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May 14, 2004

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Release No. IC-26356
File No. S7-09-04
Proposed Amendments to Rule 12b-1

Dear Mr. Katz:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law (the "Committee") in response to a request for comment by the Securities and Exchange Commission ("Commission") on whether the Commission should propose further amendments to Rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act").

The comments expressed in this letter represent the views of the Committee only and have not been approved by the American Bar Association's (the "ABA") House of Delegates or Board of Governors and therefore do not represent the official position of the ABA Section of Business Law, nor do they necessarily reflect the views of all members of the Committee.

We appreciate the opportunity to submit comments with respect to the Commission's Release No. IC-26356 (February 24, 2004) (the "Release") proposing an amendment that would prohibit open-end management investment companies ("mutual funds") from paying for the distribution of their shares with brokerage commissions. The Release also requests comment on whether the Commission should propose additional changes to Rule 12b-1 to address issues that have arisen under the rule, or propose to rescind the rule. This letter comments only upon the request for comment on whether Rule 12b-1 continues to serve the purpose for which it was originally intended and whether it should be significantly altered or repealed.

The following are our comments which are directed to (1) the importance of distribution financing for open-end funds and the role of Rule 12b-1 plans therein, (2) certain misconceptions as to the purposes for which Rule 12b-1 was originally intended and (3) a recital of the development of distribution practices under Rule 12b-1 to provide a context for understanding the significance of the rule and the extent to which these developments have been scrutinized by the Commission.

I

While the Commission staff has conducted studies of fund fees and costs as recently as 2000,[1] the last comprehensive study of Rule 12b-1 was contained in Chapter 8 of "Protecting Investors: A Half Century of Investment Company Regulation" (May 1992) (the "Special Study"). Given the many developments as to how funds and their advisers finance the distribution of fund shares that have occurred since 1992,[2] we agree that a study of the practices to finance distribution that have evolved utilizing Rule 12b-1 plans is appropriate at this time. However, it is important to bear in mind that asset-based distribution fees provide a significant portion of the financing of the distribution channels. ICI research in 2003 shows that 63 percent of all mutual fund share classes have 12b-1 plans and 50 percent of all mutual fund assets are in share classes with 12b-1 plans. *See* ICI Mutual Fund Connection, February 2003, p. 2. Accordingly, any reform of Rule 12b-1 must be considered carefully in order to avoid unintended and undesirable consequences for fund investors that would result if the distribution channels being financed by Rule 12b-1 fees are disrupted. When Marianne Smythe, then the Director of the Division of Investment Management, was working on the Special Study in the early 1990s, she frequently stated that her first rule in considering recommendations was "Do no harm." This advice is as good today for your current inquiries as it was then. We believe that any study of Rule 12b-1 practices must involve and consider the views of all interested parties before any determination is made as to any changes in Rule 12b-1 practices.

We have other words of caution related to the importance of distribution financing. With rare exceptions, share distribution is an essential function for any open-end fund and the expenses associated with distribution are extensive and require financing from some source. Ultimately under any pricing alternative, the source of the financing is the investor, although the initial costs may never be fully recovered. Distribution is obviously essential for the fund to acquire assets in the first place and thereafter to offset redemptions. Distribution is also necessary to maintain a positive cash flow for a fund, which is beneficial to investment performance.[3]

This is not to suggest that there are easy answers to the regulation of distribution. The issues raised by financing distribution costs are both significant and complicated, and inherent in the decision-making process are considerable conflicts of interest between a fund and its

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1 *See* Division of Investment Management: Report on Mutual Fund Fees and Expenses, December 2000 (the "SEC Staff 2000 Report").

2 More recent developments include fund supermarkets programs, revenue sharing, directed brokerage and the focus on differential compensation (*see* Section III of this letter).

3 In the Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472 (S.D.N.Y. 1988), decision, Judge Walker stated, "the Court is persuaded that an inflow of assets to a fund has a positive effect on investment performance regardless of the fund's absolute size. In other words, while 'bigger' may not be better *per se*, 'getting bigger' is better. Conversely, when a fund is losing assets due to increased redemptions, the fund is more difficult to manage."

sponsor/investment adviser because affiliates are frequently the recipients of distribution expenditures and the adviser stands to benefit from increased advisory fee revenue to the extent such expenditures result in asset growth. Further complications arise from the competitive implications of regulatory decisions in this area, which almost inevitably advantage or disadvantage some segment of the mutual fund industry.

II

It is submitted that much of the criticism of Rule 12b-1 and the practices that have developed thereunder is based upon misconceptions as to the purposes for which Rule 12b-1 was originally intended. Industry critics have developed a mantra to the effect that when Rule 12b-1 was adopted in 1980, the fund business was in a severe slump and the Commission adopted Rule 12b-1 to allow fund firms to adopt distribution plans as a temporary measure to help funds increase sales to offset net redemptions. One critic states that the factors that directors are required to consider in approving Rule 12b-1 plans make clear that 12b-1 fees were intended to be used as "a short-term fix to a temporary problem."[4]

The administrative history of Rule 12b-1 is well documented. *See* IC-16431 (June 13, 1988) pp. 3 – 7 and the Special Study, pp. 320 – 332. The reexamination of the Commission's opposition to the use of fund assets to finance the distribution of fund shares in the 1970s was as much, if not more, the result of growing resistance to front-end loads as it was the net redemption problem. The catalyst for this reexamination was the Commission staff's favorable response to a no-action request of a money market fund in 1976. Money funds are strictly a no-load product for short-term assets which have to maintain strong continuous share distribution to offset constant redemptions.

In June 1976, the Commission staff gave a favorable response to a proposal of a new money market fund, Mutual Liquid Assets, Inc. ("MLA") (avail. July 15, 1976) to be sponsored by a major broker-dealer whereby the investment adviser would reallocate half of the investment advisory fee to the broker-dealers selling the MLA shares. The MLA letter and the possibility of the wholesale entrance of broker-dealers into the money market fund industry gave rise to vigorous lobbying efforts on the part of the independent investment management industry. On June 29, 1976, the ICI, referring to the matter as one of "extreme urgency," requested the Commission staff to withdraw the MLA letter, which it called an "ad hoc determination," and deal with the matter through rulemaking. Responding to these pressures, the Commission on October 4, 1976, in IC-9470, instructed the staff to withdraw the MLA letter and announced that it would hold hearings on the legal and policy considerations inherent in the use of fund assets for distribution purposes. In November 1976, the Commission held public hearings and received written statements on the matter. Substantially all of the testimony favored some use of fund assets for distribution purposes. In pressing for a more flexible approach to the financing of distributions, the fund industry argued that the rigidity of the regulatory approach for fund distribution put mutual funds at a disadvantage to competing investment products that could be

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4 *See* written Testimony of Travis Plunkett, Legislative Director Consumer Federation of America Before the Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security, January 27, 2004, p. 4.

offered to investors without front-end sales loads. The industry argued that use of fund assets for distribution expenditures would result in a net flow of cash into funds, and, in turn, result in economies of scale and more effective portfolio management.

On August 30, 1977, the Commission refused to declare effective a registration statement of a new money market fund seeking to implement an MLA-type reallocation program and issued IC-9915 (August 31, 1977) to announce that it was still studying the distribution issue, and that until further action was forthcoming, it was generally improper to use fund assets, directly or indirectly, for distribution purposes.[5] In May 1978, the Commission, in IC-10252 (May 23, 1978), sought further comments on the matter in an "Advance Notice of Proposed Rulemaking"; in September 1979, the Commission proposed Rule 12b-1 in IC-10862 (September 7, 1979) (the "Proposing Release"); and in October 1980, the Commission adopted Rule 12b-1 in IC-11414 (October 28, 1980) (the "Adopting Release").

It is true that several of the factors set forth in the Adopting Release for directors to consider suggest a temporary solution. These factors had been in the rule itself in the Proposing Release. However, in the Adopting Release, the factors were taken out of the rule and put in the text of the release rather than the rule itself. In the Adopting Release, the Commission stated that directors are not required to consider any particular factor and had set forth the factors in the release as they "may provide helpful guidance." Most importantly, the Commission did not include in Rule 12b-1 a recitation of the types of distribution activities that funds could finance under the rule. The Commission specifically noted that the rule does not restrict the kinds or amounts of payments that could be made by a fund and was intended to be flexible enough to cover new distribution financing arrangements that might be developed by the mutual fund industry. The rule contains largely procedural rather than substantive requirements, and it has provided the fund industry and intermediaries with the flexibility to develop a wide variety of innovative distribution techniques.

Part of the reason for the fact that the net redemption problem was downplayed in the Adopting Release undoubtedly was the fact that by 1980, fund share sales had increased significantly and fund shares were no longer in net redemptions. In 1976, when the reexamination started, sales of shares of equity, hybrid and bond funds aggregated approximately \$4.4 billion and such funds had net redemptions of approximately \$2.4 billion. In 1980, sales had increased to approximately \$10 billion and such funds had net sales of approximately \$1.8 billion. In 1981, 1982 and 1983, these funds experienced net sales of approximately \$2.2 billion, \$8.2 billion and \$25.9 billion. These funds have had net sales in each year thereafter. *See* the ICI Mutual Fund Fact Book, 2003, p. 76.

This Committee on more than one occasion has commented upon the need to modernize certain of the procedural provisions of Rule 12b-1. These letters have addressed the continued relevance of the provision in paragraph (e) requiring the directors to make quarterly findings as to continuing benefits to the fund and its shareholders in connection with the continuation of

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[5] Around the same time, the Commission was considering a proposal to internalize distribution costs of mutual funds and the various issues raised by the concept. *See*, *e.g.,* In the Matter of The Vanguard Group, Inc., IC-9850 (July 15, 1977).

existing plans, as well as the need to update the factors for directors to consider set forth in the Adopting Release.[6] These procedural provisions seem antiquated today in the case of distribution practices like deferred sales charge plans in which a distributor makes payments at the time of sale expecting to recoup the revenues from Rule 12b-1 fees over time.[7]

III

Industry critics infer that the Rule 12b-1 practices have developed under the radar so to speak. This is not the case. The development of the distribution financing practices under Rule 12b-1 has been made under the close scrutiny of the Commission with the practices often based upon either exemptive relief or rulemaking. Furthermore, through the years, the Commission has conducted a number of studies of Rule 12b-1 practices.

Utilizing Rule 12b-1, the fund industry has developed a wide variety of methods for compensating broker-dealers that sell fund shares. These include deferred sales charge distribution financing techniques designed to enable the distributor to recoup distribution costs over time. There has been extensive use of "back-end" sales charges in the form of contingent deferred sales charges (CDSCs), payable from the proceeds of redemptions effected within a specified period after purchase, and ongoing asset-based distribution fees. Both financing techniques use Rule 12b-1 fees to pay the distributor for the up-front costs of selling fund shares on a deferred load basis.[8]

The rationale for deferred sales charges for the investor as compared to front-end sales charges is that they enable the investor to invest the full amount of the purchase price without deduction of a front-end sales load. This distribution alternative may be more beneficial to the investor than a front-end sales load depending upon the amount of his purchase, the length of time the investor expects to hold his shares, the performance of the fund[9] and the other relevant circumstances. On the other hand, investors qualifying for a significant discount on the front-end sales load may determine that the front-end sales option is superior to payment of an ongoing distribution fee. Conversely, investors whose orders would not qualify for a discount may prefer to defer the load and to have all their funds invested in shares initially.

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6 *See* the ABA Subcommittee on Investment Companies and Investment Advisers (the "ABA Subcommittee") letter to Jonathan G. Katz, Secretary, Commission dated April 12, 1995 on IC Release No. 20917 (February 23, 1995) and the ABA Subcommittee letter to Jonathan G. Katz, Secretary, Commission dated February 29, 1996 on IC Release No. 21660 (January 5, 1996).

7 *See* the SEC Staff 2000 Report, p. 38 and Joel H. Goldberg and Gregory N. Bressler, Revisiting Rule 12b-1 under the Investment Company Act, 31 Rev. Sec. and Commodities Reg., 147, 147 – 152 (1998), both of which make this point. *See* Memorandum dated June 9, 2003, of the Division of Investment Management, with respect to a letter dated March 26, 2003, from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises.

8 The use of CDSC plans required exemptive relief from the Commission, the first order being granted to E.F. Hutton in 1981 in IC-12079 (December 4, 1981). Many such orders were subsequently granted and, in 1996, they were codified in Rule 6c-10.

9 An investor benefits from having the full amount of the purchase price invested to the extent the fund has a positive rate of return.

In the early 1990s, fund groups began to offer shares with a "level load" – a relatively high trail commission with no front-end sales load and a modest CDSC. In certain instances, the level load method enabled fund groups to compensate dealers at a level amount as long as the shares are outstanding without the necessity of making a large initial payment to the dealer which strained the financial resources of many smaller fund groups.[10]

In many cases, fund groups solve their funding requirements for upfronting broker compensation premised on receipt of distribution payments by borrowing from banks, finance companies, or the capital markets using anticipated 12b-1 revenues as collateral, or as the promised source of payment.[11]

Many funds, including no-load funds, money funds and front-end sales load funds, have also established Rule 12b-1 plans to pay relatively low service fees (sometimes referred to as "trail commissions") to compensate sales personnel and others for providing ongoing services to shareholders. Other funds have concluded that shareholder service payments do not require 12b-1 plans because the payments are for administrative rather than distribution purposes. Service fee rates typically do not exceed 0.25 percent of net assets, although in some cases Rule 12b-1 fees are used to support payments to fund networks, which typically charge 0.35 percent or 0.40 percent for a combination of sales and customer service activities.

Over the years, distribution alternatives multiplied. Initially, many groups using deferred sales charge plans implemented clone funds with one fund utilizing front-end charges and its clone utilizing deferred charges. Clone funds require duplication of portfolio and fund management costs. Funds no longer have to establish clone funds because funds are now permitted to issue multiple classes of shares with each class subject to a different distribution arrangement but representing interests in the same portfolio of securities.[12] An alternative to the single (or one-tier) fund with multi-classes is the master-feeder structure in which one or more funds (the "feeder funds") invest all of their assets in another fund (the "master fund"). All portfolio management services are performed, and related costs incurred, at the master-fund level, with distribution and shareholder servicing costs borne at the feeder-fund level. It is possible to combine the two structures by having feeder funds issue multiple classes.

The Commission staff has closely scrutinized these developments. In April 1986, the Division of Investment Management raised questions with respect to certain Rule 12b-1 practices, particularly distribution plans involving "carry forward expenses" (which it referred to as "reimbursement" plans) and distribution plans that provide the opportunity for the distributor to make a profit (which it referred to as "compensation" plans).[13] This resulted in an extensive

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10 In 1994, the ICI adopted as voluntary industry guidelines standardized multiple class nomenclature. Under the guidelines, Retail classes would consist of Class A for front-end loads, Class B for back-end loads, Class C for level loads and Class D for hybrid level loads.

11 These financing techniques have been recognized by the SEC staff. *See* the SEC Staff 2000 Report, p. 39.

12 The Commission granted a number of exemptive orders permitting multi-classes for non-money funds, the first being granted to Merrill Lynch in 1988 (*see* IC-16535 (August 23, 1988)). Many such orders were granted thereafter and, in 1995, they were codified in Rule 18f-3.

13 This review was in part the result of the magnitude of the expenses being carried forward and the fact that

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examination of the Rule 12b-1 practices that had developed. In June 1988, in a comprehensive proposing release (IC-16431, June 13, 1988), the Commission proposed amendments to Rule 12b-1 in an effort to redefine the circumstances in which Rule 12b-1 can be used to finance distribution. The proposed rule change would have prohibited both "reimbursement" and "compensation" plans. The 1988 release also questioned whether the Rule 12b-1 plans circumvented the NASD's regulation of sales charges.

In the early 1980s, there was considerable criticism of the lack of disclosure with respect to Rule 12b-1 fees, which were then often referred to as "hidden loads." Commencing in 1988, all mutual fund fees and expenses were required to be fully disclosed in a standardized fee table that is required to be at the front of a fund's prospectus. The fee table requirements have been refined over the years. Today, if a fund has a 12b-1 fee, it will be clearly identified as a separate line item in the fee table as part of the fund's annual operating expenses. In addition, it must be reflected in the fund's total annual operating expenses shown in the fee table and in the hypothetical example of fund expenses that accompanies the fee table. Yet industry critics still persist in calling Rule 12b-1 fees "hidden loads."

The reform initiatives presently being considered by the Commission require further disclosure. Broker-dealers would be required to provide their customers with targeted information at both the point of sale and in transaction confirmations regarding distribution costs and conflicts of interest. Also proposed are amendments to Form N-1A requiring mutual funds to make additional disclosure as to sales loads and revenue sharing. *See* IC-26341, January 29, 2004. Further, on January 11, 2004, the Commission adopted rules intended to improve the periodic disclosure that funds provide to shareholders regarding costs.

As discussed in the Special Study,[14] the Commission's 1988 proposals were met by a storm of criticism from the industry which regarded them as dooming spread loads without a satisfactory replacement, forcing most deferred sales charge funds to revert to front-end loads. The ICI argued that the proposals would jeopardize maintenance of viable distribution systems. Such systems, the ICI argued, stimulate growth and benefit funds and shareholders by enabling advisers to build stronger advisory organizations, with greater economies of scale and more sophisticated communication and data processing facilities for shareholder servicing. We submit that these arguments are equally applicable today.

The discussion with respect to the 1988 proposals went on for a number of years and was resolved in July 1993 when the NASD sales charge limitations were expanded to include deferred and asset-based sales charges assessed against fund assets, including Rule 12b-1 distribution fees.[15]

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certain distributors had taken the position in disclosure documents that they were entitled to recover unreimbursed distribution expenses if the CDSC Rule 12b-1 plan was terminated. The then lack of transparency as to distribution fees also contributed to the concerns.

14 *See* Special Study at p. 324.

15 *See* NASD Conduct Rule 2830. Rule 12b-1 fees are limited to a maximum of 1.00 percent of the fund's

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Today, many funds offer investors alternative sales charge arrangements combining, through multi-class and/or master-feeder structures, front-end and deferred sales charge methods, and utilizing different combinations of service fees, distribution fees, CDSCs and conversion features from one class to a lower-fee rate class once a specified maximum payment level has been achieved (often tied to the NASD maximums).

Investors can also buy and redeem shares of many funds through "fund supermarket" programs sponsored by third-party broker-dealers or other institutions. In a fund supermarket, the program supermarket sponsor offers administrative and distribution services to its customers who purchase shares of a fund participating in the supermarket program. The administrative services include providing through omnibus accounts the type of shareholder services typically provided to shareholders by a fund's transfer agent and other service providers. This results in savings to the fund in that the fees which otherwise would be paid to the service providers are reduced.

The fund and/or the adviser (or an affiliate) typically pays the supermarket sponsor an asset-based fee. Fees characterized as distribution-related must be made pursuant to a Rule 12b-1 plan if they are charged to the fund (or they may be paid from the adviser's past profits or other resources), and fees for administrative services may be paid outside of a Rule 12b-1 plan. Some funds adopt defensive Rule 12b-1 plans to cover both the distribution and administrative aspects of the program. The determination of the purpose of the fee payment is made by the fund's board of directors, and this determination requires careful consideration and monitoring.[16]

In today's discussion, industry critics have focused on the fact that funds frequently continue to collect Rule 12b-1 fees even though the fund is closed to new investors. Again, this is not as simple as industry critics would have one believe. The shareholder servicing component of Rule 12b-1 fees is paid to provide service to existing shareholders in which case the fact that the fund no longer sells shares to new investors is irrelevant. In addition, if the Rule 12b-1 fees are being used to reimburse a distributor for payments made to brokers at the time of sale, continuing Rule 12b-1 fees would seem to be appropriate. This is especially the case if the Rule 12b-1 fees are being used to support borrowings to finance the upfronted expenditures.

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In light of the complexity of the issues that gave rise to the evolution of contemporary distribution practices, we urge the Commission to conduct a comprehensive study of Rule 12b-1 practices, taking into account, among other things, the history and evolution of distribution

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average net assets per year, which may include a service fee of up to 0.25 percent to compensate intermediaries for providing services or maintaining shareholder accounts. NASD rules also subject the aggregate amount of 12b-1 fees to a lifetime cap, based upon a percentage of fund sales. The NASD rule prohibits brokerage firms from marketing funds as "no-load" unless the 12b-1 fees are kept to a 0.25 percent limit.

16 *See* No-Action Letter to the Investment Company Institute (October 30, 1998)(outlining the views of the Commission staff regarding mutual fund participation in "fund supermarkets").

practices, the complexity of the issues, the desire for regulatory certainty, and the recognition that any proposed regulatory solution could result in unintended consequences that would cause more problems than the regulations would solve. We suggest that the Commission consider holding a roundtable on fund distribution, similar to those held for fund governance and the regulation of hedge funds. At the roundtable, the Commissioners would draw on the expertise of investment advisers, funds, trustees, broker-dealers, counsel, industry critics and funds themselves to identify all the legal and operational issues that proposed regulations would touch upon.

The Committee hopes that its comments will be helpful to the Commission and would be pleased to provide further comments, or respond to questions, upon request.

Respectfully submitted,

/s/ Dixie L. Johnson

Dixie L. Johnson
Chair, Committee on Federal
Regulation of Securities

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