DAVID SILVER
9410 BROOKE DRIVE
BETHESDA, MD 20817

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August 3, 2007

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

Re: File Number 4-538

Dear Ms. Morris,

I am writing to comment on certain aspects of the Commission's announced intention to re-examine Investment Company Act Rule 12b-1, adopted in 1980. I am confining my comments to the historical context in which the Rule was developed, as it may be relevant today, and a brief suggestion for future Commission action.[1]

The Commission's present reexamination of the Rule and its operation is appropriate and commendable. The mutual fund industry and the larger world of retail securities products and services have changed enormously since Rule 12b-1 was adopted. The investor base of mutual funds has changed, new channels of distribution and communication have evolved and an industry that did not reach $100 billion in managed assets until 1980 has seen incredible growth. Yet even recognizing that these and other changes have dramatically altered the retail investment landscape the Commission wisely has requested information on the genesis of the rule for the light it might shed on whether, or the extent to which, changed circumstances point to a need for changes in the Rule. As discussed

[1] I was personally involved with issues concerning the distribution of the shares of mutual funds since the early 1960's, when, as a member of the Staff of the Commission's Special Study of the Securities Markets, and thereafter, I was responsible for opening and conducting an inquiry into the "give up" system as part of a study of The New York Stock Exchange minimum commission rate schedule. From 1966 through 1991 as General Counsel and President of the Investment Company Institute I was closely involved in many of the events that led to the formulation and adoption of Rule 12b-1 and the 1989 reform proposals.

TEL: 301 365 4237 FAX: 301 365 2659 E-MAIL: ANNDAVE@VERIZON.NET

below, my own belief is that far from being a temporary expedient which has outlived its usefulness, Rule 12b-1 is a major component of the fund industry's ability to distribute shares in an orderly fashion.

First, I propose the thesis that the continuous distribution of mutual fund shares has never been sustained by the traditional transaction based sales charge because of a mismatch between the front-end sales charge and the inherent nature of the open-end investment company.[2] In summary I believe that Rule 12b-1 developed as it has because of a structural weakness in the transaction based front-end sales load. The Rule essentially replaced an earlier system of ongoing retail compensation based on portfolio brokerage allocation.

Second, I believe that the Commission would err in seeking to formulate proposals for the reform or abolition of Rule 12b-1 focusing only on those retail securities products and services subject to the Investment Company Act. Without more broadly studying the norms and patterns of compensation for other products and services, which from a retail seller's point of view are functionally similar to mutual funds, any significant governmental mandated change in the compensation structure may have totally unforeseen and inappropriate consequences. I am therefore encouraged that the Commission has determined to gather views from the public and interested parties before formulating proposals for change rather than doing so after a rule proposal.

The Historical Record

Many commentators as well as the Commission itself in its Release creating this inquiry have assumed that Rule 12b-1 was simply a response to the lackluster stock market of the 1970's and the concomitant decline in mutual fund sales that had put the industry in net redemptions for the first time since the close of World War II.[3] Therefore it has become a predicate of "anti" 12b-1 arguments that the rule was intended as a temporary measure to an "emergency" and therefore has outlived its rationale. This is not the case and to act on that assumption would be a mistake.

The history of 12b-1 is intertwined with a series of the events that occurred many years earlier that ultimately culminated in the abolition of the minimum commission rate schedule of the New York Stock Exchange. Under that schedule, Exchange members were required to charge a commission totaling (approximately) one percent of the value of the shares bought or sold by a customer regardless of the size of the transaction. Since portfolio transactions of mutual funds were of substantial size, executing brokers were willing to agree to share these commissions with other Exchange member firms at the direction of a mutual fund customer – a practice permissible under exchange rules. In

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[2] I do not discuss the special case of the no-load sector of the industry and its evolution. Also, I am not discussing the stake that existing shareholders in an open end fund have in the continuing distribution of their funds' shares

[3] i.e. that open-end funds could only meet investor redemptions that exceeded new sales out of a fund's cash or by liquidating portfolio securities. Concerns that some day fund net redemptions could have a major market impact played a role in the SEC's commissioning of the Wharton School in 1958 to study the possible effects of size of mutual funds, and sub silentio influenced the attitude of many SEC Commissioners and Staff towards mutual funds during the 1950's and '60's.

fact NYSE members executing mutual fund portfolio transactions were willing to "give-up"[4] as much as 60 per cent (or more) of mutual fund portfolio commission dollars to the sellers of fund shares at the direction of fund organizations.[5]

Without any unnecessary exhumation and detailed analysis of the data and practices of a system long gone, it suffices to say that many millions of brokerage dollars produced under the umbrella of the NYSE rate schedule were channeled to NYSE retailers of fund shares and, late in the day to all NASD member fund sellers, through developments on the regional stock exchanges.[6] I believe that the magnitude of this form of sales compensation, in the case of actively managed stock funds, may have reached .6 percent of fund assets, placing it the same monetary league as 12b-1 fees. The 1962 Wharton School Report discussed the use of fund brokerage for dealer compensation as an established practice. This system most probably developed contemporaneously with the birth of the modern fund industry after World War II.

By the late 1960's the "give-up" system was under substantial attack. With a resulting diminution of brokerage dollars to allocate to retail sellers, the fund distribution system was under stress. As suggested above, the open-end fund industry has always suffered a mismatch between its historic retail compensation system and the nature of an investment that might be expected to last for many years. It was well known that while large retail oriented New York Stock Exchange brokerage firms maintained selling group agreements with mutual fund organizations as an accommodation for their customers, many firms discouraged their registered representatives from recommending funds to their clients.[7] From the viewpoint of a retail seller an investor's holdings of individual securities might be expected to turn over with a much greater degree of frequency than a client's investment in mutual fund shares that were generally viewed throughout the industry as long-term investments, thus locking up investors' ingestible cash assets.[8] The practical effect was that when investors purchased mutual funds shares the selling firm had a substantially reduced incentive to pursue a continuing relationship with them. However, fund brokerage commissions allocated for sales either directly or through give-ups plainly diminished the resistance of many NYSE members to actively acting as mutual fund sellers on an ongoing basis.

The result of the unfolding series of events ultimately culminating in the "Mayday" 1975 abolition of the NYSE minimum Commission rate schedule substantially ended the use of fund brokerage as a source of ongoing compensation to the retail distribution channel. This caused increasing concern within the fund industry about the ability of the industry

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[4] "Give-ups" were also known as "reciprocals" in industry vernacular.

[5] See, Report of Special Study of Securities Markets Ch. VI, I, and pt. 4 at 214. A Study of Mutual Funds, Wharton School, 1962. Although eroded by litigation and judicial decision after the Special Study Report this practice finally ended with "Mayday" 1975, when the NYSE minimum commission rate schedule was abolished. See, Moses v. Burgin, 445 F.2d 369, (lst Cir. 1971).

[6] See, Moses v. Burgin supra, at p. 377

[7] Some large retail firms would not credit fund sales to the account of a selling broker. Merrill Lynch, for example only decided to abandon its hostility towards mutual funds around 1968.

[8] Put another way the issue was, who would manage investor assets- a retail brokerage firm or a mutual fund?

to effectively compete for investors' dollars particularly in light of the lackluster securities markets of the period.[9]

During the decade of the 1970's, the SEC Staff was aware of industry concerns about the mutual fund distribution system. Moreover, the Commission itself was not unaware of the concerns that the abolition of give-ups had negative effects on fund share distribution.[10] It was during this period that there were, from time to time, discussions with the SEC Staff about whether the Investment Company Act was intended to prohibit the assumption of distribution related expenses by funds, or whether contrariwise, the Act recognized this possibility while not prohibiting the practice. At the same time, there was active discussion within the industry on how to counteract the negative sales trend. While it was generally recognized that improved market conditions would help, it was also thought that this was not a panacea. Industry leaders questioned whether the front-end sales charge was adequate to attract and retain the interest of broker-dealers in selling mutual fund shares.

It was out of this mix of events, and the efforts of individual fund organizations to allocate certain distribution related expenses to their funds that Rule 12b-1 developed.

After the Rule became effective, as was anticipated, various practices developed and evolved. Not surprisingly, in view of the widely held industry belief that continuing compensation was a key ingredient for success on the retail level, practices under the rule came to include such compensation. At the suggestion of the fund industry the Commission encouraged the NASD to adopt a rule subjecting 12b-1 payments to retail distributors to the limitations of the existing sales charge rule.[11]

In summary: A front end, one-time commission fits sales of retail securities products that tend to be held for short periods of time and repeatedly turned over, such as individual stocks, closed-end funds, and more recently, exchange-traded funds. However, as stated above it is a mismatch with respect to mutual funds that are designed to be long-term investment vehicles continuously serviced by the selling broker. Here a continuous stream of payments for continuous service is more appropriate. For years the "give up" system, whatever its shortcomings, provided such a system. The end of that system created a void that served as a predicate for another form of continuous payment, Rule 12b-1.

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[9] This is not to say that all external developments had negative impacts on the fund industry. The abolition of the NYSE minimum commission rate schedule that ultimately led to reduced brokerage commission rates for retail investors had a leveling competitive effect between funds and direct investments into securities, but that was only felt over a period of years. Similarly the development, then in its early stages, of the financial planning industry as possibly an important distribution channel was not unnoticed. But that too was for the future.

[10] For example, on November 17, 1976 in testifying at a hearing before the Commission on behalf of the ICI, I reiterated (referring to a 1974 hearing) that, "[It] suffices to say that mutual fund distribution and especially dealer distributed funds [have been] impacted severely, first by the abolition of give-ups at the end of 1968, and finally by the NASD anti-reciprocal rule in 1973." Commission Hearing, Bearing of Distribution Expenses By Mutual Funds.

[11] "If the [SEC Staff] concern is that the shareholders pay more than a specified amount this can be dealt with. The NASD does have authority [to do so]. Joint ICI-SEC Staff Notes of Meeting, December 23, 1988. (Proposal of David Silver on behalf of ICI.)

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Obviously, different people naturally have different recollections of the complex events that led to the adoption of the Rule 12b-1 and its evolution thereafter; indeed, all such recollections may be substantially valid from their own perspectives. However, I am impelled to state my views for the record since during the relevant period of the early 1960's until the 1990's I was privy to and participated in the consideration of the complicated and intertwined legal, business and policy considerations of investor protection, which led to the development of Rule 12b-1.
Rule 12b-1.

Future Directions

In its Release announcing the 12b-1 Roundtable the Commission requested discussion of various proposals for future Commission action and their possible costs and benefits. The Commission also asked for comment on the expected consequences of a repeal of 12b-1. I do not believe that the answers to many of these are known or even knowable without careful study of data with respect to the various similar and competitive securities products seeking to utilize common distribution channels. The present focus as set forth in the Release is too narrow. While it uses words like costs and benefits it appears that such analyses are to be confined to data from within a closed mutual fund universe.

The Release completely ignores that certain asset based brokerage accounts including so-called wrap accounts are closely competitive with mutual funds and some may even be termed "near' investment companies or quasi-collective accounts. Various numbers as to assets and accounts have bruited about: certain of these products are said to have over one million investors accounts while another is said to have over $300 billion in managed accounts. Whatever the actual numbers may it is clear these products are large and growing. Whether or not these arrangements were crafted so as not to display the indicia that would subject them to registration as investment companies, many obviously compete for the same long-term investment dollars of investors by offering diversification and professional management. I am not aware that the Commission has any industry-wide data as to the fees and charges that accompany these products and services.

I am not suggesting that the Commission is under any mandate to regulate fees and charges for brokerage/advisory accounts.[12] However, before subjecting Rule 12b-1 to major surgery I believe that the Commission will want to understand the economic

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[12]However, it has seemed to me for some time that the convergence of investment products and services within the securities industry has been so great that for the government to directly regulate mutual fund fees alone but not regulating the fees of similar products is like having a system regulating the prices that GM can charge for cars but not the prices charged by Ford and Chrysler.
I have spoken elsewhere as to my own my belief that an increasingly obsolescent structure of the Commission's internal organization in the face of a dynamic securities industry has had an increasingly detrimental effect on the Commission's regulatory and enforcement programs.

effects of any such action. In this connection it is to be hoped that that the RAND Corporation comparative study of the asset managed accounts of brokerage firms and those of advisers will start to illuminate many of these issues or at least create a new and broader context in which to reach conclusions about reforms of Rule 12b-1.

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I hope that I have brought to the Commission's attention a different take on the background of Rule 12b-1 and the practices that developed thereunder. Rule 12b-1 was not solely the result of a single unique and transitory event but was a response to long-term structural and competitive issues. This being the case any major, substantive changes in the Rule or indeed its abolition will not ipso facto usher in a return to an earlier benign equilibrium – any such change, if deemed necessary, should come only after careful study and evaluation of its probable consequences. There should not be any illusion that what is involved is merely tinkering with a minor prop supporting the distribution system rather than a major structural component.

Sincerely Yours,

David Silver

cc:
The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Roel C. Campos, Commissioner
The Hon. Annette L. Nazareth, Commissioner
The Hon. Kathleen L. Casey, Commissioner

Andrew J. Donohue, Director
Robert E. Plaze, Associate Director
Division of Investment Management