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November 5, 2010

VIA ELECTRONIC DELIVERY

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. S7-15-10 (Release Nos. 33–9128; 34–62544; IC– 29367: Mutual Fund Distribution Fees; Confirmations)

Dear Ms. Murphy:

We respectfully submit this letter in response to a request by the U.S. Securities and Exchange Commission (the "Commission") for comments regarding the above-referenced release (the "Proposing Release"). The Proposing Release proposes a new rule and rule amendments (the "Proposed Rules") that would replace rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act"), changing the framework through which funds may use fund assets to pay for the costs of distribution.[1] The Proposed Rules also would require changes to fund disclosure documents and transaction confirmations to provide additional information about sales charges, and would provide funds with the option of offering classes of shares that could be sold by dealers at negotiated sales charges.

Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and abroad. In the United States, we represent a substantial number of U.S. mutual fund complexes, fund boards, fund independent directors, fund advisers, and service providers to funds. The mutual fund complexes we represent include a spectrum from very large complexes to small "boutique" funds. Although we have discussed certain matters addressed in the Proposing Release with some of our clients, the comments that follow reflect the views of a group of attorneys in our financial services practice, and not necessarily the views of all members of our financial services group, the firm or any client of the firm.

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[1] *See* Mutual Fund Distribution Fees; Confirmations, SEC Release No. IC-29367 (Jul. 21, 2010).

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We offer comments regarding several of the items contained in the Proposing Release. Our intent is to comment on technical matters, which we believe require adjustment, and on some policy issues, which may not be addressed by others.

1. Proposed Guidance for Directors and Trustees

We appreciate that the Proposed Rules would significantly reduce the burden on fund directors by eliminating written plans that require approval (and annual re-approval) by directors, and by eliminating quarterly board reporting currently required by rule 12b-1. We are concerned, however, that the Commission's proposed guidance creates a new standard pursuant to which directors would be required to evaluate both the underwriters' compensation and sales loads. This new standard is not contemplated by the 1940 Act and is inappropriate given both the structure of the Proposed Rules and the realities of the marketplace.[2]

The Commission proposes that directors must decide, among other things, whether

> …the underwriter's compensation is fair and reasonable (considering the nature, scope and quality of the underwriting services rendered), and whether the sales loads (including the ongoing sales charge) are fair and reasonable in light of the usual and customary charges made by others for services of similar nature and quality.[3]

This proposed guidance overstates the obligations of fund directors in making determinations with respect to the compensation of fund underwriters, including the amount of sales loads paid by investors. Section 15 of the 1940 Act sets forth the standards for approving both investment advisory contracts and principal underwriting contracts – including the requirements with respect to board approval of these contracts. In adopting Section 15(a) – the provision regarding investment advisory contracts – Congress specifically required that each investment advisory contract "precisely describe[] all compensation to be paid thereunder."[4] In contrast, Section 15(b)

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[2] Among other things, we question the basis for the Commission's reliance on Section 36(a) for the proposition that directors must find underwriting compensation or sales loads to be fair and reasonable, or even in the best interests of the fund and its shareholders. Section 36(a) permits the Commission to sue directors, officers, and others for breach of fiduciary involving personal misconduct.

[3] Proposing Release, at pp. 64-65.

[4] 15 U.S.C. § 80a-15(a).

– the provision regarding principal underwriting contracts – does *not* require that the compensation payable to an underwriter be described in the contract. In addition, Section 36(b) of the 1940 Act specifically does *not* apply to "sales loads for the acquisition of any security" issued by a fund.[5]

We believe these omissions are intentional, and reflect an understanding that underwriter compensation (including sales loads) is essentially set by the distribution marketplace, subject to limitations imposed by other provisions of the 1940 Act and FINRA rules.[6] Most importantly, Section 22(b) of the 1940 Act already authorizes FINRA to place limitations on the compensation to be paid to member firms in connection with the primary offering of investment company securities, including limitations so that such compensation "shall not include an excessive sales load but shall allow for *reasonable compensation* for sales personnel, broker-dealers, and underwriters, and for *reasonable* sales loads to investors."[7] Consistent with this authority, sales charges (including front-end sales loads and contingent deferred sales charges ("CDSCs")) already are subject to limitations by FINRA conduct rules that have been approved by the

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[5] *Id.* § 80a-36(b)(4).

[6] Since 1992, when the Commission approved the FINRA (then NASD) sales charge limitations, FINRA has been the principal regulatory body with respect to sales load maximums and the Commission has not taken any steps to reduce that oversight. In 1988, the Commission proposed a number of substantive amendments to rule 12b-1, including those designed to address the level of fees paid by funds. *Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies*, Release No. IC-16431 (Jun. 13, 1988). Many of the Commission's concerns expressed in the 1988 release were addressed by subjecting 12b-1 plan payments in their totality to the sales load limits in NASD Conduct Rule 2830. FINRA (then NASD) amended the predecessor of Conduct Rule 2830 in 1992. *See Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies*, Release No. 34-30897 (Jul. 7, 1992). The Commission has since amended Rule 12b-1 in a manner that does not affect these sales charge limits, which appear to have been an acceptable response to the Commission's 1988 proposal to amend Rule 12b-1. *See* SEC Division of Investment Management, *Protecting Investors: A Half-Century of Investment Company Act Regulation* (May 1992), at 327 (stating that the NASD sales load proposal was a "step in the direction of limiting fee levels"). In connection with the 1970 amendments to the 1940 Act, which added provisions allowing the NASD to adopt rules prohibiting excessive mutual fund sales charges, Congress stated that it had "decided to rely on the existing self-regulatory machinery of the securities industry in order to protect public investors against unreasonable sales charges subject to appropriate [Commission] oversight." S. Rep. No. 91-184, at 8 (1969).

[7] 15 U.S.C. § 80a-22(b)(1) (emphasis added).

Commission, and presumably are "reasonable" as contemplated by Section 22(b) of the 1940 Act.[8]

The Proposed Rules, and the Proposing Release, treat ongoing sales charges as approximately equivalent to front-end sales loads and CDSCs. Under proposed rule 6c-10, these sales charges would continue to be subject to FINRA limitations approved by the Commission. In light of the framework and protections provided by the 1940 Act and FINRA rules, we do not believe that additional review by fund boards of an underwriter's compensation (including sales loads) would provide meaningful additional protection to investors.[9] In addition, the proposed alternative distribution framework would permit funds to offer classes of shares that dealers may sell with negotiated sales charges, for which fund directors should have no direct oversight responsibility.

We note that a fund's distribution arrangements currently are required to be disclosed the fund's registration statement and are, thus, subject to the anti-fraud provisions of the Securities Act of 1933.[10] We further observe that the Proposed Rules would require additional transaction confirmation disclosure.

In addition, we note that, in evaluating a fund's distribution arrangements, directors will continue to be bound by the fiduciary duties they owe to the fund under state law. We believe that imposing a separate "fair and reasonable" standard, in addition to this state law fiduciary duty, would serve no practical benefit, and could only expose directors to potential criticism for failing to effect changes to expenses over which they have limited, if any, practical authority.

For these reasons, we believe that the proposed guidance is inappropriate and unnecessary.

2. Class R Share Considerations

We note that the Commission has specifically requested comment on the potential consequences of the Proposed Rules on Class R Shares (defined below) and whether investors would be harmed

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[8] *See* NASD Conduct Rule 2830. (Legacy NASD Rules that have not yet been consolidated into the FINRA rule book are referred to herein as "NASD [Rule].")

[9] For the same reason, we do not believe it is necessary or appropriate to limit the ability of funds to increase ongoing sales by requiring shareholder approval of such actions, since Section 22(b) of the 1940 Act, along with FINRA rules, already protect investors from paying excessive sales charges.

[10] Form N-1A requires disclosure regarding sales loads and 12b-1 fees in a number of places. *See*, *e.g.*, Item 3 Item 12, and Item 25.

by the Proposed Rules. The Proposed Rules raise significant operational and cost challenges for fund share classes that currently impose service and/or 12b-1 fees in excess of 0.25%, such as Class R shares, to support both distribution and shareholder services (referred to collectively herein as "Class R Shares").[11] We understand that a fund would be able to characterize 0.25% of the current Class R 12b-1 fee as a marketing and service fee under proposed rule 12b-2. With respect to any fee in excess of this marketing and service fee imposed by the Class R Shares (an "excess fee"), however, a fund would have to determine that the excess fee is either: (i) an ongoing sales charge subject to the limitations of proposed rule 6c-10; or (ii) a fee for administrative services or other services that are not primarily intended to result in the sale of fund shares. Making the latter finding may not be practical or feasible, and would result in a line-drawing exercise that is not supported by any apparent public-policy considerations.

The Commission notes that treating amounts deducted in excess of 0.25% as an ongoing sales charge and eventually converting these shares may not be a viable option for retirement plans with Class R Shares because plan expenses are ongoing. In fact, the Commission states in the Proposing Release that "our proposal would likely make [Class] R Shares a less attractive investment option for plans to offer." As a consequence, we believe the Proposed Rules could effectively eliminate the ability of funds to offer Class R Shares. We believe that Class R Shares should not be dismissed so readily.

The Proposed Rules would be problematic for Class R Shares in several respects:

- They would require conversion of Class R Shares into another class on platforms that are used to offer services to retirement plans, creating operational challenges; and

- They would mean a loss of revenue for arrangements currently employing Class R Shares, resulting from the proposed grandfathering provisions.

We believe these matters require the Commission's further attention, as discussed in greater detail below.

A. *Operational Challenges of Automatic Conversions*

The Proposing Release acknowledges that many providers of Class R Shares currently lack the operational ability to track share aging and to handle share conversions. Indeed, there is a fundamental difference between Class R Shares and retail share classes such as Class B or Class

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[11] Generally, in our experience, Class R Shares have 12b-1 fees that are lower than those of Class C shares.

C in this respect. The infrastructure already exists for most Class B shares to convert to Class A shares, so the Proposed Rules would not require substantial revamping of existing infrastructure for these retail classes. It is our understanding, however, that retirement platforms typically do not provide for a conversion feature and would likely need to double the number of share classes offered in order to provide such a feature. Further, the type of conversion contemplated by the Proposed Rules would need to occur at the platform level. The service providers who operate retirement platforms are not the transfer agents for the funds, which have generally provided systems functionality for conversions from Class B shares to Class A shares. Retirement platforms, however, typically have a very different type of relationship with funds and their managers than institutional transfer agents. The providers of the retirement platforms may not be receptive to investment in infrastructure to accommodate Commission-proposed rule changes, particularly when accommodating the rule changes would result in less revenue for the platform provider after the time of conversion. Indeed, many of them may offer investment media other than funds, such as collective investment trusts and group annuity contracts and therefore this might result in replacing funds with these other investment media. In addition, those providers may not currently offer a share class into which the Class R Shares can be converted upon the expiration of the automatic conversion period.

If platform providers choose to offer share classes requiring automatic conversion under the Proposed Rules, it would likely result in the platform provider incurring significant costs to build the operational systems both to track share aging at the participant level and to allow for conversion. Some funds will also incur costs to register additional share classes in order to comply with the Proposed Rules. The Proposing Release provides some analysis of the potential costs associated with the impact on Class R Shares,[12] but a more comprehensive analysis is clearly warranted. Retirement platform providers may be unlikely to invest in the development of conversion features. The Commission correctly observes in the Proposing Release that many plan asset dollars are invested in low cost funds, including those with servicing and/or 12b-1 fees at an annual rate of 0.25% or less. However, higher fees are frequently needed to provide services to smaller plans, and it is possible that the Proposed Rules would have an adverse effect on the ability of small qualified plans to find satisfactory platforms for their plans, and such smaller plans would have fewer investment options if platform providers cease to offer Class R Shares. This might result in plans moving towards less transparent investment options than mutual funds – including investment options with more limited regulatory protections and fiduciary protections than mutual funds, which benefit from the protections of the 1940 Act and fund board oversight.

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[12] *See* text accompanying footnotes 505 through 516.

B. *Grandfathered Class R Shares*

The current grandfathering provisions in proposed rule 12b-2 are not practicable with respect to Class R Shares (or any class of shares currently imposing 12b-1 fees of 0.26% to 0.50%). Proposed rule 12b-2 provides that share classes that currently impose a 12b-1 fee may continue to charge such fee for five years after the compliance date for the Proposed Rules, at which time such classes must exchange or convert into a class of shares that does not impose an ongoing sales charge. In contrast, Class R Shares sold in reliance on proposed rule 6c-10 would have a conversion period that is significantly longer than five years. For example, if a fund's maximum sales load rate is 6.25%[13] and the Class R Shares have an ongoing sales charge of 0.25%, the Class R Shares would have a conversion period of 25 years, at which time the Class R Shares would have to convert automatically into a class of shares that does not impose an ongoing sales charge.[14] In light of the purpose of Class R Shares, if any conversion period is appropriate, it should be a long one. Given this stark contrast between conversion period and grandfathering period, we believe that, at a minimum, the grandfathering period for Class R Shares should be extended so that it tracks more closely the automatic conversion period for shares sold in reliance on proposed rule 6c-10.

There could be several ways to lessen the adverse effect of the Proposed Rules. The Proposed Rules would set as a threshold for ongoing sales charges any asset-based distribution fee in excess of 0.25%. The Commission could consider a higher threshold for ongoing sales charge rates, such as 0.50% or 0.75%. Alternatively, the Commission could provide a special rule for funds that offer shares in connection with qualified retirement plans. We caution, however, that before taking the latter approach, the Commission should be comfortable that the issues discussed above for retirement platforms and small retirement plans do not also apply to funds sold through other channels or platforms such as "supermarkets" maintained by broker-dealers.

C. *Retail Money Market Funds*

Like funds offering Class R Shares, certain retail money market funds, particularly those which are used as sweep vehicles in conjunction with brokerage accounts, may have 12b-1 fees and/or

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13 As contemplated by proposed rule 6c-10, we have assumed that the fund does not offer a class of shares with a front-end sales load and have used the 6.25% aggregate sales load cap found in the NASD Conduct Rule 2830(d)(2)(A).

14 By contrast, a class of the same fund that imposed an ongoing sales charge of 0.75% would have an automatic conversion period of 8 years, 4 months, which closer in length to the grandfathering period.

service fees in excess of 0.25%. The Proposed Rules raise significant challenges for these funds similar to those discussed above for Class R Shares. Given the frequency with which investors purchase and sell shares of these funds, and the absence of existing systems capabilities, it would be difficult and expensive to implement systems to track share aging for the purpose of automatic conversions. Moreover, in light of the way in which such funds are used, there appears to be limited value in requiring automatic conversions. Accordingly, we believe that any benefits would fall short of these costs. In addition, many of the costs of money market fund sweep arrangements are paid for through 12b-1 fees, including many costs that may or may not be primarily intended for distribution. Requiring that 12b-1 fees in excess of 0.25% be terminated as of a future point in time has the potential to greatly disrupt money market fund sweep arrangements, and may lead many broker-dealers to seek other investment vehicles (including investment vehicles with fewer regulatory and fiduciary protections than mutual funds) for their sweep programs.

3. Shareholder Approval of Implementation of Rule 12b-2 Marketing and Service Fees.

Under proposed rule 12b-2, a fund whose shares are publicly offered would be required to obtain shareholder approval before it could institute, or increase the rate of, a marketing and service fee. The Proposing Release suggests that this is necessary because "an existing shareholder in a share class that institutes a marketing and service fee may have invested in reliance on disclosure that the fund does not charge such fees or charges them at a lower rate." The Commission notes that because shareholder approval is currently necessary to implement a 12b-1 plan or materially increase the amount paid under such a plan, the Proposed Rules do not significantly change the obligations of funds or fund underwriters.

We believe that funds and their directors would benefit from inclusion in the adopting release of a discussion about whether shareholder approval is necessary in several specific scenarios. We believe that, in each of the instances below, among others, requiring funds to obtain shareholder approval to implement a marketing and service fee would result in unnecessary expense (including a proxy solicitation) for the fund:

- A fund has a service fee that was not implemented pursuant to a rule 12b-1 plan, which was adopted by the fund's board after the initial public offering of the fund's shares and was approved by shareholders.

- A fund has a service fee that was not implemented pursuant to a rule 12b-1 plan, which was adopted by the fund's board after the initial public offering of the fund's shares and was *not* approved by shareholders.[15]

- A fund has a 12b-1 plan that has been in place since prior to the initial offering of the fund's shares (it was approved by the board and by the initial shareholder), but the fund is not currently imposing the full amount of the fee permitted under the plan or did not impose all or a portion of the fee upon the initial offering of its shares.

In each of these instances, information about the fees imposed (and about the fees authorized under the plan, but not currently imposed) is available to investors in the fund's registration statement, either in the summary prospectus fee table or in narrative disclosure in the statutory prospectus. Converting the current fee to a marketing and service fee would not result in the circumstances that the shareholder approval requirements of proposed rule 12b-2 are designed to address. Moreover, we note that many funds have imposed non-12b-1 service fees or imposed only a portion (or none) of the authorized 12b-1 fee, which is entirely consistent with current requirements. It would be inconsistent with the Commission's stated goals, therefore, to change the rules prospectively to require shareholder approval for matters that did not require such approval at the time they were put in place. Requiring a fund to obtain shareholder approval to convert these fees to rule 12b-2 marketing and service fees would result in unnecessary costs for the fund. Accordingly, we recommend that the Commission clarify that none of these scenarios would require a shareholder vote.

4. <u>Matters Relating to Exchange Transactions</u>

The Proposed Rules include conforming amendments to rule 11a-3 to ensure that investors receive credit not only for front-end sales loads they have paid, but also for ongoing sales charges, when determining any sales charges due on exchange transactions. We note, however, that neither the Proposing Release nor the Proposed Rules address certain potential operational issues with respect to exchange transactions.

First, we suggest that the adopting release provide guidance regarding how funds should determine the maximum sales load rate when an investor has exchanged from a fund with a higher maximum sales load rate into a fund with a lower maximum sales load rate and then back into a fund with a higher maximum sales load rate. Funds should be permitted to use the higher maximum sales load rate; otherwise, there would be an incentive to exchange in and out of funds

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[15] In this regard, we are aware of fund groups that adopted service fees but reduced other expenses so that total fund expense ratios were unchanged as a result.

with differing rates in order to obtain the benefits of a lower maximum rate fund while holding shares of a higher maximum rate fund.

Second, with respect to grandfathered 12b-1 fee classes, proposed rule 12b-2 and the Proposing Release are both silent on whether such classes could be exchanged into other grandfathered classes, or whether such exchanges would result in the need to convert or exchange the shares into classes without ongoing sales charges. Exchange transactions between grandfathered share classes of two funds should be permitted under the Proposed Rules. The Proposed Rules set a finite period of time (five years) during which the 12b-1 fees may be charged on the grandfathered classes and permitting exchange transactions between grandfathered share classes of different funds would have no impact on the length of time for which fees may be charged.

5. **Inclusion of CDSCs in the Maximum Sales Charge Limitation**

The Proposing Release provides that a fund could impose a CDSC in combination with an ongoing sales charge, but notes that the total sales charges could not exceed the maximum sales charge limitation. The Commission provides an example of how these limitations work together in footnote 172 of the Proposing Release and we support the proposed operation of the Rule as outlined in that example. The Commission also states that it has "designed the conversion provisions of the rule so that the maximum conversion date is easily determinable at the time the investor purchases fund shares (as is a front-end sales load)."[16] We believe, however, that using proposed definitions in rule 6c-10 to attempt to calculation the maximum conversion date results in a shorter maximum conversion period than that suggested by footnote 172 of the Proposing Release.

In the example in footnote 172, the maximum conversion period is 96 months, which is the result when the shareholder does not redeem and pays an annual ongoing sales charge of 0.75% for eight years. Proposed rule 6c-10(d)(2) states, however, that, "[t]he maximum number of months in a conversion period is determined by dividing the shareholder's maximum sales load rate by the ongoing sales charge rate and multiplying the result by 12" and proposed rule 6c-10(d)(10) defines the maximum sales load rate as "the reference load minus . . . (i) [a]ny sales load (including a deferred sales load) incurred in connection with the purchase of fund shares . . . ." These definitions provide the correct answer only when the deferred sales load is assumed to be zero. If the deferred sales load is assumed to be any other number, for example 5.25%, it produces the incorrect result.

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[16] *See* Proposing Release, at text accompanying footnote 173.

We suggest that the Commission revisit the definitions in proposed rule 6c-10(d)(10) to align them with the intended outcome as described in the Commission's example in footnote 172 of the Proposing Release.

6. Applicability of Proposed Rule 10b-10 to Variable Life Insurance and Variable Annuity Contracts and Underlying Investment Options.

We suggest that the adopting release clarify that the Commission did not intend the new confirmation disclosure requirements in proposed rule 10b-10 under the Securities Exchange Act of 1934 to alter current practices with respect to transactions in variable life insurance and variable annuity contracts and in their underlying investment options.

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We appreciate the opportunity to comment on the Proposing Release. Please feel free to contact Stephen Bier at (212) 698-3889, Thomas C. Bogle at (202) 261-3360, Ruth S. Epstein at (202) 261-3322, Joseph R. Fleming at (617) 728-7161, Geoffrey R.T. Kenyon at (617) 728-7126, Jack W. Murphy at (202) 261-3303, Jeffrey S. Puretz at (202) 261-3356, or Anthony H. Zacharski at (860) 524-3937, with any questions about this submission.

Very truly yours,

Dechert LLP