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FSI

Jim Webb
United States Senate
144 Senate Russell Office Building
Washington DC 20510-4601

Dear Sen. Webb:

On October 10th, my colleagues and I from the Financial Services Institute (FSI) had the pleasure to meet with a few of your colleagues on Capitol Hill.

We had wanted to meet with you because the SEC announced a few months ago that they are reviewing the use of 12b-1 fees in mutual funds and may decide to eliminate or curtail the use of them.

I don't feel I need to go into all the details of the issue – I've enclosed the FSI Issue Briefing for that – but I do want to make my voice heard as a small-business owner, employer, and voter in Virginia.

My key points are:

- Years ago, one of the major complaints against "brokers" was that compensation was based on transactions – to earn a commission, the financial services professional had to buy or sell within a client's account. Of course, this can lead the unscrupulous into inappropriate and excessive trading.
- Then, 12b-1 fees were introduced. They were designed to keep the financial services professional "interested" in the mutual fund account after the initial investment. Because of the compensation received from the 12b-1 fee, I can provide my existing clients ongoing portfolio advice and customer service since I do not have to spend my time constantly drumming up new business.
- The 12b-1 fee is generally 0.25% annually and is fully disclosed in the prospectus. I've been in business since 1988. Not ONCE has a client complained about this low fee.
- A major overhaul of the Rule 12b-1 is clearly inappropriate. However, improvements to the disclosure of these fees should be made.

Please contact the SEC and let them know that their goal should be to improve the effectiveness of mutual fund disclosure by using plain language, providing a concise and balanced explanation of relevant information.

Thank you for your time and attention.

Sincerely,

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The Case for Rule 12b-1

The SEC adopted Rule 12b-1 in 1980, following a period of significant mutual fund net redemptions. The rule was intended to stimulate mutual fund growth, promote a more stable fund asset base, and create economies of scale that would reduce shareholder expenses. The industry responded by using 12b-1 fees for various essential purposes. Chief among these is compensating broker-dealers and financial advisors for providing investors with critical support and guidance in planning for their financial futures. Today, Rule 12b-1 is an integral part of the mutual fund distribution system.

In recent months, SEC officials have expressed concern that 12b-1 fees no longer serve their original purpose of supporting fund distribution. On June 19, the SEC hosted a roundtable discussion on issues surrounding Rule 12b-1. While some dissenting voices were heard, the overwhelming majority of participants in the Roundtable agreed that 12b-1 fees continue to serve an important role. The benefits of 12b-1 fees are numerous and include:

1. Expanding Investor Choice – The multiple share classes made possible by Rule 12b-1 give investors choices by providing them options for how they pay their financial advisor. The flexibility offered by Rule 12b-1 allows financial advisors to tailor portfolios to their clients' specific needs.
2. Supporting Financial Literacy – Mutual funds send their investors monthly statements, confirmations, prospectuses, annual reports, and other materials. Financial advisors serve the vital role of educators by helping investors to make sense of these essential materials. 12b-1 fees provide the compensation financial advisors receive for these efforts.
3. Managing Client Expectations – Investors make certain common errors – buying high and selling low, chasing past performance and harboring unrealistic expectations. 12b-1 fees provide financial advisors with compensation as they continually manage their clients' expectations and protect them from falling into these common investor traps.
4. Insuring Small Accounts Receive Service – Investment advisory services are simply out of the reach of many small account holders. Financial advisors must have another means of being fairly compensated for servicing these accounts. 12b-1 fees provide the mechanism to insure that small investors receive the support and service they need to achieve their financial goals.
5. Subsidizing Administrative and Value-Added Services – Financial advisors provide their mutual fund clients a variety of administrative and value-added services including: change of name/address, portfolio optimization and rebalancing, transfer on death or gift, consolidated account statements, periodic portfolio review meetings, quarterly newsletters, cost basis research, and consulting on other financial decisions. These important services are made possible by the subsidy 12b-1 fees provide.

Unintended Consequences of Changes to Rule 12b-1

Elimination or the drastic curtailment of 12b-1 fees would have devastating unintended consequences for investors. Limiting investor choice, removal of the incentives to promote financial literacy and manage investor expectations, and the loss of the value-added services

described above are just the tip of the iceberg. In fact, significant changes to Rule 12b-1, combined with other recent events, including the elimination of fee-based brokerage accounts, may change the very nature of the financial services industry by driving financial advisors to become registered investment advisors to escape onerous regulatory scrutiny. As a result, it is essential that any improvements to the Rule be designed to reinforce the important benefits it provides to investors.

Effective Disclosure is the Goal

The federal securities laws are based upon one simple and straightforward concept: all investors should have access to certain basic facts about an investment prior to buying it. With the relevant facts available to them, investors are trusted to make their own decisions in pursuit of their financial goals. In the world of mutual funds, information is made available to investors via disclosure documents – primarily the prospectus. Since the fees and expenses associated with a mutual fund investment have a significant impact on an investor's return, the prospectus dedicates a significant amount of time to a discussion of them.

Unfortunately, lengthy disclosures are not necessarily effective disclosures. Effective disclosure requires more than the legal precision found in most mutual fund prospectuses. It also requires the following:

- Plain Language – Disclosures should be written in language that can be understood by the average investor.
- Brevity – Disclosures should not overload investors with unnecessary information.
- Balanced – Disclosures should provide unbiased information concerning factors relevant to the investment decision.
- Flexible Delivery – Disclosures should be delivered to investors in the fashion they choose (e.g., hard copy or via Internet).

While a major overhaul of Rule 12b-1 is clearly inappropriate, improvements to the Rule could be made by applying these guidelines to the disclosure of these fees. Renaming 12b-1 fees in more precise and descriptive language would be helpful to individual investors. In addition, making the discussion of the fees and expenses associated with mutual fund investments more streamlined would increase comprehension by avoiding information overload. The disclosure of 12b-1 fees should be accompanied by an explanation of the benefits they provide to mutual fund investors. Finally, the disclosure should be provided to clients in their chosen format.

FSI Supports Greater Transparency Through Improved Disclosure

The Financial Services Institute (FSI) supports efforts to improve investors' understanding of Rule 12b-1 and associated fees. We believe the SEC's goal should be to improve mutual fund disclosure effectiveness by using plain language, providing a concise and balanced explanation of relevant information, and delivering it to investors the way they want it. Done properly, this effort will require thoughtful consideration and industry comment.

For more information on FSI and the 12b-1 fee issue, click on financialservices.org, or contact Dale E. Brown, CAE, President & CEO, at 770 980-8487 or dale.brown@financialservices.org.