

June 15, 2007

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-1090

Re: File Number 4-538 SEC Request for Public Comments Regarding 12b-1 Reform

Dear Ms. Morris:

The purpose of this letter is to specifically address the issues to be discussed in Panel #3 of the upcoming June 19th round table discussion of Rule 12b-1. According to the agenda, the forum will discuss the costs and benefits of 12b-1 fees. Specifically, the panel will address the issue of whether 12b-1 fees add value or, alternatively, whether they are simply hidden fees that represent a “dead weight loss” to shareholders. This letter asserts that academic research which has concluded that 12b-1 fees represent nothing more than hidden deadweight costs is flawed, and that the flaws stem from the failure of the researchers to properly model and account for the nature of the advisor-investor relationship. Further, this discussion will also illuminate flaws in the common academic argument that 12b-1 fees in the context of multiple share classes lead to conflicts of interest. To prove these points, this letter will provide specific examples of flawed assumptions and direct evidence to refute conclusions that some authors from the academic community have made.

Cost Benefit Analysis of 12b-1 Fees

A review of the academic literature reveals a significant body of research devoted to determining how 12b-1 fees impact investors. A sampling of papers relating to this subject include Morey, *Should you carry the load?: A comprehensive analysis of the out of sample performance of load and no-load mutual funds* (Journal of Banking & Finance, 2001); Walsh, *The costs & benefits to fund shareholders of 12b-1 plans: An examination of fund flows, expenses, and returns*, (SEC white paper, 2003); Bergstresser, Chalmers, & Tufano, *Assessing the costs and benefits of brokers in the mutual fund industry* (working paper, 2004); Sirri & Tufano, *Costly search and mutual fund flows*, (Journal of Finance, 1998), Ferris & Chance, *The effect of 12b-1 plans on mutual fund expense ratios* (Journal of Finance 1987), and Barber, Odean & Zheng, *Out of sight, out of mind: The effects of expenses on mutual fund flows*, (The Journal of Business, 2005). Although the methodologies and focus differ from paper to paper, a common theme tends to be some application of cost-benefit analysis based upon performance comparisons of funds with 12b-1 fees to funds without. Some common conclusions that include: (1) broker sold funds do not appear to offer any significant benefits in terms of performance over no-load funds or that no-load funds may even have a slight performance advantage, (2) there is no quantifiable value to be discerned from the decision to purchase mutual funds through a financial advisor, (3) fund expenses, including 12b-1 fees, represent a significant drag on performance, and (4) one reason why investors may make irrational decisions regarding the purchase of 12b-1 funds through financial advisors may be that the costs are hidden.

Although a deconstruction of all of the above articles is beyond the scope of this letter, SEC round table panelist Brad Barber’s collaborative paper, “*Out of sight, out of mind: The effects of expenses on mutual fund flows*,” may be used to exemplify common academic errors. In this paper, the authors examine how investors consider various mutual fund expenses including sales loads, operating expenses and 12b-1 fees. By analyzing fund flow and trading data, the authors find that investors have learned to avoid up front sales charges. However, despite empirical evidence that funds with lower total expenses tend to have better performance records

than funds with higher expenses, the authors' analysis finds that investors' purchasing behavior is not sensitive to operating expenses and that there is actually a positive correlation between fund flows and 12b-1 fees. Perplexed by the finding that investors are willing to purchase mutual funds with higher total expenses (operating expenses + 12b-1 fees) in the absence of performance advantages when low cost, no transaction fee alternatives exist, the authors conclude that individual investors have learned to avoid mutual funds with up front sales charges but have not learned to avoid funds with 12b-1 fees because such expenses are largely opaque. In the conclusion of the paper, the author's find no valid reason why rational investors should purchase advisor distributed funds with 12b-1 fees, and theorize that, with greater transparency and awareness, investors would learn to avoid funds with 12b-1 fees just as they avoid up front sales charges.

Although this paper was published in a highly respected academic journal, from a financial advisor's perspective, flaws in the author's assumptions about why investors purchase mutual funds through financial advisors are readily obvious. To begin, the author's theory that investors would shun 12b-1 fees if they were transparent is easily dispelled simply by considering the exponential growth that has occurred over the past decade in investment advisory wrap fee mutual fund accounts. Industry data shows that the average mutual fund advisory wrap fee is approximately 1.3% (vs. maximum 1% annual 12b-1 fees). These investment advisory fees are billed to the accounts and, as such, are entirely transparent to investors. Further, the underlying investments are typically no-load mutual funds. Thus, in direct conflict with the author's predictions, it is demonstrated that millions of investors are willing to pay fees that are even higher than 12b-1 fees to acquire the same no-load funds that they could purchase directly from the fund companies on their own. Clearly, Barber et al. have missed something.

In particular, a major source of the disconnect between the authors' idealized view of how investor behavior should work and how it actually does work stems from their admitted inability to comprehend why investors might be willing to pay higher fees to purchase mutual funds through an advisor. At the heart of this disconnect is a flawed implicit assumption that investors who purchase mutual funds through an advisor are paying for an expectation of superior performance. In reality, most financial advisors openly concede that advisor-distributed funds as a whole do not perform better and perhaps under-perform their no-load counterparts, and that the expenses that are paid to the brokerage firm or RIA undeniably serve to reduce fund performance. In fact, most advisors will likely report that they place far greater emphasis on asset allocation than on fund selection. Broadly speaking, what is missing from the academic world's understanding of the advisor-client relationship is that investors are not paying to get the best possible mutual funds, but rather they are paying for (1) implementation of sound investment strategies (e.g., asset allocation consistent with modern portfolio theory), and, in many cases, (2) for personalized modular financial planning guidance.

Interestingly, Barber et al. do briefly consider the possibility that service differences might account for some willingness by investors to pay higher fees. However, the authors quickly dismiss the notion by claiming that "...first rate service and low expenses are not mutually exclusive. For example, Vanguard, which is well known for its low-cost mutual fund offerings, has won numerous service awards." Academic ignorance of the degree to which investors value sophisticated full-service investment and financial planning guidance is not limited to Barber's paper. Indeed, Bergstresser, Chalmers & Tufano (2004) and Walsh (2003), also limit the scope of their analysis to mutual fund performance differences and completely discount the value of any other advice investors might receive from advisors in return for 12b-1 fees. From the advisor's perspective (and the investor's), helping a client build an efficient asset allocation model portfolio consistent with MPT is a valuable service and one that most investors

do not have the sophistication or knowledge to implement on their own. Similarly, modular financial planning guidance, such as pointing out asset registration issues that might save them hundreds of thousands of dollars in estate taxes, is also highly valued by investors. As dozens of financial advisors have attested in their public comments to the SEC, these are services that investors get in return for 12b-1 fees, and they are services that are most definitely not provided by a telephone rep at Vanguard.

In summary, the above discussion has disproved the notions that 12b-1 fees provide investors with no measurable benefit and that investors only purchase 12b-1 funds because the fees are opaque. As we have shown, investors can and do pay fees of 1% or more to purchase mutual funds, even when such fees are entirely transparent. The failure of the academic community to find any value in paying such fees stems from its limited focus on mutual fund performance and its complete lack of understanding of the real value that many full-service advisors provide to investors.

12b-1 Fees and Share Class Decisions

Another source of academic criticism of 12b-1 fees comes from research that has been done on the suitability of various advisor-distributed fund share classes. Although there have been many papers devoted to the benefits and detriments of multiple share classes, one paper that typifies the criticism of 12b-1 fees is Professor Edward S. O'Neal's journal article entitled "*Mutual fund share classes and broker incentives*" (Financial Analysts Journal, 1999). In this paper, O'Neal states that "because the loads and distribution fees are different for the three classes [A, B, and C shares], but the underlying assets held by the fund are identical, the analysis of investor preferences for the different share classes can be reduced to an examination of the effects of the share fees on investment returns." From his analysis, O'Neal concludes that for a given fund with A, B, and C shares, investors with anticipated holding periods of less than six years (assuming no eligibility for A share breakpoints) would be best served with C shares. In years 7 & 8, B and C shares perform equally, and in years 9 and beyond A & B shares perform equally. O'Neal then goes on to demonstrate how expense differences between C and A shares would add up to significant differences in account values over long periods of time. The paper concludes by suggesting that the multiple share class format that emerged under Rules 12b-1 and 18f-3 leads to conflicts of interest because brokers have an incentive to steer investors toward the share class that will pay them the most, rather than the share class that best fits the investor's anticipated holding period.

As with the Barber, Odean, and Zheng paper, O'Neal's paper also contains flawed assumptions that stem from a lack of understanding of the investment planning process. First, O'Neal's analysis is flawed because the author fails to understand the difference between investor time horizon and anticipated holding period. While it is widely acknowledged in the advisor community that stock mutual funds are only suitable for investors with long time horizons, the reality is that time horizons bear little relation to actual investor holding periods. Numerous studies have shown that the average holding period for mutual investors (both load and no-load) is less than three years. Although some might argue that this behavior represents investor folly, there are many legitimate reasons why investors should and indeed do make regular changes to their fund portfolios. Rational reasons for switching might include style drift, asset bloat, manager change, or the emergence of a competing fund with lower expenses and/or more desirable asset allocation. Further, the author's assertion that there are no other differences that should influence investors' decisions to purchase one share class over another fails to recognize an important structural difference between class A&B shares as commission-based share classes and Class C shares as a fee-based share class. It is an established fact that many advisors and investors prefer asset-based fees as a means of advisor compensation because this compensation

structure better aligns advisor and client interests than commissions. Given the relatively high likelihood of fund turnover, a strong argument can be made that the choice of class C shares helps avoid certain conflicts of interest, since the fee-based advisor does not receive any additional compensation (i.e., no commission) when recommending a switch from one fund to another. Ironically, once these flaws in the author's assumptions are revealed, the logical conclusion that one might draw from O'Neal's work is that the share class that is most suitable for the broadest set of retail investors is Class C shares – the share class with the highest 12b-1 fees!

Summary and Closing Remarks

While a wide body of academic research exists that is decidedly skeptical of the value of 12b-1 fees to investors, this letter has demonstrated that obvious flaws in the mainstream academic models exist and that these flaws generally stem from a failure of the academic community to fully understand and account for the true nature of the advisor-investor relationship. Part of this failure is no doubt attributable to the tendency of the academic community to limit its application of cost-benefit analyses to subjects, such as mutual fund performance, that are easily measurable. However, as presented in the discussion above, the value that 12b-1 fees provide to investors in terms of service and planning guidance and, in the case of Class C shares, in avoidance of conflicts of interest, is challenging to measure. However, as illustrated by investor willingness to pay 12b-1 fees, these benefits are intuitively tangible and absolutely cannot be discounted from consideration.

In closing, while it may seem difficult to accept that a couple of troglodyte financial advisors from Hawaii could credibly deconstruct a large body of published academic research, a treatise by Temple University law professor, Peter H. Huang entitled, "*Beyond Cost-Benefit Analysis in Financial Regulation: Process Concerns and Emotional Impact Analysis*" (working paper, 2005) suggests that a very real disconnect between academic ideals and economic reality truly exists. Specifically, Huang suggests that academicians and regulators are predisposed to applying cost-benefit analysis to subjects that are easily measurable and tend to discount those benefits that are more ephemeral. The result, he argues, can be harmful, ill-conceived regulation. If the current academic analysis of 12b-1 fees is used to justify the repeal of Rule 12b-1, the disruption that will result will indeed do great harm to investors.

Thank you for your consideration.

Respectfully,

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Honolulu, Hawaii		Honolulu, Hawaii

The opinions expressed herein represent are solely those of the authors and are not intended to represent the views of their firm or any other organization or individual.