THE FINANCIAL SERVICES ROUNDTABLE

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Ms. Nancy Morris
Secretary
United States Securities and Exchange Commission
100 F Street, NW
Washington, DC 20549

File Number 4-538

Dear Ms. Morris:

The Financial Services Roundtable is pleased to submit these comments in connection with the forthcoming roundtable convened by the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") examining issues presented by Rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act").[1] As discussed further below, Rule 12b-1 plans provide a legitimate and well-established mechanism for compensating broker-dealers and other intermediaries for the sale of fund shares and for services to fund shareholders. We urge the Commission to recognize this important role in its examination of the rule. More radical changes such as prohibiting the use of Rule 12b-1 plans as compensation for sales or services or as requiring the use of account-level fees would mark a total reversal of policy and would impose substantial costs, without any discernible benefit to investors. The majority (52%) of 12b-1 payments are directed to ongoing shareholder services. Compensation to financial advisors constitutes 40% while payments to fund underwriters, advertising and promotional expenses consume the balance.

A. *Investor Choice*

Following the SEC's adoption of Rule 12b-1, and subsequent regulatory actions, fund sponsors and broker-dealers made available to fund investors a host of innovations and new choices. Instead of being offered only funds that charge significant front-end loads or a limited number of no-load funds, investors can now choose from a much larger universe of load, spread load, or no-load funds.[2] As discussed below, the rule makes it much easier for fund investors to

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[1] SEC Press Release 2007-106, May 29, 2007. The release indicates that the Roundtable will consist of panels addressing:

- the historical circumstances that led to the promulgation of Rule 12b-1, and the original intended purpose of the rule;
- the evolution of the uses of Rule 12b-1 and the rule's current role in fund distribution practices;
- the costs and benefits of the current use of Rule 12b-1; and
- the options for reform or rescission of Rule 12b-1.

http://www.sec.gov/news/press/2007/2007-106.htm. *See also* Press Release 2007-112 and links therein.

[2] Some investors mistakenly assume that no-load funds include no fees, such as Rule 12b-1 fees. The SEC notes:

seek out the advice and continued support of financial intermediaries. Rule 12b-1 fees allow investors to spread out payments to financial intermediaries during the course of their investment. While front-end load funds are still available to investors, the typical maximum front-end load has declined from 8.0% in 1980 to about 4.8% in 2006.[3] Investors can also choose to pay contingent deferred sales charges ("CDSCs") or a combination of lower 12b-1 fees and lower front-end loads or CDSCs. Having these options allows investors to choose funds that best suit their needs.

In the quarter century since Rule 12b-1 went into effect, the rule has become a basic cornerstone of the mutual fund distribution process in the United States. Broker-dealers and other intermediaries provide valuable services to funds and investors in promoting the distribution of mutual funds and in providing ongoing services and legitimately are paid for those services. In recent years, sales through intermediaries have risen proportionally in relation to direct sales, indicating the importance that investors attach to the advice and other services provided by such intermediaries. A recent study by the Investment Company Institute recognized this role and outlined key services provided by intermediaries.[4] Similarly, from the fund's point of view, the Mutual Fund Directors Forum has recognized, "fund shares must be distributed ─ assets are likely to decline if the fund is eliminated from significant distribution channels and fund expense ratios may likewise increase, perhaps significantly."[5]

Fees permitted under Rule 12b-1, combined with other revenues from fund complexes have created a revolution in the sale and processing of mutual funds. For example, funds may have delegated substantial portions of their processing activities to the broker-dealers selling the funds. Rule 12b-1 fees permit broker-dealers to handle accounting and other shareholder services that the funds themselves would otherwise have to provide. These include: shareholder account set-up and maintenance; transaction processing and settlement; preparation and distribution of transaction confirmations and account statements; distribution of prospectuses and shareholder reports; payment of fund distributions; and clearing and custodial services. Often broker-dealer combine these fees with other revenue from the fund complex to provide investors with a much higher level of service and a broader range of investment choices than existed prior to the SEC's adoption of Rule 12b-1.

> Some funds call themselves "no-load." As the name implies, this means that the fund does not charge any type of sales load. *** However, not every type of shareholder fee is a "sales load," and a no-load fund may charge fees that are not sales loads. For example, a no-load fund is permitted to charge purchase fees, redemption fees, exchange fees, and account fees, none of which is considered to be a "sales load." In addition, under NASD rules, a fund is permitted to pay its annual operating expenses and still call itself "no-load," unless the combined amount of the fund's 12b-1 fees or separate shareholder service fees exceeds 0.25% of the fund's average annual net assets.
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> SEC, Mutual Fund Fees and Expenses, http://www.sec.gov/answers/mffees.htm#distribution

[3] *See* Investment Company Institute, 2007 Investment Company Fact Book (2007) at 56 (available at http://www.icifactbook.org/pdf/2007_factbook.pdf) [hereinafter, 2007 ICI Fact Book].

[4] ICI, Why Do Mutual Fund Investors Use Professional Financial Advisers, Research Fundamentals, vol. 16 no. 1 (April 2007).

[5] Mutual Fund Directors Forum, Best Practices and Practical Guidance for Directors under Rule 12b-1 at 10 (May 2007).

B. History and Evolution of the Rule

The text and history of Rule 12b-1 itself make clear that an original core purpose of the rule was to fund payments to brokers for transaction-related compensation at the time of sale and for ongoing services after the point of sale.[6] Subsequently, the Commission did not adopt 1988 proposals that would have prohibited the use of 12b-1 fees to pay sales compensation[7] and instead worked with the NASD and the fund industry to implement caps on the total amount of such fees to provide express comparability of Rule 12b-1 fees to the existing statutory limits on front-end loads.[8] Similarly, since even before the proposal of Rule 12b-1, the Commission repeatedly has considered the potential parallelism of traditional front-end loads and 12b-1 fees in developing criteria for when funds paying such fees could be advertised as "no-load."[9] The Commission further sanctioned the use of Rule 12b-1 plans for sales compensation in permitting multiple-class funds by exemptive order, and subsequently in adopting Rule 18f-3 under the 1940 Act.

In short, the SEC designed a regulatory framework that it intended to facilitate the sale of mutual fund shares and the Commission and its staff have repeatedly taken steps to broaden and adapt that framework to accommodate an evolving market. To suggest that the brokerage or fund industries have used Rule 12b-1 to achieve purposes that its framers never intended or without the continuing assent of the SEC and its staff, is inaccurate.

Some critics have raised concerns about mutual funds that continue to charge Rule 12b-1 fees, even after the funds are closed to new investors. Eliminating the use of 12b-1 fees for funds that are closed to new investors would have negative consequences for shareholder support services and unfairly affect distribution arrangements that underpin Class B shares. If closed funds can no longer collect 12b-1 fees, there no longer would be an incentive for financial intermediaries to provide support services to shareholders invested in those funds.[10] Statements made by the SEC staff dating back to 1993 have acknowledged the propriety of 12b-1 charges by closed funds.[11] Eliminating the use of 12b-1 fees would interfere with distribution arrangements that were entered into in good faith and further erode shareholder support services, on which most investors have come to rely. Safeguards already exist in

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6 The 1978 advance notice of proposed rulemaking "specifically … request[ed] comment whether a distinction should be made between transactional fees (e.g., payments to dealers at the time fund shares are purchased) and continuing payments to third parties for distribution services, particularly to dealers in fund shares." Bearing of Distribution Expenses by Mutual Funds, Inv. Co. Act Rel. No. 10252 (May 23, 1978). The Commission's 1979 proposal of rule 12b-1 did not differentiate or restrict such distribution expenses, and the examples of distribution expenses included in the text of the proposed rule (and in the rule currently in effect) expressly included sales compensation: "compensation of underwriters, dealers, and sales personnel." Bearing of Distribution Expenses by Mutual Funds, Inv. Co. Act Rel. No. 10862 (Sept. 7, 1979).

7 Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Inv. Co. Act Rel. No. 16431 (June 13, 1988).

8 *See* Exch. Act Rel. No. 30897 (July 7, 1992) (approving NASD sales charge rule provisions).

9 *See* Rel. No. 10252, *supra* (stating the Commission's view that funds using asset based sales charges to pay for distribution should not be characterized as "no load"); *In re The Vanguard Group, Inc.*, Inv. Co. Act Rel. No. 11645 (Feb. 25, 1981) (finding "no valid basis for continuing to prohibit the Funds from using 'no-load' terminology").

10 *See* Investment Company Institute, Report of the Working Group Report (May 2007), ("ICI Working Group Report") at 17.

11 *See id*. at 18, citing a 1993 memorandum authored by the SEC staff and sent by then SEC Chairman Arthur Levitt to John D. Dingell, Chairman of the House Committee on Energy and Commerce. The memorandum noted that "even if a fund closes to new investors, it may continue to pay 12b-1 fees in order to compensate the distributor for past distribution efforts" because "Rule 12b-1 permits a fund to spread its distribution expenses over several years and allows payment of fees for past distribution services."

the form of NASD Conduct Rule 2830(d), which places a cumulative limit on 12b-1 fees that an NASD member may charge based on a fund's overall sales of shares.[12]

C. Need for Reexamination

As a general matter, we support the Commission's examination of the issues that Rule 12b-1 raises. Given the age of the rule, some fund directors have raised questions about the precise nature of their responsibilities in approving plans.[13] In addition, public questions about the extent of investor understanding of the nature and purposes of such fees indicate that there is a need for further attention by regulators, funds and intermediaries to promote better investor understanding. Accordingly, certain specific aspects of the rule and related Commission guidance do merit further consideration, including clarification of the factors that boards must consider in approving 12b-1 plans, re-examining the need for annual board approval of such plans, and prospectus simplification.

However, we urge the Commission not to make more drastic changes such as prohibiting the use of 12b-1 fees to pay for distribution or shareholder services or replacing fund payments with account-level fees. Revising Rule 12b-1 to prohibit such uses of 12b-1 fees would involve a 180-degree change in policy without any underlying need or any benefit to funds and shareholders that has been identified. Such a change also could affect the willingness of intermediaries to sell shares and provide ongoing services to fund shareholders. Other suggestions, such as mandating the implementation of account-level fees would impose significant costs without any corresponding benefits. Those costs would include a higher tax burden on shareholders,[14] changes to fund selling and servicing agreements,[15] changes to IT and compliance systems at funds, principal underwriters, selling broker-dealers, transfer agents, administrators, third-party administrators and other intermediaries and service providers.

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12 *See id*.

13 *See* Division of Investment Management, SEC, Report on Mutual Fund Fees and Expenses 80 n. 126 (2000) (noting that the rule had not be substantively amended since 1980).

14 In 1992, the SEC staff found that "the tax laws are a significant impediment to implementing non-contingent deferred loads and installment loads." Protecting Investors: A Half Century of Investment Company Regulation 329 (1992). To the best of our knowledge, differences in tax status still would make account-level fees more costly to investors than fees paid from fund assets. *See also* ICI Working Group Report, at 15-17.

15 The recent implementation of Rule 22c-2 under the 1940 Act, which required the addition of specific provisions to intermediary agreements, imposed major logistical and financial burdens on fund service providers and intermediaries, costs that significantly exceeded the amounts estimated by the Commission in proposing the rule. We urge the Commission to bear that experience in mind in considering changes to Rule 12b-1 and to be sensitive to the disruption that would be imposed by yet another industry-wide revision to intermediary agreements.

D. Conclusion

The marketplace has afforded investors with a multitude of choices. During the past decades, the Commission has fostered an environment in which competition has flourished. Investors may choose from front end load, spread load, or no-load funds, which they may choose to purchase with or without professional advice. They also may choose from other pooled investment vehicles, such as exchange traded funds. In this environment, there is no risk that investors face a "take it or leave it" investment decision. Finally, we respectfully suggest that despite years of experience and evolutionary change under Rule 12b-1, we are not aware of any material problems that would warrant major change.

If you have any questions about the foregoing comments, please do not hesitate to contact me or Irving Daniels of my staff at 202-289-4322.

Best regards,

Steve Bartlett
President and CEO