OppenheimerFunds®
The Right Way to Invest

Two World Financial Center
225 Liberty Street
New York, NY 10281-1008

Ari Gabinet
Executive Vice President &
General Counsel – Asset Management
Telephone: 212-323-5062
Facsimile: 212-323-4070
E-mail: agabinet@oppenheimerfunds.com

November 5, 2010

Via E-Mail to rule-comments@sec.gov

Ms. Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Study Regarding Obligations of Brokers, Dealers and Investment Advisers (Release Nos. 34-62577; IA-3058; File No. 4-606); Proposed Rule and Rule Amendments Regarding Mutual Fund Distribution Fees and Confirmations (Release Nos. 33-9128; 34-62544; IC-29367; File Number S7-15-10)

Dear Ms. Murphy:

OppenheimerFunds, Inc. ("OppenheimerFunds")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") on its proposed rulemaking regarding mutual fund distribution fees, and to inform the study by the SEC on the obligations of broker-dealers and investment advisers. OppenheimerFunds is commenting separately on the details of the Commission's proposal regarding mutual fund distribution fees, but we are taking this

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[1] OppenheimerFunds is a registered investment adviser, providing investment management, transfer agency, and, through its wholly owned subsidiary, Oppenheimer Funds Distributor, Inc. ("OFDI"), distribution services to approximately 94 registered investment companies. OppenheimerFunds, with more than $170 billion in assets under management, has been in the investment advisory business since 1960.

occasion to discuss the specific issue of the disparate treatment of registered investment advisers and broker-dealers in the area of mutual fund distribution.

OppenheimerFunds believes that rationalization of the rules applying to those who provide investment guidance may benefit investors. Although OppenheimerFunds is not aware of any pattern of abusive behavior on the part of broker-dealers that militates in favor of a more stringent standard of care for their registered representatives, we understand that there may be logic, in some cases, to applying a standard of conduct based on the nature of the activity, not the regulatory registration of the person engaged in it. Recent studies suggest that most investors do not understand or appreciate the differences in how investment advisers and brokers are regulated. Investors should not discover those differences, to their regret, only after they suffer a loss at the hands of the person who guided their investment decisions.

Creating a rational and internally consistent approach to regulating investment guidance, however, involves more than just the standard of care that applies to investment advisers and brokers. It involves taking a holistic approach to the distribution of securities. In the area of mutual fund distribution, OppenheimerFunds suggests that the Commission reconsider the current framework. "Distribution" of mutual fund shares, from a legal standpoint, encompasses a broad array of activities that may be performed by a variety of entities. The Commission has stated that the various share class and load and fee structures for mutual funds are all different ways for investors to "pay" for the services they receive. When it comes to the use of fund assets to pay for those services, however, the Commission differentiates between the entities that provide materially similar distribution services on the basis of how they are registered and on the manner in which they are paid, not on the nature of the activity or service provided. These distinctions can result in regulatory arbitrage, and may lead to the creation of unnecessary and complex structures to allow intermediaries to receive distribution payments from funds.

A. Background of Investment Adviser and Broker Services and Standards of Care

Historically, the differences between investment advisers and brokers were clear. Brokers were the necessary agents for the buying and selling of shares; as defined in the Securities Exchange Act of 1934, a broker is a person that is "engaged in the business of effecting securities transactions for the account of others."[2] Brokers were compensated with a commission charged for each share sold. They were paid for buying and selling shares for their customers through exchanges, over the counter, or in the case of dealers, from their own inventory. Brokerage accounts could be discretionary, but the default model was that the broker executed the trades that the customer authorized. In the absence of investment discretion, a broker's obligation in connection with recommending

[2] Exchange Act §3(a)(4) (codified at 15 U.S.C. §78a *et seq.*).

investments to clients was generally limited to determining that the recommendation was "suitable" for the investor.

Investment advisers, on the other hand, were more often ceded control of their clients' accounts. Their investment strategies had to be implemented through brokers who bought and sold shares on their behalf, but the advisory function was separate from the trading function. By virtue of the nature of their services and the reliance and trust their clients repose in them, investment advisers were held to a strict fiduciary standard.[3]

Today, however, the distinctions between brokers and investment advisers have blurred. Broker-dealer registered representatives regularly suggest investments to their clients and assist them in developing asset allocation strategies (and, outside of wrap programs, are compensated on a transaction basis). Thus, it is hard to distinguish the nature of activities from those provided by registered investment advisers, who advise their clients on asset allocation strategies and recommend individual securities, charging a fee based on a percentage of assets they manage for their clients. It is not surprising that the Rand Corporation, commissioned by the SEC to study the issue, concluded that "investors typically fail to distinguish broker-dealers and investment advisers along the lines defined by federal regulations."[4]

The impetus behind the drive to rationalize broker-dealer and investment adviser standards of care is, presumably, the notion that similar activities should be regulated the same way; otherwise, regulatory arbitrage can become a factor in the behavior of investment professionals. The choice of regulatory registration may be driven by the registrant's desire to mitigate its regulatory burden, and, specifically in the case of mutual fund shares, to be eligible for certain types or forms of compensation. There is, therefore, logic to the suggestion that investment advisers and broker-dealers assisting investors in selecting investments should be subject to the same standard of care vis-à-vis the provision of that service, particularly in the case of mutual fund shares.

B. Intermediaries and the Distribution of Mutual Fund Shares

The standard of care, however, is not the only regulatory aspect of the provision of investment advice that should be rationalized. In particular, OppenheimerFunds believes the Commission should consider this issue in connection with the proposed revision of the rules relating to the distribution of mutual fund shares. The sweeping system that has grown up under Rule 12b-1 under the Investment Company Act, which permits mutual funds to pay for the distribution of their own shares,[5] has many features

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[3] *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

[4] *See* RAND CORPORATION, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS (2008) at 118, *available at*: http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf [hereinafter RAND REPORT].

[5] 17 C.F.R. §270.12b-1 (2010).

that are based on historical distinctions between brokers and investment advisers, distinctions that have given way to converging business models over the past thirty years.

Specifically, although many types of intermediaries are involved in activities related to the distribution of mutual fund shares, the use of mutual fund assets to compensate intermediaries that are not broker-dealers is problematic. The Commission considers at least some 12b-1 fees to be substitutes for front-end loads, which, in turn, are viewed as commissions on transactions in mutual fund shares. The Commission has declared such transaction-based compensation to be a hallmark of brokerage activity, requiring the recipient to register as a broker-dealer. The proposed rulemaking on mutual fund distribution fees is explicit regarding the payment of the "ongoing sales charge" and possibly the "marketing and service fee" as transaction-based compensation:

> As a form of deferred sales load, all payments of ongoing sales charges to intermediaries would constitute transaction-based compensation. Intermediaries receiving those payments thus would need to register as broker-dealers under section 15 of the Exchange Act unless they can avail themselves of an exception or exemption from registration. Marketing and service fees paid to an intermediary may similarly require the intermediary to register under the Exchange Act.[6]

This approach, equating mutual fund "distribution" with "brokerage" is not consistent with legal definitions of those activities and is out of sync with market reality. Worse, it creates a fiction that the activities of investment advisers and broker-dealers in connection with the distribution of mutual fund shares are somehow different from each other. Indeed, as the Rand Report illustrated, what these two classes of financial professionals do is, for many purposes, virtually identical. In one way or another, they each assist investors in making intelligent and informed investments in mutual funds.[7] Among other services they offer, investment advisers and brokers both:

- Recommend specific funds or menus of similar funds from multiple complexes;
- Create model portfolios or asset allocations that include specific funds or fund options; and
- Offer "platforms" from which investors may pick investments from a pre-culled list.

All of these services have a common theme of counseling clients on their investment choices, and, to the extent that those choices include fund shares, they all aid in the "distribution" of fund shares. Thus, when performed by a registered broker-dealer,

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[6] Mutual Fund Distribution Fees; Confirmations, Securities Act Release No. 9128; Exchange Act Release No. 62544; Investment Company Act Release No. 29367)(File No. S7-15-10) (proposed July 21, 2010); 75 Fed. Reg. 47064 (August 4, 2010)[hereinafter Proposing Release] at 47 n.168.

[7] *See* RAND REPORT, *supra* note 4 at 14-15.

or a registered representative, these activities may be supported by fund assets under a plan authorized under Rule 12b-1. Yet, under the SEC's existing guidance (specifically, the SEC's "Guide to Broker-Dealer Registration" (April 2008)), and under the language of the Proposing Release quoted above, an investment adviser performing *exactly the same services* may not receive payments from fund assets for these services unless it registers as a broker-dealer.[8]

C. Mutual Fund Distribution Is Not Identical To Brokerage

The statutory definitions of "broker" and "dealer" do not necessarily reach the kind of activity for which mutual fund sales charges are imposed and collected, as the SEC has itself defined them in its Guide to Broker-Dealer Registration:

> Section 3(a)(4)(A) of the [Securities Exchange] Act generally defines a "broker" broadly as any person engaged in the business of effecting transactions in securities for the account of others.
>
> . . .
>
> Unlike a broker, who acts as agent, a dealer acts as principal. Section 3(a)(5)(A) of the [Securities Exchange] Act generally defines a "dealer" as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.[9]

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[8]Some litigants have asserted that funds may not, consistent with the Investment Company Act, Rule 38a-1 (17 C.F.R. 270.38a-1), or the Investment Advisers Act, pay 12b-1 fees to broker-dealers who have not registered as investment advisers, because 12b-1 fees, as "asset-based compensation," constitute "special compensation" under section 2(a)(11) of the Investment Advisers Act. The one court to address this argument to date has squarely rejected it. *See* Smith v. Franklin/Templeton Distributors, Inc., 2010 U.S. Dist. Lexis 56516 (N.D. Cal. June 8, 2010)(*see also* order dated Oct 22, 2010 vacating hearing). The same plaintiff has sued OppenheimerFunds' distributor affiliate and the trustees of two Oppenheimer funds on this theory. Smith v. OppenheimerFunds Distributor, Inc., Case Nos. 10-7387, 10-7394 (S.D.N.Y). The Commission has consistently permitted fund assets to be used to pay asset-based fees to broker-dealers for distribution-related services without requiring that they register as investment advisers. Lest there be any confusion by those litigants, OppenheimerFunds does not concede that the "distribution related activities" that broker-dealers engage in necessarily constitutes investment advice or that 12b-1 fees can be considered "special compensation." Rather, our suggestion herein is that as the fiduciary standards applicable to brokers and investment advisers converge, neither the form of registration nor the basis of the compensation should dictate which intermediaries should be permitted to receive fund assets for distribution-related activity.

[9] SEC, GUIDE TO BROKER-DEALER REGISTRATION (April 2008), *available at*: http://www.sec.gov/divisions/marketreg/bdguide.htm.

The Commission's view has been that many activities that stop short of actually effecting sales of securities may actually constitute brokerage activity, one such activity being the receipt of trailing commissions or 12b-1 fees.[10]

In contrast, Rule 12b-1(a)(2) defines distribution of mutual fund shares as "any activity which is primarily intended to result in the sale of fund shares." This definition encompasses many activities that are remote from the "effecting" of transactions or "buying and selling securities for [one's] own account." This is especially true because mutual fund shares are purchased and redeemed directly from the fund.[11] Fees paid under 12b-1 plans are used today – with the Commission's knowledge and consent – to compensate intermediaries for certain services, including recordkeeping, shareholder services, updating clients about funds, providing marketing materials and current filings, and advising, educating, reporting and recommending to investors types of funds, fund families, or even specific funds. That registered representatives of brokers – entities that also effect transactions for others – engage in these activities does not mean that the specific activities constitute "brokerage" for regulatory purposes.

The theory that appears to tie some distribution-related activities to brokerage is that the compensation for them is "transaction-based" – that is, the intermediary performing the service gets paid on the basis of the number of shares it has sold. Brokers, whose job is to effect trades for others, get paid on the basis of the transactions they "effect." Therefore, the argument proceeds, any investment professional that gets paid on a transaction-by-transaction basis is a broker and should be registered as a broker. But the method of payment does not necessarily define the regulatory character of the person's role. If the activity for which the payment is made is remote from the "effecting" of transactions, why should the intermediary be required to register as a broker-dealer?

Consider a direct-sold fund's use of its assets to pay for distribution. In theory, shares of such a fund may be bought and sold directly from the fund through its transfer agent without the intercession of a broker.[12] Section 12(b) and Rule 12b-1 permit the fund to use its assets to pay service providers to "distribute" the fund – to engage in activities primarily intended to result in the sale of fund shares. Such activities might include creating and distributing fund marketing material, including the fund on a recommended list or model portfolio, or recommending that clients purchase shares directly from the fund. If all purchases and sales of the fund's shares are "effected" directly with the fund (through its transfer agent), is the "distribution" activity of those

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[10] *Id.*

[11] With the exception of ETF shares, mutual fund shares are not ordinarily bought or sold from dealer inventory.

[12] Fund shares may be sold directly by the fund, without an underwriter. Section 22(d) of the Investment Company Act requires that fund shares be sold "either to or through a principal underwriter . . . *or at a current offering price described in the prospectus.*"

service providers "brokerage?" Should intermediaries be required to register as broker-dealers if they are paid on the basis of shares sold to clients they refer?

The Commission could of course decide that all activities intended primarily to result in the sale of fund shares should be performed only by registered broker-dealers. But that does not compel the conclusion that because brokers may engage in a particular activity in addition to "effecting transactions," all persons who engage in the same activity should register as broker-dealers. Nor do we support the notion that broker-dealer regulation is optimally designed to control the behavior of entities receiving fund assets for distribution-related services.

The practical reality is that a variety of different intermediaries perform the same kinds of services for investors in relation to investing in mutual funds. The Commission recognized this reality in the Proposing Release for the reform of mutual fund distribution when it wrote that:

> [i]nvestors can select among many types of intermediaries from which they can purchase fund shares, and have choices as to how they pay for the services of those intermediaries. They may pay a "sales load" at the time they purchase shares, or a deferred sales load when they redeem shares, or they may invest in a fund that pays ongoing sales charges on behalf of investors from fund assets, otherwise known as 12b-1 fees. As an alternative, they may choose to invest through an intermediary that deducts fees directly from the investor's account by a separate agreement (*e.g.* "wrap fee programs"). *Whether an investor pays sales charges depends upon the fee structure of the fund in which the investor chooses to invest, and how those sales charges are paid depends upon the "class" of fund shares that the investor selects.*[13]

Thus, the Commission appears to recognize that front-end loads, contingent deferred sales charges ("CDSCs"), ongoing sales charges, and wrap fees are all different ways to pay for the same thing – intermediary services which are "intended primarily to result in the sale of mutual fund shares," but which may not be, and in fact generally are not, closely related to effecting transactions. In fact, it is notable that the Commission even includes front-end loads – the closest thing to a traditional "commission" in the sale of mutual fund shares – as another form in which investors "pay" for intermediary services.

The language cited above from the Proposing Release states the market reality that front-end loads are not just, or even primarily, "commissions." For one thing, today they are set by the funds, not by the brokers, and the amounts are far removed from the

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[13] Proposing Release, *supra* note 6 at 7 (emphasis added); *see also id.* at 24-28.

pennies per share commissions on equity securities which, presumably, reflect the market price for "effecting transactions in securities."[14] Acknowledging this reality should compel the result that, just as a front-end load is a payment for distribution related services, not just, or even primarily, for brokerage, so CDSCs, ongoing sales charges and other "12b-1 fees" are payments for distribution, not brokerage. Despite this logic, the Commission suggests that in the future, ongoing sales charges (and potentially proposed 12b-2 fees as well) may only be paid to registered broker-dealers.

D. Regulatory Structure Drives Regulatory Arbitrage

Treating investment advisers, bank trust companies and brokers differently with respect to payment for fund distribution-related activities also has real-world consequences. There are a number of very current business examples. Fund complexes that distribute through the investment adviser channel, and the investment advisers who promote those funds, face a number of challenges in supporting distribution.[15] An investment adviser who wants to receive the same kind of "support" that a broker-dealer may receive in front-end loads or their deferred substitutes must resort to machinations. It must register as a broker-dealer (despite not being in the business of "effecting transactions" for its clients) and incur the costs associated with that regulatory structure, create an affiliated broker-dealer to collect the fees or to introduce the trades to a clearing broker who may share with the introducing broker some portion of the revenue it collects from funds.[16]

Alternatively, investment advisers without affiliated broker-dealers may negotiate for "revenue sharing" payments from the fund's advisory firm. The fund, or its adviser or distributor, for its part must restrict fund-sourced payments to registered broker-dealers (leaving a significant market underserved) or make revenue sharing payments. Revenue

[14] Front end loads on mutual fund shares may be higher than equity trading commissions because of the additional services brokers provide in connection with the distribution of mutual fund shares. But those additional services are related to "distribution," not to "effecting" the transaction, and the front end load is just one of the various ways that shareholders may elect to pay for those services.

[15] The question of why funds, or their advisers, should "support" the selling activities of brokers and others rather than force the intermediaries to bear all of their own costs is complex; it would seem from an economic standpoint that the cost of distribution is the same, regardless of which entity pays for it; the various participants in the mutual fund distribution network compete with each other to avoid being viewed by investors as the source of a drag on returns. With the large supply of intermediary-sold funds competing for access to distribution outlets and visibility in the distribution channels, the distributors have market power that allows them to shift the burden to the funds or their advisers. The funds either shift the cost to investors in the form of loads or "12b-1 fees," or to the fund advisers, who make revenue sharing payments to intermediaries. This in turn creates the revenue pressure on fund advisers described above.

[16] The interpositioning of an affiliated broker-dealer into the transaction doesn't change the nature of the services the investment adviser provides to its clients, and the affiliated broker-dealer is ordinarily nothing more than an "introducing broker" that plays no role in actually effecting the purchase or sale of the fund shares.

sharing, in turn, is an expense that the fund's adviser is prohibited from recouping, *per se,* in the negotiation of its advisory contract, but the regulatory structure puts pressure on revenues of the fund's adviser merely because of the registration status of the entity that provided distribution-related services.

OppenheimerFunds understands the regulatory peril fund advisers confront in connection with revenue sharing, particularly in light of the (we believe unjustified and legally unsound) warning in the Proposing Release that "revenue sharing payments could be construed as an indirect use of fund assets for distribution that is unlawful unless made pursuant to a rule 12b-1 plan."[17] But the SEC's foray into the investment adviser's use of its own legitimate profits merely underscores the need to rationalize the ability to use fund assets to compensate investment advisers, brokers and others providing distribution related services. The present regulatory distinctions create these undesirable incentives with no apparent justification other than those borne of historical differences in business models. If it is permissible to use fund assets to subsidize distribution, the regulatory registration of the recipient should not matter.

Taking a more market-based approach to regulation in this area has other benefits. If all entities that provide individualized investment advice are held to a common standard of care, it should no longer be problematic for broker-dealers to receive "asset-based" fees. This could vastly simplify the structure of wrap programs, which, today, may be sponsored by brokers who, unless dually registered, must use adviser-registered affiliates to collect associated asset-based fees, but which may at the same time receive some portion of 12b-1 fees paid by funds that are in the program. It would also obviate questions about whether "marketing and service fees" may be paid only to broker-dealers, and what services are legitimately included in such fees.

E. Conclusion

Thirty years ago the Commission adopted Rule 12b-1, having determined that it was in the best interests of fund shareholders to allow some amount of fund assets to be used to promote sales. The Proposing Release, which would continue to allow the use of fund assets for distribution, appears to reaffirm that determination. The issue today is not whether there are benefits to shareholders of an expanding fund (it is quite clear that there are). Rather, the question is whether, having concluded that it is appropriate to allow funds to pay for some amount of distribution, the Commission should perpetuate regulatory discrimination among different classes of entities that provide similar "distribution-related services."

The SEC's and Congress' initiatives to study, and ultimately rationalize, the standards of care applicable to brokers and investment advisers where their activities overlap is presumably based on the notion that the same activity should be subject to the same regulatory standards regardless of the entity performing it. The soundness of this

[17] Proposing Release, *supra* note 6 at 19 n.65.

principle as a basis for regulatory rationalization in each case depends on the specific activity to be regulated. With respect to the distribution of mutual fund shares, however, OppenheimerFunds believes that as standards of care converge, investment advisers, broker-dealers and bank trust companies, all of whom perform the same mutual fund distribution-related services, should have the same ability to receive fund payments in support of their distribution-related activities without regard to the particular form of their regulatory registration, or the basis upon which their compensation is calculated.

OppenheimerFunds is grateful for the opportunity to raise some of these complexities with the Commission and its staff. If you have any questions, please feel free to contact Ari Gabinet at (212) 323-5062 or Robert Zack at (212) 323-0250.

Respectfully submitted,

Ari Gabinet
Executive Vice President and
General Counsel, Asset Management
OppenheimerFunds, Inc.

Robert G. Zack
Executive Vice President and
General Counsel, Corporate
OppenheimerFunds, Inc.

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
Andrew J. Donohue, Director, Division of Investment Management
Robert E. Plaze, Associate Director, Division of Investment Management