit values, recorded, and traded as part of increasingly intricate arrangements by which fund advisers barter fund brokerage for sales efforts. These arrangements are today far from the benign practice that we approved in 1981 when we allowed funds to merely consider sales in allocating brokerage.

Prohibition on the Use of Brokerage commissions to Finance Distribution, Investment Company Act Release No. 26,591, 83 SEC Docket 2106 (Sept. 2, 2004).

269. *See Mutual Fund Directors Forum Advises End to Soft Dollars at Funds*, 31 Sec. Reg. & L. Rep. (BNA) 1384 (July 29, 2004). The Fund Directors Forum distinguishes between two types of directed brokerage arrangements, those that are permissible, because they "typically involve the use of a fund's commission dollars to obtain services that directly and exclusively benefit the fund" and thereby reduce the fund's expenses, and payments of commissions. Letter from Allan S. Mostoff, President, Mutual Fund Directors Forum, to Jonathan G. Katz 5 (Nov. 25, 2005), *available at* http://www.mfdf.com/UserFiles/File/SoftDollar.pdf

270. 17 C.F.R. § 170.12(1)(h) (2006).

271. Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26,591, 83 SEC Docket 2106 (Sept. 2, 2004). The NASD also attacked revenue sharing, promulgating the "Anti-Reciprocal Rule," Rule 2830(k). Self-Regulatory Organizations: Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Investment Company Portfolio Transactions, Release No. 50,611, 69 Fed. Reg. 64,609 (Nov. 5, 2004), *available at* http://www.sec.gov/rules/sro/nasd/34-50611.pdf. Rule 2830(k) generally prohibits NASD members from favoring share sales for any particular fund company on the basis of brokerage commissions received or

A very plausible reason why the SEC chose not to take fund sponsors to task for breaching their fiduciary duties by inflating fund brokerage costs to pay for distribution outside of Rule 12b-1 is that in 1981 the Commission had given the green light to the practice.[272] As with Rule 12b-1's adoption a year earlier, the seemingly modest, innocuous action taken by the SEC in 1981, with the belief fund managers would discharge their fiduciary duties, paved the way for excesses and abuses harmful to investors. The SEC's long-standing indifference to directed brokerage is particularly disturbing, for it allowed devious fund managers to hide selling costs amidst brokerage charges, costs that are invisible to investors at the point of sale and which never show up in funds' expense ratios.[273]

C. More SEC Laxity–Using "Advisory Profits" to Pay for Distribution

One source of money to pay indirectly for distribution is brokerage fees; as discussed above, the SEC allowed this evasion of the rule through directed brokerage payments until quite recently. A more serious loophole relates to fund advisers paying "brokers out of their own pockets for selling fund shares ('revenue sharing')."[274] Fund retailers are hungry for this revenue sharing money. Consider this commentary from PFS

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expected by the members from any source, including the fund itself. The rule was aimed at preventing "quid pro quo arrangements in which brokerage commissions, which represent an asset of the fund, are used to compensate members for selling fund shares." *Id.*

272. *See* Order Approving Proposed Rule Change and Related Interpretation under Section 36 of the Investment Company Act, Investment Company Act, SEC Release No. 11,662, 46 Fed. Reg. 16,012 (Mar. 4, 1981). In its release adopting the 12b-1 amendment outlawing directed brokerage the SEC admitted that the practice had gotten out of hand, and involved "involved unmanageable conflicts of interest." Prohibition on the Use of Brokerage Commissions to Finance Distributions, 69 Fed. Reg. 9726 (proposed Mar. 1, 2004).

273. The SEC's practice of allowing funds to conceal from prospective investors their trading costs enables the fund industry to keep off the books charges that amount to 0.78% annually for equity funds. *See* John M.R. Chalmers et al., *Transaction-cost Expenditures and the Relative Performance of Mutual Funds* 11 (Wharton Working Paper Series, Paper No. 00-02, 1999).

274. "Revenue sharing" is the SEC's euphemism for the practice. Prohibition on the Use of Brokerage Commissions to Finance Distribution, Release No. 26,591, 69 Fed. Reg. 54,728 (Sept. 9, 2004), *available at* 2004 WL 1969665. The Edward D. Jones firm is the poster child for illicit revenue sharing arrangements. *See* Edward D. Jones & Co., L.P., Securities Act Release No. 8520, Exchange Act Release No. 50,910, 84 SEC Docket 1798 (Dec. 22, 2004) (cease and desist order and civil order regarding undisclosed revenue sharing); *Broker-Dealers: Calif. AG Sues Edward D. Jones over "Shelf Space" Deals with Funds*, 37 Sec. Reg. & L. Rep. (BNA) 20 (Jan. 3, 2005); *Broker-Dealers: Edward Jones to Pay $75M to Avoid Charges in Deferred Compensation Deal*, 37 Sec. Reg. & L. Rep. (BNA) 7 (Jan. 3, 2005); Laura Johannes & John Hechinger, *Why a Brokerage Giant Pushes Some Mediocre Mutual Funds*, WALL ST. J., Jan. 9, 2004, at 1. According to the *Wall Street Journal*, the Edward Jones administrative proceeding marked the "largest regulatory settlement to date involving revenue sharing at a brokerage house, . . ." Laura Johannes et al., *Edward Jones Agrees to Settle Host of Charges*, WALL ST. J., Dec. 21, 2004, at C1. For similar SEC proceedings, see Putnam Inv. Mgmt., LLC, Investment Advisers Act Release No. 2,370, Investment Company Act Release No. 26,788 (Mar. 23, 2005); Am. Express Fin. Advisors, Inc., Security Act Release No. 8,637, Exchange Act Release No. 52,861 (Dec. 1, 2005); Mass. Fin. Srvs. Co., Investment Advisers Act Release No. 2,224, Investment Company Act Release No. 26,409 (Mar. 31, 2004); Franklin Advisers, Inc. & Franklin/Templeton Distribs., Inc., Exchange Act Release No. 50,841, Investment Advisers Act of 1940 Release No. 2,337, Investment Company Act Release No. 26,692 (Dec. 13, 2004); Morgan Stanley DW, Inc., Exchange Act Release No. 48,789, Securities Act Release No. 8,339 (Nov. 17, 2003). For a case upholding fraud claims targeting directed brokerage and revenue sharing, see Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2006 WL 2355411 (N.D. Cal. Aug. 14, 2006).

Investments Inc., a member of the Primerica group of companies and a subsidiary of Citigroup, which markets mutual funds:

> PFS Investments Inc. . . . endeavors to collect a mutual fund support fee, or what has come to be called a revenue-sharing payment, from the fund families we offer to the public. These revenue-sharing payments are in addition to the sales charges, annual service fees (referred to as "12b-1 fees"), applicable redemption fees and deferred sales charges, and other fees and expenses disclosed in a fund's prospectus fee table. Revenue-sharing payments are paid out of the investment adviser's or other fund affiliate's assets and not from the fund's assets.[275]

Since pre-12b-1 times, with at least tacit SEC approval, advisers anxious to increase asset growth and advisory fee income have allocated a portion of advisory profits to pay distribution charges.[276] The SEC gave the go-ahead to this slippery slope practice in its Release adopting Rule 12b-1:

> If a mutual fund makes payments, which are earmarked for distribution, that is obviously a direct use of fund assets for distribution. If a fund makes payments, which are ostensibly for some other purpose, and the recipient of those payments finances distribution, the question arises whether the fund's assets are being used indirectly. The Commission's position has been and continues to be that there can be no precise definition of what types of expenditures constitute indirect use of fund assets. That judgment will have to be made based on the facts and circumstances of each individual case. . . . It is the Commission's view that, an indirect use of fund assets results if any allowance is made in the adviser's fee to provide money to finance distribution. Therefore, when an adviser finances distribution, fund directors, in discharging their responsibilities in connection with approval of the advisory contract, must satisfy themselves either that the management fee is not a conduit for the indirect use of the fund's assets for distribution or that the rule has been complied with. However, under the rule there is no indirect use of fund assets if an adviser makes distribution related payments out of its own resources. In determining whether there is an indirect use of fund assets, it is appropriate to relate a fund's payments pursuant to the advisory contract to the adviser's expenditures for distribution and to view such expenditures as having been made from the adviser's profits, if any,

275. Primerica, Revenue Sharing from Mutual Funds, http://ww3.primerica.com/public/revenue_sharing_disclosure.html (last visited Apr. 2, 2007).

276. *E.g.*, Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16,431, 53 Fed. Reg. 23,258 (June 21, 1988) (reiterating the Commission's position "that an investment adviser could continue to pay for distribution out of its profits, as long as those profits were not 'excessive'"). To date, the Commission has not defined what "excessive" profits are other than to state that "[p]rofits which are legitimate or not excessive are simply those which are derived from an advisory contract which does not result in a breach of fiduciary duty under section 36 of the Act." Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11,414, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,678, at 83,730 (Oct. 28, 1980). The SEC also indicated that payments made to an adviser as part of an advisory fee that are earmarked for distribution constitute indirect financing, and hence are proper only if authorized under rule 12b-1. *See id.* ¶¶ 83,729-730.

> from the advisory contract. To the extent that such profits are "legitimate" or "not excessive", the adviser's distribution expenses are not an indirect use of fund assets. Many commentators drew unwarranted inferences from the use of "legitimate" and "not excessive" in Release No. 10862. Profits which are legitimate or not excessive are simply those which are derived from an advisory contract which does not result in a breach of fiduciary duty under section 36 of the Act. The courts, have not established definitive standards for determining what does or does not constitute a breach of fiduciary duty in the compensation area, and, although the Commission reserves the right to express its own views of what such standards should be, it has not done so.[277]

Revenue sharing has been billed as a "major expense" item that is "the dirty little secret of the mutual fund industry."[278] According to one source, "the sums are enormous," aggregating more than $2 billion annually.[279] The $2 billion spent yearly on revenue sharing was almost four times more than the fund industry spends on advertising.[280] It is far more than the total expenses of all kinds borne by all mutual funds during 1980, the year when 12b-1 was adopted.[281] Despite the enormity of revenue sharing payments, according to one source, the terms of revenue sharing dealings "are seldom codified in written contracts."[282] It is troubling to find a highly regulated industry known to crow about its embrace of transparency and accountability spending billions of

277. *Id.* ¶¶ 83,729-730.

278. Letter from Richard H. Baker, *supra* note 264, para. 12.

279. Rich Blake, *How High Can Costs Go?*, INSTITUTIONAL INVESTOR, May 1, 2001, at 56. The history of revenue sharing and the SEC's largely ineffectual efforts to cope with the practice are surveyed in Bibb L. Strench & Katy Mobedshahi, *Regulators Take a Hard Look at Mutual Fund Revenue Sharing Arrangements*, INVESTMENT LAW, May 2004, at 1, *available at* http://www.accessmylibrary.com/coms2/summary_0286-21504654_ITM.

280. *Id.* The number should not be shocking. In the fund industry,

> [m]arketing and distribution . . . are highly expensive. So "money is no object" seems to have become our industry's tacit watchword in the search for the holy grail of market share. Yet it is the fund *shareholder* whose money is no object, but the fund *manager* who reaps the benefit of the money spent on marketing, earning higher fees as the assets roll in.

JOHN C. BOGLE, JOHN BOGLE ON INVESTING 149 (2000) (emphasis in original).

281. *See supra* notes 175-176 and accompanying text.

282. GEN. ACCOUNTING OFFICE, MUTUAL FUNDS GREATER TRANSPARENCY NEEDED IN DISCLOSURE TO INVESTORS 39 (June 2003). A recent federal district court analysis of revenue sharing had this to say about the quality of disclosure concerning revenue sharing payments:

> Given the competitiveness among funds for investor dollars, the sponsors had a strong incentive to hide the subject of revenue sharing, a subject that would logically reveal to potential customers that *they* would ultimately have to bear its burden. Using watered-down disclosures in the prospectuses as a way to gloss over the true price of admission to investors and the magnitude of the conflict of interest. The arrangements, moreover, were not reduced to writing and were shrouded in secrecy. By using vague disclosures, the sponsors intended to suppress the fact that the common fund was being diverted for secret compensation to brokers to hype the funds, at least according to the allegations.

Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2007 WL 760750, at *12 (N.D. Cal. Mar. 9, 2007). The *Siemers* order is the best judicial decision to date dealing with the fiduciary duty and disclosure issues raised by mutual fund distribution payments. It is discussed further *infra* notes 420-424 and accompanying text.

dollars annually on agreements that are seldom committed to writing. Big money contracts that are oral and thus invisible are breeding grounds for deceptive practices and fiduciary duty breaches. Richard H. Baker, Chairman of the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, connected the dots leading to investor deception when he said: "Revenue sharing is generally not disclosed to investors, thus leaving investors unaware of the incentives a broker may have for recommending one fund over another."[283] Fund managers' cavalier and intentionally vague handling of billions of dollars of revenue sharing money can and has given rise to litigation asserting claims under federal antifraud laws and investment company fiduciary duty principles.[284]

In 1980, when it promulgated Rule 12b-1, the Commission had an opportunity to regulate, once and for all, all expenditures drawing directly or indirectly upon fund assets used to pay for sales efforts. In so many words, as the foregoing quote from Rule 12b-1's adopting release reflects, the Commission punted. In ruling that only payments out of advisory fees directly "earmarked for distribution" are covered by 12b-1,[285] whereas non-earmarked payments made outside of 12b-1 plans by advisers to generate selling activity would be tolerated, the SEC gave fund sponsors permission to raid fund assets to finance distribution costs without complying with Rule 12b-1. The notion that billions of dollars in "advisory profits" can be spent outside of 12b-1's disclosure requirements and fee caps to pay for distribution-related items is dubious at best. NASD Rule of Conduct 2830 broadly defines cash and non-cash compensation "paid in connection with the sale and distribution of investment company securities" and brings those payments within the 1% maximum payment limit of 12b-1.

As a result of the SEC's refusal to clamp down on the diversion of fund assets to pay distribution charges, advisory profits are used today to pay distribution costs,[286] just as

283. *Mutual Funds: Trading Practices and Abuses that Harm Investors Before the Subcomm. on Financial Management, the Budget and International Security of the S. Comm. On Governmental Affairs*, 108th Cong. (2003) (statement of Rep. Richard H. Baker), *available at* http://www.senate.gov/~govt-aff/_files/ACF1D1.pdf.

284. *See infra* notes 392-423 and accompanying text.

285. Payment of Asset-Based Loads, *supra* note 78, at 215 (proposing amendments to Rule 12b-1). This would occur where, for example, the fund's board approved an increase in the adviser's fee to pay distribution costs. Inv. Co. Inst., SEC No-Action Letter, [1998-1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,477 at 78,436 (Oct. 30, 1998). Because of 12b-1's potential reach, some funds have adopted what is called a "defensive" Rule 12b-1 plan providing expressly that the adviser may use a portion of its advisory fee (not directly out of fund assets) to pay for distribution. The intent is to insulate an adviser's possible indirect use of fund assets for distribution from scrutiny under section 36(b) of the 1940 Act. *See* Gary O. Cohen, *Revenue Sharing by Mutual Funds with Life Insurance Companies Pursuant to Rule 12b-1 Plans And Administrative Services Arrangements*, *in* CONFERENCE ON LIFE INSURANCE COMPANY PRODUCTS: CURRENT SECURITIES, TAX, ERISA, AND STATE REGULATORY ISSUES 139, 149-50, 159-60 (ALI-ABA 1998); Clifford Kirsch, *Distribution*, *in* THE ABCS OF MUTUAL FUNDS, 167, 199 n.49 (PLI Course Handbook Series 1497 PLI/Corp 2005). However, the SEC has taken the position that "[w]here separate payments are made, or a specified portion of the management fee paid to the adviser is earmarked for distribution, the 12b-1 plan cannot be characterized as a defensive plan." Payment of Asset-Based Loads, *supra* note 78, at 215.

286. A recent study by the Government Accounting Office concluded that, despite the $11 billion-plus in annual subsidy for distribution flowing through 12b-1 plans, "mutual fund advisers have been *increasingly* engaged in a practice known as revenue sharing under which they make additional payments to the broker-dealers that sell their fund shares." *Mutual Funds Integrity and Fee Transparency Act of 2003: Hearing on H.R. 2420 Before the Subcomm. On Capital Markets, Insurance, and Government Sponsored Enterprises of the H.*

was the case prior to Rule 12b-1's adoption.[287] In 1978 the Commission was told in no uncertain terms that "substantial fund assets are being used for distribution—and this is the case throughout the industry."[288] The same comment letter pleaded that "this fact should be fully disclosed in the fund's proxy and prospectus."[289] Today, the pre-12b-1 practice of distribution subsidization through bloated advisory fees continues with a vengeance, and still there is no SEC-mandated requirement of detailed disclosure in SEC documents. Instead, as discussed above, "revenue sharing," the new name for the old practice, has managed to grow in importance while earning a less neutral designation: the fund industry's "dirty little secret."[290]

By promulgating 12b-1 to allow advisers to dip into fund assets directly to generate cash for marketing costs over and above money derived from loads, the SEC really just temporarily lessened the need for advisers to subsidize distribution out of advisory revenues. In essence, the SEC gave fund sponsors a pay hike. As it is, the SEC's pay subsidy of nearly $12 billion per year to fund sponsors leaves the industry's marketing efforts still ravenous for more marketing money.[291] Revenue sharing has blossomed into a mechanism to evade caps on 12b-1 fees.[292] The lesson is clear: fund sellers have an insatiable demand for compensation,[293] and fund advisers' appetites for asset growth is likewise insatiable. The losers in this game are fund shareholders who get little to nothing out of added sales and yet are getting stuck with the tab.

Comm. on Financial Services, 108th Cong. (2003) (statement of Richard J. Hillman, Dir., Fin. Markets and Cmty. Inv., Gov. Accounting Office) (emphasis added).

287. *See* Letter from John C. Bogle, Chairman, Vanguard Group to George A. Fitzsimmons, Sec'y, SEC (Nov. 24, 1979) (SEC File No. S7-743) ("It is no secret that today virtually every major fund group is in fact financing distribution expenses indirectly through the advisory fee it pays to its adviser/distributor."); DIV. OF INV. MGMT. REGULATION, SEC, MUTUAL FUND DISTRIBUTION AND SECTION 22(D) OF THE INVESTMENT COMPANY ACT OF 1940, at 20 (1974) (fund distribution, "seldom profitable in and of itself in the best of times, seems to have become even less profitable (or more unprofitable) lately, thus requiring greater subsidization of distribution from advisory profits"); Freeman, *The Use of Mutual Fund Assets to Pay Marketing Costs*, *supra* note 78, at 533, 540 (stating "the distribution of fund shares was becoming a money-losing proposition for the fund industry"); *id.* at 537 n.18, 559 (noting that the use of assets to pay fund marketing costs is a matter of everyday life in the fund industry. Both the industry and the SEC know it. The SEC generally has been willing to look the other way, rationalizing that marketing costs are paid not out of shareholders' savings but out of "advisers' profits").

288. *See* Letter from John C. Bogle to George A. Fitzsimmons, *supra* note 287.

289. *Id.*

290. Letter from Richard H. Baker, *supra* note 264, para. 12.

291. Rich Blake, *How High Can Costs Go?*, INSTITUTIONAL INVESTOR, May 1, 2001, at 56 ("The cost of distribution in rising. Revenue sharing is an increasingly large part of it.").

292. *The Mutual Fund Summit: Transcript*, 73 MISS. L.J. 1153, 1191 (2004) (remarks of Paul Roye, Dir., Div. of Inv. Mgmt., SEC). Though the SEC well knows about revenue sharing serving as a mechanism to evade 12b-1 payment caps and has professed surprise at the extent of the practice, it has yet to formulate a plan to curtail or limit the draining of fund assets through revenue sharing. *See id.* at 1191-92.

293. The revenue sharing payments are crucial to selling brokers' financial success. For example, in 2005, brokerage firm Edward Jones had a total net income of $330 million. *More than half of that sum*, $172 million, was attributable *purely* to revenue sharing payments, that is receipts over and above sales load or 12b-1 fee revenue, from the firm's eight "preferred fund families" and Federated Investors. *See* Edward Jones, Mutual Fund Families, Including Information about Our Preferred Fund Families and Revenue Sharing, http://www.edwardjones.com/cgi/getHTML.cgi?page=/USA/products/mutualfunds_revenue_sharing.html (last visited Mar. 6, 2007).

Assuming the adviser elects to indirectly earmark a part of the advisory fee to pay for distribution, the only practical limitation on the amount of assets the adviser indirectly diverts out of "advisory profits" would arise under the fiduciary duty standard in section 36(b).[294] As is discussed below, the 36(b) standard has been interpreted to date as very forgiving toward fund sponsors and very problematic for fund shareholders.

D. A Complication: "Soft Dollar" Payments

A core disclosure and management integrity problem plaguing the fund industry is the chronic tendency of fund managers to hide what they are doing with fund shareholders' money. Another integrity problem relates to the ingenuity shown by managers in finding ways to divert fund assets to bolster sales outside of Rule 12b-1's strictures. This penchant for deception and diversion gave us the directed brokerage scam discussed above.

There is another way to achieve the same sales boost by using cash generated when funds overpay their portfolio brokerage expenses. This arises when, instead of paying the lowest possible commission for stock trades, a fund pays an inflated commission charge, creating an overcharge that gives rise to "soft dollars." The term "soft dollars" is not defined under the federal securities laws. Nevertheless, the SEC has interpreted the term to mean products and services, other than execution of securities transactions, that an investment manager receives from or through a broker-dealer in exchange for the adviser's direction of client brokerage transactions to the broker-dealer.[295] The overcharge is arranged with the "understanding that the brokerage house will use the excess to provide services that otherwise would be paid for directly by the fund, such as research."[296] When advisory profits are increased by offloading research expenses onto shareholders through soft dollar payments, the inflated advisory profits are then available to subsidize distribution. There is evidence that the excess commission money is huge. In 2002, "the mutual fund industry paid brokers about $6 billion in commissions."[297] A 1998 SEC study of 75 broker-dealers and 280 investment advisers and investment companies reflected that nearly 60% of brokerage commissions were returned to the adviser in the form of soft dollar products and services.[298]

294. *See, e.g.*, Clifford E. Kirsch, *Distribution*, *in* THE ABCS OF MUTUAL FUNDS 2006, at 277, 309 (PLI Course Handbook Series 1550 PLI/Corp 2006). In so many words, the SEC's position is that so long as the investment advisory fee is not "excessive" within the meaning of section 36(b), then the profits are "legitimate," allowing distribution expenses to be borne by the investment adviser because the payments are not an indirect use of a mutual fund's assets. Of course, in truth, the payments *are* an indirect use of fund assets, since that is where the advisory income originated. *Id.*

295. Investment Advisers Act Release No. 34-35375, 60 Fed. Reg. 9750 (Feb. 21, 1995). *See also* OFFICE OF COMPLIANCE, INSPECTIONS AND EXAMINATIONS, SEC, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS 2 (Sept. 22, 1998), *available at* http://www.sec.gov/news/studies/softdolr.htm [hereinafter SEC SWEEP REPORT].

296. Tom Lauricella & Deborah Solomon, *SEC Readies Cases on Mutual Funds' Deals with Brokers*, WALL ST. J., Jan. 14, 2004, at C1.

297. Julie Creswell, *Dirty Little Secrets*, FORTUNE, Sept. 1, 2003, at 133, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2003/09/01/348192/index.htm.

298. SEC, INSPECTION REPORT OF THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (Sept. 22, 1998), *available at* http://www.sec.gov/news/studies/softdolr.htm. In Siemers v. West Fargo & Co., No. C 05-04518 WHA, 2007 WL 760750 (N.D. Cal. Mar. 9, 2007), the district

Commission payments generating soft dollars currently are permissible within limits under section 28(e) of the Securities and Exchange Act of 1934.[299] That provision was added to the 1934 Act to make clear that, in the face of the abolition of fixed brokerage commission rates, money managers could consider the provision of research, as well as execution services, in evaluating the cost of brokerage services without violating their fiduciary responsibilities.[300] However, in the words of one SEC Commissioner, "Times have changed and the original limited goal of Congress in providing the safe harbor has long ago gone the way of the Dodo bird."[301] Meanwhile, soft dollar arrangements continue to flourish, together with the monitoring and accountability challenges they beget.[302]

If soft dollars are used to defray advisory expenses, this can free the fund's adviser from bearing those costs. This, in turn, can enhance the adviser's profitability, unless the soft dollar expenses paid out serve to reduce the advisory fee paid by the fund. If the advisory fee is not reduced, excess profits are created for the advisor. There is evidence this is occurring. According to one study, soft dollar payments do not reduce management expenses and hence do not benefit shareholders.[303] Instead of generating

court approved fraud allegations attacking diversion of fund assets to pay distribution charges conferring no benefit on existing investors. Plaintiffs had alleged a loss based on

> dollars siphoned out of the corpus for undisclosed purposes of no benefit to investors. . . . Dressed up as fees, cash was being misappropriated from the common fund. The fees were not used for their ostensible purposes but were diverted to support ongoing distribution. The true price of admission to the fund was greater than was represented. At least that is the allegation. It is sufficient at this stage.

Id. at *14. Though *Siemers* is principally a 10b-5 fraud case, a fiduciary duty claim under section 36(b) was also alleged and upheld. The court's expressed concern over fund fiduciaries misappropriating shareholders' cash dovetails nicely with section 36(b) prohibition against the unjustifiable extraction of fees from fund assets.

299. 15 U.S.C. § 78o(e) (2000). The safe harbor was created when fixed brokerage commissions were abolished in 1975, paving the way for negotiated rates. Section 28(e) protects an investment adviser from claims that it breached its fiduciary duty by causing clients to pay more than the lowest available commission rates. The safe harbor permits an adviser to pay a higher commission rate upon determining the rate is "reasonable in relation to the value of the brokerage or research services" received from a broker-dealer. *Id.*

300. *See* Securities Exchange Act Release No. 34-23170, 51 Fed. Reg. 16,004 (Apr. 30, 1986).

301. Roel C. Campos, Commissioner, SEC, Statement on Soft Dollar Interpretation at SEC Open Meeting (July 12, 2006), *available at* http://www.sec.gov/news/speech/2006/spch071206rcc2.htm (referring to the fact that the "original limited goal" Congress sought to achieve has long since been accomplished, Comm'r Campos continued, "This is precisely the reason investor advocates are opposed to the safe harbor and industry participants favor it. The question is, what is best for investors?").

302. *See* Paul F. Roye, Dir., Div. of Inv. Mgmt., SEC, Remarks Before the American Law Institute/American Bar Association (June 19, 2003), *available at* http://www.sec.gov/news/speech/spch061903pfr.htm. In response to Congressional inquiries, Roye stated:

> We expressed concern about the growth of soft dollar arrangements and the conflicts they may present to fund advisers. Certain soft dollar arrangements are protected by Section 28(e) under the Securities and Exchange Act. However, the general effect of Section 28(e) is to suspend the application of otherwise applicable law, including fiduciary principles, and to shift the responsibility to fund boards to supervise the adviser's use of soft dollars and the resulting conflicts of interest, subject to best execution and disclosure requirements.

Id.

303. *See* LATZKO, *supra* note 245, at 19. Professor Latzko found:

savings, it appears soft dollar payments simply set the table for revenue sharing payouts to brokers out of cash generated from fund assets by advisory fee overcharges. This is essentially the same payment scheme (inflate brokerage charges to free up cash to funnel to selling brokers) that was occurring with directed brokerage. Thus, the use of soft dollar payments to inflate fund brokerage bills allows evasion of the SEC's prohibition in 2004 of sales compensation-generating directed brokerage payoffs,[304] as well as an evasion of the premise that distribution payments made out of fund assets are supposed to travel through the 12b-1 corridor. The indirect linkage between brokerage payments and distribution charges is obvious, as is the adviser's conflict of interest and the opportunity for fiduciary duty breaches.[305]

Those challenges are so imposing that the Mutual Fund Directors Forum has recommended that "a fund's board should not permit a fund's adviser to participate in soft dollar arrangements in trades for the fund."[306] This is good policy. The cleanest way for a fund adviser to pay third parties for investment research is out of advisory fee proceeds, i.e., with "hard dollars," not out of excess brokerage commissions,[307] i.e., with "soft dollars." After all, spending cash visibly for useful services is more consistent with the "transparency and accountability principles" that the industry embraces publicly rather than the hidden, convoluted, and conflicted compensation system that soft dollars payments epitomize and promote. At a minimum, anything purchased with fund brokerage dollars beyond the "best execution" of trades, needs to be identified by the

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> If soft dollar arrangements reduce explicit management fees, then, controlling for the volume of transactions, brokerage commissions ought to be negatively associated with investment advisory fees. However, the coefficient on the amount of brokerage commissions paid is positive but not significantly different from zero. Soft dollars do not benefit shareholders by reducing explicit management expenses.

Id.

304. *Id.* For a report on various ways advisers have used soft dollars to enrich themselves while abusing their fiduciary positions, see OFFICE OF COMPLIANCE, INSPECTION AND EXAMINATIONS, SEC, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (1998), *available at* http://www.sec.gov/news/studies/softdolr.htm (finding "many instances where advisers' soft dollar disclosures were inadequate or wholly lacking—especially with respect to non-research items").

305. A study of soft dollar practices identified a variety of potential abuses:

> [A]dvisers have an incentive to trade a client account more actively than is in the client's best interest in order to generate soft dollar credits, or to be less vigilant in obtaining best execution for all client trades. An adviser also may pay more in soft dollars for research than the adviser would be willing to pay from its own assets. In addition, advisers may face conflicts of interest due to the potential for using one fund's Commissions to pay for soft dollar research that benefits another fund. For example, under Section 28(e), a large-cap equity fund's Commissions may pay for research that benefits a bond fund's investors, despite the fact that the bond fund does not pay Commissions on its portfolio transactions.

MUTUAL FUND TASK FORCE, NATIONAL ASS'N OF SEC. DEALERS, SOFT DOLLARS AND PORTFOLIO TRANSACTION COSTS 3, *available at* http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf.

306. Letter of Allan S. Mostoff, President, Mutual Fund Directors Forum, to Jonathan G. Katz, Sec'y, SEC 2 (Nov. 25, 2005), *available at* http://www.mfdf.com/UserFiles/File/SoftDollar.pdf. Driving this decision were three "fundamental principles;" first, that "brokerage commissions are an asset of the fund"; second, "[b]est execution should govern"; and third, that "[t]ransparency is an important objective." *Id.* at 2-3.

307. In other words, no higher than needed to obtain best execution.

fund's adviser, quantified in dollar terms, justified as a proper expense, and disclosed to the fund's board of directors in connection with the board's annual approval of the adviser's advisory contract.[308]

The most telling reason why soft dollar payments for research should be banned, or at least included in the 12b-1 expense cap, is that key reasons given by the SEC for banning directed brokerage apply as well to soft dollar kickbacks coupled with distribution payments out of advisory profits.[309] Those key reasons were: (1) there is a potential for an adverse impact on the duty of the adviser to seek best execution of trades;[310] (2) extra compensation funneled to selling brokers can violate NASD sales compensation limits;[311] and (3) advisory profit or revenue sharing payments are off the books, which "diminishes the transparency of fund distribution costs and the ability of an investor or prospective investor to understand the amount of those costs."[312] In other words, when load increases in the form of brokerage allocations or soft dollar payments to fund advisers are hidden in inflated portfolio brokerage commissions, the costs never show up in fund expense ratios, causing investor confusion about pricing and management efficiency, and enabling the industry to report falling costs.[313]

E. Another Regulatory Failure—Spread Load Deception

By tolerating Rule 12b-1's use to facilitate spread load sales, the SEC has handed unscrupulous fund load sponsors a marketing ploy tailor-made for winning investors away from competitors offering a superior product, namely no-load fund shares. The proliferation of different load fund classes boils down to a cynical attempt to compete by engendering consumer confusion and exploiting consumer ignorance.[314] As fund

308. The Mutual Fund Directors Forum has "recommended" that fund boards "request" this information. In truth, the adviser has an agency law duty to disclose this information. *See* RESTATEMENT (SECOND) OF AGENCY § 281 (1957). The directors have a perfect right to demand the data from the fund's fiduciary. Letter of Allan S. Mostoff, President, Mutual Fund Directors Forum, to Jonathan G. Katz, Sec'y, SEC 2 (Nov. 25, 2005), *available at* http://www.mfdf.com/UserFiles/File/SoftDollar.pdf.

309. Prohibition on the Use of Brokerage Commissions to Finance Distribution, SEC Release No. IC-26, 69 Fed. Reg. 54,728-30 (Sept. 9, 2004).

310. *Id.* at 54,729.

311. *Id.* at 54,730.

312. *Id.*

313. A standard ICI refrain is that the "total costs of fund ownership" have been dropping for fund shareholders. *See Improving Price Competition for Mutual Funds and Bonds: Hearing Before the Subcomm. on Finance and Hazardous Materials of the H. Comm. on Commerce*, 105th Cong. 86 (1998) (statement of Matthew P. Fink, President, Inv. Co. Inst.). The industry's lobbying organization's policy position was subsequently backed up by a study featuring tortured results published in November of 1998. *See* John D. Rea & Brian K. Reid, *Trends in the Ownership Cost of Equity Mutual Funds*, PERSPECTIVE (Inv. Co. Inst., Washington, D.C.), Nov. 1998, at 12, *available at* http://www.ici.org/pdf/per04-03.pdf (finding that the "total cost of investing" in mutual funds, or the "total cost of fund ownership" has been decreasing). *But see* John C. Bogle, Mutual Funds at the Millennium: Fund Directors and Fund Myths (May 15, 2000), http://www.vanguard.com/bogle_site/may152000.html (for a different view of fund costs).

314. *See supra* notes 242-253 and accompanying text. *See also* Middleton, *supra* note 252 (noting that the push into share classes was due to in-roads being made by the no-loads, and that "proliferation of share classes begets increasing complexity [that] can cloud the true cost of owning a mutual fund share"). As Bogle reports, the ICI manipulated its data in reaching its conclusion that the cost of fund ownership had declined from 2.25% in 1980 to 1.49% in 1997. For example, the ICI totally ignored the cost borne by shareholders when their funds

industry pioneer John C. Bogle explained: "They don't just go by the alphabet anymore . . . . Franklin has class 1 and class 2 shares now. They leave investors in a perplexing miasma of imperfect knowledge, and the whole purpose is to make it look like they're selling a no-load fund."[315]

Mr. Bogle has a point. Before Rule 12b-1, the no-loads competed straight up with the load funds; loads typically were charged at the time of sale, with a smattering of funds featuring redemption fees. With a big assist from Rule 12b-1, load funds now have a marketing weapon able to counteract price competition pressure exerted by the no-loads.[316] Although marketing Class B shares as "no-load" is illegal, that does not mean brokers do not engage in the practice. In fact, the SEC has long been on notice that 12b-1 and CDSCs lend themselves to deceptive sales practices.[317] According to one report, distribution literature passed out by one fund sponsor lauds the deceptive nature of Class B shares: "Because there is no up-front sales charge, brokers who offer B (CDSC) shares may compete effectively with no-load funds."[318] Effective competition and fair competition are two different things. Class B share sellers who bill their product as "no load" are violating the NASD's sales charge rule which bars NASD members and their associated persons from describing a mutual fund as no load or having no sales charge if the fund imposes a front-end load, a back-end load, or a 12b-1 fee and/or service fee that exceeds 0.25% of average net assets per year.[319]

In 1998, the SEC proposed a rule aimed at creating detailed prospectus disclosure requirements for multiple class funds in order to help mutual fund investors understand the options presented by multi-class fund share offerings, particularly as to 12b-1 fees

pay brokerage commissions on portfolio trades. Rea & Reid, *supra* note 313, at 4 n.5. As this article reports, over the years those brokerage commissions have been bloated to finance directed brokerage payments to selling brokers, and to provide off-the-books advisory services benefiting the equity funds' managers. Even putting aside brokerage cost increases, from 1980 to 2004, the weighted average equity mutual fund expense ratio ballooned from 0.96% to 1.56%. Richard M. Ennis, *Are Active Management Fees Too High?* FIN. ANALYSTS J., Sept./Oct 2005, at 44, 46. Over the time period when fund expenses were rising, the cost of buying common stocks was dropping. From 1975 through 2004, the cost of one-way stock trades dropped by roughly 90%. *Id.* at 45.

315. Middleton, *supra* note 252, at 8 (quoting John C. Bogle).

316. Investment Company Act Release. No. 16,619, 53 Fed. Reg. 45,275 (Nov. 2, 1988) ("[I]ncreased competition from no-load funds and a perceived resistance among mutual fund investors to products that charge front-end sales loads . . . prompted load funds to develop alternative methods of distribution financing, such as the imposition of sales loads payable other than at the time of purchase.").

317. *See supra* note 244.

318. Michael A. Jones et al., *Financial Advisers and Multiple Share Class Mutual Funds*, FIN. SERVS. REV, 2005, at 5, *available at* http://www.rmi.gsu.edu/FSR/abstracts/Vol14/zux00105000001.pdf [hereinafter Financial Advisers and Multiple Share Class Mutual Funds].

319. NASD MANUAL COND. RULE 2830(d)(3). Amazingly, despite load funds' unfair sales practices, no-load funds have become the industry's sales leaders in the last few years as increasing numbers of investors have recognized that they offer greater value over time than the load fund option. REPORT ON MUTUAL FUND FEES, *supra* note 47, tbl.4 (showing that no-loads' share of fund industry assets has risen from 26% in 1992 to 51% in 1999). Helping to drive no-loads success has been the simple fact that they are cheaper to own. Over the period 1992-1999, no-load funds' operating expense ratios declined almost 10%, from 0.80% to 0.72%; load funds' expense ratios traveled in the opposite direction by about the same percentages, increasing, from 0.96% in 1992 to 1.17% in 1999. *Id.* Investments in the no-load Vanguard Group accounted for 60% of the net cash flow into no-loads in 1999. John C. Bogle, Founder, The Vanguard Group, Inc., Honing the Competitive Edge in Mutual Funds, Remarks Before the Smithsonian Forum in Washington, D.C. (Mar. 23, 1999).

and CDSCs.[320] The notice sought public comment as to whether prospectus disclosure alone would be an effective way to ensure that fund investors would understand their investment options and whether the Commission should work with NASD to set standards for basic information that representatives must communicate with their customers, either orally or in writing.[321] Virtually all commentators assailed the SEC's detailed disclosure proposal, causing the agency to back off its proposed requirements.[322] In the Release adopting the proposed rule in modified form, the SEC noted:

> The Commission recognizes that the complexity of distribution charge options can be confusing to some investors. Instead of relying on prospectus disclosure, however, the Commission is addressing these concerns through consumer education and the promotion of good sales practices. . . . The Commission staff has been working, and will continue to work, with the NASD on providing guidance about the duties of sales representatives when recommending the purchase of multiple class and master-feeder funds. Finally, the Commission expects to promote consumer education in this area through the development and publication of a brochure explaining the structures and expenses of multiple class and master-feeder funds.[323]

Thus, in the face of fierce industry opposition to detailed prospectus disclosure designed to protect investors, the SEC retreated in favor of a disclosure scheme premised on "the development and publication of [an explanatory] brochure" aimed at fostering "consumer education." The SEC's brochure commitment was made 12 years ago. The brochure has never been published.[324] This deficiency was pointed out in *In re*

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320. Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds, Investment Company Act Release No. 19,955, 58 Fed. Reg. 68,074 (Dec. 23, 1993).

321. *Id.*

322. Exemption For Open-End Management Investment Companies Issuing Multiple Classes Of Shares; Disclosure By Multiple Class and Master-Feeder Funds; Class Voting On Distribution Plans, Investment Company Act Release No. 20,915, 58 SEC Docket 2231 (Feb. 23, 1995).

323. *Id.*

324. The SEC's web site does feature a one-page discussion headed "Mutual Fund Classes," with such investor-friendly comments as this: "Mutual fund classes are regulated primarily under the Investment Company Act of 1940 and the rules and registration forms adopted under that Act, in particular Rule 18f-3." SEC, Mutual Fund Classes, http://www.sec.gov/answers/mfclass.htm (last visited Feb. 23, 2007). The SEC's site also features a link to an "investor alert" bulletin posted by the NASD relating to Class B share abuses. *See* Nat'l Ass'n of Sec. Dealers, Class B Mutual Fund Shares: Do they Make the Grade? (June 25, 2003), http://www.nasd.com/InvestorInformation/InvestorAlerts/MutualFunds/ClassBMutualFundSharesDoTheyMake theGrade/index.htm?ssSourceNodeId=451. Among the vague suggestions offered to the public on the NASD's web site is this: "Before purchasing Class B mutual fund shares, you should determine whether this investment is in your interest, and not just in the interest of your broker or adviser who may receive higher commissions from the sale of Class B shares than other classes of fund shares." *Id.* The focus on Class B shares followed on the heels of an earlier "Investor Alert." Nat'l Ass'n of Sec. Dealers, Mutual Fund Breakpoints: A Break Worth Taking (Jan. 14, 2003), http://www.nasd.com/Investor/Alerts/alert_breakpoint.htm. Further evidencing a belated "get tough" policy in dealing with Class B share sales, on June 25, 2003, the NASD announced an enforcement proceeding attacking Class B share sales. *See* Nat'l Ass'n of Sec. Dealers, NASD Brings Enforcement Action for Class B Mutual Fund Share Sales Abuses and Issues Investor Alert on Class B Shares (June 25, 2003), http://www.nasd.com/PressRoom/NewsReleases/2003/NewsReleases/NASDW_002901.

Flanagan,[325] an administrative proceeding brought against a broker-dealer, registered representatives, and an investment advisory firm for allegedly abusing clients by concealing from the clients that large investments in Class A shares entitled the investor to breakpoint discounts and that comparable discounts on sales charges were not available for large investments in Class B shares.[326] The administrative law judge held:

> If a registered representative sells mutual fund shares, in amounts close to but less than a breakpoint at which a lower sales load becomes applicable, to a customer known to have available for investment total amounts which exceed the breakpoint, the representative must disclose to the customer prior to the transaction the savings in sales charges obtainable through increasing the amount of the purchase. A representative who fails to do so violates the antifraud provisions of the securities laws.
>
> The Division has shown that a reasonable "buy and hold" mutual fund investor would consider it material to know that, above breakpoints, Class A shares generally outperform Class B shares in the long run. It has also shown that the two investors in this case were not provided with such information.[327]

The administrative judge's ruling in *In re Flanagan*, that brokers commit a fraud on their Class B share customers when they fail to disclose savings available through investment in other classes, should concern fund retailers whose registered representatives overwhelmingly push B shares. The world of 12b-1 and CDSCs is never simple, however. The Commission subsequently reversed the administrative judge's ruling,[328] while nonetheless observing that "[c]ases involving breakpoints and the sale of Class B mutual fund shares involve important issues, and the Commission will continue to pursue cases on appropriate facts."[329] The SEC's loss in *In re Flanagan* illustrates the difficulty of proving fraud in cases attacking the suitability of Class B shares, a difficulty confirmed by results in other cases. Suits brought by injured customers must, as a rule, be filed as NASD arbitrations, and those tried to a conclusion usually result in defense verdicts.[330] Federal class action litigants have fared no better.[331] A relatively small number of regulatory proceedings, typically instituted by the NASD, have resulted in sanctions.[332]

325. Initial Decisions Release No. 160, Adm. Proc. File No. 3-9784, 71 SEC Docket 1415, *available at* 2000 WL 98210, at *n.5 (SEC Initial Decision Jan. 30, 2000).

326. *Id.*

327. *Id.* (italics omitted).

328. Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc., SEC Release. No. 34-48255 and IA-2152, 80 SEC Docket 2766 (July 30, 2003).

329. *Id.* For one such case, see *In re* H.D. Vest Inv. Sec., Inc., Administrative Proceeding File No. 3-11413 (Feb. 12, 2004), *available at* http://www.sec.gov/litigation/admin/33-8383.htm (finding that brokers had committed fraud "by recommending the purchase of Class B shares in amounts of $100,000 or greater to certain customers without disclosing the potential economic benefits of purchasing an equivalent amount of Class A shares").

330. Michaels & Anderson, *supra* note 137, at 410-19.

331. *See* Benzon v. Morgan Stanley Distribs., Inc., 420 F.3d 598 (6th Cir. 2005). *But see* Siemers v. Wells Fargo & Co., No. C. 05-04518 WHA, 2006 WL 2355411 (N.D. Cal. Aug. 14, 2006) (disagreeing with *Benzon* on the materiality of the defendants' allegedly deceptive disclosures).

332. *See* Michaels & Anderson, *supra* note 137, at 410-19.

Rule 12b-1 poses disclosure problems from multiple directions besides the no-load confusion/fraud angle. From the fund shareholder's standpoint, the rule has led to a single fund having different load fee configurations that make price comparisons extremely difficult, if not impossible.[333] At a minimum, choosing correctly between Class A, B, and C shares requires careful study of gross amounts available for investment, diversification needs, and foreseeable share holding periods.[334] According to former SEC Chairman Arthur Levitt, the differences between classes "leave investors' heads spinning"[335] and pave the way for misrepresentations by sales representatives.[336] The load funds, it seems, have chosen a marketing strategy built upon deception and obfuscation.[337] In the words of Chairman Levitt:

> [T]he mutual fund industry . . . does an exemplary job touting the benefits of mutual funds, but prefers to gloss over what it costs you each year. To the industry, one of the greatest design features of funds is the way they artfully camouflage fees as a percentage of assets. Most people would consider a 2 percent annual fee to be quite low, and don't realize that is really a punishing levy.[338]

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333. In the statement he presented when opening recent congressional hearings into fund disclosure practices, Representative Michael G. Oxley observed that the shift from visible loads to concealed costs hurts competition:

> While [fund] investors have become sensitive to certain fees like sales loads, other fees are either hidden or opaque, escaping the attention of even savvy fund investors. This precludes them from "comparison shopping," a strong market influence that would encourage fee-based competition and would likely bring down costs.

Quality of Information provided to Mutual Fund Investors: Hearing Before the Subcomm. On Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services, 108th Cong. (2003) (statement of Michael G. Oxley, Chairman).

334. *See supra* notes 135-137 and accompanying text (discussing general guidelines applicable to choosing between fund classes).

335. ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW, AND WHAT YOU CAN DO TO FIGHT BACK 60 (2002).

336. "Brokers like to recommend Class B shares because, they tell clients, there is no up front fee. But B shares are more expensive in the long run . . . ." *Id.* at 61.

337. "12b-1 fees have been used as a hidden way to pay brokers for using the fund." Dustin Woodard, *Beware of 12b-1 Fees*, ABOUT.COM, http://mutualfunds.about.com/library/weekly/aa040501a.htm. (last visited Mar. 6, 2007).

338. LEVITT, *supra* note 335, at 47. Of course, the ICI, which represents the interests of fund managers, not shareholders, has a different, more investor-friendly view: "The Institute and its members are committed to providing investors with the tools they need to help them make informed decisions about mutual fund investing." Inv. Co. Inst., *Understanding Mutual Funds' Investor Awareness Guide*, PR NEWSWIRE, Mar. 31, 1998 (quoting Julie Domenick, Executive Vice President, Inv. Co. Inst.), *available at* http://www.prnewswire.com (search "Archive Search" and search for headline "Understanding Mutual Funds"). The current version of the ICI's 50-page *Guide to Understanding Mutual Funds* offers only superficial commentary about 12b-1 fees. Inv. Co. Inst., GUIDE TO UNDERSTANDING MUTUAL FUNDS 49 (2000), *available at* http://www.ici.org/pdf/g2understanding.pdf (last visited Feb. 22, 2007).

> 12b-1 Fee—A mutual fund fee, named for the SEC rule that permits it, used to pay for broker-dealer compensation and other distribution costs. If a fund has a 12b-1 fee, it will be disclosed in the fee table of a fund's prospectus.

Id.

Levitt offered these words of wisdom to investors about how they should react to fees charged under Rule 12b-1, a rule the SEC promulgated supposedly to serve investors' interests:

> Naturally, investors don't like it when funds skim 5 percent of their savings right off the top. So fund companies have figured out ways to hide some of the load by assessing annual fees that you pay as a percent of your assets in the fund. This is called a distribution fee, or a 12b-1 fee, after the Investment Company Act rule that governs such fees. . . . You should avoid owning shares in a fund that charges these fees.[339]

Of course, though he was the longest-serving SEC Chairman in history,[340] Mr. Levitt never saw fit to take any action to fix SEC Rule 12b-1 while he was in a position to do so. The spectacle of a former-SEC Chairman warning investors to get out of the path of an SEC-created, administered, and sustained rule illustrates the extent to which Rule 12b-1 has run amuck. A simple, naïve concept has evolved into something seriously flawed, if not grotesque.

F. A Consequence of Lax Regulation: Higher Risks Are Assumed and Hidden

Another documented way that Rule 12b-1 plays into deception is through the practice of some bond funds burdened by 12b-1 expenses to pump up their yields to investors by buying riskier portfolio holdings than their peer funds.[341] This is a phenomenon few investors know about, and which is largely ignored by the financial press. That expense-heavy funds resort to using high-risk portfolio holdings to raise investment returns has been considered insignificant by both the SEC, which has failed to require risk-adjusted return disclosures, and by a judge called on to rule in a case challenging the reasonableness of fund fees who thought it inappropriate to take into account the portfolio's volatility when evaluating the quality of the fund manager's investment performance.[342] Exactly why risk adjusted returns should not be disclosed is

339. INV. CO. INST. GUIDE, *supra* note 338, at 47-48.

340. Carlyle Group, Former SEC Chairman Arthur Levitt to Join The Carlyle Group, Mar. 2, 2001, http://www.thecarlylegroup.com/eng/news/l5-news712.html.

341. Nicholaj Sigglekow, Expense Shifting: An Empirical Study of Agency Costs in the Mutual Fund Industry 30 (Jan. 4, 1999), *available at* http://fic.wharton.upenn.edu/fic/papers/99/9909.pdf ("[I]nvestors in bond funds should be aware that funds with 12b-1 fees, while often sporting similar returns, tend to have significantly higher volatility than funds without 12b-1 fees."). Sigglekow's findings are consistent with anecdotal evidence that managers of funds bearing high cost structures "have to gamble to overcome high fund expenses." David J. Lynch, *Vanguard Boss Steps Down / His Legacy: No. 2 Mutual Fund Company*, USA TODAY, May 25, 1995, at B1 (quoting Don Phillips of Morningstar).

342. *See* Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472 (S.D.N.Y. 1988). *Krinsk* involved a challenge to the level of fees charged in a money market fund. A key defense argument was that the fund's return was "at or near the top of money market funds." *Id.* at 487. The plaintiff claimed the return was actually inferior when analyzed on a "risk-adjusted" basis taking into account the portfolio's volatility. Noting that the SEC did not require risk-adjusted performance ratings, the court rejected the "concept of 'risk-adjusted' return as a standard of fund performance measurement." *Id.* On the contrary, a highly qualified economist knowledgeable about the fund industry has noted that one of the fund industry's chief disclosure shortcomings is that "there is little quantitative risk disclosure. Quantitative measures of risk can greatly aid in judging the quality of a mutual fund . . . ." *Improving Price Competition for Mutual Funds and Bonds: Hearing Before the Subcomm. on Financial and Hazardous Materials of the H. Comm. on Commerce*, 105th Cong. 53 (Sept. 29, 1998) (statement of

unclear, since pursuing high risk-adjusted returns is something business managers are expected to do.[343] Moreover, "[t]he method of analyzing risk-adjusted returns, known as the Sharpe ratio, is a fundamental of modern portfolio theory, an influential approach to investing."[344] Even more importantly, when buying fund shares, "most shareholders want to know about a fund's . . . level of risk."[345]

Here, as with its failure to demand accurate, coherent spread load disclosure, the SEC's indifference to adequate cost disclosure plays into the hands of high cost sellers eager to compete by disguising a key fact—in this case, the investment risk of the portfolio that investors are buying into. Oddly, on its web site, the SEC implores mutual fund investors to consider a handful of key determinants of investment success other than past performance.[346] Prominent among the five factors listed is "the fund's risks and volatility."[347] The instructions to the SEC's mutual fund prospectus disclosure requirements likewise demand that the prospectus "help investors to evaluate the risks of an investment . . . by providing a balanced disclosure of positive and negative factors."[348] The current disclosure regime is better than nothing. It uses a bar chart and table to reveal the fund's historical returns, comparing it with equivalent information for an index reflecting a "broad measure of market performance."[349] Funds are also required to disclose their highest and lowest returns for a quarter during the period covered by the bar chart. The SEC could help investors and eliminate fund performance deception by demanding[350] disclosure of risk-adjusted performance, but it has not.[351] This is a serious

Charles Trzcinka, Professor of Fin., State Univ. of New York at Buffalo), *available at* http://www.kelley.iu.edu/ctrzcink/test.html.

343. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened In Delaware Corporate Law And Governance From 1992-2004?: A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1424 (2005) ("In their strategic vision, directors should pursue with integrity the highest available risk-adjusted returns that exceed the corporation's cost of capital.").

344. Steven H. Sholk, *ERISA and Federal Income Tax Aspects of Participant Directed Investments in Defined Contribution Plans*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2002, at 371, 421 (PLI Course Handbook Series 544 PLI/Tax 2002). Investors can benefit by being able to examine risk adjusted returns. *See* Gretchen Morgenson, *Some Balanced Funds Are Tipping Toward More Risk*, N.Y. TIMES, June 23, 2002, § 3, at 1:

> RiskMetrics will post a free analysis of risk levels at a wide variety of funds on its Web site, www.riskmetrics.com. It will also identify the best and worst fund performers adjusted for the risk taken by managers. Adjusting for risk will also help investors eliminate funds that have done well only because the market soared.

Indeed, "degree of risk" has been called one of the four most important criteria in evaluating a mutual fund, together with rate of return, expenses, and quality of service. Sholk, *supra*, at 463.

345. INV. CO. INST., UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 11 (2006), *available at* http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf.

346. SEC, MUTUAL FUND INVESTING: LOOK AT MORE THAN A FUND'S PAST PERFORMANCE, *available at* http://www.sec.gov/investor/pubs/mfperform.htm (last visited Mar. 6, 2007).

347. *Id.* Sample advice: "Funds with higher rates of return may take risks that are beyond your comfort level and are inconsistent with your financial goals."

348. SEC, Form N-1A, at General Instruction C(1)(b), *available at* http://www.sec.gov/about/forms/formn1-a.pdf (last visited Mar. 30, 2007).

349. *Id.* at Item 2(c)(2).

350. And, hence, validating.

351. Twice the SEC has solicited comments on risk-adjusted performance standards without taking action.

oversight.[352]

G. Another Rule 12b-1 Glitch: Extended Class B Payment Periods

Using 12b-1 fees in tandem with CDSCs is a way to assure that the fund will have available the money needed to pay the sales commission to the fund's salesperson, who typically receives payment at the time the shares are sold. In essence, the seller gets paid up front whether the shares sold are Class A or Class B. During the period that the CDSC withdrawal fee is assessed, there is not a big difference between the overall cost of either type of share, putting aside the availability of breakpoints with Class A shares.

If 12b-1 fees used to finance Class B share sales were solely a financing mechanism, the Class B shares would convert to Class A shares immediately after they had been held by the Class B shareholder long enough for the fund's underwriter to amortize the commission compensation paid at the time of sale. However, for many funds there is a delay, turning Class B shares into profit centers for fund distributors. Consider the following table, derived from Morningstar data, consisting of top Class B funds listed by assets, showing the maximum deferred load payable, and showing the number of years it takes to for Class B shares convert to Class A shares and escape 12b-1's load charge. This data raises the question why, once the commission paid at the time of purchase has

In 1990, the SEC requested comment on whether mutual funds should be required to adjust performance figures to reflect risk for purposes of Item 5A of Form N-1A. *See* Disclosure and Analysis of Mutual Fund Performance Information; Portfolio Manager Disclosure, Investment Company Act Release. No. 17,294, 55 Fed Reg. 1460 (Jan. 8, 1990). In 1986, the SEC requested comment on how funds could present risk-adjusted performance information in advertising. *See* Investment Company Act Release. No. 15,315, 51 Fed Reg. 34,384 (Sept. 26, 1986).

352. Sholk, *supra* note 344, at 461 (calling attention to the fund's "degree of risk" as a key factor to be weighed in evaluating the fund). *See also id.* at 462 (calling for professional fiduciaries called on to consider purchasing fund shares to study "the fund's performance and risk-adjusted performance over at least the prior five (5) years against the performance of funds with the same or similar investment objectives"). Such data is available through private services, such as Morningstar, www.morningstar.com, which offers a 1-5 star risk-adjusted rating. Morgan Stanley has also developed a system for evaluating mutual funds on a risk-adjusted basis. *See* Suzanne McGee, *Morgan Stanley Pitches System to Measure Mutual-Fund Risk*, WALL ST. J., Feb. 10, 1997, at C1. Risk adjusted evaluation of funds exists, it is important, and the SEC should insist that it be made available to all investors. We live in an age in which stock "analysts are expected to deliver superior risk-adjusted returns based on their recommendations." Michael Morano, *Reg. FD: Its Effects on the Role of Analysts, Market Volatility on Wall Street, and Information Flow from Issuers*, 54 RUTGERS L. REV. 535, 544 (2002). If stock analysts are judged on a risk-adjusted basis, it is high time that fund portfolio managers be subjected to the same standard. Finally, consider this argument in favor of disclosure of risk-adjusted returns:

> [R]esults should be risk adjusted. Underperformance of a benchmark at a low level of portfolio risk is not proof of inept asset management any more than overperformance of a benchmark at a high level of portfolio risk is a sign of investment skill. Performance measurements based on peer group comparisons (how did other commingled bank trust funds do? How did mutual fund managers do? etc.) are nothing more than horse-race analogies where no one knows which horses are legitimate and which are running on steroids. At the end of the day, the best manager may simply be the one that took the most risk—hardly a strong investment recommendation for a fiduciary.

Patrick J. Collins, *Observation on Selected Tax and Investment Issues*, SG012 ALI-ABA 157, 164 (2001). On the other hand, it is hard to properly risk-adjust past fund performance, much less extrapolate likely future accomplishments from past performance. *See* Henry T. C. Hu, *The New Portfolio Society, SEC Mutual Fund Disclosure, And The Public Corporation Model*, 60 BUS. LAW. 1303, 1317 n.77 (2005).

been recouped, are the Class B shares not converted?

TABLE 4

Fund Name	**Deferred Load**	**12b-1 Current**	**Net Assets $MM**	**Converts in**	**Load/.75**
AllianceBernstein Grth & Inc B	4	1	2427.4	8 years	5.3
MFS Total Return B	4	1	2472.3	8 years	5.3
PIMCO Total Ret B	5	1	2500.6	7 years	6.7
MFS Mass Inv Trust B	4	1	2557.9	8 years	5.3
MFS Mass Inv Grth Stk B	4	1	2821.0	8 years	5.3
Putnam Voyager B	5	1	2987.4	8 years	6.7
Oppenheimer Main Gr&IncB	5	1	3014.1	6 Years	6.7
AllianceBernstein Premier Gr B	4	1	3086.4	8 years	5.3
AXP New Dimensions B	5	1	3436.1	8 years	6.7
Putnam Fund for Gr&Inc B	5	1	4118.1	8 years	6.7
Morgan Stanley US Govt Sec B	5	0.75	4432.4	10 years	6.7
Davis NY Venture B	4	1	4566.1	8 years	5.3
AIM Premier Equity B	5	1	4697.8	8 years	6.7

For example, note the Morgan Stanley fund on the chart. It converts only after 10 years, well after the fund sponsor has collected enough cash to pay off the commission earned by the seller at the time of sale. Fully a third of the 12b-1 fees collected by Morgan Stanley are not needed to compensate for selling costs, which, after all, is why the spread load is charged. What is the function of the extra 12b-1 fees assessed against Class B shareholders? Enrich the sponsor is one correct answer. This may help explain why we find that, "[w]ithin the Morgan Stanley Fund group, B shares comprise roughly 90% of the assets among share classes most commonly sold to individual investors, even though in many cases B shares are the costliest option when compared with the other shares."[353] This may also explain why Morgan Stanley came under attack for allegedly abusive sales practices.[354]

353. Tom Lauricella & Randall Smith, *Morgan Stanley Fund Sales Get Close Look*, WALL ST. J., April 1, 2003, at C1.

354. *See id.* (discussing Morgan Stanley's mutual fund sales practices); *see also* Administrative Complaint, *In re* Morgan Stanley DW, Inc., No. E-2003-31 (Mass. Sec. Div. May 24, 2004), *available at* http://www.state.ma.us/sec/sct/sctpdf/mscmp.pdf (detailing various Morgan Stanley mutual fund compensation abuses, as well as ineffectual efforts to mislead the Massachusetts Securities Division by a Morgan Stanley lawyer).

H. Another Failing: The SEC Allows the Industry to Issue Deceptive Data

In the fund industry we find a willingness by fund managers to use brokerage costs to pay for sales efforts (directed brokerage) and for advisory services (soft dollars). Data that should be readily accessible to the public is hard to find. Even very sophisticated financial analysts have severe problems getting basic information about what funds pay to buy and sell portfolio securities.[355] Analyzing the reasonableness of advisory fee payments is a task complicated by the SEC's failure to require standardized reporting of fund expenses.[356] In the distribution area, we find a mish-mash of terminology and varying ways of accounting for the same expense items. Thus, the SEC's web site counsels that "shareholder service fees" are accounted for as 12b-1 fees,[357] except when they are not.[358] As for accounting consistency, it is nonexistent. Consider this report in an SEC staff no-action letter:

> The Commission's Office of Compliance Inspections and Examinations . . . recently conducted a review of fund supermarkets and several brokerage firms that sponsor fund supermarket programs. The review revealed that different funds participating in the programs generally received the same services from

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355. Consider this comment from a research piece written by three authors, each holding a doctorate in finance: "Anyone trying to objectively examine the level of mutual fund brokerage commissions is immediately struck by the difficulty of obtaining data on these commissions." JASON KARCESKI ET AL., MUTUAL FUND BROKERAGE COMMISSIONS 4 (2004), *available at* http://www.zeroalphagroup.com/news/ZAG_mutual_fund_true_cost_study.pdf.; *see also* Livingston & O'Neal, *supra* note 54:

> Mutual funds pay well over $1 billion in brokerage commissions per year. In spite of the large amounts involved, empirical research on mutual fund brokerage commissions is relatively sparse. This lack of research is at least partially explained by the difficulty in obtaining information about mutual fund brokerage commissions.

Id.

356. According to the ICI, "management fees of mutual funds cover more than just portfolio management. The management fees of mutual funds support the costs of fund executives, shareholder communications, fund pricing, fund accounting and bookkeeping, costs of building and office equipment, and compliance with state and federal laws and regulations." Matthew Fink, ICI President Issues Statement Concerning Mutual Fund Fees, Inv. Co. Inst., (Jan. 27, 2004), http://www.ici.org/statements/nr/2004/04_news_sen_hrg.html.

357. SEC, Invest Wisely: An Introduction to Mutual Funds (modified Oct. 12, 2006), *available at* http://www.sec.gov/investor/pubs/inwsmf.htm.

> Distribution [and/or Service] Fees ("12b-1" Fees) — fees paid by the fund out of fund assets to cover the costs of marketing and selling fund shares and sometimes to cover the costs of providing shareholder services. "Distribution fees" include fees to compensate brokers and others who sell fund shares and to pay for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. "Shareholder Service Fees" are fees paid to persons to respond to investor inquiries and provide investors with information about their investments.

Id.

358. *See id.* The SEC's website states:

> Other Expenses — expenses not included under "Management Fees" or "Distribution or Service (12b-1) Fees," such as *any shareholder service expenses that are not already included in the 12b-1 fees*, custodial expenses, legal and accounting expenses, transfer agent expenses, and other administrative expenses.

Id. (emphasis added).

> program sponsors, although the funds characterized the services differently and paid for those services in different ways. Some funds, for example, characterized all of the services that they received as distribution-related in nature and paid for those services through plans of distribution adopted pursuant to Rule 12b-1 under the Investment Company Act of 1940. Other funds characterized a portion of the services that they received as administrative in nature and paid for those services outside of Rule 12b-1 plans. In some cases, advisers or their affiliates paid a portion of the fee.[359]

The same no-action letter mentioned that fund supermarkets charged fees to funds of "from .25% to .40% [25 to 40 basis points] annually of the average net asset value of the shares of the fund held by the sponsor's customers."[360] The fee ostensibly is used to pay "for permitting the fund to participate in the fund supermarket and for providing the services used by the fund."[361] The fee is bloated. We know the fee is bloated because the true all-in cost for all no-load equity mutual fund operations, other than investment advisory services but including profit to the sponsor and other service providers, is a maximum of .25% (25 basis points) on a weighted average basis.[362] Since the 25 basis point charge covers all mutual fund costs, excluding advisory services, the actual cost for services performed for shareholder out of the shareholder service component of the funds' annual payments to fund supermarkets obviously is miniscule. The large difference between the true cost of the service performed by the fund supermarket and the price charged is banked by the fund supermarket as profit. Most of the payments made by mutual funds to supermarket sponsors are not really for services performed; the payments largely are compensation for distribution efforts. Those expenses need to be accounted for as such.

I. Summary–A Regulatory Breakdown

When Rule 12b-1's supposed plusses are scrutinized closely, it becomes evident that the money management industry has outwitted and outmaneuvered the federal agency that supposedly regulates it, to investors' detriment. Fundamental flaws in the SEC's approach to fund marketing, principally through deficient disclosure requirements, have paved the way for industry marketing ploys calculated to exploit investor ignorance. The SEC's dealings with the mutual fund industry prove that regulatory capture can and does actually happen. The SEC regulators have been outsmarted and co-opted by the formerly weak but now robust industry they once tried to help and still ostensibly control.

VIII. WANTED FROM THE SEC: INVESTOR-ORIENTED LEADERSHIP

Congress expressly invited searching scrutiny of fund industry sponsors and managers when it made this policy finding, which was included in this language in the 1940 Act:

359. Inv. Co. Inst., SEC No-Action Letter, [1998-1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,477 at 78,436 (Oct. 30, 1998).

360. *Id.*

361. *Id.*

362. *See supra* note 177 and accompanying text.

> [T]he national public interest and the interest of investors are adversely affected . . . when investment companies are organized, operated, managed . . . in the interest of . . . investment advisors . . . rather than in the interest of . . . securityholders . . . [or] when investment companies are not subjected to adequate independent scrutiny.[363]

The SEC was vested with regulatory power over the fund industry and has used that power extensively. In the words of a former SEC chairman, "[n]o issuer of securities is subject to more detailed regulation than a mutual fund."[364] The last five years show there is a difference between detailed regulation and careful, intelligent oversight. In a nutshell, the mutual fund industry has been over-regulated and under-policed.[365]

Help in understanding 12b-1 from the SEC's perspective is provided in the form of a Memorandum from Thomas P. Lemke, Chief Counsel for the SEC's Division of Investment Management, to Mary Joan Hoene,[366] Associate Division Director in 1986, reporting on the chief reasons advanced in support of 12b-1, the opponents' position, and the scope of SEC rulemaking power according to commentators:

> Eighteen persons appeared at the public hearings and over thirty written statements were submitted. The overwhelming majority of presentations were made by persons associated in some way with the mutual fund industry, and they were virtually unanimous in the view that, as a matter of policy, using fund assets to promote distribution could benefit shareholders and should be permitted, at least under some circumstances.
>
> Industry commentators made a number of arguments in favor of permitting such expenditures, and these arguments were generally repeated in connection with the subsequent proposal and adoption of Rule 12b-1. They argued that such expenditures would lead to additional sales of shares, thereby increasing the size of a fund's asset base and benefiting shareholders in a variety of ways. Specifically, they argued that increased size (1) could lead to economies of

363. Investment Company Act of 1940 § 1(b)(2), 15 U.S.C. § 80a-1(b)(2) (1994).

364. Letter from Ray Garrett, Jr., Chairman, SEC, to Sen. John Sparkman (Nov. 4, 1974), *reprinted in* [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) No. 559, pt. II (1976).

365. There are some slight signs of change. In a speech given in February of 2004, then SEC Chairman William H. Donaldson lamented "the past 18 months" as a "difficult and troubling period for the mutual fund industry[,]" during which the Commission instituted 61 cases "related to mutual funds," and obtained "$1.4 billion in disgorgements and $1 billion in penalties." William H. Donaldson, Chairman, SEC, Remarks Before the Mutual Fund Directors Forum (Feb. 16, 2004), *available at* 2004 WL 3199456. Missing from Chairman Donaldson's speech was recognition that the impetus for the SEC's cases came from pressure exerted to clean up the fund industry by state regulators, not from any newfound antifraud zeal stemming from within the Commission. *See, e.g.*, Justin Pope, *Mutual Fund Scandal puts Galvin in the Spotlight*, DUBUQUE TELEGRAPH HERALD, Dec. 7, 2003, at B9 ("Even critics acknowledge [Massachusetts' Secretary of State William] Galvin, along with New York Attorney General Eliot Spitzer, has done as much as anyone to shatter the once-pristine image of the mutual fund industry—and that includes the Securities and Exchange Commission, thought by many to be playing catchup to the state regulators.").

366. Memorandum from Thomas P. Lemke, Chief Counsel, SEC, Div. of Inv. Mgmt., to Mary Joan Hoene (May 21, 1986), *in* Arthur Z. Gardiner, Jr., *Distribution of Investment Company Shares Under Rule 12b-1*, *in* INVESTMENT COMPANIES 1987: MEETING NEW CHALLENGES 91, 255 (PLI Course Handbook Series 548 PLI/Corp 1987).

> scale because the overall expense ratio of a fund declines as its size increases, (2) may permit a fund to employ a greater variety of portfolio management techniques and strategies and may aid a fund in maintaining a significant degree of portfolio diversification, (3) generally permits a fund to obtain better, and lower cost, portfolio execution services, and (4) attracts useful reports and recommendations about securities transactions from Wall Street professionals. They also argued that if mutual funds were permitted to use fund assets for distribution, instead of traditional front-end sales loads, investors would benefit directly because funds could offer better and more attractive investment products. Without a traditional front-end sales load, a greater proportion of investors' dollars could be invested immediately. In addition, commentators pointed out that the rigidity of the then-existing distribution regulatory scheme imposed an unfair burden on new shareholders because all shareholders benefit from a viable distribution network and that the scheme, in fact, was no longer viable because investors were increasingly unwilling to pay a high entrance fee. The scheme was also said to put funds at a disadvantage with competing investment products because it precluded alternative distribution methods to attract investors' funds they could not reach with the traditional method. Finally, commentators pointed out that the mutual fund industry generally was suffering from net redemptions, and that if this malady were not reversed, the interests of all shareholders would be harmed by, among other things, increasing the overall expense ratios of funds and jeopardizing shareholders' right of net asset redeemability.
>
> Commentators opposed to the use of fund assets for distribution maintained that increased sales benefited mainly the fund's adviser by increasing the size of the asset base against which the advisory fee is charged. Any benefit to fund shareholders from using fund assets for distribution, they asserted, was speculative at best.
>
> The legal issues associated with fund distribution were discussed in relatively few of the presentations. However, among those who did address these issues, the prevalent view was that, while the use of fund assets to promote distribution was not necessarily prohibited by the Act, the Commission had rulemaking authority under the Act to prohibit or limit such use of fund assets.[367]

The foregoing quote freezes in time the arguments advanced for 12b-1's adoption, and those against it. Today, 27 years after 12b-1's adoption, not a single one of the arguments in favor of the rule has been validated. The skeptics, however, were right on target. The supposed benefits they decried as "speculative at best" have been proved to be illusory. Not illusory is the SEC's power, working in the interest of investors, to end the annual drain of almost $12 billion from shareholders' pockets via the regulatory monstrosity it created.

If the SEC truly is interested in regulating in the public interest and cleaning up

367. *Id.* at 255-57.

mutual fund distribution fees, then it needs to start by eliminating Rule 12b-1. The rule was conceived, proposed, and adopted at a time when the fund industry was struggling to win investor favor. It has done that. As imposed, 12b-1 fees are only permissible where boards, in the exercise of their business judgments, are able to find the diversion of fund assets' promises to benefit the fund and its shareholders. Fund directors who have discovered substantial financial benefits accruing to their funds and shareholders from Rule 12b-1's operation, like zealots claiming to have made UFO sightings, are witnesses to an alleged phenomenon that decades of researchers have not been able to prove exists. After 27 years of 12b-1 plan adoptions and renewals, no proof of 12b-1 fees' cost-effectiveness has surfaced. This lack of evidence does not speak well for the business judgment of fund boards.[368]

It is true that the major use of 12b-1 fees today is as a load financing mechanism. It has been estimated that the amount of 12b-1 fees paid by investors was more than triple the front-end load payments made in 2002.[369] The SEC sponsors "full and fair disclosure" as a way of life in the investment world. As such, it needs to explain how a system of "hidden loads" is superior to load charges that are visible to the investor at the time of sale. Class B share sales proliferate, though Class B shares are demonstrably almost never the best choice for the investor at the point of sale. At a minimum, it is time to ban Class B shares. What is the logic of allowing the sale of a class of shares that lends itself to misrepresentation, while failing to offer clear-cut advantages to investors over other share classes? Class B shares do not add value for shareholders. Instead they function as a tool useful for exploiting consumer ignorance. They do not encourage fair price competition, they encourage unfair competition and deception. They should be eliminated.

The same holds true for all 12b-1 payments. That they add a sales push beneficial to fund sponsors was absolutely foreseeable[370] and is indisputable. But benefit to fund sponsors is not the same as benefit to fund shareholders, and the latter effect is lacking. If the SEC allows 12b-1 fees to continue, then, in the interest of full disclosure, it should demand that the fund directors annually identify, quantify, and disclose for shareholders' review the specific financial benefits that allegedly have accrued, or that are expected to

368. In the words of a former SEC official: "the requirements of the rule make absolutely no sense in the context of contingent deferred sales loads, especially the requirement that the plan can't continue for more than a year at a time, and it can be terminated at any time." SEC Historical Society, *supra* note 21, at 91-92 (remarks of Joel Goldberg). On the other hand, for funds and fund classes where 12b-1 money is being used not to finance CDSCs, but supposedly to generate benefits for the fund and its shareholders, it is time for the SEC to face up to the absence of any proof over 27 years that rule 12b-1 payments yield financial benefits for fund shareholders. The absence of evidence over many years proves that it is time for 12b-1 payments to subsidize CDSCs and nothing more, assuming the rule is not eliminated completely, as it should be.

369. "Using a variety of industry data, we estimate that mutual investors may have paid as much as $3.6 billion in front end loads in 2002, $2.8 billion in back-end loads and another $8.8 billion in 12b-1 fees." Bergstresser et al., *supra* note 236, at 2.

370. As one industry participant put it in a written submission to the staff years ago: "To close one's eyes to the reality . . . that salesmen in the [mutual fund] industry have traditionally sold products which pay the most money is to regulate without a sense of what the industry is about." MUTUAL FUND DISTRIBUTION, *supra* note 65, at 23 (quoting Seaboard Corp.'s written submission). In response to an inquiry whether fund investors were price conscious, another witness testified: "I think there is an extremely inelastic demand for load funds. I think . . . it is true . . . that load funds are sold, but not bought." *Id.* at 19 n.3 (quoting Dr. Stephen F. Sherwin).

accrue to the fund and its shareholders due to the levy.

Fee payments flowing from Rule 12b-1 grease the broker channel, but the services rendered to the public through this channel have been found to be hard to locate. A recent academic study's findings about value added by the broker channel are startling:[371]

- "[W]e do not find that brokers deliver substantial tangible benefits."[372]
- "The bulk of our evidence fails to identify tangible advantages of the broker channel. In the broker channel, consumers pay extra distribution fees to buy funds with higher non-distribution fees expenses. The funds they buy underperform those in the direct channel even before deduction of any distribution related expenses."[373]
- "While we can't seem to locate tangible benefits delivered by brokers, we remain open to the possibility that substantial intangible benefits exist."[374]

The inability of finance experts to find tangible benefits flowing to investors from lavish 12b-1 outlays ought to disturb the Commission.[375] The same is true of the spectacle presented when Arthur Levitt, a former SEC Chairman, warned investors *not* to buy funds carrying 12b-1 fees.[376] Former Chairman Levitt's warning cry provides eloquent testimony in favor of recalling the defective rule. Chairman Levitt's admission testifies to the simple reality that, when it comes to 12b-1 fees, in the words of the congressional declaration, "investment companies are [being] . . . operated and managed in the interest of investment advisers, rather than in the interest of shareholders." By enabling and presiding over this perversity, the SEC deserves blame not simply for indolence, but for complicity.

Congress wanted the fund industry to be subject to "independent scrutiny," and here, again, the SEC has failed. Though supposedly a paragon of "accountability" and "transparency," the fund industry, with the SEC's acquiescence, has for decades featured not just funds carrying "hidden loads," but brokerage charges padded to hide direct

371. Bergstresser, et al., *supra* note 236 (quantifying "the benefits that investors enjoy in exchange for the higher costs they pay in order to purchase funds through the broker channel").

372. *Id.* at 1.

373. *Id.* at 36.

374. *Id.*

375. Not that these particular experts would have been reluctant to identify industry-helpful data had they found it. They acknowledge "very valuable guidance and comments" from, among other groups, the ICI Academic/Practitioner Conference, "staff members of the Investment Company Institute," and "representatives of various fund companies." *Id.* at 1, n.*. In fact, prior versions of the paper were entitled: "*The Benefits of Brokers: A Preliminary Analysis of the Mutual Fund Industry*." Bergstresser, et al., supra note 236, at 1, n.*. Presumably the title got changed when it became clear the authors "[could not] seem to locate" significant, tangible benefits conferred on fund investors by the broker channel. *Id.* at 36. These authors are not alone. *See generally* BULLARD & O'NEAL, *supra* note 28 ("The findings suggest that brokers are not acting in the best interests of their clients."); Houge & Wellman, *supra* note 176, at 24 ("[U]nlike other consumer products, higher mutual fund costs are not associated with higher quality. In fact, the opposite is true . . . .").

376. This advice is furnished in a chapter entitled, "The Seven Deadly Sins of Mutual Funds" in the discussion of the first sin, "the deadliest sin of all" which is, according to Mr. Levitt, "the high cost of owning some mutual funds." LEVITT, *supra* note 335, at 46.

distribution payments or payments for "research services" via soft dollars that never show up in fund expense ratios, and revenue sharing payola. At the same time research services are being paid for out of brokerage charges, we find that direct payments out of the fund for advisory fees that have been inflated to generate lavish advisory profits useful to subsidize distribution expenses.

The link is clear: fund sales drive fund growth, and fund size determines advisory fee income. Fund growth and distribution spending tend to be linked. As one industry observer noted long ago: "To close one's eyes to the reality . . . that salesmen in the [mutual fund] industry have traditionally sold products which pay the most money is to regulate without a sense of what the industry is about."[377] Because of the linkage between sales, asset growth, and advisory profits, there is an ever-present risk that fund shareholders' financial interests will be sacrificed by having fund assets diverted to pay distribution costs in order to generate cash for selling brokers and advisory income for fund sponsors.

Given the fund industry's inherently conflicted management and sales compensation structure, there is no justification for an unnecessarily complicated methodology when it comes to funds paying their bills. At a minimum, competent regulation requires the marketplace be informed in a uniform, systematic, and accurate way about any and all expenses being paid for with dollars extracted from fund assets. The SEC should insist that when funds pay for brokerage execution, they buy that and nothing more. If a fund investment adviser wishes to buy research in the free market, then it should feel free to do so, with its own money. The fund advisory business, after all, is "enormously profitable,"[378] and the beneficiaries of that enormous profitability are competent to write checks to buy research if they wish to do so. They do not need to obtain research help by padding fund brokerage charges and sticking fund shareholders with the tab.

Likewise any and all payments out of fund assets to promote fund distribution need to be identified as such, clearly flagged, and approved only upon a finding that the payment is reasonably likely to confer a net financial benefit on fund shareholders. Finally, to the extent that sponsors use "advisory profits" to pay distribution costs, they should be required annually to account to the fund's board and its shareholders for the payments made in terms of dollars and usage. Furthermore, sponsors should be required to explain why distribution costs subsidized by advisory profits could not have been paid by some other visible means, such as by levying a load borne by buying investors.

SEC Chairman Arthur Levitt articulated the following standard of conduct for corporate directors: "When corporate directors have reason to know—because of their positions and expertise—that important information is not being disclosed, it is their responsibility to ask the basic question: 'Why not?'"[379] The SEC needs to answer the same question under the same circumstances. Today, in the mutual fund area, the SEC actions do not measure up to the disclosure standards to which it holds others. When it comes to mutual fund expense accounting and reporting, the SEC has failed investors. It

377. MUTUAL FUND DISTRIBUTION, *supra* note 65, at 23 (quoting Seaboard Corp.'s written submission).

378. SEC Historical Society, *supra* note 21, at 33 (remarks of Joel Goldberg).

379. Arthur Levitt, Chairman, SEC, Address at Tulane University, Corporate Governance: Integrity in the Information Age (Mar. 12, 1998), *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch206.txt.

is time for the Commission to draw some bright lines and bring coherence, accountability, and visibility to financial reporting in an industry populated by fund sponsors who have grown rich doing business in the shadows for far too long. The SEC's history of tolerating weak, misleading fund expense disclosure undercuts its moral authority as the fund industry's regulator.

In a release issued in December of 2003 rebuking Eliot Spitzer's attack on mutual fund fees, the Commission observed:

> While we can all applaud fair and reasonable fees, we think the best way to ensure them is a marketplace of vigorous, independent, and diligent mutual fund boards coupled with fully informed investors who are armed with complete, easy-to-digest disclosure about fees paid and the services rendered.[380]

If wishful thinking and high-sounding rhetoric were enough, the SEC would be a stellar regulator and the mutual fund marketplace would be a paragon of price competition. Instead, the marketplace is rife with deceptive product pricing, mis-labeling of expense items, and bloated profit margins. Presiding over this travesty of accountability and competitiveness are the fund industry's boards of directors who have been anything but "vigorous, independent, and diligent" when it comes to reining in the fund sponsors who actually call the shots.

IX. FUND BOARDS AS REFORM LEADERS–MISSING IN ACTION

The SEC's blueprint for 12b-1's operation counted heavily on board diligence and oversight and that plan has failed. Under the SEC-established 12b-1 plan-adoption regime, full disclosure would precede careful judgments by decision makers. Fund boards and shareholders would carefully evaluate the rule's perceived benefits and costs prior to adopting a plan, expenditures would be reviewed by the board quarterly, annual reviews would test whether the 12b-1 expenditures were yielding the expected returns, and so forth. This failed plan relied on fund boards carefully exercising their business judgments to insure that funds and fund shareholders gained financially. Here is how the 12b-1-fee approval system is supposed to work, according to an ABA-authored set of behavioral guidelines for mutual fund directors:

> In considering the establishment or renewal of a fund's Rule 12b-1 plan, the board of directors has an express duty to request and evaluate, and the distributor has an express duty to furnish, such information as may reasonably be necessary to make an informed determination. To approve the plan, the board must decide, in the exercise of its reasonable business judgment and in light of its fiduciary duties under applicable state law and under the 1940 Act, that the plan is reasonably likely to benefit the fund and its shareholders. In addition, the board must be satisfied that the amounts to be paid by the fund are reasonable in light of the distribution services that have been performed and that they represent a charge within the range of what would have been

380. Press Release, SEC, Statement of the Commission Regarding the Enforcement Action Against Alliance Capital Management, L.P. (Dec. 18, 2005), *available at* http://www.sec.gov/news/press/2003-176.htm.

negotiated at arm's-length. A fundamental factor to be considered in connection with all Rule 12b-1 plans is whether the distribution method under consideration provides for a reasonable financing alternative under the facts and circumstances of the particular fund and the type of investor to which the plan is directed.[381]

Twenty-seven years have passed since Rule 12b-1 was promulgated, and we are still waiting for the first competent study showing that 12b-1 plans are likely to generate net financial benefits to mutual funds and their shareholders. As discussed above, the data show the opposite. It is also unclear how a competent, responsible fund board "in the exercise of its reasonable business judgment and in light of its fiduciary duties," authorizes the sale of Class B, well knowing that, as one financial writer put it, "[they] always have been second-class investments."[382] It also is difficult to understand how any sensible fund director can conclude, as required under Rule 12b-1(e),[383] that offering a "second-class investment" prone to being marketed deceptively is "reasonably likely to benefit the . . . shareholders." When it comes to discharging their fiduciary obligations, fund directors have earned a reputation for what Warren Buffet has called "zombie-like" behavior "that makes a mockery of stewardship." [384] Either Warren Buffet does not know what he is talking about when talking about corporate stewardship, or the mindset in fund boardrooms needs a makeover.

Putting aside indolence, a major reason why fund boards have been ineffectual in discharging the stewardship obligation they owe under the Investment Company Act is because the truth sometimes never reaches them. This is shown by the SEC's startling findings in *In re BISYS*.[385] In that case advisers for 27 fund families were found to have delegated to BISYS Fund Services, Inc. the task of performing administrative services for the funds. The cost for the work evidently was set around 20 basis points of net assets. The order suggests that BISYS actually did the work for a lot less, around 5.5 basis points, secretly kicking back 6 basis points to the funds' advisers. Most notably for present purposes, another 8.5 basis points given up by BISYS was secretly being used for "marketing," i.e., to pay for distribution, not for administrative services. Over a five-year period, BISYS kicked back $230 million in administrative fees "to use in marketing budgets."[386] Meanwhile, the funds' boards and the funds' shareholders were duped, with fund assets being diverted for marketing costs via the back door as administrative costs, rather than as charges under a proper 12b-1 plan.

Another shocking example of fund boards being duped is presented by Citigroup's recently uncovered scheme to grossly over-bill shareholders in its Smith Barney mutual fund group for transfer agent fees. In that case the fund boards were led to believe transfer agency business was being moved from a third-party provider to a Citigroup

381. ABA, *Fund Director's Guidebook*, 52 BUS. LAW. 229, 254 (1996).

382. Helen Huntley, *Class B Shares Face Increasing Scrutiny*, ST. PETERSBURG TIMES, Feb. 6, 2005, *available at* http://www.sptimes.com/2005/02/06/Columns/Class_B_shares_face_i.html.

383. 17 C.F.R. § 270.12b-1(e) (2006).

384. BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT (2003), *available at* www.berkshirehathaway.com/2002ar/2002ar.pdf.

385. *In re* BISYS Fund Serv., Inc., Admin. Proc. File No. 3-12432 (Sept. 26, 2006), *available at* http://www.sec.gov/litigation/admin/2006/ia-2554.pdf.

386. *Id.* at 3, ¶ 4.

affiliate. In reality, most of the work continued to be done by the third party transfer agent, but at a steeply reduced cost. The fee discount amounting to tens of millions per year of shareholders' money secretly was diverted to two Citigroup subsidiaries.[387]

The BISYS kickback scheme and the Citigroup fraud demonstrate that fund advisers are capable of reaping huge profits off such mundane items as transfer agent costs, and are prone to lie about what they are doing to fund directors. If transfer agent fees can be grossly inflated, perverted, and lied about, who can have confidence that 12b-1 fees and advisory fees are being fairly set and the relevant facts about them honestly disclosed? The secret BISYS and Citigroup payoff schemes are thus reminiscent of another fund marketing ploy flagrantly violative of Rule 12b-1: directed brokerage. In both the *BISYS* and Citigroup cases and the situation with directed brokerage, expenses were mislabeled to generate cash usable to sell fund shares. In both the directed brokerage situation and the BISYS fraud, one finds boards not informed by the advisers that expenses were being inflated to generate cash to use for marketing.[388] If advisers are willing to deal unfairly over fund brokerage and administrative charges, there is no reason to believe they will not also be abusive in extracting inflated distribution charges via 12b-1. The need for heightened vigilance is clear.

Unfortunately, heightened vigilance by fund boards over distribution charges is a pious wish, nothing more. The tendency of fund boards routinely to renew 12b-1 plans without proof the plans actually confer a net financial benefit on the fund and its shareholders may be understood, though not excused, by two realities. First, the rule was SEC-adopted and remains in effect. Its very existence can be seen as giving a government-approved green light to diversions of shareholder money proposed by fund sponsors and their affiliates. Second, there are more than 8500 mutual fund share classes bearing 12b-1 fees.[389] The large number of 12b-1 plan adoptions make it more than likely that an "everyone is doing it" mentality has developed in fund board rooms. Complacent, self-satisfied board members comfortable with the "everybody's doing it" justification would do well to spend a few hours reading the academic literature reporting no significant, tangible benefits to investors from 12b-1 or, for that matter, from the mutual fund distribution through the 12b-1 financed broker-channel.[390]

Meanwhile, to put it mildly, the road to 12b-1-fee reform does not travel through mutual fund boardrooms. In the future it may, however, depending on the outcome from lawsuits attacking fund sponsors and fund directors for breaching their fiduciary duties in the handling of 12b-1 plan approvals. Legal theories for use in 12b-1 cases are discussed

387. *See* News Release, SEC, *Citigroup To Pay $208 Million to Settle Charges Arising From Creation of Affiliated Transfer Agent to Serve Its Proprietary Mutual Funds* (May 31, 2005), *available at* 2005 WL 1274240. Details concerning the scheme are provided in SEC v. Jones, No. 05 Civ. 7044 (RCC), 2006 WL 1084276 (S.D.N.Y. Apr. 25, 2006).

388. For a directed brokerage case where this occurred, see *In re* Matter of Franklin Advisers, Inc., Release No. 50,841, 84 SEC Docket 1357 (Dec. 13, 2004). In BISYS key details were not disclosed (such as that side-deals calling for BISYS to kick back money to the advisers were in place before the advisers presented the BISYS contract to the boards), and the boards were never asked to evaluate the marketing fees as part of a 12b-1 plan review.

389. By the end of 1999, 56% of the 15,264 share classes of all mutual funds had 12b-1 plans. *Use of Rule 12b-1 Fees by Mutual Funds in 1999*, FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Apr. 2000, at 2, *available at* http://www.ici.org/pdf/fm-v9n1.pdf.

390. *See supra* notes 370-374 and accompanying text.

in the following section.

X. LEGAL RECOURSE AS A TOOL FOR CHANGE

A. Introduction

If load fund boardrooms seem like an inhospitable place to look for 12b-1 reform, the same is true of the nation's courtrooms, at least to date. No lawsuit attacking 12b-1 plans has succeeded, and, as discussed above, suits contesting Class B share sales (funded with 12b-1 fees) on fraud or suitability grounds have not met much success. Derivative suit attacks mounted under state law on boards who approve 12b-1 plans are destined to fail in the face of directors' impressive defensive weaponry, consisting of the demand requirement,[391] special litigation committees,[392] the business judgment rule, and various statutes capping damages. Direct class action claims asserting state causes of action risk preemption under Securities Litigation Uniform Standards Act of 1998[393] ("SLUSA"). No court has upheld a claim asserting an implied right of recovery under Rule 12b-1.

391. For a case dismissing an attack on 12b-1 fees for failure to allege a demand or plead futility, see Miller v. Mitchell Hutchins Asset Mgmt., No. 01-CV-00192DRH, 2003 WL 24260305 (S.D. Ill. Mar. 6, 2003) (order issued on motions to dismiss second amended complaint). If a demand on the board is made, it is apt to be refused, and the case is likely to be dismissed in deference to the board's business judgment. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 395, 399-400 (2002) (discussing efficiency of special litigation committees in eliminating derivative lawsuits in demand-excused cases, and noting that in only one of the first 20 reported decisions dealing with special litigation committee determinations did the committee conclude the derivative lawsuit should be allowed to proceed).

392. Even plaintiffs asserting derivative claims premised on claimed misconduct involving 12b-1 fees violations who are able to plead demand futility are apt never to see their cases tried on the merits due to the functioning of special litigation committees. *See, e.g.*, ROBERT W. HAMILTON & JONATHAN R. MACEY, CORPORATIONS 885 (8th ed. 2003). The authors explain that:

> In virtually every case in which derivative litigation has been considered by a litigation committee or by the board of directors since 1984, the determination has been made that the pursuit of the litigation is not in the best interest of the corporation. Does that not lend credence to the objection that there is in fact a 'structural bias' in this decisional process?

Id. See also FRANKLIN A. GEVURTZ, CORPORATION LAW 412 (2000) ("Special litigation committees, almost without exception, have concluded that the derivative suits, which the committees looked into, were not in the corporation's best interests.").

393. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified in various sections of 15 U.S.C. (2000)). The statute provides in part that "[n]o covered class action based" on state law and alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security" "may be maintained in State or Federal court by private party." Pub. L. No. 105-353, § 101(b), 112 Stat. 3227, 3228 (codified as amended at 15 U.S.C. § 78bb(f)(1)(A)). The Supreme Court held in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 126 S.Ct. 1503, 1507 (2006), that SLUSA operates to preempt even those state class action claims for which there is no federal right of recovery. This ruling calls into question a prior lower court ruling allowing state claims attacking 12b-1 fees to proceed as a class action. *See* Strigliabotti v. Franklin Resources, Inc., 398 F. Supp. 2d 1094 (N.D. Cal. 2005). For another mutual fund fee case held to be beyond SLUSA's reach, see *Kircher v. Putnam Funds Trust*, No. 03 C 691 (S.D. Ill. Jan. 24, 2004) (order filed) (remanding claims removed under SLUSA to state court), *rev'd*, 373 F.3d 847 (7th Cir. 2004), *vacated and remanded*, 126 S.Ct. 2145 (2006).

B. Section 36(b) Standards

Offering more promise to plaintiffs is the assertion of claims premised on violations of section 36(b) of the Investment Company Act.[394] Claims alleging misconduct as to 12b-1 fees have been upheld under section 36(b) of the Investment Company Act of 1940 at the pleading stage.[395]

Proving a violation of section 36(b) requires a strong showing: "[T]he adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[396] Under section 36(b), some fund shareholders challenging the 12b-1-fee drain have been able to state causes of action.[397] One contention that has found favor at the pleading stage is that the payment by fund shareholders of money for no benefit, a "something for nothing" exchange, meets the statutory test under section 36(b) as an improper disproportionate payment.[398]

394. 15 U.S.C. § 80a-35(b) (2000). The section reads:

> [The] investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person.

Id.

395. *E.g.*, Forsythe v. Sun Life Fin., Inc., 417 F. Supp. 2d 100 (D. Mass. 2006).

396. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982).

397. *See, e.g.*, Meyer v. Oppenheimer Mgmt. Corp., 764 F.2d 76 (2d Cir. 1985) (accepting the claim that the 12b-1 fee combined with the advisory fee was excessive did state a cause of action upon which relief could be granted under section 36(b) of the Act); Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472 (S.D.N.Y. 1988) (holding 12b-1 fees subject to section 36(b)); Second Amended Complaint at 8-9, Miller v. Mitchell Hutchins Asset Mgmt., Inc., No. 01-CV-0192-DRH (S.D. Ill Apr. 25, 2001). However, one court has held that even section 36(b) is unavailable as a means to recoup 12b-1 fees on the ground that the fees simply pass through the adviser into the hands of other service providers to whom service payments are made. Pfeiffer v. Integrated Fund Servs., Inc., 371 F. Supp. 2d 502 (S.D.N.Y. 2005). For an example of the kind of distribution fee allegations asserted under section 36(b) that have proved capable of withstanding a motion to dismiss, see Third Amended Complaint at ¶¶ 19-27, 55-56, 62, 68, 79, 92-99, Strigliabotti v. Franklin Res., Inc., No. C-0400883, 2005 WL 3689486, at *4 (N.D. Cal. Aug. 4, 2005). On the other hand, one court seemingly has granted immunity to advisers who collect 12b-1 fees under rule 36(b), reasoning that such advisers merely are conduits through which fees pass rather than "recipients" of 12b-1 fees covered by section 36(b). *See* Pfeiffer v. Bjurman, Barry & Assocs., 03 Civ. 9741 (DCL), 2006 U.S. Dist. LEXIS 7862, at *5 (S.D.N.Y Mar. 2, 2006) (plaintiffs did not bear burden of proof that defendants were not recipients). Though the adviser or a holding company might not have liability under the *Pfeiffer* court's analysis, the fund's underwriter or other agent who collects and spends the money certainly would be a "recipient" of the 12b-1 cash and reachable under section 36(b).

398. *See* Forsythe v. Sun Life Fin., Inc., 417 F. Supp. 2d 100, 116 (D. Mass. 2006) (citing Jones v. Harris Assocs., L.P., No. 04 C 8305, 2005 WL 831301, at *3 (N.D. Ill. Apr. 7, 2005) (stating that a something for nothing exchange represents an actionably disproportional relationship between the fees paid and the services rendered)).

In the context of cases challenging fund advisory fees, it has been held that in assessing whether section 36(b)'s demanding fiduciary duty breach test[399] has been satisfied, "all pertinent facts must be weighed,"[400] including (a) the nature and quality of services provided to fund shareholders; (b) the profitability of the fund to the adviser-manager; (c) fall-out benefits;[401] (d) economies of scale; (e) comparative fee structures; and (f) the independence and conscientiousness of the trustees.[402] Section 36(b) holds out promise, but only that; never has a dissident shareholder plaintiff won a trial contesting fee payments under the section.[403]

This test may be of some use in the advisory fee context, but the factors are of limited value in assessing 12b-1 payments. For 12b-1 outlays, the "something for nothing" test should apply because, as recently observed by the district court in *Siemers v. Wells Fargo & Co.*,[404] fiduciary duties are not reducible to a fixed, immutable formula and "often include duties of candor and fair dealing."[405] The lack of any proof that 12b-1 payments produce tangible financial benefits for fund shareholders suggests that 12b-1 payments ought to be a fertile ground for shareholder litigation.

At a minimum, directors challenged to prove they have discharged their fiduciary duties in adopting 12b-1 plans had better be prepared to turn over the data they considered and calculations they made when they voted on implementing or continuing Rule 12b-1 plans. When it adopted Rule 12b-1, the SEC referred to various factors boards might weigh in deciding whether to adopt or continue 12b-1 plans. They were: the involvement of independent legal counsel or experts; the nature and causes of the fund's specific distribution problems or circumstances; the manner in which the 12b-1 plan addresses problems or circumstances; the merits of possible alternative plans; the inter-relationship between the plan and activities of other persons; possible benefits of the plan to any other person relative to those expected to inure to the fund; the effect of the plan on existing shareholders; and evaluation of success of the plan.[406]

The rule allows implementation of a distribution plan only subject to certain conditions. One set of conditions, set forth in Rule 12b-1(d), demands:

> (d) In considering whether a [mutual fund] should implement or continue a plan in reliance on paragraph (b) of this section, the directors of such company shall

399. The test is set forth at *supra* note 396 & *infra* notes 400-402 and accompanying text. The test *is* demanding, a fact demonstrated by the inability of any plaintiff ever to win a section 36(b) case on the merits, notwithstanding stratospheric profits being banked by fund advisory firms. *See generally* Freeman & Brown, *supra* note 31, at 642-49 (discussing how plaintiffs' claims are "subject to severe limitations").

400. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 929 (2d Cir. 1982).

401. Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472, 494 (S.D.N.Y. 1988). Fall-out benefits are indirect financial benefits reaped by the fund's sponsor flowing in some way from the fund's existence. *Id.* For a discussion of fall-out benefits in the context of a money market fund 12b-1/advisory fee case, see *Krinsk v. Fund Asset Mgmt., Inc.*, 715 F. Supp. 472, 481, 494 (S.D.N.Y. 1988).

402. *Gartenberg*, 694 F.2d at 929-32.

403. For a critique of section 36(b)'s requirements and a call for reform, see Caroline J. Dillon, *Do You Get What You Pay For? A Look at the High Fees and Low Protections of Mutual Funds*, 2006 COLUM. BUS. L. REV. 281, 294-309.

404. Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2006 WL 2355411 (N.D. Cal. Aug. 14, 2006).

405. *Id.* at *18.

406. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11,414, 45 Fed. Reg. 73,898 (Oct. 28, 1980).

have a duty to request and evaluate, and any person who is a party to any agreement with such company relating to such plan shall have a duty to furnish, such information as may reasonably be necessary to an informed determination of whether such plan should be implemented or continued; in fulfilling their duties under this paragraph the directors should consider and give appropriate weight to all pertinent factors, and minutes describing the factors considered and the basis for the decision to use company assets for distribution must be made and preserved in accordance with paragraph (f) of this section;

Fund directors willing to approve 12b-1 fees based on the view that the fees are "SEC-approved," or that "everybody does it," are heading for a rude awakening. The rule's touchstone is deference to directors' reasonable business judgment, and there is nothing judgmental about ignorance.[407] A board finding itself under attack for having approved 12b-1 fees had better be prepared to show it actually engaged in the honest, conscientious, thorough deliberative process envisioned by the SEC when approving adoption or renewal of 12b-1 plans. After all, 12b-1 springs not from SEC approval of diverting fund assets to pay distribution costs based on directors' whims, but rather it reflects the Commission's decision to respect and defer to fund directors' sound business judgment. For fund boards, the acid test when exercising that requisite sound business judgment called for under Rule 12b-1 is whether allowing fund sponsors to siphon off shareholder money actually promises to yield a net financial benefit for the shareholders whose money is being taken. If the answer to that question is "no," then the sponsor's conduct in raking off the 12b-1 fee begins to take on the trappings of theft.

Further, Rule 12b-1 demands that a fund's "directors *shall* review, at least quarterly, a written report of the amounts so expended [under Rule 12b-1] and the purposes for which such expenditures were made"[408] in determining whether the intended benefits to the fund and its shareholders are being realized. Rule 12b-1's mandatory requirement of quarterly study and annual reconsideration and re-approval demands that fund managers identify and quantify what distribution problems are to be addressed, and specifically what 12b-1 payments have done or promise to do in solving them. Boards also should determine if the objectives sought to be achieved through 12b-1 payments could still be achieved if payments were reduced.[409] Such calculations are crucial if the wisdom of using 12b-1 fees as a problem-solving device is to be fairly evaluated. Sunlight needs to

407. "The business judgment rule may apply to a deliberate decision not to act, but it has no bearing on a claim that directors' inaction was the result of ignorance." Rabkin v. Philip A. Hunt Chemical Corp., 547 A.2d 963, 972 (Del. Ch. 1986). Instead, "[d]irectors will be held liable for injuries caused as a result of their neglect where they fail to use 'that amount of care which ordinarily careful and prudent men would use in similar circumstances.'" *Id.* (citing Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963)). The factors set forth in SEC Investment Company Act Release No. 11414 cited in the text above include those factors, among others, that "ordinarily careful and prudent [mutual fund directors] would use in similar circumstances" in making decisions about 12b-1 plans.

408. 17 CFR § 270.12b-1(b)(3)(ii) (2006) (emphasis added).

409. That every dollar of 12b-1 payments is not needed to compensate selling brokers is proved by the behavior of E*Trade Financial, a brokerage firm that rebates half of all 12b-1 fees it receives back to its customers. *See* E*Trade Financial, https://us.etrade.com/flash/isg/anthony2.swf (last visited Mar. 6, 2007). Directors who approve contracts not offering the best price available are not doing their jobs. *See* Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1119 (Del. 1994) (noting directors' duty is to get the best deal available).

shine on directors' decision making under Rule 12b-1. The same is true for data on revenue sharing payments. This shadowy practice needs to be scrutinized carefully in fund boardrooms. With $2 billion annually being paid for distribution via revenue sharing, the problem is too big to ignore, and directors have an obligation to address it.[410]

If the SEC decides to retain 12b-1, it should at least demand that fund boards be required publicly to disclose those calculations so that interested shareholders, the financial press and academics can understand and evaluate the decision making process. As it is, billions of dollars annually are exiting the funds to address and solve supposed problems. At the same time, shareholders and those interested in understanding and evaluating fund managers, such as the financial press, are being left in the dark, unable to assess the wisdom and care of board members' decision-making.

C. Claims Under the 1933 and 1934 Acts

Offering a glimmer of hope for attacking the fund industry's deceptive marketing practices under misrepresentation theories is the recent California district court decision in *Siemers v. Wells Fargo & Co.*[411] In *Siemers*, deception claims attacking revenue sharing and directed brokerage deals were upheld under section 12(a)(2) of the Securities Act of 1933[412] against broker-dealers who sold fund shares,[413] under the 1933 and 1934 Acts' control person provisions[414] against the holding company that was the "ultimate parent" of the other defendants,[415] and under rule 10b-5.[416] The 10b-5 claim was asserted against all defendants, including the funds' sponsor, the holding company controlling it, and the funds' investment advisers, distributors, and selling broker-dealers. The funds' prospectus disclosures allegedly were materially misleading because they simply suggested that payoffs to selling brokers were a possibility, "when it was, in reality, already a done deal."[417] The court held that investors had stated a valid claim based on their contention they had been duped into believing that the brokers selling them fund shares were unbiased. "If a reasonable investor knows the broker-dealer has a payback agreement to showcase a particular fund, the investor is likely to take a harder look at the recommendation."[418] In essence, the plaintiff fund investors stated claims they had been defrauded out of the ability clearly to see, understand, and compensate for

410. Monitoring the fund sponsor's performance in handling distribution is a fund director's job. *See* Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962, 968 (S.D.N.Y. 1987) (noting legal advice given to a fund's board that "directors . . . must insure that the advisory fee 'does not involve the use of Fund assets to finance distribution in violation of the rules of the Securities and Exchange Commission'").

411. Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2006 WL 2355411 (N.D. Cal. Aug. 14, 2006).

412. 15 U.S.C. § 77l(a)(2) (2000).

413. Section 12(a)(2) only imposes liability against a defendant that "offers or sells a security . . . to the person purchasing such security from him." In a subsequent order, one of the named broker dealers, H.D. Vest Investment Services, LLC, was dismissed due to the plaintiff lacking standing. *Siemers*, 2006 WL 3041090.

414. Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o; Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t.

415. *Siemers*, 2006 WL 2355411, at *13.

416. 17 C.F.R. § 240. 10b-5 (2006).

417. *Id.* at *5.

418. *Id.* at *10. The court in *Siemers* was blunt about what it was seeing in defendants' mutual fund distribution practices, observing the complaint "alleges a persistent and deliberate scheme to use half truths to conceal a thriving system of kickbacks and its concomitant conflicts of interest." *Id.* at *9.

their trusted brokers' conflict of interest. In upholding various claims targeting fraudulent fund distribution practices, *Siemers* rejected pro-industry precedent finding no disclosure duty owed by brokers to their customers.[419]

In an order dated March 9, 2007, the district court in *Siemers* revisited the topic of mutual fund distribution payments when it considered the sufficiency of plaintiffs' third amended complaint.[420] The court's order stands as the most comprehensive and incisive judicial opinion yet written on the subject of mutual fund distribution practices. While careful to explain that he was judging only untested allegations, entitled to be taken as true at the pleading stage,[421] Judge William Alsup made it plain that the fund adviser and distributor's alleged misbehavior raised serious federal securities liability questions. The court homed in on the tendency of fund sponsors to use fund shareholders' money to generate new sales,[422] the resort to vague, unhelpful disclosures used to mask distribution payments,[423] and, ominously, implied that advisers who divert shareholder money to generate new sales risk liability for breaching their fiduciary duties owed to current investors.[424] If the analytical seeds found in the recent *Siemers* opinion take root, there is reason to believe the grave fiduciary duty problems afflicting mutual fund distribution will be addressed and resolved by federal court lawsuits.

D. Recent Delaware Case Law Holds Potential in Fee-Related Fund Lawsuits

Fund industry fiduciary duty cases may be more winnable now than ever before, not because of any breakthrough in federal law, but, amazingly, because of pro-shareholder leanings shown by the Delaware judiciary. To put it mildly, Delaware, historically, has not been known as a bastion of shareholder protection. Rather, it has been favored by corporate executives as a jurisdiction known for being sympathetic to management and the status quo. However, a series of Delaware Supreme Court cases may show the way to courts called on to assess the reasonableness of fees in the mutual fund industry. According to Delaware's highest court, scrupulous diligence is required: "in making

419. Specifically, *Siemers* repudiated *Castillo v. Dean Witter Discover & Co.*, No. 97 Civ. 1272 (RPP), 1998 WL 342050 (S.D.N.Y. June 25, 1998). *Siemers*, 2006 WL 2355411, at *8. In *Castillo*, a broker misconduct case involving fund sales, the district court held that the Dean Witter broker-dealer had no duty to disclose that individual selling agents got more money when they sold Dean Witter products than other products. The court based its ruling on plaintiffs' inability to cite favorable case law, and on the own assumption that "[p]laintiffs should have been aware that sale of a Dean Witter fund, as opposed to an outside fund, would mean greater compensation for the Dean Witter companies." Recognizing a duty to disclose such differential compensation, explained the *Castillo* court, "would engender an almost impossible problem of defining the limits of such a duty." *Id.* at *9. The court in *Siemers* had no problem defining a duty not to conceal material facts on the part of conflicted fund sellers. *See id.* at *8.

420. Siemers v. Wells Fargo, & Co., No. C 05-04518 WHA, 2007 WL 760750 (N.D. Cal. Mar. 9, 2007).

421. *See id.*, at *15 n.13.

422. "A skeptic might say that the imagination of mutual fund sponsors has not slept in inventing ways to use shareholder money rather [than] their own to finance the ongoing distribution of new shares." *Id.* at *8.

423. "The vague disclosures-written in plain Greek-concealed thriving revenue sharing schemes. The muscularity of the programs had grown so large that language adopted in the earlier era concealed the truth, or so it is alleged." *Id.* at *13.

424. "The common fund belongs to the investors. It is not a cash register for the fiduciaries to use as they wish. . . . To diminish the common fund by causing it to finance an ongoing search for new money would . . . be a violation of the sponsor's fiduciary duty to the old money." *Id.* at *7.

business decisions, directors must consider all material information reasonably available."[425] In one case pertinent to the fund industry, the Delaware Supreme Court admonished independent directors to bargain hard in order to insure that the best possible bargain is struck on their corporation's behalf:

> The power to say no is a significant power. It is the duty of the directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available.[426]

Recently, Delaware Supreme Court Chief Justice Norman Veasey observed that "[d]irectors who are supposed to be independent should have the guts to be a pain in the neck and act independently."[427] The Delaware judiciary has been doing more than speaking from a bully pulpit. Since June 2002, Delaware's Supreme Court has issued written decisions in a number of cases involving the directors' handling of their fiduciary obligations. In five of these decisions, the supreme court held for the shareholders and against directors and, in doing so, reversed court of chancery decisions that had rejected the shareholder claims.[428] The message that corporate boards, like the rest of humanity, are capable of falling down on the job thus seems to have taken root in Delaware. On June 8, 2006, Delaware's Supreme Court affirmed in *In re The Walt Disney Company Derivative Litigation*,[429] that a director breaches his or her fiduciary obligations and acts in bad faith "where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[430]

As a matter of law, fund directors have been notified by the SEC that their approval of 12b-1 plans must be careful and deliberate. They have been ordered to gather data and review it periodically and, after that, to approve 12b-1 payments only upon specific findings that those payments benefit the fund and its shareholders. Failure of a director to heed the SEC's direction can well be taken by a court as bad faith misconduct. Failure of a fund sponsor receiving 12b-1 fees to supply directors with the necessary data will provide a basis for a fiduciary duty claim under section 36(b) since the sponsor will have received payments extracted illegally from the fund.

When it comes to bargaining over payments out of fund assets to mutual fund

425. *E.g.*, Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000); *see also* Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985).

426. Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1119 (Del. 1994) (brackets in original) (quoting *In re* First Boston, Inc. S'holder Litig., C.A. 10338, 1990 WL 78836, at *15-*16 (Del. Ch. June 7, 1990)).

427. *What's Wrong with Executive Compensation? A Roundtable Moderated by Charles Elson*, 81 HARV. BUS. REV. 68, 76 (2003).

428. *See* Telxon Corp. v. Meyerson, 802 A.2d 257 (Del. 2002) (reversing grant of summary judgment); Saito v. McKesson HBOC, Inc., 806 A.2d 113 (Del. 2002) (reversing ruling limiting access to corporate books and records by shareholder); Levco Alternative Fund Ltd. v. Reader's Digest Ass'n, Inc., No. 467,2002, 2002 WL 1859064 (Del. Aug. 13, 2002) (reversing denial of motion for preliminary injunction); OmniCare, Inc. v. NCS Healthcare, Inc., Nos. 605,2002, 649, 2002, 2002 WL 31767892 (Del. Dec. 10, 2002) (reversing denial of preliminary injunction); MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003) (reversing final judgment dismissing challenge to board decision to adopt defensive measures altering size and composition of the board during a proxy contest).

429. *In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

430. *Id.* at 67.

sponsors, fund directors must be prepared to bargain hard, bearing in mind the Delaware Supreme Court's demand that they "approve only a transaction that is in the best interests of the public shareholders [and] . . . *say no to any transaction that is not fair to those shareholders and is not the best transaction available.*"[431] To be assured deals cut between the fund's sponsor and the fund are "the best transaction available," fund directors need to start bargaining harder than ever before.

E. A Pertinent Criminal Law Analogy

Any discussion of soft dollar payments, brokerage commission kickbacks, padded administrative fees, or secret revenue sharing payola would be incomplete if the criminal overtones were not identified and explored. Those overtones are serious. Billions of dollars are being made and spent, and control and careful approval by the decision makers, principally fund boards, is essential. The hidden diversion of money has consequences and some of them relate to criminal law.

Consider the ubiquitous federal white-collar crime of mail fraud.[432] It has been characterized as consisting of "little more than an evil scheme."[433] The essence of the offense is that the actor participates in a scheme to defraud.[434] Fund sponsors who divert fund assets in unapproved, undisclosed ways doubtless do not view themselves as participating in "schemes to defraud," but the legitimacy of their behavior is far from clear. A Seventh Circuit case on point is *United States v. George*.[435] The case involved a Zenith Radio Corporation employee named Yonan, who was in charge of buying stereo cabinets. Using his fiduciary position with Zenith, Yonan arranged for an entity named Accurate Box Corporation to furnish cabinets to Zenith. Yonan also cut a side-deal with Accurate Box's owner by which Yonan secretly received kickbacks of up to $1 per-cabinet.[436] The kickbacks violated Zenith's policy (known and assented to by Yonan)

431. Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1119 (Del. 1984) (brackets in original) (emphasis added) (quoting *In re* First Boston, Inc. S'holders Litig., C.A. 10338, 1990 WL 78836, at *15-*16 (Del. Ch. June 7, 1990)).

432. The mail fraud statute is 18 U.S.C.A. § 1341 (West 2006). According to one former federal prosecutor, now a federal district court judge:

> To federal prosecutors of white collar crime, the mail fraud statute is our Stradivarius, our Colt 45, our Louisville Slugger, our Cuisinart—and our true love. We may flirt with RICO, show off with 10b-5, and call the conspiracy law "darling," but we always come home to the virtues of 18 U.S.C. § 1341, with its simplicity, adaptability, and comfortable familiarity. It understands us and, like many a foolish spouse, we like to think we understand it.

Jed S. Rakoff, *The Federal Mail Fraud Statute (pt. 1)*, 18 DUQ. L. REV. 771, 771 (1980).

433. John C. Coffee, Jr., *The Metastasis of Mail Fraud: The Continuing Story of the "Evolution" of a White-Collar Crime*, 21 AM. CRIM. L. REV. 1, 11 (1983).

434. *See* Geraldine Szott Moohr, *Mail Fraud and the Intangible Rights Doctrine: Someone to Watch Over Us*, 31 HARV. J. LEGIS. 153, 160-62 (1994).

435. United States v. George, 477 F.2d 508 (7th Cir. 1973). *George* predated *McNally v. United States*, 483 U.S. 350 (1987), which held that the mail and wire fraud statutes did not apply to "honest services" cases. *McNally*, 483 U.S. at 356. Congress responded with legislation making clear that the mail and wire fraud statutes also applied to schemes calculated to cheat people out of "the intangible right of honest services." *See* 18 U.S.C. § 1346 (1994).

436. *See George*, 477 F.2d at 510.

against buyers accepting gratuities from suppliers.[437] There was no proof that the cabinet contract was a bad deal for Zenith. To the contrary, the court found that Zenith had paid a fair price for the cabinets, and the profit that Accurate made was within the 10% allowed by Zenith. Moreover, it appears that Yonan had always demanded quality and efficiency and had never requested from Zenith any preferential treatment for Accurate. Following his conviction, Yonan argued on appeal that reversal was warranted

> because the kickbacks were never shown to come out of Zenith's pockets, . . . because Yonan was never shown to provide or secure any special services for [Accurate and its owner], and because Zenith was never shown to be dissatisfied with Accurate's cabinets or prices, no fraud within the contemplation of the statute can have occurred.[438]

The Seventh Circuit rejected these contentions, finding it "unnecessary that the Government allege or prove that the victim of the scheme was actually defrauded or suffered a loss,"[439] and that it was "of no moment whether or not the kickback money actually came from Zenith."[440] Zenith actually was defrauded, held the court, because Yonan breached his "duty . . . to negotiate the best price possible for Zenith or at least to apprise Zenith that [Accurate's owner] was willing to sell his cabinets for substantially less money."[441] Yonan's wrong was two-pronged:

> Not only did Yonan secretly earn a profit from his agency, but also he deprived Zenith of material knowledge that [Accurate's owner] would accept less profit. There was a very real and tangible harm to Zenith in losing the discount or losing the opportunity to bargain with a most relevant fact before it.[442]

George should send a stern message to fund sponsors and their affiliates. Advisers who pad expense items such as brokerage, advisory fees, or administrative costs to generate cash to pay brokers had better be able to prove this behavior is fair, reasonable, and disclosed up front in exacting detail to fund directors. Kickbacks can amount to criminal payoffs whether they come directly from the victim or not. After all, in *George* it was the supplier, not Zenith, who was giving up profits to fund the kickbacks. Under the logic used in the *George* case, fiduciary misconduct of the sort found in the BISYS and Citigroup kickback schemes could yield criminal prosecutions. The same is true of any deliberate mis-labeling of expense items, such as the inflation of brokerage commissions or advisory fees to pay for distribution services.

George held that fiduciaries owe business decision makers a duty to disclose how the business' money is being spent. The decision makers have a right to information material to the business decision, including the right to know how much is required to pay for the specific service at issue. Secretly bundling two items together, such as advisory services and revenue sharing kick-backs to brokers, or brokerage costs and "soft dollar" payoffs for the benefit of the adviser, are practices that run afoul of the

437. *Id.* at 511.
438. *Id.* at 512.
439. *Id.*
440. *Id.*
441. *George*, 477 F. 2d at 510, 512-13.
442. *Id.* at 513.

requirement in *George*[443] that decision makers be accurately informed. *George* shows that an agent's intentional evasion of a known standard of proper conduct is ill-advised in the extreme. Any investment adviser inclined secretly to divert fund assets to finance unapproved and undisclosed distribution schemes ought to ponder not only whether the diversion makes business sense for the fund, but also whether the behavior is indictable.

XI. CONCLUSION

Rule 12b-1 stands as a monument to the law of unintended consequences. The benefits that 12b-1 fees supposedly would confer remain unrealized, yet the revenues generated under the rule have grown impressively over the years. Any objective analysis of winners and losers under the SEC's 12b-1 regime will show that fund sponsors are doing very well. The distribution system they administer consumes huge sums of money to generate new sales, thereby enriching fund sponsors, but offers no net pecuniary gains to shareholders who pay much of the tab. As the game's big winners, fund sponsors have a vested interest in keeping the game going. The value of the status quo to others, like fund shareholders, is more dubious.

There is no reason to assume prompt action will be forthcoming. Self-congratulation, not self-criticism, is the order of the day in the fund industry and at the SEC. Consider the following recent colloquy between two former SEC Investment Management Division Directors, both of whom currently represent mutual fund industry clients:

> MS. MCGRATH: Well, you know, this leads into an overall question that I have always had and that we've discussed to a certain extent, which is why has the fund industry stayed relatively clean over all these years compared to the other segments of the financial services industry, both those regulated by the SEC, the banks and S&Ls, and insurance companies. . . . [I]s it that big problems, massive scandals haven't been detected? Or is there some weird combination of culture in the industry, this statute, the rules, all the cooks that have to get involved in complying with it that has made this work so that business can go on and grow, while at the same time, the money isn't getting stolen?
>
> MR. GOLDBERG: Well, a cynic might say that this is such an *enormously profitable* industry, you don't have to steal.
>
> MS. MCGRATH: Well that's true.[444]

Even a cynic would concede that the fund industry is enormously profitable for fund

443. There is nothing unique about *George*'s root holding that employees need to be honest with their employers. Straight-forward agency law features the same requirement of honesty and unswerving loyalty. *See* RESTATEMENT (SECOND) OF AGENCY § 387 (1958) ("Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency."); *id.* § 388 ("Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal.").

444. SEC Historical Society, *supra* note 21, at 32-33 (remarks of Kathryn McGrath and Joel Goldberg) (emphasis added).

sponsors. But an informed cynic would never concede that there is no stealing going on in the fund industry.[445] The BISYS and Citigroup frauds[446] are shocking, and exemplify the lengths to which faithless fund managers will go to misappropriate shareholders' assets. Still, those startling scams represent only two small pieces of a shameful asset diversion mosaic.

If the fund business is "enormously profitable" for fund managers, for many fund shareholders it has been something different. Between 1984 and 2002, "The average equity [mutual fund] investor earned a paltry 2.57% annually, compared to inflation of 3.14% and the 12.22% the S & P 500 index earned annually for the last 19 years."[447] An average equity investment return that does not keep pace with inflation over a 19-year span is not "enormously profitable." It is scandalous.[448]

Some may contend that there can be no fee thievery in an industry that is subject to market forces. Free market theory adherents may contend competition can be counted on to keep fees low, squeezing out extraordinary profits. But the fund market does not correlate with the free market. Service providers in "highly competitive industries" customarily do not earn pre-tax profit margins exceeding 60% or 70%.[449] Markets function best to keep prices low when consumers can benefit from full disclosure and independent, arm's-length bargaining. Judged by these criteria the fund industry is dysfunctional.[450]

Load funds compete vigorously for investor favor, but they also saddle buyers with the highest cost structure. Load fund competition for selling brokers' favor tends to drive

445. *See, e.g.*, Peter Elkind, *The Secrets of Eddie Stern*, FORTUNE, Apr. 19, 2004, at 107. The article begins with this grim advisory: "If you think you know how bad the mutual fund scandal is, you're wrong. It's worse." *Id.*

446. *See supra* notes 385-388 and accompanying text.

447. DALBAR, QUANTITATIVE ANALYSIS OF INVESTOR BEHAVIOR 3 (2003).

448. Consider this explanation for fund shareholders' poor investment performance from one experienced industry observer:

> All those management fees and operating expenses and front-end sales charges amortized for the purpose of these data over 10 years, 12b-1 fees, hidden portfolio transaction costs, all-in cost that in fact come to something like 2.5% or even more per year. . . . A return of 10% in a 12.5% market is obviously a shocking gap but the reality is much, much, much worse than that.
>
> As a marketing business versus an investment profession, we bring out these new funds based on the choices of the day and draw in the investing public often at exactly the wrong time. Call it the "timing penalty," and I call it the "selection penalty." Together, the average fund investor lags the average fund by nearly another 3%—it's actually 2.7% leaving the investor with a net return of just 7.3% a year . . . . [This yields] a real return of about four percent after we take a 3.3% inflation rate out. When compounded over this grand 25-year era for investing, the average fund investor has captured 22% of the market's real pre-tax return. . . . If we adjusted those figures for taxes, and funds are horrendously tax-inefficient, it would get even worse.

John C. Bogle, Remarks at the American Enterprise Institute: The Bogle Critique of the Mutual Fund Industry (May 9, 2006), *available at* http://www.aei.org/events/filter.all,eventID.1317/transcript.asp.

449. Such profit margins are found in the fund industry. *See* Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962, 978-79 (S.D.N.Y. 1987).

450. As one finance expert has explained: "When mutual funds are compared across broad classes of investments, the mutual fund industry is spectacularly successful. If competition is defined within the mutual fund industry by comparing funds against each other, the story is very different." Statement of Charles Trzcinka, *supra* note 342.

costs up, not down, in the fund industry.[451] Load fund distribution through the broker channel is lubricated with 12b-1 fees but is so costly for investors at the point of sale and thereafter that finance experts confess they "can't seem to locate tangible benefits delivered by brokers."[452] What the experts do find is that "[e]ven before accounting for distribution expenses, the underperformance of broker channel funds. . . costs investors approximately $9 billion per year."[453] A marketplace where the least valuable products sell for the highest prices does not qualify as truly competitive. Pricing inefficiencies occur because the fund marketplace is contaminated by weak disclosure, conflicts of interests, and inattentive stewardship, which is precisely why Congress wrote the Investment Company Act in the first place. If markets held the answer, the simple precept of honoring one's fiduciary duty would not be on life support in the fund industry, as it is.

Rule 12b-1 does not deserve all of the blame for fund industry regulatory and competitive ills, but it is a good place to start. The rule has given us a fund marketplace where we find deceptive selling of Class B shares, deceptive competition with the no-loads, fund brokerage fees fattened to provide soft-dollar and shelf space payoffs, advisory fees fattened to provide revenue-sharing sales push for selling brokers, and adoption of 12b-1 plans in the face of precious little evidence that fund shareholders, on balance, benefit from the pay-outs. This state of affairs suggests a fund industry that is far from scandal-free; it suggests a rogue industry where shareholder abuse is rampant, with government regulators turning a blind eye toward the problems. In the words of a former SEC official: "12b-1, I think, really needs to be revisited. I think that it's now becoming a method for the brokerage industry to siphon off assets out of the funds. And I think that so much of the money just goes right through to pay brokers. . . ."[454] A government-sponsored rule, throwing off almost $12 billion per year, paid for by shareholders who get no net financial benefit,[455] is a boondoggle in search of a sensible rationale.

Fund shareholders should not expect the SEC to rescue them any time soon. The self-proclaimed "investor's advocate" seemingly finds the fund industry's distribution expense problems too daunting or, more likely, too politically charged. Though "full and fair disclosure" is a securities law mantra, the fund industry, operating under the SEC's regulatory thumb, features abysmal, deceptive disclosure. Selling costs and advisory expenses have been masked as brokerage charges, load funds masquerade as no-loads, dollars taken in as advisory fees goes out the door by the billions to pay for distribution,

451. *See The Cost of Buying and Owning Mutual Funds*, FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Feb. 2004, at 15 fig.16 (tracing average expense ratios for load and no-load mutual funds for 1990-2002 and showing consistently higher operating expense ratios for load funds compared to no-loads); BULLARD & O'NEAL, *supra* note 28 (finding that annual operating expenses were lowest for no-load index funds that do not bear 12b-1 fees, considerably higher for no-load index funds with 12b-1 fees, and much higher for load index funds; these results suggest aggressive competition in the fund industry, for broker favor tends to inflate costs, not help curb them). Another study shows that from 1990 onward, the funds that are cheapest to buy, no-load funds, are also, by far, the cheapest to own, featuring low expense ratios when compared to load funds. *See* Houge & Wellman, *supra* note 176, at 31 ("Load funds consistently charge higher 12b-1 fees, asset management fees, and total expenses than their no-load counterparts.").

452. Bergstresser et al., *supra* note 236, at 36.

453. *Id.*

454. SEC Historical Society, *supra* note 21, at 117 (remarks of Ed. O'Dell).

455. *See, e.g.*, LATZKO, *supra* note 245, at 19, 21 ("High cost funds have high costs in all expense categories. . . . Distribution fees remain a deadweight loss for shareholders.").

often with no written contracts, and such expense data as does exist is buried so deeply that finance Ph.D.'s have trouble finding and deciphering it.[456] The status quo is intolerable.

The mutual-fund industry needs to be put on a rigorous, uniform, detailed disclosure regimen. Every expense item needs to be clearly defined so industry cost information can be standardized and examined by academics, Wall Street analysts, journalists, plaintiffs' lawyers, expert witnesses, and judges. With visible, accurate, intelligible data to study, these groups can be trusted to do a better job holding the industry accountable than the SEC.

A chilling anecdote helps snap into focus the SEC's susceptibility to political manipulation. In the course of a discussion of notable events in the history of the Investment Company Act, including 12b-1's birth and maturity, former SEC Investment Management Division Director Kathryn McGrath noted her largely ineffectual efforts to "tackle and clean up 12b-1,"[457] in the 1980s. She lamented that her attempt was foiled because, "[t]here was too much money flowing through 12b-1 fees to make it touchable."[458] This is a telling admission from someone who stood on the firing line as a high government official. The money flowing to Wall Street through 12b-1 back in the entire decade of the 1980s was a pittance compared to the billions generated *annually* by the rule today.[459] If 12b-1 was "untouchable" and too tough to "tackle" in the 1980s,[460]

456. See Livingston & O'Neal, *supra* note 355 and accompanying text. Weak disclosure in the fund industry is a chronic problem. As fund industry pioneer John Bogle has explained:

> [T]he fact of the matter is that we simply don't know nearly as much as we should about where the money goes in the mutual fund industry. We ought to know. It is high time that either the SEC or General Accounting Office conduct an economic study of this industry, showing the specific sources and uses of shareholder dollars. Given the obvious and crucial role of fund costs in shaping fund returns, it is high time to "follow the money," wherever the trail may lead.

Mutual Fund Industry Practices and Their Effect upon Individual Investors: Hearings Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services, 108th Cong. (2003) (statement of John C. Bogle), *available at* http://www.vanguard.com/bogle_site/sp20030312a.html. *See also Regarding Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors Before the Subcomm. on Financial Management, the Budge, and International Security of the S. Comm. on Governmental Affairs*, 108th Cong. (2004) (statement of Travis Plunkett, Legislative Dir., Consumer Fed'n of Am.), *available at* http://hsgac.senate.gov/_files/012704plunkett.pdf (complaining that in the mutual fund industry, shareholder disclosures fail all three critical tests for effective disclosure: the disclosures provide (1) the information investors need, (2) in a form they can understand and use, (3) at a time when it is likely to affect their purchase decision).

457. SEC Historical Society, *supra* note 21, at 108 (remarks of Kathryn McGrath).

458. *Id.* The key reforms proposed under Ms. McGrath's aegis are identified *supra* note 259.

459. According to data derived from Morningstar by the author, 12b-1 fees from 1980 through 1989 totaled $2.32 billion. In 2004 *alone* the number was $11.6 billion, five time greater than for the entire decade of the 1980s. Gretchen Morgenson, *U.S. Cautions Bank on Fees Intended to Steer Retiree Accounts*, N.Y. TIMES, May 24, 2005, at C1.

460. Interestingly, the most recently appointed Director of the SEC's Division of Investment Management, Andrew J. Donahue, borrowed the football jargon used by his predecessor, Ms. McGrath, when he announced on Nov. 17, 2006, that "Rule 12b-1 is an issue that I would like to tackle during my tenure. . . ." Andrew J. Donahue, Remarks Before the ALI-ABA Conference on Life Insurance Company Products, Washington, D.C. (Nov. 17, 2006), *available at* http://www.sec.gov/news/speech/2006/spch111706ajd.htm. Erstwhile tackler McGrath got pancaked by the fund sponsor industry, and Mr. Donahue's tackling the runaway engine driving

nobody cannot be optimistic about an SEC-sponsored federal "clean up" today. The same pessimism applies to any SEC efforts to clean up revenue sharing, the mutual fund industry's "dirty little secret."[461] This shady practice, featuring massive payments often unsupported by written contracts, pumps huge amounts of cash into the broker-dealer community over and above compensation from load fund commissions or 12b-1 fees.[462]

After more than 60 years of intensive government regulation, we find the load mutual fund business sporting a dysfunctional governance model grounded on conflicts of interest, and a haphazard, costly distribution system where false labeling of expense items is rampant. The system is built on disproved hypotheses, hidden payoffs, and deceptive marketing ploys. Watching over it is a federal agency that functions more as the fund managers' crony than as a defender of the public good. That a seasoned SEC veteran labeled 12b-1 as "untouchable" signals that any change for the better for fund shareholders is not apt to come from the politically-influenced agency that ostensibly regulates the investment management industry. If it ever is to arrive, change must travel via orders issued by federal judges still able to recall what it means to be a diligent and honest fiduciary.

load fund distribution will require far more than good intentions.

461. Fund sponsors' revenue sharing activities certainly do tend to be secretive, but the problem truly is not little. It involves over $2 billion in payoffs annually. Revenue sharing and the problems it generates are discussed *supra* at notes 274-294 and accompanying text.

462. As noted earlier, for one major national brokerage firm, in 2005 its revenue sharing receipts alone amounted to more than one-half of the firm's total net income. *See supra* note 293.