S7-15-10

Comments to SEC regarding proposed rule 33-9128 on Mutual Fund distribution fees

Frankly the proposed rules make one question whether the SEC is truly concerned about individual investors. The rules proposed threaten to take away one of the few investment products left that truly has provided value to investors. I understand and agree there is a need for more clarification regarding fee disclosure. However, I think this proposal this proposal has the following shortcomings; (1.) it unfairly condemns the use of "C" shares, and lacks a thorough analysis of how they are used in the advisory channel and how they differ from "A" shares. Secondly, (2) it focuses on cost savings for mutual fund companies, and clears the way for financial service providers to remove a "ceiling" on fees of 1%. (3) It attempts to develop universal rules and apply them to two very different distribution channels. Finally, (4) it reveals the deficiencies with the overall process of "seeking comment".

The "C" share argument

I have dealt with small investors in all three distribution channels (fund super-markets, full-service brokerage, and as an independent advisor) for 20 years. I am truly confident that in this distribution channel, the "C" share alternative is the most logical and cost efficient of the alternatives available. I want to offer my clients a multi-managed portfolio with flexibility to make changes. The Department of Labor strongly suggests these characteristics as "best practices" for fiduciaries on 401K plans. These are the same advantages offered in most fee-based platforms, but of course they come with a program fee (ranging from 10 – 50 basis points). This fee is then typically passed on to the client. Another alternative is to utilize "A" shares. The "A" share comparison used in this proposal (to validate the elimination of fees over the long term) is invalid. In practice the "A' shares are very different from "C" shares, yet this proposal treats them as if they are identical products needing a breakeven point regarding fees. The "A" share structure lacks the very characteristics (multi-managed and liquidity) that the investor should be looking for. The "A" shares are restrictive from the outset. The investor has a consequence for leaving that fund family which limits flexibility. They just paid a fee to get in, therefore the investor (and the advisor) are now restricted from moving that asset for many years. This creates a lack of liquidity that reduces objectivity.

The SEC needs to better analyze just how "C" shares are being utilized in the Advisor channel. In my situation they are a vital need. I demand of myself a careful and unbiased decision on what is in the best interest of my client. In many situations it has been the "C" share alternative. As an example, many of my clients are invested in a diversified portfolio of four well regarded stock funds and one strategic bond fund (about 80% equity and 20% bonds). The average gross expenses to the client are 2.08% according to Morningstar. That is all in. This includes 1% that goes to my firm (each client knows this), and the average expense ratio of each fund. The client also knows what I should be providing. I provide monitoring of these funds, and a wide array of planning services. This is arguably cheaper than any managed 'WRAP' offered on the street. In terms of expenses it beats the fee-based alternatives offered by a range of 10-75 basis points. Even up against those charging just 1% this program is about .25 less expensive. The only additional thing that I would be providing in a fee-based platform for that extra .25 would be transparency, and that can be accomplished with a letter of acknowledgement.   Using hypothetical illustrations, (provided on request) the model using the "C' shares consistently outperformed the fee-based model. Over the period 10/24/2001 (earliest common) - 10/31/2010, the "C" shares annualized 5.27 vs.4.74, and 58.94 cumulative vs. 51.83. Some will make the case the fee-based account adds features like an extra layer of due diligence, rebalancing, customization, and enhanced reporting. It can also be argued that all these things could be, and should be, provided in the traditional brokerage account.

Removing a "ceiling" on fees

When looking at the comments on this proposal it appears that virtually all responses have come from Advisors, Brokers, or Independents, like me. I can only pull up those that responded using the "B letter" format. However, even if it is just a majority of responses that are from us, then the fund companies and broker/dealers are suspiciously absent. I believe this is because they are either complacent, or have a vested interest in seeing what this proposal will accomplish. From what it says in your report, the fund companies have had the burden of additional reporting associated with 12-b1 fees for years. As for the firms, there is an interesting statement in a comment submitted previous to mine titled Anonymous. Another 20 year veteran does an analysis of his "C" shares and then states "I am still trying to understand why my firm is strongly emphasizing and suggesting managed accounts for my clients". I have several reasons for him. First, the firm has a program fee for that managed product (ie.25bps on the low end) which will typically be passed to the client. Also, if the revenue had been coming from a traditional transaction based product, it will instead create recurring revenue going forward. Firms have learned that it is much easier to plan for the future when the revenue is recurring. The firm is also drastically reducing its liability because it is shifting much of the responsibility to the Representative - who is now a fiduciary. The firm is thereby reducing by far its highest operating expense – compliance. Over the last 15-20 years, Wall St. has once again shown us that they can be very creative. They've shown what is possible if they can package a product differently, add a fee, and as a bonus it reduces their biggest expense and reduces liability. The unprecedented growth of the fee-based segment of our industry has been nothing short of phenomenal. The growth is well documented throughout this proposal, and so is the stagnant condition of anything other than "A" shares in wrap programs. The sad part for the consumers and for the regulators is that nowhere in this scenario has there been a reduction in fees, but rather it has moved the other way. As the proposal points out, in most cases the "C" share 12b-1 has a maximum of 1%. My question is - Why would the regulators (in the investor's best interest) work toward eliminating the one product which by prospectus, has a maximum fee? Just the implication of eliminating the level fee format provided by "C" shares has already promoted the migration of assets to products having higher fees.

<u>Many issues and different distribution channels</u>

It seems that the list of rules developed address valid concerns in two distinct distribution channels that are using the famously misnamed 12b-1 fee to compensate third parties. One channel being the no-load or transaction fee funds offered through "mutual fund supermarkets" developed by discount brokers. The second being those funds that are distributed through a sales force via Broker/dealers or RIAs. Many of the rules base their justification on one channel while ignoring the other. As an example, there is a large difference between the levels of service being provided by a Representative whose firm may be compensated with a 1% trail vs. a discounter providing an outlet for a .25 trail. I did not see that difference acknowledged.

<u>The Process</u>

One of the main charges of the SEC recently has been promoting clarity and conciseness in communications with investors. I am willing to bet my next years salary that I am one of just a handful of people in the world that read this 278 page proposal. I admit that I skimmed a few sections toward the end, but I have been committed to reading, and commenting on this proposal since it was distributed. I have 3 kids, a wife, a house, a dog, a job, etc. I honestly cannot imagine anyone, even within our industry, taking the time to evaluate such a document, unless it could have a tremendous effect on their career, or they were assigned to it. I agree with the mandate for conciseness, and I believe it should apply to SEC communication within the industry and to the public. However, the effort to improve communication should not come at a cost to the average investor, the way the drive for transparency did. The 12b-1 fee should indeed be renamed. A "helping you out fee", annual fee, - anything. After all, anything more descriptive than just a few numbers with a – will be a vast improvement.

In Summary, investors need to know what they are being charged. The industry has responded by finding a way to shift that responsibility to the client themselves, by migrating to the Advisory distribution channel, where fees are transparent. Ironically, the indirect mandate for transparency has resulted in higher fees to investors. Regulation has focused on what it thought was important to the investor, the communication of fees, for years – and look at the result.   The client may not be so interested in how the fees are communicated, but we know they are interested in a better result. The alternatives to "C" shares that are being offered for use by Advisers/Brokers today are either too restrictive ("A" shares) or more expensive to the client (Fee-Based). This proposal attempts to solve several valid problems that exist in very different distribution channels with a centralized solution that very possibly will end up hindering investors.