

Comments on File No. 4-538

(Roundtable Discussion Regarding Rule 12b-1)

Issues regarding 12b-1 fees seem to fall into three different categories: Intent of the rule, effect on advisers and their clients (0.75% distribution fee), and selling no-transaction-fee shares through supermarkets (0.25% service fee). I offer some thoughts on each of these.

1. Original purpose of Rule 12b-1. Many commentators have remarked that the original purpose of the rule was to enable a flagging industry to boost sales, and that its use has since changed. Regardless of whether this is correct, the fact is that fees charged under this rule are currently being used to replace front-end loads and pay for servicing accounts. Since this has gone on for many years without SEC action, we can reasonably assume that these uses are legal, even if contrary to original intent. So the real question seems to be whether these fees should be permitted (regardless of whether the permission comes from Rule 12b-1 or some other, perhaps new, rule). The question of original purpose is effectively a distraction.
2. Effects on advisers.
 - a. Trailing service fees enable advisers to serve the small investor, especially with buy and hold (or dormant) accounts. Certainly servicing investors has a cost, which the investors should bear. I do not believe there is a reasonable argument to the contrary.

Several advisers write that they would be unable to provide the same service for the same price if the fund did not collect this fee. Some state that the alternative would be a higher-charging wrap account. But why should a mutual fund wrap account cost more if it is only providing the same level of service? Moreover, if the levels of service are indeed different, couldn't advisers create another tier of service for a lower fee, much as mutual fund wrap accounts typically charge less than equity wrap accounts?

An effect of shifting the fee from one that is collected by the mutual fund to one that is assessed directly upon the investor is that the fee will be more transparent. Even though 12b-1 fees are listed in all fund prospectuses, there is a level of indirection, with the fee being skimmed almost invisibly by the fund, and then passed back to the adviser, that hides the fee from the investor. A direct charge is one that the investor cannot fail to see. Transparency for the investor is a goal that the SEC should strive toward.

One commentator pointed out that there is a tax advantage to embedding the service fee within the mutual fund expenses. That is correct, because fund expenses are deducted from top line income, while an individual's investment expenses, including wrap fees, are generally treated as miscellaneous itemized

deductions subject to a 2% floor. See, e.g. “IRS ices tactic used by holders of fee accounts”, Investment News, June 11, 2007.

<http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070611/FREE/70611002>

This tax advantage appears to be more an artifact of the tax code construction than one of clear intent. It also favors one form of fee structure over another, and thus distorts the competitive marketplace. For these reasons, the fact that 12b-1 fees have a certain tax advantage does not militate strongly in favor of their preservation.

b. 12b-1 distribution fees enable innovative fee structures. This is true, but is it necessarily good? It is the 12b-1 fee that enabled class B shares which have been badly misused; many fund companies are running away from B shares as fast as they can now. Simplicity is also a virtue. The complexity of pricing structures makes it more difficult for the small investor to compare prices and services of different advisers.

3. No-transaction-fee (NTF) offerings through fund supermarkets.

There is a question of fairness in charging all investors the same service fee even if they do not receive any service. As a do-it-yourself investor purchasing no-load funds, I am usually charged the same 12b-1 fee whether I buy directly or through a fund supermarket that, like an adviser, needs to be paid for its services. There are multiple approaches to this issue, and none is perfect.

Some fund companies offer two different share classes, one with no 12b-1 fee, and one with a 0.25% 12b-1 fee for sale by brokers. This is perfectly reasonable. However, the fund supermarkets have fought this approach. For example, when Selected Shares brought out a cheaper share class (one without a 12b-1 fee) for sale directly to investors, major fund supermarkets refused to sell the original share class, though it was priced specifically for NTF supermarkets.

Forbidding a 12b-1 service fee might at first blush address this problem by eliminating multiple share classes. But then only the higher cost class might survive; that would hurt the direct investor, and wouldn't help the NTF supermarket investor. The 12b-1 fee would simply be shifted to the management fee, and the management company would pay the service fee to have the fund offered NTF.

American Century funds demonstrate the viability of such a shift. Their funds pay their advisor (management company) “a single unified management fee for arranging all services necessary for the fund to operate. ... A portion of the fund's management fee may be paid by the fund's advisor to unaffiliated third parties who provide recordkeeping and administrative services” This verbiage appears in most, if not all, of American Century's fund prospectuses.

I do not wish to appear as though I am criticizing American Century here. It is a fund family with lower than average fees that I appreciate. (I am an American Century investor.) American Century is perhaps more clear than most in disclosing how its fund fees are used, which in turn enables me to use its funds as an example.

Conclusion

In my opinion, the goals should be to improve transparency and enable investors to pay for services they receive while not paying for services they do not receive. Eliminating the 12b-1 fee would seem to result in a minor improvement in transparency, but not substantially affect the total fees that investors pay. So I regard the proposal as a minor positive. A better approach would be to start with these goals and design a system that comes closer to achieving them, rather than simply eliminating the rule because it is perhaps being used differently than originally intended.

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