FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT BROKER-DEALERS AND INDEPENDENT FINANCIAL ADVISORS
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VIA ELECTRONIC MAIL

November 5, 2010

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549- 1090

RE: File Number S7-15-10 – Mutual Fund Distribution Fees; Confirmations

Dear Ms. Murphy:

On July 21, 2010, the Securities and Exchange Commission (SEC) released a proposed rule and other amendments designed to reform mutual fund distribution fee practices (Proposal).[1] The Proposal attempts to accomplish this by replacing Rule 12b-1 with a new Rule, 12b-2, and making other changes to the securities laws in an effort to:

1. Improve transparency through disclosure;
2. Cap ongoing sales charges;
3. Encourage retail price competition; and
4. Modify the oversight role of fund directors.

The Financial Services Institute (FSI)[2] welcomes this opportunity to comment on the Proposal. We commend the SEC for its efforts to bring greater transparency to mutual fund distribution fees. However, we have concerns with the Proposal's plan to alter significantly the financial incentives offered to financial advisors who advise their clients to purchase mutual funds.[3] If adopted in its present form, the Proposal would have important unintended consequences for independent broker-dealers, independent financial advisors, and their clients by unnecessarily limiting investor access to service and support and creating a duplicative, ineffective, post-transaction disclosure regime. Our concerns are discussed in detail in this letter.

Background on FSI Members

FSI represents independent broker-dealers (IBD) and the independent financial advisors that affiliate with them. The IBD community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and

[1] *Mutual Fund Distribution Fees; Confirmations*, SEC Release Nos. 33-9128; 34-62544; IC-29367 (July 21, 2010), 75 FR 47064 (August 4, 2010).

[2] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 124 Broker-Dealer member firms that have more than 190,000 affiliated registered representatives serving more than 15 million American households. FSI also has more than 14,500 Financial Advisor members.

[3] As used herein, the term "financial advisor" refers to a registered representative or investment adviser representative affiliated with an independent broker-dealer and/or an affiliated investment adviser firm.

objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 financial advisors – or 64% percent of all practicing registered representatives – operate as self-employed independent contractors, rather than employees, of their affiliated broker-dealer firm.[4] These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[5] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI's mission is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

A Success Story: The History of Rule 12b-1

Mutual funds provide a simple, accessible, and affordable way for many investors to achieve both short-term and long-term financial goals. The benefits of mutual fund investing include:

- Professional management;
- Diversification;
- Variety;
- Liquidity;
- Affordability;
- Convenience; and
- Ease of Recordkeeping.[6]

Today the mutual fund industry serves a central role in the financial lives of many Americans. In 2009, the U.S. mutual fund industry had over $11 trillion in total net assets invested in nearly

[4] Cerulli Associates at http://www.cerulli.com/.
[5] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.
[6] *See generally*, ICI Guide to Mutual Funds http://www.ici.org/pdf/bro_g2mfs_p.pdf.

7,700 different funds.[7] Forty-three percent of all U.S. households owned mutual funds.[8] This translates to 50.4 million households and 87 million individual investors.[9] However, the industry was not always so large and successful. In 1979 – one year before Rule 12b-1 was enacted, the U.S. mutual fund industry had only $94 billion in net assets invested in 526 different funds.[10] Nearly all research on the history of 12b-1 indicates that the Rule has been a major factor in the tremendous growth of the industry.

Prior to Rule 12b-1's adoption in 1980, the SEC "generally prohibited funds using assets to pay for the sales of its shares, out of concerns about the inherent conflicts of interest [between a fund and its shareholders] in such arrangements."[11] As a result, before Rule 12b-1, funds sold through financial advisors compensated those advisors only via front-end sales loads.[12] From 1976 to 1979, fund redemptions increased from $16 billion a year to over $86 billion per year.[13] Although there is debate among industry experts as to whether Rule 12b-1 was adopted to help mutual funds address the increase in net redemptions,[14] what is certain is that in 1979 the SEC issued a release proposing Rule 12b-1,[15] which would allow funds to use assets to help pay for distribution costs.

The SEC adopted Rule 12b-1 under the Investment Company Act of 1940 ('40 Act) in 1980.[16] The Rule allows funds to adopt 12b-1 plans designed to "deduct an annual fee from net assets [to bear distribution and marketing expenses] a portion of which is paid to brokers to compensate for distribution costs . . . [that] is included in the [mutual fund's] reported expense ratio."[17] The mutual fund's board of directors has to approve the 12b-1 plan, and must reapprove it annually as appropriate for the fund's shareholders.[18] Funds can implement 12b-1 plans "if they [are] (a) written; (b) initially approved by a majority of fund directors, independent directors, and

[7] Investment Company Inst., 2010 Investment Company Factbook 124 (April 28, 2010), available at http://www.ici.org/pdf/2010_factbook.pdf.
[8] *Id.* at 80.
[9] *Id.*
[10] *Id.*
[11] Andrew J. Donohue, Remarks at the SEC Division of Investment Management Rule 12b-1 Roundtable 7 (June 19, 2007) [hereinafter *SEC Roundtable*] (transcript *available at* http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf). The conflict of interest exists because investment advisers are usually compensated based on the amount of assets in the fund (advisory fees are usually based on a percentage of assets), whereas existing shareholders are (arguably) hurt when they subsidize the cost of attracting new investors via a reduction in fund assets. *See* Remarks by Joel H. Goldberg and Richard W. Grant at the *SEC Roundtable* 17-18.
[12] MARK R. FETTING ET AL., INVESTMENT COMPANY INST. REPORT OF THE WORKING GROUP ON RULE 12B-1 (May 2007), available at http://www.ici.org/pdf/rpt_07_12b-1.pdf. The only other alternative for investors was to buy from the fund directly to avoid front-end loads; this became more popular in the 1980's and 1990's.
[13] *See* 2010 Investment Company Factbook, *supra* note 7, at 125.
[14] *See* Remarks by Joel H. Goldberg at the *SEC Roundtable*, *supra* note 11, at 13 (arguing that it is a myth that 12-1 was proposed and adopted in response to net redemptions). *But see* LORI WALSH, THE COSTS AND BENEFITS TO FUND SHAREHOLDERS OF 12B-1 PLANS: AN EXAMINATION OF FUND FLOWS, EXPENSES AND RETURNS 6 (2005), *available at* http://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf (arguing that as a result of cash outflow from funds, investors who remained in the funds were paying higher expenses, and that the "industry asked the SEC to allow advisers to use fund assets to help pay for distribution costs").
[15] Bearing of Distribution Expenses by Mutual Funds, SEC Release No. IC-10862 (Sept. 7, 1979). The SEC actually adopted Rule 12b-1 through a series of several no-action letters and five releases over four years (1976-1980). See Remarks by Richard W. Grant at the *SEC Roundtable*, *supra* note 11, at 18.
[16] Bearing of Distribution Expenses by Mutual Funds, Release No. IC-11414 (October 28, 1980).
[17] Walsh, *supra* note 14, at 6.
[18] *Id.*

shareholders; (c) annually re-approved by a majority of fund directors and independent directors; [and] (d) terminable at any time by a majority of independent directors or fund shareholders."[19]

Rule 12b-1 saw little use within the first few years of its passage.[20] However, in 1982 the SEC began issuing exemptive orders for "spread loads," defined as asset-based 12b-1 fees charged along with a contingent deferred sales load ("CDSL").[21] Through this clever financial innovation, investors who relied on a financial advisor for guidance in purchasing mutual funds now had the option to pay for those services over several years instead of up front. In other words, the fund distributor could now pay the financial advisor's commission in advance with the expectation that it would collect the money back over time.[22] In this way, 12b-1 fees began to be used as substitutes for front-end loads in certain share classes.[23] In 1985, the SEC started allowing mutual funds to adopt different share classes.[24] Ten years later, the SEC streamlined the conditions for funds using multiple class structures,[25] giving investors more choices for paying 12b-1 fees and spread loads.[26] In the years that followed, Rule 12b-1 plans proliferated among loaded mutual fund shares. Over half of all load fund share classes implemented 12b-1 plans by 1990 and by 2002 this number had risen to 92%.[27] Not coincidentally, mutual fund assets grew from $495 billion in 1985 to nearly $7 trillion by 2000.[28]

It is clear that Rule 12b-1 has benefitted the mutual fund business, but more importantly, the Rule also provides several important benefits to mutual fund shareholders. These benefits include:

- **Expanded Investor Choice** - The number of share classes within U.S. mutual funds has increased dramatically since Rule 12b-1's inception. By way of illustration, there were 1,243 share classes in 1984, compared to 21,726 share classes in 2009.[29] By increasing the number of funds and share classes available, 12b-1 fees provide investors access to a wide range of suitable mutual fund product choices and a variety of ways to pay for service and support. In fact, "[t]he ability of funds to assess asset-based distribution fees [i.e. 12b-1 fees] has allowed many small fund groups to remain competitive..."[30] In other words, investors benefit from the choices created through the competitive mutual fund marketplace made possible by Rule 12b-1.
- **Ongoing Relationship Between Clients and Financial Advisors** - Most individuals purchase mutual funds through professional advisors, with whom they intend to have an ongoing relationship.[31] In fact, between June 2008 and May 2009, 95% of shareholders who had a financial advisor reported having some form of contact with their chosen

[19] SEAN COLLINS, THE EFFECT OF 12B-1 PLANS ON MUTUAL FUND INVESTORS, REVISITED 5 (March 2004), *available at* http://www.sec.gov/rules/proposed/s70904/s70904-154.pdf.
[20] Remarks by Richard W. Grant at the *SEC Roundtable*, *supra* note 11, at 36-37.
[21] Fetting et al., *supra* note 12, at 3.
[22] *Id.*
[23] *Id.*
[24] *Id.* at n. 16.
[25] *Id.*
[26] *Id.*
[27] Collins, *supra* note 19, at 23.
[28] 2010 Investment Company Factbook, *supra* note 7, at 124.
[29] *Id.* at 124.
[30] Fetting et al., *supra* note 12, at 5.
[31] *See generally*, 2010 Investment Company Factbook, *supra* note 7. Eighty percent of those that owned funds outside a workplace retirement plan held funds purchased through a professional adviser. Professional advisers may include full-service brokers, discount brokers, independent advisers, financial planners, mutual fund company representatives, advisers at a bank, insurance agents, accountants, and lawyers.

advisor.[32] 12b-1 fees support and encourage these ongoing relationships by compensating financial advisors for services performed after the initial sale of the funds.[33] The ability of funds to compensate financial advisors for ongoing services provided to clients is critical to investor access to service and support after the initial sale.

- **Increased Availability of Mutual Funds** - Finally, Rule 12b-1 has also resulted in an increase of available distribution channels for mutual funds. The variety of pricing models has allowed investors to pick the share class suited to the channel they intend to use.[34] An Investment Company Institute[35] report states that as a result of these new distribution channels, "[i]nvestors, seeking advice and assistance, [can] purchase and redeem shares through financial advisers at securities firms, banks, insurance agencies, and financial planning firms. Investors also can buy and redeem shares of many funds through 'fund supermarkets' or retirement plan platforms sponsored by third party brokers-dealers, retirement plan administrators and other institutions."[36] The increased availability of mutual funds and distribution channels allows investors to expanded access to mutual fund products, advice, and support.

In summary, Rule 12b-1 has greatly benefitted mutual fund investors by fostering tremendous growth in the industry, resulting in more funds, share classes, and increased competition. The Rule also facilitates ongoing relationships between financial advisors and their clients by compensating the advisor for providing ongoing service to investors. Finally, Rule 12b-1 has facilitated the creation of additional distribution channels, giving investors more choice as to where and how they purchase their mutual fund shares. Since Rule 12b-1 has proven so successful, the FSI believes the SEC should carefully review its proposal and substantiate its recommendations before altering the mutual fund distribution fee structure currently in place.

Summary of the Proposal

Despite the success of Rule 12b-1 in expanding mutual fund ownership and providing other important benefits to investors, the SEC has raised concerns in recent years about their current use. In response to these concerns, the SEC has proposed reforms to mutual fund distribution fee practices, Rule 12b-1, and other regulatory requirements. As mentioned above, the SEC's Proposal attempts to address four primary objectives:

1. Improve transparency through disclosure;
2. Cap ongoing sales charges;
3. Encourage retail price competition; and
4. Modify the oversight role of fund directors.

The Proposal aims to improve transparency of distribution and marketing fees by eliminating the term "12b-1 fee" to describe the trail commission on a mutual fund transaction and introduces two new terms to describe these payments. The first, "marketing and service fees," will be used to describe the ongoing 25 basis points fee used to pay for ongoing marketing, distribution, and

[32] 2010 Investment Company Factbook, *supra* note 7, at 86.
[33] Remarks by Mellody Hobson at the *SEC Roundtable*, *supra* note 11, at 69. Ms. Hobson's firm uses 12b-1 fees for four purposes: (1) to pay financial advisers and consultants who sell the funds; (2) to pay the fund supermarkets that offer the platform for the funds and combined statements for customers; (3) to pay 401(k) plan administrators; and (4) to offset internal marketing costs. *Id.* at 67–68.
[34] Fetting et al., *supra* note 12, at 5.
[35] The Investment Company Institute is the national association of U.S. investment companies. *See* http://www.ici.org/ for more information.
[36] *Id.*

other shareholder services (e.g., the traditional A-share trail).[37] The second, "ongoing sales charge," will be used to describe the continuing commission charge assessed after the initial purchase of a mutual fund (e.g., the 75 bps found in traditional C-share trails).[38]

The Proposal provides for more detailed disclosures to investors through the mutual fund prospectus and confirmation statements.[39] For example, the details of the marketing and service fees and ongoing sales charges would be disclosed in prospectus fee tables, along with explanations of the services provided under these categories. The Proposal would also make changes to Rule 10b-10 under the Securities and Exchange Act of 1934.[40] These amendments would require additional extensive disclosure of sales charges, contingent deferred sales charges, marketing and service fees, and ongoing sales charges on individual trade confirmations.

The Proposal would cap ongoing sales charges through amendments to Rule 6c-10 of the '40 Act.[41] Under the Proposal, ongoing sales charges would be capped at the lower of:

> (1) The highest front-end load the investor would have paid had he bought another class of fund (usually A-shares); or
> (2) The maximum sales charge permitted under FINRA Rule 2830 (currently 6.25%) if there is not a fund within the fund family that has a front-end load.[42]

The Proposal would establish a five-year grandfathering period for shares issued prior to the compliance date that deduct ongoing sales charges under Rule 12b-1, as it exists today.[43] After the five-year period has expired, those shares would be required to be converted or exchanged into a class that does not deduct ongoing sales charges.[44] All funds would be required to comply with the proposed changes for all shares issued after the compliance date of the Proposal.[45]

The Proposal would also attempt to encourage retail price competition by introducing a new share class.[46] Under the current rules, mutual fund sales charges are determined by a fund and disclosed in its prospectus. The Proposal would allow funds to establish a share class that would be offered through broker-dealers at Net Asset Value (NAV).[47] Financial advisors would be able to set their own commission based on the level of services provided and charge this fee directly to investors. The SEC has indicated that by allowing broker-dealers to compete based on sales charges and services, the Proposal is meant to provide a more level playing field for broker-dealers and funds of varying sizes, as well as to place downward pressure on sales charges.[48]

Finally, the Proposal would ease the burden on directors of mutual funds. Directors of funds would continue to have fiduciary duties with respect to the oversight of the use of fund assets to

[37] *Mutual Fund Distribution Fees; Confirmations*, SEC Release Nos. 33-9128; 34-62544; IC-29367 (July 21, 2010), 75 FR 47064 at 47074 (August 4, 2010).
[38] *Id.*
[39] *Id.* at 47082.
[40] *Id.*
[41] *Id.* at 47077.
[42] *Id.* at 47079.
[43] *Mutual Fund Distribution Fees; Confirmations*, SEC Release Nos. 33-9128; 34-62544; IC-29367 (July 21, 2010), 75 FR 47064 at 47101 (August 4, 2010).
[44] *Id.*
[45] *Id.*
[46] *Id.* at 47088.
[47] *Id.* at 47089.
[48] *Id.*

pay ongoing sales charges, within the proposed caps, but would no longer have any explicit responsibilities to approve or re-approve asset-based sales charges.[49]

If adopted, the Proposal would become effective within 60 days, followed by a period of 18 months to allow firms to amend policies, procedures, and systems to ensure compliance with the proposals requirements.[50]

Interviews with Financial Advisors

In preparing this comment letter, FSI engaged in a series of qualitative interviews with a sample of our financial advisor members. The purpose of the interviews was to determine the expected impact of the Proposal on the clients of financial advisors who recommend mutual fund investments. During the course of these interviews, several common themes emerged. These themes are summarized below:

- **Descriptive Names for Mutual Fund Distribution Fees and Improved Prospectus Disclosures Will be Beneficial** – Financial advisors generally support the adoption of the proposed descriptive names for mutual fund distribution fees and enhanced prospectus disclosure improvements included in the Proposal. The following quotes from financial advisors are representative of the feedback we received:
    - "I am not opposed to increased disclosures. I always tell my clients up front how much I make, what the expenses are, etc. So I do not see more [prospectus] disclosures as a burden."[51]
    - "I would support a clearly written, very concise, easy to read and understand disclosure."[52]
    - "Plain English disclosures and descriptions that better explain what the actual charges are associated with the mutual funds would be welcome."[53]
- **Fee and Expense Disclosures on Confirmation Statements Will Prove Ineffective** – While financial advisors support the use of descriptive names for mutual fund distribution fees and prospectus improvements, they oppose the detailed confirmation disclosures included in the Proposal. The following quotes from financial advisors are representative of the feedback we received:
    - "Will add another level of confusion for many investors."[54]
    - "These added disclosures are all in the prospectus already. This is more paper on top of paper."[55]
    - "How can all of this fit on a confirm statement? Clients will not benefit from these additional disclosures."[56]
    - "I think all that will happen if this is enacted is [it will] confuse [clients] even more!"[57]

[49] *Mutual Fund Distribution Fees; Confirmations*, SEC Release Nos. 33-9128; 34-62544; IC-29367 (July 21, 2010), 75 FR 47064 at 47081 (August 4, 2010).
[50] *Id.* at 47101.
[51] Email Interview with Mike Stephens, Stephens Financial & Insurance Services, in Saratoga, Cal. (October 18, 2010).
[52] Email Interview with Bill Gettings, Gettings Reed Financial Services, LLC, in Lafayette, Ind. (October 11, 2010).
[53] Telephone Interview with Fred Greene, Woodforest Financial Services, Inc., in The Woodlands, Tex. (October 12, 2010).
[54] Telephone Interview with Jamieson Grabenhorst, CGC Financial Services, LLC, in Lake Oswego, Or. (October 15, 2010).
[55] Telephone Interview with Tim Reeves, Tim Reeves and Associates, in Midlothian, Ill. (October 15, 2010).
[56] Telephone Interview with Timothy Leveroni, Leveroni Financial Management Corp., in Braintree, Mass. (October 15, 2010).
[57] Email Interview with James T. McDonald, Gettings Reed Financial, LLC, in Lafayette, Ind. (October 11, 2010).

- **Investor Access to Competent Professional Service and Support will be Reduced** – Financial advisors report that the Proposal's cap on ongoing sales charges will reduce investors' access to competent service and support. Many note that C-shares provide a cost-effective means of providing investors much needed and desired ongoing service and support after the initial sale. The following quotes from financial advisors are representative of the feedback we received:
    - "Limiting ongoing [sales charges] after a set period will negatively affect the client [. . .] It simply isn't economically feasible to service smaller accounts at the new rate caps."[58]
    - "The Proposal will primarily impact smaller account holders who are either not comfortable or can't afford fee based accounts, but want ongoing financial advice and service. C-share funds are an appropriate and cost-effective means to service these important and growing account holders."[59]
    - "There are thousands of reps who work with millions of small accounts…The introduction of a 1% [trail] allowed for many of these small investors to receive professional advice for the first time. It also allowed thousands of reps to build their businesses by serving the middle class and not just the very wealthy…[Capping] the 1% trail will reverse this trend and take us back to where only the wealthy are valued as clients."[60]
    - "I deal with middle America – if the proposal goes into effect, for the first time in my career, I will start implementing account minimums. Small investors are going to be the real losers – they will lose the ability to get professional 'big picture' financial advice as it will not make financial sense for advisors to help them."[61]
- **Costs for Some Investors will Increase** –Financial advisors affiliated with IBD firms are often dual registrants who offer C-shares to small accounts requiring ongoing investment advice. C-shares allow these financial advisors to provide small net worth investors with advisory services or incidental advice by outsourcing the expense of fee debiting, invoicing, and other costs associated with investment adviser accounts. Unfortunately, these financial advisors report that the Proposal would cause them to move certain clients to investment advisory accounts. The result will be higher costs for the investor because of the loss of the efficiencies provided by C-shares. The following quotes from financial advisors are representative of the feedback we received:
    - "Currently, we do not use fee-based accounts for investors with less than $100,000, but we may have to. If we do, we may have to increase the minimum investment adviser fee on our accounts."[62]
    - "C-shares are very useful…because they align the client's interests with the advisor's interests…This is one of the most cost effective ways for consumers to invest and still receive personalized financial advice."[63]

In summary, financial advisor members of FSI support common sense improvements to the disclosure of mutual fund distribution fees, but are concerned that the Proposal's detailed confirmation disclosures will confuse investors or prove ineffective. Financial advisors are also

[58] Telephone Interview with Charlie Maxim, Shared Vision Advisors, in Cincinnati, Ohio (October 13, 2010).
[59] Telephone Interview with Bruce Cook, Cook and Phillips Financial Group, in Saint Petersburg, Fla. (October 12, 2010).
[60] Telephone Interview with Thomas Dillon, Dillon Financial Services, LLC, in Saint Louis, Mo. (October 19, 2010).
[61] Telephone Interview with Anthony Nori, Centaurus Financial, Inc., in East Amherst, N.Y. (October 12, 2010).
[62] Telephone Interview with Chris Borden Canby Financial Advisors, in Framingham, Mass. (October 14, 2010).
[63] Telephone Interview with Tim Reeves, Tim Reeves and Associates, in Midlothian, Ill. (October 15, 2010).

concerned that the Proposal's cap on ongoing sales charges will leave many investors without the support and service they need to achieve their financial goals. Those who can afford to pay for this service will see their costs increase substantially.

Comments on the Proposal
As a result of these financial advisor interviews and our own careful analysis, FSI raises the following concerns with the Proposal:

- **Timing of the Proposal** – On July 27, the SEC published a request for public comment related to its study of the obligations and standards of care of broker-dealers and investment advisers providing personalized investment advice about securities to retail investors (Study). The Study is required under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act),[64] which President Obama signed into law on July 21, 2010. As required by the Dodd-Frank Act, the SEC is requesting public input, comment, and data on issues related to the effectiveness of existing standards of care for brokers, dealers, and investment advisers, and whether there are gaps, shortcomings, or overlaps in the current legal or regulatory standards.[65] The results of this Study will have far-reaching impact for broker-dealers, financial advisors, and investors. In spite of the great uncertainty inherent in the ongoing Study of these fundamental issues, the SEC has chosen this time to propose a major intervention in the complex system of mutual distribution.

  Since either one of these initiatives on its own is likely to create unanticipated and potentially undesirable outcomes, we believe it would be prudent to deal with them in sequence, rather than concurrently. This approach will allow the market to absorb the new standard of care, and any new required client disclosures, before introducing new complexities into the market place through the reform of mutual fund distribution fees. Following the current approach of offering these initiatives in tandem significantly increases the likelihood for unforeseen negative consequences for broker-dealers, financial advisors, and their clients. As a result, we urge the SEC to delay further consideration of the Proposal until after implementation of the recommendations of the Study.

- **Efforts to Increase Transparency Through Disclosure** - FSI supports the adoption of the terms "marketing and service fee" and "ongoing sales charge" as common sense improvements to the language used to describe mutual fund distribution fees. In addition, FSI supports the proposed changes to mutual fund prospectus disclosures of the "marketing and service fee" and "ongoing sales charge." These disclosures are prepared by the mutual fund sponsors who are in the best position to report the information accurately. In addition, the prospectus places this fee and expense date in the appropriate context along with other information an investor should consider before investing.

  However, FSI opposes the adoption of confirmation statement disclosure of specific mutual fund fee details as overly burdensome, prone to unintentional error, and without clear client benefit. The IBD business model provides investors access to literally thousands of mutual fund products and share classes. Tracking the commission and

[64] Public Law No: 111-20, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.
[65] Dale Brown, Financial Services Institute, Comment Letter, *Study Regarding Obligations of Brokers, Dealers, and Investment Advisers*, File No. 4-606, (August 31, 2008), *available at* http://www.sec.gov/comments/4-606/4606-2687.pdf.

mutual fund distribution fee details and reporting that information in real time is a monumental task. Since confirmation statements are provided after the transaction, they will have no impact on investors' investment choices. Confirmation disclosure of asset-based fees may also lead investors to mistakenly assume the charge is transaction based. We conclude that it is unreasonable to burden broker-dealers with the duty of providing detailed post-transaction fee and expense data on confirmation statements when the mutual fund company is in the best position to provide this information accurately and the disclosure will not influence mutual fund investor decision making.

Instead, we encourage the SEC to consider the creation of an appropriate point of sale disclosure document as required by Section 919 of the Dodd-Frank Act.[66] Such a disclosure document will provide relevant information to investors in a summary format, including clear and concise information about investment objectives, strategies, costs, risks, and compensation received by a broker-dealer or any other intermediary in connection with the purchase of the mutual fund.[67] The point of sale disclosure document is preferable to confirmation disclosures because the document provides the relevant information prior to the investor's decision making. Such disclosures provide investors an opportunity to thoughtfully consider the mutual fund's fee and expense structure before making their investment decision.

- **Proposed Cap on Ongoing Sales Charges** - FSI opposes the Proposal's cap on ongoing sales charges. Investors are in need of ongoing support and service. Financial advisors affiliated with IBD firms meet this need by providing incidental investment advice, if they are securities licensed only, or comprehensive financial planning and investment advice as dual registrants. C-shares allow financial advisors to provide small net worth investors with these services by outsourcing the expense of fee debiting, invoicing, and other costs associated with investment adviser accounts. In addition, investors enjoy the benefit of putting their entire investment to work in the market and avoiding capital gains taxes that would be incurred if positions were liquidated to pay a management fee. If ongoing sales charges are capped, many investors who currently own C-shares will face a Hobson's choice: either move into more expensive fee-based advisory accounts or find they are no longer able to obtain the service and support that they currently enjoy. This outcome would be an unfortunate unintended consequence for mutual fund investors who need the support of a financial advisor to achieve their financial goals and objectives.

- **Efforts to Encourage Retail Price Competition** - FSI opposes the Proposal's effort to encourage retail price competition through a share class offered at NAV by adopting Rule 6c-10(c) as an exemption from Section 22(d) of the '40 Act. As noted above, Rule 12b-1 has already benefited mutual fund investors by dramatically expanding the competition that exists between mutual fund families. With thousands of funds, tens of thousands of share classes, and hundreds of thousands of financial advisors offering mutual fund and other products for sale, we believe the SEC's concerns about competition are unfounded. In addition, we are worried that the Proposal will alter the distribution model from one based upon ongoing relationships to one driven by sales and focused on transaction-based revenue by eliminating the financial incentive to provide ongoing service and support to mutual fund clients. In addition, we believe this Proposal has the unintended

[66] Public Law No: 111-20 § 919, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf. Clarification of Commission authority to require investor disclosures before purchase of investment products and services.
[67] *Id.*

consequence of being an anti-competitive measure likely to result in pricing advantages for large mutual fund families and broker-dealers.

Additionally, we have significant concerns about the operational impact of the Proposal. NAV shares subject to specific broker-dealer and/or financial advisor pricing models will present significant challenges to compliance and operations personnel, including tracking, monitoring, and communicating the unique fee and commission schedules. These challenges will be further complicated when shares transfer with the movement of client accounts or financial advisors between broker-dealer firms. There simply is no current mechanism in place to ensure the portability of this information. The costs to create these systems are likely to be significant and will be borne by investors.

However, should the SEC choose to reject these policy arguments, we respectfully ask that it provide clarification as to the legal basis for the proposed exemption to Section 22(d)'s distribution rules. We note that the proposed Rule 6c-10(c) appears inconsistent with Section 22(d) because it would exempt broker-dealers from complying with Section 22(d)'s distribution rules. The SEC justifies the discrepancy with a "legislative intent" analysis by arguing that Congress' intent was unclear in Section 22(d). While this may have some merit, it is our understanding that a legislative intent analysis is irrelevant where the statute's language is unambiguous. Because the language in section 22(d) is unambiguous, we believe clarification of the SEC's legal basis to create this exemption is necessary.

Conclusion

In summary, Rule 12b-1 has proven to be an enormously effective tool in expanding investor choice and accessibility by supporting ongoing relationships between financial advisors and clients. While the SEC's Proposal makes some helpful suggestions for improving the transparency of mutual fund distribution fees, it also offers several proposals with significant unintended consequences. In light of our concerns and the SEC's ongoing review of the standard of care owed to investors by broker-dealers and financial advisors, we urge the SEC to carefully review its proposal and substantiate its recommendations before altering the mutual fund distribution fee structure currently in place.

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you to improve the transparency of mutual fund distribution fees without these unintended consequences.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 202 379-0943.

Respectfully submitted,

Dale E. Brown, CAE
President & CEO