November 19, 2010

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

Subject: Mutual Fund Distribution Fees/Confirmations,
File No. S7-15-10

Dear Ms. Murphy:

The Coalition of Mutual Fund Investors ("CMFI")[1] appreciates the opportunity to provide comments on the rulemaking proposal by the Securities and Exchange Commission ("SEC") to reform Rule 12b-1, regarding mutual fund distribution fees and confirmations.[2]

CMFI agrees with the SEC that Rule 12-1 may "no longer fully reflect the current economic realities of the mutual fund marketplace or best serve the interests of fund investors."[3] Overall, the SEC's proposals to reform Rule 12b-1 are a significant step in the right direction. What follows are CMFI's recommendations for improving upon the framework outlined in the Proposing Release ("Release").

I. Introduction

As an overall comment, CMFI is concerned that there may be unintended consequences for individual investors—and especially small investors—as a result of gaps in the new regulatory framework for distribution fees proposed by the SEC. For example, the caps and restrictions that the SEC proposes to place on the proposed marketing and service fee can be expected to encourage financial intermediaries to move small investors into more costly products, such as wrap or managed accounts and variable annuity contracts.

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[1] The Coalition of Mutual Fund Investors ("CMFI") is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors. You can learn more about CMFI and its advocacy activities at www.investorscoalition.com.

[2] Mutual Fund Distribution Fees; Confirmations, SEC Release Nos. 33-9128, 34-62544, and IC-29367 (July 21, 2010), 75 Fed. Reg. 47,064 (Aug. 4, 2010) (hereinafter "SEC Mutual Fund Distribution Fee Release").

[3] SEC Mutual Fund Distribution Fee Release at 8.

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Wrap and managed accounts offer investment advice for a single fee that is typically based on the level of assets in an account. Sales loads and brokerage commissions are replaced with this fixed advisory fee, which is generally between 1% and 3% of assets.[4] These accounts are expensive when investments are made in mutual funds, as the advisory fee is in addition to the overall cost of each mutual fund position in an investor's account. For reasons that are stated elsewhere in this comment letter, gaps in the current framework proposed by the SEC will only encourage broker-dealers and financial advisers to expand the use of these more expensive fee-based structures, as a method for avoiding the caps and restrictions contained in the current SEC proposal. Especially for smaller investors, this type of result would certainly not be what the SEC intended in developing and proposing this new framework.

Similarly, intermediaries may be encouraged to move small investors into variable annuity contracts that rely on mutual funds as the underlying investment product. In its most basic form, a variable annuity is a tax-deferred investment vehicle that comes with an insurance contract. The annuity can be accessed immediately, or deferred until some later date or event. These investment vehicles are also expensive, with fees that can cost as much as 3% each year, on top of the overall cost of each underlying mutual fund position in an annuity account.[5] As a result of some of the gaps discussed in this comment letter, the SEC's proposal will also create incentives for broker-dealers and financial advisors to increase the use of this very expensive alternative investment vehicle, to the detriment of individual investors.

CMFI urges the SEC to evaluate its proposed distribution fee framework in a more comprehensive manner so that it does not create incentives for placing individual investors—and especially smaller investors—into more expensive wrap and variable

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[4] See Art Ernst, "Wrap Accounts: Great for brokers, not for you," New Jersey Lawyer, July 2, 2008, available at http://www.byrneasset.com/article-wrapaccounts.htm ("Instead of charging for trades, an account is charged a set fee, commonly 1 percent to 3 percent of assets, usually with an annual minimum in the low thousands."); Dan Caplinger, "4 Fees You Don't Need to Pay," The Motley Fool, Nov. 24, 2008, available at http://www.fool.com/investing/mutual-funds/2008/11/24/4-fees-you-dont-need-to-pay.aspx ("Sold as a way to save on brokerage commissions, wrap accounts let advisors instead collect a quarterly or annual fee based on a percentage of your total assets. But, if you don't trade often, paying as much as 3% of your account balance annually is highway robbery."); and John C. Bogle, Bogle on Mutual Funds: Perspectives for the Intelligent Investor, at 54 (1994), available at http://finance.yahoo.com/funds/how_to_choose/article/100524/Beware_of_Wrap_Accounts ("More importantly, the costs involved in wrap accounts are very high. Maximum annual fees typically total 3% of assets, with reduced fees available to investors with assets of $1 million (2.5%) or $5 million (2%). Hidden execution costs may add another 0.5% or more to the fee.").

[5] See Janet Paskin, "More Insurers Raise Fees on Variable Annuities," Smart Money, Dec. 16, 2008, available at http://www.smartmoney.com/personal-finance/retirement/more-insurers-raise-fees-on-variable-annuities/ ("A variable annuity already costs almost 3% per year. As the prices go up and the balances go down, as a percentage, the cost rises closer to 4%."); and Dana Anspach, "5 Variable Annuity Fees To Ask About," About.com: Money Over 55, available at http://moneyover55.about.com/od/understandingannuities/a/variableannuityfees.htm ("Variable annuity fees can be as high as 3.00% or more per year.").

annuity accounts, as alternative methods for compensating broker-dealers and financial advisers for their services.

Another potential problem with the SEC's proposed framework is it may create incentives for financial intermediaries to discontinue selling mutual funds in favor of collective investment trusts and other investment vehicles that are not subject to SEC regulation.[6] The SEC needs to ensure that any new framework it develops through its regulatory authority is carefully constructed to address mutual fund-like products, so as to not encourage the use of investment vehicles designed to avoid SEC regulation and oversight.

All of these potential outcomes will increase costs for investors and reduce the attractiveness of the mutual fund as an investment vehicle, absent a more holistic regulatory approach that anticipates these unintended consequences of the SEC's proposal. For these reasons, the SEC should: (1) consider all of the payment and fee arrangements used by both financial intermediaries and funds for investment advice and services; and (2) refine its regulatory proposals to reflect the leverage that mutual fund distributors currently have in the financial marketplace.

II. Proposed Rule 12b-2: The Marketing and Service Fee

The SEC proposes a new Rule 12b-2, which would permit funds to deduct a fee up to the National Association of Securities Dealers ("NASD") service fee limit of 25 basis points (0.25%) from fund assets to pay for distribution activities.[7] This fee would be renamed a "marketing and service fee" and it could be used for the following distribution-related services:

> *Distribution activity* means any activity which is primarily intended to result in the sale of shares issued by a fund, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature.[8]

CMFI recommends the following improvements to proposed rule 12b-2, in order to close several gaps in regulating and disclosing intermediary fee structures, and to improve transparency of distribution fees and services.

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[6] See Jerry Cooper, "Collective Investment Funds Re-emerge as Mainstream Investment Option, Practice Management, Dec. 11, 2009, available at http://thetrustadvisor.com/tag/collective-investment-trust ("Investment managers that have traditionally offered registered funds (mutual funds) are showing considerable interest in non-Securities Exchange Commission (SEC) registered vehicles as of late, such as collective investment funds. Investment managers are looking to commingle separately managed accounts to save on operational costs, and roll them into collective investment funds.").

[7] See SEC Mutual Fund Distribution Fee Release at 41.

[8] New proposed Rule 12b-2(e)(2). See SEC Mutual Fund Distribution Fee Release at 267.

A. Rule 12b-2 Fees Should Not be Paid for Shareholder Services Already Required Under Current NASD Rules

CMFI just completed an extensive study on the costs of providing shareholder services to investor accounts controlled by large broker-dealers.[9] This study is available on both the CMFI and SEC websites.[10]

The CMFI study found that large broker-dealers are imposing costs on individual investors each year of as much as $2.2 billion in account maintenance charges and more than $4.18 billion in shareholder servicing payments.[11] These charges and payments are being made to broker-dealers for shareholder servicing activities within omnibus accounts, which are aggregated customer positions that are structured operationally in the same manner as "street name" accounting. Under the omnibus account structure, fund orders are consolidated together and submitted to each mutual fund as a single transaction, with the broker-dealer (or other intermediary) serving as the account holder and as the shareholder of record.

Within an omnibus account, underlying customer fund accounts are not generally transparent to mutual fund compliance personnel, resulting in a number of regulatory problems that have been identified over the years. Trading activities and investor identities are not typically provided to mutual fund compliance personnel for these accounts; and, by not disclosing this information, mutual funds are unable to uniformly apply their prospectus policies and procedures to these third-party "hidden" accounts.

Using the leverage that they have over the mutual fund distribution system, large broker-dealers are demanding certain fees and payments to support this non-transparent accounting and recordkeeping structure. If a fund wants a particular broker-dealer to distribute its shares, the fund must agree to let the brokerage firm handle recordkeeping and shareholder servicing tasks for its customers, at a price dictated by the broker-dealer. Broker-dealer recordkeeping services are not selected though a competitive bidding process and fees are not generally discounted to reflect economies of scale, such as the use of a fee schedule that results in lower account fees as volume increases.

To add to the problem, CMFI's study found that many of these shareholder servicing activities are already required to be performed under NASD Rules 2340 and 2310.[12] These servicing activities include: (1) providing regular account statements to

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[9] Coalition of Mutual Fund Investors, "CMFI White Paper: The Costs of Providing Shareholder Services to Hidden Mutual Fund Accounts," Aug. 18, 2010 (hereinafter "CMFI White Paper").
[10] See Id., available at http://www.investorscoalition.com/CMFIWhitePaperAug18.pdf; See also http://www.sec.gov/comments/s7-15-10/s71510-181.pdf.
[11] CMFI also estimates that more than $2.09 billion in revenue-sharing payments are also being made from mutual fund advisers to broker-dealers for shareholder servicing activities within third-party omnibus accounts. This revenue-sharing payment issue is discussed elsewhere in the CMFI comment letter.
[12] See CMFI White Paper at 12-16.

customers; (2) handling investor inquiries and other aspects of the customer relationship; (3) conducting individual customer suitability analyses prior to the execution of any recommended transactions; and (4) reporting required information to the Internal Revenue Service.[13]

The SEC appears to acknowledge this fact, as it noted the following in footnote 100 of the Release:

> ... we understand that funds continue to include 'service fees' as distribution expenses under rule 12b-1, presumably because the stream of payments (often called 'trail commissions') may act as an inducement to intermediaries' sales personnel to sell fund shares, and, arguably, because fund intermediaries would provide these services in the ordinary course of business regardless of whether they receive compensation from the fund (which may be just one of many other investments held by the intermediary's clients).[14]

An additional concern is the fact that these fees are not being charged when broker-dealers hold corporate shares, corporate and municipal bonds, and Exchange-Traded Funds ("ETFs") in their customer accounts. Under the current regulatory framework, broker-dealers are responsible for holding these positions for their customers without compensation from the issuers of these securities.[15]

CMFI believes that the SEC should not create a new regulatory framework that sanctions the payment of fees from fund assets to support activities that are already the responsibility of a broker-dealer to perform at the account level. The SEC should evaluate these account maintenance and shareholder servicing fees, and eliminate any charges for services that broker-dealers are already required to perform under existing NASD rules.[16] Similarly, the SEC should also restrict those fees which are not established through competitive bidding processes and do not benefit all shareholders.

B. The SEC Should Address the Disparity in Treatment of Omnibus Accounts vs. Direct Accounts

In its Release, the SEC asks if "investors in omnibus accounts receive equivalent levels of service relative to investors who invest directly and pay similar 12b-1 fees?"[17] As noted above, CMFI does not believe that fund assets—through new 12b-2 fees or

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[13] See NASD Rule 2340, Customer Account Statements, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3647; and NASD Rule 2310, Recommendations to Customers (Suitability), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638.

[14] SEC Mutual Fund Distribution Fee Release at 26-27, note 100.

[15] The only exception to this statement is the amount that some issuers have to pay for proxy processing services, when necessary.

[16] NASD has merged into the Financial Industry Regulatory Authority ("FINRA").

[17] SEC Mutual Fund Distribution Fee Release at 45.

other charges—should be used to finance distribution activities that do not benefit all shareholders.

An example of how certain distribution arrangements are financed was discussed in the 2007 SEC Roundtable on Rule 12b-1. During the Roundtable session, it was noted by several panelists that Charles Schwab charges 40 basis points to mutual funds seeking to participate in its fund supermarket. One panelist described how this fee is generally divided into two fees—a 25 basis point distribution fee and a 15 basis point sub-transfer agent fee:

> So, even though it's 40 basis points that we're paying, the 25 basis point 12b-1 fee would be paid regardless. So that's first and foremost. Then, the 15 basis points that is the difference comes out of what we call the sub-TA fee. So basically, what we say is, if this account had been on our system at Ariel, all these thousands, hundreds of thousands of accounts we have with Schwab, what would that have cost us to maintain them ourselves? What our trustees tell us is we can't pay any more than what we would pay ourselves. And so, it runs us about 15 basis points to service our shareholders.[18]

Another problem with the SEC's proposed framework is the fact that payments to broker-dealers for shareholder servicing activities within omnibus accounts are not creating additional protections for individual investors, who have a right to expect that the policies and procedures outlined in fund prospectuses will be applied uniformly and fairly across all shareholder classes and in a manner independent of an investor's choice of distribution channel. In fact, the opposite is taking place, as these hidden mutual fund accounts remain shielded from mutual fund compliance personnel.

As CMFI has noted in previous studies and SEC comment letters, many funds rely on broker-dealers and other intermediaries to enforce prospectus policies and procedures, causing a lack of uniformity in investor treatment within omnibus accounts.[19] This has resulted in a lack of effective oversight by mutual funds of investor activities within these accounts, which now involve as many as 100 million shareholder positions.[20] Most funds now freely acknowledge in their prospectus filings that they are unable to

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[18] Statement by Mellody Hobson, Ariel Capital Management, SEC Rule 12b-1 Roundtable, June 19, 2007, Unofficial Transcript at 89, available at http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf.

[19] See, e.g., Coalition of Mutual Fund Investors, "CMFI White Paper: Who is Watching Out for Mutual Fund Investors?," Mar. 30, 2009, available at http://www.investorscoalition.com/CMFIWhitePaper3-27-09.pdf; Letter to SEC Chairman Mary Schapiro from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, May 6, 2009, available at http://www.investorscoalition.com/CMFIWhitePaper3-27-09.pdf; and Letter to SEC Chairman Christopher Cox from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, Dec. 15, 2008, available at http://www.investorscoalition.com/CMFILettertoSECChairmanCoxDec2008.pdf.

[20] See CMFI White Paper at 5.

apply prospectus policies and procedures in a uniform manner within these third-party accounts, as a result of the lack of transparency in the omnibus account structure.[21]

In order to respond to these problems, the SEC's proposed reforms should, at the very least, address this disparity in treatment among shareholders, based on their choice of distribution channel, and the lack of transparency within omnibus accounts.

C. The Definition of "Distribution Activity" Should Be Expanded to Include All Distribution-Related Fees

If the SEC decides to authorize a 12b-2 marketing and service fee, then it should expand its current definition of "distribution activity" to include all fees involved in servicing third-party shareholders.

As the SEC acknowledges in its Release, NASD Rule 2830(b)(9) defines service fees as "payments by an investment company for personal service and/or the maintenance of shareholder accounts." In 1993, the NASD published an explanatory Notice that specifically excluded sub-accounting fees, sub-transfer agency fees, and administrative fees from the definition of service fee.[22]

Sub-accounting and sub-transfer fees are clearly connected to distribution services and, as such, should be included in the definition of distribution activity.[23] Otherwise, these expenses will be characterized as administrative expenses and paid for, in a less transparent manner, as a non-12b-2 expense out of fund assets.[24]

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[21] See Coalition of Mutual Fund Investors, "Excerpts from SEC Prospectus Filings Regarding Enforcement of Market Timing and Other Short-Term Trading Policies within Third-Party Hidden Accounts," Mar. 1, 2010, available at http://www.investorscoalition.com/Prospectus_Filings.pdf.

[22] NASD Notice to Members 93-12, at Question #17 (1993), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1627 ("In broad categories the term [service fee] does not include subtransfer agency services, subaccounting services, or administrative services.").

[23] See Statement by Jeffrey Keil, Keil Fiduciary Strategies LLC, SEC Rule 12b-1 Roundtable, June 19, 2007, Unofficial Transcript at 167-168 ("The other piece that happens also is a level of personal servicing that goes under the guise of the transfer agency fees under sub-transfer agency. Again, this needs to be defined clearly, so that needs to be under the 12b-1 purview, as well.").

[24] See SEC Mutual Fund Distribution Fee Release at 41-42, note 153 ("However, to the extent that funds need not rely on proposed rule 12b-2 to charge expenses that can clearly be identified as not distribution related (*e.g.*, sub-transfer agency fees), funds could instead characterize those expenses as administrative expenses and thus keep total asset-based distribution fees within the 25 basis point limit of the marketing and service fee."). But see id. at 132, note 397 ("We understand that representatives from the fund industry have asserted that because [a retirement plan] rather than plan participants is the legal owner of the fund shares, the use of plan assets will exclusively benefit the fund shareholder. This reliance on legal ownership is, however, inconsistent with the justifications given for the use of fund assets to pay for sub-accounting, transfer agency and other plan expenses. If the plan is the owner for purposes of this analysis, then only the cost of effecting plan transactions and maintaining records (and not transactions of plan beneficiaries) would be legitimate fund expenses.").

D. The SEC Rule Proposal Should Address Revenue-Sharing Payments

As noted in the Release, the new proposed SEC framework for mutual fund distribution fees does not address "revenue-sharing" payments being made by fund advisers to broker-dealers for distribution purposes, even though the SEC remains understandably concerned about these payments.[25]

In the Release, these payments are described by the SEC as an indirect method of financing the fund distribution system:

> Another concern relates to the recent growth in the frequency and amount of payments made by fund advisers to broker-dealers and others distributing fund shares, a practice commonly known as 'revenue sharing.' Because fund advisers derive their earnings from sources including advisory fees paid by the fund, the payment of distribution expenses by advisers could involve the indirect use of fund assets to pay for distribution. Rule 12b-1 explicitly applies to direct and *indirect* financing of distribution activities. Thus, revenue sharing could be construed as an indirect use of fund assets for distribution that is unlawful unless made pursuant to a rule 12b-1 plan. The Commission has historically taken the position that an adviser's financing of distribution activities would not necessarily involve an indirect use of fund assets if the payments are made from profits that are 'legitimate' or 'not excessive,' *i.e.*, profits that are 'derived from an advisory contract which does not result in a breach of fiduciary duty under section 36 of the Act.'[26]

Revenue-sharing payments from fund advisers to broker-dealers and other intermediaries can be quite significant. The CMFI study on broker compensation practices noted above estimates that revenue-sharing payments to support marketing and shareholder servicing activities within omnibus accounts are generating more than $2.09 billion each year in fees. Any type of cap or restriction on proposed Rule 12b-2 fees will only increase the pressure to raise the level of these revenue-sharing payments.[27] As such, the SEC should address this issue in its rulemaking proposal to reform Rule 12b-1.

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[25] Id. at 19, note 65 ("We are not addressing revenue sharing practices in connection with these proposals. However, we remain concerned that revenue sharing payments may give broker-dealers and other recipients incentives to market particular funds or fund classes, through 'preferred lists' or otherwise, and that such incentives create conflicts of interest (*e.g.*, between a broker-dealer's suitability obligation to its customers and its self-interest in maximizing revenue) that may be inadequately disclosed. ... We are continuing to consider further rule amendments related to revenue sharing.").

[26] Id. at 19, note 65.

[27] See Dan Jamieson, "12b-1 reform won't expose hidden fees, brokers say," Investment News, Aug. 10, 2010.

E. The SEC Rule Proposal Should Address the Role of Fund Boards in Overseeing Distribution Arrangements

The SEC notes that it intends for fund boards (including independent directors) to oversee the amount and uses of these fees, in the same manner that they oversee the use of fund assets to pay for other fund operating expenses.[28] The SEC also states that fund boards play a critical role in overseeing fund operations and protecting the interests of shareholders, in view of the inherent conflicts of interest that can exist between funds and their advisers.[29]

The SEC's proposal leaves fund boards with the obligation of oversight, but without any real tools to address the problems and conflicts in the fund distribution system. Funds and their boards are without any ability to negotiate fee levels with broker-dealers and other intermediaries responsible for distributing their shares. Many of these fees and payments are not transparent; and large broker-dealers are increasing their demands to take more shareholder accounts away from a fund's control and into the omnibus accounting structure. These problems are only going create more regulatory issues for funds and their boards, unless additional steps are taken to address both the fee structures and transparency within omnibus accounts.

III. Proposed Amendments to Rule 6c-10: The Ongoing Sales Charge

The SEC also proposes to restructure Rule 12b-1 fees that are in excess of the fees permitted under new Rule 12b-2 and that are used, more directly, to compensate broker-dealers and other intermediaries for sales of fund shares.[30] In lieu of 12b-1 fees being used as a substitute for a sales load, the proposed rule in the Release permits a fund to charge an "ongoing sales charge" for any particular fund or class of a fund.[31] However, this ongoing sales charge would be capped at the maximum rate charged for an upfront sales charge. After this capped rate has been reached, the fund shares would automatically convert to a class of shares that do not charge an ongoing sales charge, although a fund could continue to charge the 0.25% marketing and service fee authorized by new Rule 12b-2, for an indefinite period.

CMFI supports this proposal as a significant improvement over the current Rule 12b-1 framework. CMFI has the following specific comments about the mechanics of how this rule proposal should be implemented.

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[28] See SEC Mutual Fund Distribution Fee Release at 42-43.
[29] Id. at 43, note 157.
[30] Id. at 46-47.
[31] See Id.

A. The Proposed Automatic Conversion Process Should Be Improved Through Full Transparency Within Omnibus Accounts

The SEC has designed the conversion process for this rule proposal to closely mirror the process that funds currently use to convert class "B" shares to another class which does not have any ongoing sales charges.[32] The SEC's Release also states the following about the operational issues involved in this conversion process:

> Our proposed account-level cap would build upon innovations of fund management companies that have developed the operational capacity to issue, track the aging of, and convert class B shares. As a result, we expect that funds and intermediaries will be able to utilize existing transfer agency and other recordkeeping systems that administer funds issuing class B shares, which we believe operate in a manner similar to the proposed conversion provision or could easily be adjusted to do so.[33]

CMFI believes that the biggest operational obstacle to implementing this proposal is—once again—the widespread use of omnibus accounts by the same financial intermediaries—primarily large broker-dealers—which are going to be the primary beneficiaries of these ongoing sales charges. As noted earlier, CMFI estimates that omnibus accounting is being utilized for as many as 100 million shareholder positions.[34]

There are several very specific problems that need to be addressed in this SEC proposal. First, the SEC Release notes that several financial intermediaries, such as retirement plans and insurance companies, do not currently track and age share lots, for a variety of structural reasons.[35]

A second problem involves the mechanics of tracking fund share lots between financial institutions, when an investor moves his or her account from one intermediary to another.[36] Specifically, the SEC describes this problem as follows:

> The proposed automatic conversion feature, and its attendant requirement to track fund shares, may present additional issues when shareholder accounts are transferred between different intermediaries. We understand that, in some cases, tracking fund shares is a responsibility assumed by the fund transfer agent in

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[32] Id. at 48-49. Class B shares typically are sold without a front-end load, but charge a spread load of 100 basis points as a 12b-1 fee, with a declining contingent deferred sales load ("CDSL"). Class B shares usually convert automatically to a class of shares without ongoing sales charges after a fixed period of time has elapsed (commonly six to eight years from the date of purchase). See Id. at 23-24.
[33] Id. at 51-52.
[34] See CMFI White Paper at 5.
[35] See SEC Mutual Fund Distribution Fee Release at 53, note 184.
[36] Id. at 52.

> which case the portability of fund shares (*i.e.*, the ability of an investor to move his account from one intermediary to another) should not be affected. In other cases (*e.g.*, where the shares are held in omnibus accounts), fund intermediaries track share lots and would need to provide share lot histories to the new intermediary for the new intermediary to be able to determine the remaining maximum sales charge for transferred shares.[37]

A third operational problem involves the application of sales load breakpoint discounts. As the SEC Release notes, a number of funds provide volume or "breakpoint" discounts to shareholders who are charged a sales load for their purchases of mutual fund shares.[38] The SEC proposes to permit (but not require) funds to apply any quantity discounts or scheduled variations in the front-end load for which the investor may qualify when determining the reference load for an ongoing sales charge.[39]

When a financial intermediary uses an omnibus account structure, the mutual fund and the individual investor generally have to rely on the intermediary to calculate and apply the correct discount, in a manner consistent with fund policies. However, the intermediary often will have insufficient information to calculate the appropriate discount. For example, individual shareholders may use different broker-dealers for transactions within the same mutual fund family; and the involvement of multiple intermediaries is even more likely for related-party investors who may qualify for breakpoint discounts as a group. In contrast, when an investor purchases shares directly from a mutual fund, the fund and its transfer agent are able to calculate and apply the discount without relying on an intermediary.

These issues can be successfully addressed through an SEC requirement of full transparency within omnibus accounts at the shareholder account level. This can be accomplished by amending SEC Rule 22c-2 to require investor-level information to be shared with funds by broker-dealers (and other intermediaries using omnibus accounting) as orders are being placed and/or on a same-day basis.[40]

By providing mutual funds with access to shareholder level information within omnibus accounts, the SEC can address all three of the operational issues identified above. First, it can provide a framework by which retirement plans and insurance company accounts can track share lots at the investor account level, with transparency to mutual fund compliance personnel. Second, a mutual fund transfer agent will be in a position to track fund share lots for any investor that moves his or her account between intermediaries, eliminating the need for the old intermediary to provide share lot histories to the new intermediary, in an account transfer. Third, breakpoint discounts will be more

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[37] Id. at 52-53.
[38] See Id. at 58-59.
[39] Id. at 58.
[40] SEC Rule 22c-2 requires financial intermediaries to share account-level information with funds only upon request. See 17 C.F.R. § 270.22c-2(c)(5).

accurately calculated for each investor through this full transparency approach, as the transfer agent is the only entity in possession of all the information necessary to apply the discounts accurately, especially in situations where investors are holding shares of the same fund family, with accounts at different intermediaries.

B. The SEC Rule Proposal Should Calculate Ongoing Sales Charges in Fixed Dollar Amounts

CMFI is concerned about the implications of higher ongoing sales charges being assessed as fund assets grow over time. Under the SEC's proposal, the conversion period for the ongoing sale charge would be determined at the time the investor purchases shares and it would be tracked on a share lot basis.[41] Each purchase (or share lot) would be programmed to convert to a different class of shares on a particular date.[42] Since the shares are subject to a percentage charge each year, the amount of ongoing sales charges will increase as the fund assets grow.

As noted in the Release, this approach differs from the approach used in SEC Rule 6c-10(a)(1), which limits the maximum amount of a deferred sales load—such as a contingent deferred sales load ("CDSL")—to a dollar amount specified at the time the shares were purchased.[43] The SEC believes that its proposed approach is easy to administer, although the Release does acknowledge that investors will pay more in sales charges if the value of the fund shares increases over time.[44]

To evaluate the interaction of fund performance with ongoing sales charges that are percentage-based over a fixed period of time, consider the SEC's own example of a $10,000 investment in a fund with a 0.75% ongoing sales charge for 8 years, as described in footnote 200 in the Release.[45] If the investor were to be charged an upfront sales load of 6%, he or she would pay $600 in sales charges. As the SEC notes in this example, the total ongoing sales charges over the 8-year period would be $697, assuming an average annual return of 5%, or, alternatively, $835, assuming an average return of 10%.[46] In both cases, the investor pays more in total fund charges over the 8-year period ($697-$835) than he or she does in an upfront payment ($600), although the investor does have a higher overall account balance under the ongoing sales charge example because of the time value of money.

CMFI believes that a fund and its transfer agent can determine the maximum amount of sales charges in dollar terms at the time of purchase.[47] In addition to tracking

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[41] See SEC Mutual Fund Distribution Fee Release at 59-60.
[42] Id.
[43] Id. at 60.
[44] Id.
[45] Id. at 60, note 200.
[46] Id.
[47] At least one commentator has confirmed that fees can be tracked at the shareholder account level, even within omnibus accounts. See Letter to Nancy M. Morris, Secretary, Securities and Exchange Commission, from James J. Dolan, Chairman and CEO, Access Data Corp., July 19, 2007, available at

each investor purchase on a share lot basis, a fund can ensure that ongoing sales charges do not exceed this dollar amount, in a manner identical to the process used for other corporate actions, such as deferred sales loads (e.g., CDSLs) and reinvestment of dividends. For shareholders within omnibus accounts, the fund would need the type of same-day disclosure of account-level information from intermediaries advocated above.

This alternative approach would avoid the problem of positive fund returns increasing the amount of ongoing sales charges over time, by replacing an annual percentage rate with a fixed dollar amount over the period before the conversion date. This approach also would align economic interests with regulatory needs. It is in a mutual fund's economic interest to correctly calculate these ongoing sales charges in order to avoid losing unnecessary investment monies in each shareholder account. On the other hand, a broker-dealer is the direct beneficiary of any excessive ongoing sales charges and, therefore, does not have any economic incentive to ensure that ongoing sales charges do not exceed the maximum level established by the fund.

C. The SEC Rule Proposal Should Not Permit Reinvested Dividends and Distributions to Incur Ongoing Sales Charges

The SEC's proposed rule would permit funds to reinvest dividends and other distributions in the same share class as the shares on which the dividend or distribution was declared.[48] However, the reinvested shares would have the same conversion period as the shares on which the dividend or distribution was declared.[49] This process would still cause reinvested shares to be subject to an ongoing sales charge for the period remaining until the conversion of the shares to a class without such charges.

As stated in the Release, this approach differs from NASD Rule 2830. This Rule prohibits all sales charges on reinvested dividends, including front-end loads and CDSLs, as the reinvestment of dividends does not involve the expenditure of sales-related efforts.[50]

The SEC requests comment on whether it should require funds to reinvest dividends and distributions in a share class that does not have any ongoing share charges.

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http://www.sec.gov/comments/4-538/4538-270.pdf ("Once again, some may suggest that calculating different fee types by category at the account level is too difficult and expensive, but again the technology exists to calculate, track and report these multiple types of payments at the shareholder account level. The technology also exists to determine payments made to financial intermediaries from individual shareholders (assets of the shareholder's fund account) versus payments made by the advisor (from assets of the advisor).").

[48] SEC Mutual Fund Distribution Fee Release at 61.

[49] Id.

[50] See NASD Conduct Rule 2830(d)(6)(B); and NASD Notice to Members 97-48, August 1997, at 392, available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p004659.pdf ("NASD Regulation proposes to amend the Investment Company Rule to prohibit *all* loads on reinvested dividends because these charges will typically cause an investor to pay a charge twice on the same assets, and could exceed the appropriate sales charge limits.").

While this proposed alternative would address the issue, it may result in unnecessary complexity for investors, funds, and intermediaries. The problem can be entirely avoided, however, by adopting the CMFI recommendation to convert ongoing sales charges to a fixed dollar amount each year, during the period leading up to when shares are converted into a different class. By only taking fixed and predetermined dollar amounts out of each shareholder account each year, a fund can reinvest dividends and distributions without subjecting them to an ongoing sales charge that is based on a percentage of fund assets.

D. The SEC Should Consider Additional Measures to Help Fund Directors Oversee Distribution Activities and Fees

Under the SEC's proposal, fund directors would no longer have to formally approve a Rule 12b-1 plan each year. However, the Release states that fund directors will continue to exercise their fiduciary obligations, under state law and Section 36(a) of the Investment Company Act, to consider whether use of the fund's assets to pay ongoing sales charges is in the best interest of the fund and its shareholders.[51]

As noted earlier, fund and their boards are involved in a distribution system in which prices and fees are determined by broker-dealers and other intermediaries with far more leverage in the marketplace.[52] The SEC needs to further evaluate intermediary compensation issues, so that a combination of new SEC rules and additional fund board authority can be used to address these issues more effectively.[53]

IV. Proposed Amendments to Rule 10b-10:Transaction Confirmations

The Release proposes to amend SEC Rule 10b-10, to require disclosure of certain information in customer confirmations for transactions involving mutual fund shares.[54] The Release also notes that the SEC staff is considering recommendations to enhance the information provided to investors at the point of sale.[55]

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[51] See SEC Mutual Fund Distribution Fee Release at 64.
[52] See Statement by Barbara Roper, Consumer Federation of America, SEC Rule 12b-1 Roundtable, June 19, 2007, Unofficial Transcript at 186 ("I would say that 12b-1 fees have in common with the entire sort of product-based system for how we compensate brokers is that they foster reverse competition, constrained by regulatory limits. And that funds, like other investment vehicles, compete to be sold, rather than competing to be bought.").
[53] See Statement by Richard Phillips, Kirkpatrick & Lockhart LLP, SEC Rule 12b-1 Roundtable, June 19, 2007, Unofficial Transcript at 194 ("And directors have a responsibility to understand the operations of distribution systems, the financing of it, and to make a judgment whether or not the manager is devoting sufficient resources to distribution, and whether or not there are conflicts in the distribution system that need monitoring and oversight by the directors. And that is how the duty of directors ought to be reformed, in terms of 12b-1 – much broader than it is today.").
[54] SEC Mutual Fund Distribution Fee Release at 67.
[55] Id. at 68.

CMFI generally supports the recommended disclosures in the Release, although it opposes the elimination of any specific disclosure of revenue-sharing or other payments—such as recordkeeping, sub-accounting, and sub-transfer agency fees—made by funds outside of Rule 12b-2, for the purpose of shareholder servicing of customer accounts not maintained on a fund's own books and records.[56]

As documented by CMFI's recent study on broker-dealer compensations, funds are paying significant recordkeeping fees, 12b-1 service fees, and revenue-sharing fees for account maintenance and shareholder servicing activities within third-party omnibus accounts. CMFI estimates that these fees are imposing costs on individual investors each year of as much as $2.2 billion in account maintenance charges, more than $4.18 billion in 12b-1 shareholder servicing fees, and more than $2.09 billion in revenue-sharing payments.

These fees and charges are all part of the overall costs of maintaining the fund distribution system and, as such, should be disclosed to investors in at least the Prospectus and on the confirmation statement.[57] CMFI advocates that the SEC should require the disclosure of all fees, revenue-sharing payments, and other remuneration being paid to broker-dealers and other intermediaries for account maintenance and shareholder servicing activities within omnibus accounts. These disclosures should include the dollar amount that a broker-dealer (or other intermediary) is receiving for each account. This latter disclosure should also be disclosed in monthly shareholder account statements.

This recommended disclosure should be as broad as possible, to ensure that all payments, fees, and charges by (and to) all parties involved in the sale and distribution of fund shares are disclosed to the investor, regardless of the stated purpose of such costs and including activities that occur both before and after the purchase of fund shares.[58]

As a final recommendation regarding confirmation statements, the SEC should consider requiring that a legend be inserted in these statements for any fund that is: (1) paying fees to broker-dealers for omnibus sub-accounting; and (2) unable to receive ongoing investor-level information about fund shareholders in these intermediary accounts. If required, the legend should contain the following language regarding the use of omnibus sub-accounting by broker-dealers or other intermediaries:

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[56] See Id. at 71, note 229 ("We also are not proposing to specifically require that purchase confirmations disclose other categories of compensation that the broker-dealer receives in connection with the particular mutual fund being purchased, such as 'revenue sharing" received from a fund's adviser.").

[57] This information may need to be included in other investor disclosures as well.

[58] CMFI has advocated for the broadest possible disclosure of third-party distribution costs since 2004. See Statement of Niels C. Holch, Executive Director, Coalition of Mutual Fund Investors, Subcommittee on Financial Management, the Budget and International Security, Committee on Governmental Affairs, U.S. Senate, Jan. 27, 2004, at 8-9, available at http://www.investorscoalition.com/StatementBeforeSenateGovernmentalAffairs.pdf.

> *"A broker-dealer or other intermediary may receive fees to manage your account that are not being charged by other financial institutions selling or distributing your mutual fund shares. A broker-dealer or other financial intermediary also may not be applying the policies and procedures of a mutual fund to your account in the same manner as other investors, unless your account transactions are disclosed to each mutual fund on an ongoing basis."*

V. Proposed Shareholder Approval Provisions

CMFI supports the SEC's proposal to require shareholder approval to institute or increase a marketing and service fee.[59] CMFI also supports the SEC's proposal to prohibit ongoing sales charges from being instituted or increased in existing funds, or lengthened in duration, regardless of shareholder approval.[60]

VI. Application of New SEC Rules to Funds Underlying Separate Accounts

The Release states that the provisions of this proposed rule would apply to funds that serve as investment vehicles for insurance company separate accounts offering variable annuities or life insurance contracts.[61] These separate accounts are typically organized as unit investment trusts and are invested in mutual funds that manage the assets supporting the insurance contracts.[62]

Under the SEC's proposal, mutual funds invested in by these separate accounts would be treated the same as other mutual funds. Thus, a marketing and service fee could be charged, up to the NASD limit of 0.25%. And an ongoing sales charge would be permitted, assuming that the insurance company separate account has the capability to track and age share lots. An insurance company separate account would not be permitted to offer shares of classes with ongoing sales charges unless it has developed the capability to track and age share lots.

CMFI supports these proposals. CMFI also believes that there should be full transparency through the omnibus account down to the shareholder level within these separate accounts, as recommended above. Additionally, the SEC should examine the substantial sales and distribution costs that investors in these insurance contracts are paying for these services.[63]

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[59] See SEC Mutual Fund Distribution Fee Release at 78-79.
[60] See Id.
[61] See Id. at 83-84.
[62] See Id.
[63] For example, as noted in footnote 256 of the Release, the NASD/FINRA sales charge rules do not place a maximum sales charge limitation on variable annuities.

VII. Proposed Amendments to Rule 6c-10: Account-Level Sales Charges

The SEC proposes to provide funds with an alternative (and elective) approach to distributing its shares. As described in the Release:

> Under the proposed elective provision, a fund (or a class of the fund) could issue shares at net asset value (*i.e.*, without a sales load) and dealers could impose their own sales charges based on their own schedules and in light of the value investors place on the dealer's services. In effect, this exemption would allow the unbundling of the sales charge components of distribution from the price of fund shares, similar to the existing ETF distribution model. The proposed rule amendment is, among other things, designed to provide flexibility to fund underwriters and dealers, encourage price competition among dealers offering mutual funds and, ultimately, benefit fund investors.[64]

CMFI supports this proposal and agrees with the arguments in the Release that this elective approach would expand the range of distribution models available to mutual funds, enhance transparency of costs to investors, promote greater price competition, and provide a new alternative means for investors to purchase fund shares at potentially lower costs.[65]

However, the SEC will need to examine its regulatory framework for current and potential externalized fee arrangements, to ensure that overall fees do not end up higher than today's levels. For example, the Release quotes several participants from the SEC 12b-1 Roundtable in 2007 as expressing concern that fees for broker-dealer wrap and managed accounts and insurance company separate accounts may be higher than necessary.[66]

The SEC's proposal also imposes two conditions on funds making this election.[67] First, the fund would not be able to impose an ongoing sales charge for any fund (or share class) that offers this alternative approach. However, the SEC's proposal would permit a fund to charge a marketing and service fee for the fund (or share class). Second, the fund would have to disclose in its registration statement—specifically in the Statement of Additional Information—that it has elected to offer this alternative approach.

In response to the first condition, CMFI does not believe that a fund should be permitted to charge a marketing and service fee in these circumstances, unless that fee is

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[64] SEC Mutual Fund Distribution Fee Release at 86.
[65] See Id. at 90.
[66] See Id. at 94 ("Some of the roundtable participants expressed concern that current externalized fee arrangements in other contexts (*e.g.*, separately managed accounts and wrap accounts) tended to have higher rather than lower fees than mutual funds and thus may be disadvantageous to smaller investors.")
[67] See Id. at 96.

devoid of all distribution- related expenses, including fees for shareholder account maintenance, recordkeeping, and shareholder servicing activities within omnibus accounts.

In response to the second condition, CMFI believes that this disclosure is more likely to be read and understood by individual investors if it is placed in a fund's Prospectus, instead of in a fund's Statement of Additional Information.

Finally, in CMFI's view, a fund making this election would still need full transparency down to the shareholder account level, to ensure that prospectus policies and procedures—such as redemption fees and other market timing policies—are applied uniformly within omnibus accounts.

VIII. Amendments to Improve Disclosure to Investors

A. The SEC Should Improve Its Proposed Form N-1A Disclosures

The SEC proposes to change the current Form N-1A fee table in two ways: (1) the current 12b-1 heading would be replaced with a heading for "Ongoing Sales Charges; and (2) a new subheading for "Marketing and Service Fee" would be added to the "Other Expenses" category.[68]

In its explanation for the placement of the amount of the marketing and service fee, the SEC highlighted the differing treatment by funds for sub-accounting and other fees in connection with omnibus accounts:

> Today, some funds may pay for certain services (*e.g.*, sub-accounting fees to a retirement plan administrator) in the form of a 'rule 12b-1 fee,' while others pay for the same service as an ordinary fund operating expense and account for the expense as 'other expenses' in the operating expenses portion of the current fee table. Similarly, under our proposed approach, some funds are likely to treat expenses for the same service as a 'marketing and service fee' or 'other expenses.' Different approaches to the same fees do not affect the comparability of fund expense ratios, but will affect the subcategories of the fee table. Because of the various uses and purposes of the charges that may be included as marketing and service fees under our proposal, we believe disclosure of this fee would best fit as a subheading to the 'other expenses' category.[69]

While CMFI agrees with the logic behind this proposed location in the fee table for the marketing and service fee, it reiterates its earlier recommendation that the

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[68] See Id. at 99.
[69] Id. at 100-101.

proposed Rule 12b-2 fee be expanded to include all fees being charged to service third-party shareholder accounts, including sub-accounting and sub-transfer fees. This can be accomplished by expanding the definition of "distribution activity," as noted above.

The SEC also proposes to amend Item 12(b) of Form N-1A to require a fund that deducts an asset-based distribution fee for services provided to fund investors to describe the "nature and extent of the services provided."[70] While this is a helpful disclosure for investors, funds also should be required to describe these services in greater detail and with greater specificity than current practices. An important objective for the SEC should be full transparency of all commissions, fees, and other intermediary charges that broker-dealers—and especially the larger brokerage firms—are currently demanding for account maintenance and shareholder servicing activities within their customer accounts.

B. The SEC Should Consider Implementing Its Account Statement Alternative

In June 2000, the General Accounting Office ("GAO") recommended that funds be required to disclose in shareholder account statements the actual dollar amount of fees and expenses that each shareholder directly or indirectly has paid as an investor in the fund.[71] In its Release, the SEC requests comment on this proposal and, especially, whether technological advances permit this type of disclosure to be made on a shareholder's account statement without undue costs.[72]

Since 2004, CMFI has advocated for this type of account statement disclosure.[73] CMFI believes that investors should receive information on all the actual fees being charged in their account statements.

Dollar disclosure of this type will help educate investors about the true costs of owning a particular mutual fund, as long as the methodology used is common to all funds and it is implemented in a manner that will facilitate comparisons among funds.

At a minimum, this disclosure should be made in the annual shareholder account statement, although this type of disclosure can be made quarterly or semi-annually in an account statement, by calculating a pro-rata portion of the annual fees charged.

Finally, CMFI believes that this disclosure will be more complicated to implement for shareholders within omnibus accounts, as these shareholders receive their account statements from a broker-dealer or other intermediary.

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[70] Id at 103.
[71] See General Accounting Office, Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition, June 2000, at 15, available at http://www.gao.gov/archive/2000/gg00126.pdf. The Office is now called the Government Accountability Office (www.gao.gov).
[72] See SEC Mutual Fund Distribution Fee Release at 109.
[73] See Statement of Niels C. Holch, Executive Director, Coalition of Mutual Fund Investors, Subcommittee on Financial Management, the Budget and International Security, Committee on Governmental Affairs, U.S. Senate, Jan. 27, 2004, at 3-5, available at http://www.investorscoalition.com/StatementBeforeSenateGovernmentalAffairs.pdf.

IX. Proposed Conforming Amendments to Rule 11a-3

The SEC proposes two conforming amendments involving share exchanges within a fund family. First, the SEC proposes to require that all shareholders are credited with the payment of ongoing sales charges in any exchange.[74] Second, the SEC proposes to require that, in an exchange, a shareholder is credited with the ongoing sales charge in a fund's calculation of the amount of a deferred sales load due upon redemption.[75]

The SEC requests comment on the operational difficulties of these two proposals and CMFI reiterates its recommendation that permitting funds to have real-time transparency at the shareholder account level within omnibus accounts will help fund compliance personnel ensure that these exchange credits are implemented properly and accurately. Additionally, the adoption of CMFI's recommendation to convert ongoing sales charges from a percentage rate to a fixed dollar amount at the shareholder account level also will address a number of the issues raised by the Release.

X. Conclusion

The SEC's proposed reforms to Rule 12b-1 are a significant step in the right direction, at least from the perspective of the individual investor. However, the Release does not address broker-dealer and other intermediary compensation issues adequately. As noted by one of the participants in the 2007 SEC 12b-1 Fee Roundtable:

> If I could do anything, I would change the topic from 12b-1 fees to broker compensation issues, and have the Commission look holistically at these issues, to ensure that, one, it doesn't create incentives to simply move to a different form of non-transparent compensation within the mutual fund context, but more importantly perhaps, to ensure that it doesn't create a disadvantage for the sale of mutual funds, which I think we can all agree has been one of the great innovations for investors from recent decades.[76]

Additionally, the Release also does not address the lack of transparency within omnibus accounts, a problem that remains as an obstacle to resolving a number of mutual fund regulatory problems.

By broadening the scope of this rulemaking, and looking more closely at the inner workings of the mutual fund distribution system—from fees to transparency issues—the SEC can dramatically improve the impact of these proposed reforms to Rule 12b-1 on individual investors.

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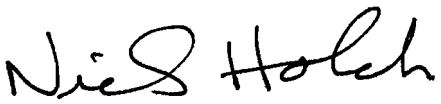
[74] See SEC Mutual Fund Distribution Fee Release at 111.
[75] See Id.
[76] Statement of Barbara Roper, Consumer Federation of America, SEC Rule 12b-1 Roundtable, June 19, 2007, Unofficial Transcript at 217.

Sincerely,



Niels Holch
Executive Director
Coalition of Mutual Fund Investors

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