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November 8, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-15-10
Request for Comment –
Mutual Fund Distribution Fees

Dear Ms. Murphy:

The Committee on Investment Management Regulation (the "Committee") of the Association of the Bar of the City of New York (the "Association") is composed of lawyers with diverse perspectives on investment management issues. The Committee includes members of private law firms as well as in-house counsel of financial services firms, investment company complexes and registered and unregistered investment advisers. A list of the Committee's members is attached as Annex A.

This letter responds to the request of the Securities and Exchange Commission (the "Commission" or "SEC") in Release IC-29367 (July 21, 2010) (the "Proposing Release") for comments on proposed rules under the Investment Company Act of 1940 (the "Investment Company Act") that are designed to replace Rule 12b-1 under the Investment Company Act, the rule that has permitted registered open-end management investment companies ("mutual funds" or "funds") to use fund assets to pay for the cost of promoting sales of fund shares.

As an initial matter, the Committee notes that the proposals, if adopted, would have a significant impact on mutual funds and their service providers, including the financial intermediaries that distribute mutual fund shares. The commercial impact of the proposals on these entities may be positive or negative, depending on, among other things, the manner in which the shares of a particular mutual fund are distributed. Given that the Committee is comprised of a diverse collection of attorneys representing a variety of clients in the investment management industry and related financial services businesses, we are not expressing any views on the economic advisability of the substantive proposals themselves; we understand that many industry groups, firms, investor groups, and individuals are expressing views on these aspects of the proposals. We do have comments that relate to the technical aspects of the proposals and matters that relate to their regulatory underpinnings.

COMMENTS

A. Need for the Commission to Conduct a Comprehensive Analysis of the Economic Effects of the Proposed Rules, and to Clarify its Statutory Authority to Promulgate Rule 6c-10(c)

Under Section 2(c) of the Investment Company Act, the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is consistent with the public interest, must consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. Similar provisions are contained in the Securities Act of 1933 and the Securities Exchange Act of 1934. In proposing new Rule 6c-10(c) under the Investment Company Act, which would permit funds to offer their shares with sales charges assessed at the account level rather than at the fund level, the Commission relies in part on its exemptive authority under Section 6(c) of the Investment Company Act, which permits the Commission to adopt rules that "may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes or persons, securities, or transactions" from any provision of the Investment Company Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Investment Company Act. The Commission also relies on Section 22(d)(iii) of the Investment Company Act, which provides an exception from the retail price maintenance provision of Section 22(d) for sales made "in accordance with rules and regulations of the Commission made pursuant to [Section 12(b) of the Investment Company Act.]" Section 12(b) contains a requirement for a "public interest finding" similar to that in Section 6(c).

We acknowledge that the process of evaluating and otherwise taking into consideration comments received with respect to a Commission rule proposal serves as an important means of developing the record and analysis contemplated by the provisions governing the Commission's rulemaking process. While we compliment the Commission on its ample preliminary analysis of the potential costs and benefits of the proposals in the Proposing Release, we believe that any forthcoming adopting release must bolster the analysis underlying the Commission's conclusions by taking into account additional factors to assure that the Commission's thorough and well-reasoned analysis of the economic effect of the proposals, including their costs and benefits, and effects on efficiency, competition and capital formation, will withstand judicial legal scrutiny.[1] Such an analysis is also important to investment management industry participants as they work to create and implement systems and procedures necessary to assure compliance with the Commission's rules as adopted.

This analysis should address the potential effect of the rule proposals not only on different types of funds and fund sponsors, but also on the various categories of distributors and intermediaries (*e.g.*, wirehouses, independent contractor broker-dealers, financial planners, insurance-affiliated broker dealers, retirement plan recordkeepers, insurance company separate accounts). For example, certain types of intermediaries may be able to recoup the 12b-1 revenue lost as a result of the Commission's proposals through other means, while others may be more constrained; these differences will almost certainly have an effect on competition. While the Proposing Release does provide some economic analysis of the effects of certain aspects of the

[1] *See, e.g., American Equity Investment Life Insurance Company v. SEC*, 2010 U.S. App. LEXIS 14257 (D.C. Cir., July 12, 2010) (vacating SEC Rule 151A for failure to properly consider the effects of the Rule upon efficiency, competition and capital formation); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005) (finding that the SEC violated the Administrative Procedure Act in failing to adequately consider costs of compliance with independent chairman condition to certain exemptive rules).

rule proposals on funds, it has relatively little to say about their potential impact on distributors and intermediaries. The rule proposals, if adopted, could, for instance, cause such distributors and intermediaries to shift resources from the sale of mutual fund shares and the servicing of mutual fund shareholder accounts, which, in turn, could result in fewer funds from which investors may choose. A much more comprehensive analysis would be advisable before the rules are adopted.

We also note that in undertaking the requisite analysis, it may not be sufficient for the Commission to rely solely on data introduced at Commission roundtables, compiled through interviews with selected members of the fund industry or submitted by commenters, as many distribution firms may be reluctant to introduce information about compensation they receive and other sensitive and proprietary financial information into the public record. The Commission should be proactive and perform its own research and analysis. The Commission's Division of Investment Management should work closely with the newly-created Division of Risk, Strategy and Financial Innovation to assure that this analysis is undertaken.

The Commission should devote particular attention in its economic analysis to the account-level sales charge proposal, which may have broad and disparate effects upon different types of distributors and their clients. For example, it is unclear how the widespread introduction of fund share classes with account-level sales charges may impact the amount of ongoing asset-based fees paid by small investors, as well as the level of ongoing services and support that these investors receive from broker-dealers in return. While a reduction in such asset-based fees may not adversely affect ongoing services provided to large investors who purchase funds through fee-based accounts, small investors who are unable to establish such accounts may be affected negatively.[2] In general, there is at least a possibility that the account-level sales charge proposal could result in a focus by broker-dealers and other intermediaries on the cost of services rather than the quality of services, which could offset some or all of the purported benefits of the proposal.

It is also unclear how the introduction of fund share classes with account-level sales charges may affect portability of fund shares. For example, brokers could conceivably become reluctant to accept new customers who are paying a lower ongoing sales charge for a particular fund than the charge paid by the broker's current customers because of suitability and/or fiduciary duty concerns. To address these and similar concerns, we believe that it is advisable for the Commission to coordinate the analysis of the likely economic impact on distributors of its proposals with its development of a uniform standard of care for investment advisers and broker-dealers under the Dodd-Frank Act.[3]

The Commission should conduct a similarly thorough economic analysis on the effect of its "grandfathering" proposal, which would effectively require all current 12b-1 fees in excess of 25 basis points to be phased out after a five-year compliance period (following an 18-month period between the effective date of the rules and the compliance date). Insofar as broker-dealer

[2] The Commission's Proposing Release appears to suggest that broker-dealers who use ongoing asset-based charges to select suitable investments for their customers may be running afoul of Section 202(a)(11) of the Investment Advisers Act unless they are registered as investment advisers. *See* Proposing Release, p. 125 at n.372. However, not all support and services provided by a broker-dealer necessarily fall under the rubric of investment advice.

[3] Similarly, the Commission's cost-benefit analysis should consider the potential impact of a pending Department of Labor ("DOL") proposal to broaden the circumstances under which a person may be considered an ERISA fiduciary by reason of giving investment advice to a plan or plan participants. *See* Definition of the Term "Fiduciary," 75 FR 65263 [Oct. 22, 2010]. If the DOL's expanded definition is adopted, certain investment advisers and broker-dealers who advise plan sponsors or participants but are not currently deemed ERISA fiduciaries may become subject to greater restrictions on their ability to receive varying levels of 12b-1 fees, directly or indirectly, from the funds that they recommend or sell. These restrictions would likely have an impact on the purported benefits and costs of the SEC's proposals.

firms may make internal financial assumptions based on the expected revenue from such fees (and in some cases may even use this revenue stream as collateral for loans), the loss of 12b-1 revenues may have a disproportionately significant impact on certain firms. The Commission should conduct further economic analysis of the disparate effects of the grandfathering proposal on distributors and funds. Absent a clear understanding of these effects, the Committee urges the Commission to allow fund firms broader flexibility in determining how to convert fund shares that currently charge 12b-1 fees in excess of 25 basis points.[4]

In addition to a comprehensive economic analysis, the Commission should provide a better articulation of its statutory authority to adopt the proposed account-level sales charge proposal, in light of Section 22(d) of the Investment Company Act and the Commission's previous interpretations of this provision. As the Commission notes in its Proposing Release, Section 22(d) prohibits mutual funds, their principal underwriters and dealers from selling fund shares to the public except at the current public offering price as described in their prospectus, and as a result effectively prohibits competition in sales loads on mutual fund shares at the retail level. In the 1980s, the Commission considered a proposal that would have made sales loads on mutual fund shares freely negotiable, but apparently determined that it lacked statutory authority to adopt such a broad exemption to Section 22(d).[5] Similarly, while the Commission in its 1992

[4] More flexible alternatives to the current six-and-one-half year grandfathering proposal may, if appropriate, include "permanent grandfathering" of shares sold prior to the compliance date, or permitting funds to treat 12b-1 fees in excess of 25 basis points on existing shares as ongoing sales charges under Rule 6c-10(b), for purposes of determining when to stop assessing such fees.

[5] *See Division of Investment Management, U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation*, 306-07 (1992) (discussing a 1983 proposal that would have permitted funds latitude to allow offering prices to be arrived at through negotiation with purchasers, and noting that when the Commission dropped the proposed negotiation provision and instead adopted current Rule 22d-1, "concern over the Commission's authority was a primary factor").

study, *Protecting Investors*, concluded that there was no longer any basis for restricting retail price competition in mutual fund distribution, and that the introduction of forward pricing of funds and other developments in the five decades since 1940 had eliminated the original rationales for retail price maintenance, it chose to recommend amendments to Section 22(d) to address its concerns rather than to propose new rules using its exemptive authority. Although the Commission's Section 6(c) authority to exempt "classes of persons, securities, or transactions" is indeed broad, the Commission should clarify why it now believes its authority is sufficiently broad to allow the adoption of a rule that could – if all funds choose to establish share classes with account-level sales charges – overwhelm the retail price maintenance requirement in Section 22(d) altogether.[6]

Likewise, to the extent that the Commission now believes that it has statutory authority to adopt the account-level sales charge proposal under Section 22(b)(iii) which, as noted above, excludes sales made in accordance with rules adopted under Section 12(b) from the retail price maintenance requirement of Section 22(d), the Commission should state more explicitly why this particular proposal should be deemed a rule under Section 12(b). Section 12(b) places restrictions on a fund's ability to act as a distributor of its own securities, but does not address other distributors, at least explicitly. A clearer explanation of the connection between the Commission's authority under Section 12(b) and Section 22(d), and the account-level sales

[6] *Cf. NASD v. SEC*, 420 F.2d 83, 92 (D.C. Cir. 1969), *vacated on other grounds, ICI v. Camp*, 401 U.S. 617 (1971) (noting that the Commission has exercised its authority under Section 6(c) "generally to adjust [the] provisions [of the Investment Company Act] to take account of *special situations* not foreseen when the Act was drafted") (emphasis added).

charge in Rule 6c-10(c), may help to reduce the legal vulnerability of this aspect of the proposals.[7]

B. Proposed Role of Directors

Proposed Rule 12b-2 and the proposed amendments to Rule 6c-10 would not impose any explicit responsibilities on a fund's board of directors to approve or renew asset-based sales charges. The Committee agrees with the Commission's objective of reducing the burden that Rule 12b-1 places on fund boards of directors. While the Commission comes close to achieving this objective in characterizing the contemplated role of a fund board under proposed Rule 12b-2,[8] it does not do so in connection with its proposed guidance to fund boards on issues arising under Rule 6c-10, and threatens once again to impose burdens on directors beyond their areas of expertise.

The Proposing Release argues that the ongoing sales charges that would be paid by fund shareholders under Rule 6c-10 are "another form of sales load;"[9] "funds lack the bargaining power to effectively negotiate the level of fees that are paid to financial intermediaries through 12b-1 plans and other sources . . ."[10] and, most importantly, "one of the fundamental premises of

[7] *Cf. Goldstein v. SEC*, 451 F.3d 873, 883 (D.C. Cir. 2006) (vacating hedge fund manager registration rule in part because the Commission "failed adequately to justify departing from its prior interpretation of [Section 203(b)(3) of the Investment Advisers Act of 1940]").

[8] But *see*, *infra* at Part C, the problematic suggestion that directors need to track adviser distribution expenditures.

[9] Proposing Release at p. 38.

[10] The Proposing Release further notes:

> This is particularly true in the case of fund supermarkets, where the sponsor may charge all participating funds according to the same rate schedule. These and other statements made at the roundtable and in the comment letters suggest that one of the fundamental premises of Rule 12b-1 – that independent directors would play an active part in setting distribution fees – does not reflect the current economic realities of fund distribution and the role 12b-1 fees play in it.

Rule 12b-1 – that independent directors would play an active part in setting distribution fees – does not reflect the current economic realities of fund distribution . . . ."[11] In setting forth its views on the oversight role of directors, the Commission states its intention to provide guidance in the adopting release to assist fund directors in satisfying their fiduciary obligations and likens the board's review of the proposed sales charges to its review of fund distribution agreements.

It should be noted that the Investment Company Act and existing rules do not provide any explicit guidance as to the factors to be considered in evaluating underwriting contracts. The Committee agrees that, in evaluating underwriting contracts and sales charges, boards should take into account and weigh all factors that pertain to the services to be rendered. However, certain statements in the Proposing Release suggest, contrary to the conclusions cited in the foregoing paragraph, that fund directors may be capable of assessing and negotiating marketplace practices between dealers and their customers (who have not yet even become fund shareholders).[12] This posture is also inconsistent with the Commission's attempt to coordinate responsibilities with economic realities.

Proposing Release at p. 35.

[11] Proposing Release at p. 35.

[12] On this point, the Proposing Release states the following:

> In determining whether to approve (or re-approve) the underwriting contract, the directors must exercise their reasonable business judgment to 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. In evaluating the "fairness and reasonableness" of the contract, the directors should consider any factors that may be relevant, including whether the fund's distribution networks and overall structure are effective in promoting and selling fund shares....

Proposing Release at p. 64-65.

The Committee cautions the Commission against, perhaps inadvertently, suggesting standards of inquiry that the Commission admits are beyond directors' capabilities – matters that "funds lack the bargaining power to effectively negotiate" and that boards may have previously found unnecessary and inadvisable to examine. In particular, the Proposing Release suggests that fund boards should consider whether sales loads (including the ongoing sales charge) "are fair and reasonable." A determination as to the fairness of front-end sales loads or any other type of sales charges goes beyond concerns considered by many boards. Boards have relied on the Financial Regulatory Authority's ("FINRA") responsibility for maintaining standards of fair dealing by its members and have assumed that the board's role of protecting fund shareholders begins once shares have been issued at their stated offering price. Most of the compensation paid to principal underwriters is passed on to financial intermediaries, such as fund supermarkets and broker-dealers, and the amount paid is generally driven by the requirements of the marketplace. Also, the services provided by these financial intermediaries are essentially sales services to the customer and not to the fund itself, so that it is impossible and inappropriate for boards to evaluate the quality of such services. In approving distribution agreements, fund boards consider fund distribution arrangements, but not the market appropriateness of dealer compensation.

The text of the Investment Company Act itself supports this approach. For example, Section 36(b)(4) of the Investment Company Act excludes from the scope of Section 36(b) "sales loads for the acquisition of any security issued by a registered investment company." In addition, Section 15 addresses the consideration and approval of underwriting agreements in a very different manner than it does the approval of investment advisory contracts. Unlike Section 15(a), Section 15(b) does not require an underwriting agreement to "precisely describe[] all compensation to be paid thereunder." Nor does Section 15(c) impose on fund directors a duty "to request and evaluate" or a duty for the underwriter to "furnish" such information as may reasonably be necessary to evaluate the terms of the underwriting agreement as it does in the case of the investment advisory contract. Thus, the Commission appears to have overstated the obligations of a fund board with respect to the assessment of the "reasonableness" of front-end sales loads. This is a matter that is subject to the jurisdiction of FINRA and, consequently, the Committee believes that the Commission should not provide formal guidance to fund directors in this area.

C. Payments Made for Non-Distribution Related Services

The Committee agrees with the Commission's conclusion that the current rulemaking provides an opportunity to eliminate the uncertainties that led many funds to adopt so-called "defensive" Rule 12b-1 plans. However, the Committee would like to alert the Commission to the risk that this process might put into question the benign business practices that were adopted to address issues associated with the formulation of Rule 12b-1. In particular, the Committee believes that the Commission's comments concerning defensive plans could lead to considerable uncertainty concerning the scope of proposed Rule 12b-2 and the board's oversight role.

The Committee notes that defensive plans were developed to address the risk that a portion of a fund's advisory fee could be used by the adviser to pay for the distribution of fund shares. This concern grew out of language in the release adopting Rule 12b-1 to the effect that amounts paid by the adviser for distribution out of its "legitimate" profits would not be viewed as an indirect payment of distribution-related costs.[13]

[13] *See* Release IC-11414 (October 28, 1980), CCH 1980 Transfer Binder ¶82,678 at p. 83,730.

As the Commission noted in its 1988 release proposing certain amendments to Rule 12b-1, an adviser does not indirectly use a fund's assets to pay for distribution expenses so long as those costs are paid out of the adviser's own resources.[14] The Commission emphasized that the adoption of a defensive plan was unnecessary if a fund's directors reasonably concluded that the advisory contract was "not a conduit" for the payment of costs associated with the sale of fund shares.

Nevertheless, certain funds continue to maintain defensive plans, most likely to thwart any challenge to a board's judgment concerning whether the management contract serves as a conduit or whether an adviser's profits are properly characterized as "legitimate" or whether some products or services provided by advisers to their funds or fund shareholders could be characterized as "distributive" in nature. The Committee believes that the seeming necessity of contemplating such issues contributes a certain artificiality to a fund's board of directors' deliberations. The Committee feels strongly that if a fund board determines that a management fee satisfies the standards required by Sections 15 and 36(b) of the Investment Company Act, it need not also separately conclude that the fee does not serve as a conduit for the payment of distribution-related costs. The Committee urges the Commission to state that payments made pursuant to a management contract that satisfies the standards of Sections 15 and 36(b) shall not be deemed to implicate any rule adopted under Section 12(b). Articulation of that statement, rather than the mere repeal of Rule 12b-1, would relieve boards of the concerns about the issues that led to adoption of "defensive" plans.

The Committee has serious concerns with the statement in the Proposing Release that "the exemption provided by Rule 12b-2 could serve the same purpose as a defensive plan to the

[14] *See* Release IC-16431 (July 13, 1988).

extent that the amount of assets permitted to be used for distribution under Rule 12b-2 has not otherwise been fully utilized."[15] This statement may be read as suggesting that distribution expenses paid out of the adviser's own resources would have to be "tracked" as if they were fund expenses that would be charged against the cap. It also raises the question whether advisers to funds that pay the full 25 basis point fee to brokers would be precluded from engaging in certain distribution-related activities available to other advisers, despite the fact that they were doing so out of their "legitimate" profits.

The Committee believes that the Commission should ameliorate any suggestion that funds have a rationale for measuring unutilized marketing and service fees against excessive management fees. The Commission should instead reaffirm that payments by the adviser from its own resources, regardless of source (unless specifically identified as being paid pursuant to Rule 12b-2) would not be charged against the cap. Consistent with our earlier comment, the Committee also recommends that paragraph (a) of Rule 12b-2 specifically provide that a management fee that meets the standards of Sections 15(a) and 36(b) would not be viewed as serving as a direct or indirect use of fund assets to finance any distribution activity except to the extent that a portion of the fee paid pursuant to the management contract is specifically identified as being paid for that purpose. The Committee believes that this language should be incorporated into the Rule and not simply addressed in the adopting release.

D. Proposed Amendments to Form N-1A Disclosure

The Committee agrees that the proposed amendments may improve disclosure to investors and provide better transparency of sales loads and asset-based distribution fees.

[15] *See* Release at p. 42 n. 155.

The reference in the current fee table to "12b-1 fees" may not be informative to investors and should be replaced. Assuming that the Commission adopts the proposed rules, amending the fee table to separate asset-based distribution fees into two component fees could be more effective and improve investor understanding. The Committee agrees that the "Ongoing Sales Charge" heading should better convey to investors that this portion of the asset-based distribution fee may operate as a substitute for a sales load. The Committee also agrees with the proposal to add a new subheading to the "Other Expenses" category called "Marketing and Service Fee." However, the Commission may not achieve its goal of greater comparability. The Committee notes that non-distribution services that may be paid for by some funds as marketing and service fees may be legitimately characterized differently by other funds, or their advisers, *e.g.*, as sub-transfer agency or recordkeeping fees or revenue-sharing payments. Thus, it is likely that funds may take different approaches to determining the types of services that should be covered by this line item since, as the Proposing Release points out, "proposed rule 12b-2 would not preclude funds from paying for [administrative and other non-distribution expenses] under rule 12b-2."[16] The Commission may wish to consider requiring that the Statement of Additional Information contain disclosure concerning the use of marketing and service fees. This may avoid the need for funds to use alternative headings. As for sales charges, additional information in the fee table (or a footnote to the table) indicating whether fees are to be paid initially, annually or upon redemption may also be useful to investors, as would disclosure of the conversion period for ongoing sales charges. With respect to asset-based distribution fees charged under existing 12b-1 plans, as would be permitted by proposed Rule 12b-2(d), the Committee believes that grandfathered 12b-1 fees should be disclosed as ongoing sales charges

[16] *See* Release at p. 41 n. 153.

and marketing and service fees, as appropriate, to enhance comparability between funds with full corresponding disclosure.

The Committee questions the effectiveness of the proposal to amend Item 12(b) of Form N-1A to provide investors with more detailed disclosure concerning the circumstances under which an investment in one class may be more advantageous than another class. It is unclear to the Committee that increased disclosure in the prospectus on this point would be particularly informative to investors. The Commission may instead want to encourage investors to use various "tools," such as cost calculators, or to seek the help of a qualified financial adviser, to determine the class that is best suited for their investment objectives.

The Committee agrees with the Commission that paragraphs 2 through 5 of Item 19(g) of Form N-1A, which requires a fund to describe in detail the material aspects of its 12b-1 plans and related agreements in the fund's Statement of Additional Information, should be eliminated. However, the Committee believes that paragraph 6 should be modified and retained to disclose the anticipated benefits to investors from such payments.

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The Committee appreciates the opportunity to comment on the proposed rules. If we can be of any further assistance in this regard, please do not hesitate to contact Ken Berman at (202) 383-8050 or kjberman@debevoise.com.

Very truly yours,

Kenneth J. Berman
Chair,
Committee on Investment Management Regulation

cc: The Honorable Mary Schapiro, Chairman
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Andrew J. Donohue, Director
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Annex A

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