

November 28, 2005

1940 Act Rule 12b-1

BY HAND DELIVERY

Douglas J. Scheidt, Esq.
Associate Director and Chief Counsel
Division of Investment Management
Securities and Exchange Commission
901 E Street, NW
Washington, D.C. 20549

Re: **E*TRADE 12b-1 Rebate Program**

Dear Mr. Scheidt:

We are writing to request that the Division of Investment Management staff ("Staff") clarify certain statements made in its *Edward Mahaffy* no-action letter¹ with respect to the rebating of fees paid pursuant to Rule 12b-1 under the Investment Company Act of 1940 ("1940 Act"). Certain statements in the letter may raise concerns among mutual funds and their affiliates regarding the ability of a mutual fund's board of directors ("board") to determine that there is a reasonable likelihood that a 12b-1 plan would benefit a fund and its shareholders if a broker-dealer rebates 12b-1 fees to its customers.² We are asking the Staff to confirm that it was not the Staff's intent that the language in the *Edward Mahaffy* no-action letter be interpreted to preclude a fund board from approving a 12b-1 plan or its continuation when an unaffiliated broker-dealer, such as E*TRADE Securities, LLC ("E*TRADE"), rebates to its customers a portion of the 12b-1 fees and service fees it receives under the facts and circumstances described below.

I. FACTS

A. E*TRADE

E*TRADE is registered as a broker-dealer with the Securities and Exchange Commission ("SEC" or "Commission"), all 50 states, and the District of Columbia. E*TRADE is a member of the National Association of Securities Dealers, Inc. ("NASD"). E*TRADE is a subsidiary of

¹ SEC Staff No-Action Letter (Mar. 17, 2003).

² For convenience, we sometimes use "fund" or "funds" in place of "mutual fund" or "mutual funds," respectively.

E*TRADE FINANCIAL Corporation, a diversified financial services company that offers a wide range of financial products and services under the brand “E*TRADE FINANCIAL.”

E*TRADE FINANCIAL, a global financial services holding company headquartered in New York, New York, provides an integrated offering of diversified financial services and solutions to retail and institutional customers. E*TRADE FINANCIAL currently offers branded web sites in 14 countries and serves approximately 2.7 million households and approximately 3.6 million customer accounts worldwide. E*TRADE FINANCIAL offers its products and services primarily through the Internet and other electronic media, and therefore has a lower operating cost structure than traditional “brick and mortar” financial services companies. In addition, the domestic retail brokerage services offered to customers are primarily designed to serve the needs of self-directed investors; the company does not have an extensive, high cost network of brokers actively advising customers as to particular investment vehicles. Rather, the company has focused on leveraging its technology platform to provide leading edge investment tools and information, creating a powerful and economical alternative to traditional, more expensive investing systems enabling customers to take greater control of their own financial lives.

B. Service Fees

E*TRADE Clearing LLC (“E*TRADE Clearing”), an affiliate of E*TRADE, has agreements with numerous fund companies and their affiliates pursuant to which E*TRADE Clearing receives fees for providing distribution and/or shareholder services. E*TRADE Clearing pays these fees to E*TRADE, which performs these services for its customers. These fees (collectively, “Service Fees”) are expressed as a percentage (typically ranging from 0.10% to 1.00% per annum) of the fund’s average daily net assets attributable to E*TRADE customers.

Service Fees may take the form of Rule 12b-1 fees, which are fees paid by funds to their distributors pursuant to Rule 12b-1 plans adopted by the funds to cover the costs of distribution of fund shares and the costs of providing shareholder services. Rule 12b-1 fees include fees to compensate brokers and others who sell fund shares and to pay for such items as advertising and marketing, the printing and mailing of prospectuses to new investors, the printing and mailing of sales literature, and shareholder services.

Apart from Rule 12b-1 fees, Service Fees also may be paid by mutual funds and their affiliates, such as distributors or advisers, to brokers and others who sell fund shares to secure such services as responding to investor inquiries and providing investors with information about their investments.³

³ For convenience, we sometimes refer to fund sponsors, advisers, and distributors as “fund affiliates.”

C. E*TRADE's 12b-1 Rebate Program

Under E*TRADE's 12b-1 Rebate Program (the "Program"), E*TRADE currently makes an incentive payment or "rebate" to its eligible customers in an amount equal to 50 percent of the Service Fees it receives (the "E*TRADE incentive payment") from funds (or their affiliates) whose shares are the subject of incentive payments under the Program. E*TRADE currently offers rebates to its customers with respect to more than 5,000 funds under the Program. As discussed below, E*TRADE in its sole discretion selects the funds whose shares are the subject of E*TRADE incentive payments under the Program. Currently, the Program covers all funds available through its mutual fund supermarket and from which E*TRADE receives Service Fees, but excludes funds that are affiliated persons of E*TRADE.⁴

E*TRADE pays this amount to all eligible customers at six-month intervals, with payments to be made each June and December. Eligible customers are those who have an active E*TRADE brokerage account or IRA with a minimum balance of \$25 at the end of the relevant period and who owned during the previous six months any mutual fund shares to which the Program applies.⁵ E*TRADE will pay the rebate to eligible customers regardless of whether they purchase fund shares through E*TRADE or whether they transfer fund shares to their E*TRADE brokerage account after purchasing them elsewhere. The Program applies to fund shares, or classes of shares included in the Program, with respect to which E*TRADE receives Service Fees. E*TRADE has no affiliation with these funds or fund affiliates.

The amount of each payment to an account holder's account is 50 percent of the amount of Service Fees that E*TRADE has received that are attributable to that particular account holder's account during the preceding six month period. Payments are calculated at the end of each six-month holding period by multiplying the daily net asset value for each fund in the Program by the Service Fee rate paid to E*TRADE, then calculating an amount equal to 50% of that number. Daily amounts are then totaled to determine the total amount of the E*TRADE incentive payment.

Thus, for example, assume that the account of an E*TRADE customer has an average daily value of \$200,000 in shares of a mutual fund. Assume also that E*TRADE receives Service Fees at an annual rate of 0.25% (25 basis points) from the mutual fund, and makes an incentive payment to the customer of 50 percent of these fees. In this example, E*TRADE

⁴ In addition, E*TRADE, in its sole discretion, may not include in the Program a fund that has asked E*TRADE not to be included.

⁵ In the future, E*TRADE may impose a *de minimis* threshold for eligibility for the E*TRADE incentive payment. Eligible customers would receive an E*TRADE incentive payment only if the payment was above the threshold amount. Any *de minimis* threshold would be fully disclosed and would be applied uniformly to all eligible customers.

would receive annually Service Fees of \$500 attributable to that account (0.25 percent of \$200,000), and the customer would receive incentive payments (on an annual basis) totaling \$250 (50 percent of \$500). The actual E*TRADE incentive payment would consist of cash credited to the customer's E*TRADE account.

E*TRADE may offer classes of shares with a front-end sales load. However, in no case will E*TRADE rebate any portion of any such sales load. For transactions effected electronically, E*TRADE does not impose its own separate transaction charges in connection with the sale of shares of funds with respect to which it receives a Service Fee unless a broker assists in the transaction. Although E*TRADE's sales of fund shares are primarily through electronic delivery channels, E*TRADE also has a certain number of full service investment specialists who advise customers on funds and fixed income products. All sales of funds through these investment specialists are subject to a transaction fee and would also be eligible for the E*TRADE incentive payment to the extent that a fund is included in the Program.

The Program is the creation of E*TRADE. E*TRADE, in its sole discretion, selects the funds whose shares are the subject of E*TRADE incentive payments under the Program. The Program operates independently and is not an obligation or liability of any fund or fund affiliate. E*TRADE administers the Program in its sole discretion. Mutual funds and their affiliates have no control over the operation of the Program. Although E*TRADE may notify relevant funds, including their sponsors, advisers, and distributors, of the Program, and respond to inquiries regarding the Program, E*TRADE does not seek nor will it seek their approval before rebating any fees to eligible customers nor will it allow them any control over the operation of the Program. E*TRADE retains sole control over the amount of the payments under the Program, the timing of such payments, the scope of the Program, and the length of the Program, which it may offer, amend or discontinue at any time in its sole discretion. The Program is not and will not be the subject of any agreement or arrangement, written or otherwise, between E*TRADE and any fund included in the Program or any affiliate of such fund.⁶

E*TRADE's purpose in creating the Program is to attract new customers to E*TRADE and underscore the benefits of investing through its platform, to attract additional fund assets from existing customers who may have accounts elsewhere, and to provide a "persistency bonus" for customers who maintain active accounts at E*TRADE. E*TRADE believes these activities will result in attracting new assets to the funds included in the Program, and the early results in the time during which the Program has been active indicate that investors find the Program attractive. It is E*TRADE's sophisticated and lower-cost electronic infrastructure that enables it to reduce the amount of Service Fees it finds it necessary to retain.

⁶ Of course, the Service Fees being rebated under the Program are the subject of 12b-1 or other agreements with funds and their affiliates, as described elsewhere in this letter. However, those agreements do not confer upon any fund or fund affiliate any control over the Program itself.

For ease of calculation and clarity to our customers, the E*TRADE incentive payments under the Program are computed as a percentage of Service Fees. In economic reality, the E*TRADE incentive payments may be paid out of the Service Fees received or out of E*TRADE's other financial resources or some combination thereof. This result follows from the fact that E*TRADE is prepared to fund the E*TRADE incentive payments under the Program using profits generated from all of its activities and lines of business, including any profits from Service Fees. E*TRADE does not expect to earmark specific amounts received as Service Fees to fund the Program. E*TRADE believes it can afford to offer incentive payments because of economies of scale and efficiencies resulting from its focus on technology, as applied to fund share order processing and customer service.

It is also possible that, under some Service Fee arrangements, the cost of the E*TRADE incentive payments will eliminate any profit under the Service Fee. For example, although the low cost and efficient service that E*TRADE is able to offer its customers is in large part due to the electronic delivery of its services, under the law, a customer may still request and receive paper copies of all account statements. In addition, some customers may need additional assistance when making account inquiries through the use of telephone service representatives. Because, currently, E*TRADE does not generally charge any additional amounts for these materials and services, the cost of providing administrative and distribution services to such a customer may exceed the incentive payment paid to a particular customer during the relevant period. E*TRADE charges a transaction fee for broker-assisted trades and a custodial fee on certain IRAs that request paper statements.

II. DISCUSSION

A. Applicable Law

1. Section 12(b)

Section 12(b) makes it "unlawful for any registered open-end company (other than a company complying with the provisions of Section 10(d)) to act as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

The legislative history of section 12(b) indicates that it was intended to protect mutual funds “against excessive sales, promotion expenses, and so forth.”⁷ Shortly after the passage of the 1940 Act, Alfred Jaretzki, who had participated in the drafting of the 1940 Act as a representative of closed-end companies, wrote about Section 12(b), as follows:

[a]pparently the Commission was particularly fearful of the possibility that open-end investment companies in their formative stages might be made to shoulder the unprofitable burden of selling and distributing their shares during this period of heavy expenses and small return, building up the investment company for the benefit of some controlling person.⁸

Prior to its adoption of Rule 12b-1, as discussed below, the Commission generally opposed the direct or indirect use of mutual fund assets to finance distribution.⁹ According to the Commission, its opposition “was based on a concern that, if funds were allowed to pay such expenses, the decisions as to the level of expenditures for distribution would be made or influenced by the fund's investment adviser.”¹⁰ The Commission was concerned that an adviser that received asset-based compensation would be inclined to spend an excessive amount of the fund's assets on distribution in order to increase its own compensation.¹¹

2. Rule 12b-1

In 1980, the Commission adopted Rule 12b-1 to permit mutual funds to finance the distribution of fund shares, thereby enabling mutual funds to offer investors distribution alternatives more attractive than the traditional front-end sales load charge.¹² The Commission took this step in the belief that mutual fund directors could make their own business judgments

⁷ *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. Of the House Comm. on Interstate and Foreign Commerce*, 76th Cong. 3d Sess. 112 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Study).

⁸ Jaretzki, Alfred, *The Investment Company Act of 1940*, 26 Wash. U.L.Q. 303, 324-25 (1941) (footnote omitted).

⁹ *See Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Release No. 9915 (Aug. 31, 1977).

¹⁰ *Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies*, Investment Company Act Release No. 16431, 1988 SEC Lexis 1206 at 10 (June 13, 1988) (proposing amendments to Rule 12b-1).

¹¹ *Id.*

¹² Investment Company Act Release No. 11414, 1980 SEC Lexis 444 (Oct. 8, 1980) (adopting Rule 12b-1) [hereinafter, “Rule 12b-1 Adopting Release”].

on whether to use fund assets for distribution, subject to certain conditions¹³ that were designed to ensure that such business judgments were made “free of undue management influence” and after careful consideration of “all relevant factors.”¹⁴

To approve a 12b-1 plan, mutual fund directors must request and evaluate information reasonably necessary to an informed determination of whether to adopt or continue a 12b-1 plan. In addition, the Rule imposes on any person who is a party to any agreement with the mutual fund relating to the 12b-1 plan a duty to furnish such information to the directors. The Rule instructs fund directors to consider and give appropriate weight to “all pertinent factors,” and a note to the Rule refers the reader to the Rule’s Adopting Release for a discussion of factors that would normally be relevant to any decision to use fund assets for distribution.¹⁵

Notably, neither the Rule nor any of the factors enumerated in the Adopting Release requires a finding with respect to any particular group of shareholders or any particular marketing program sponsored by a broker-dealer. Rather, the Rule, by its terms, only requires that a fund board find that any plan adopted pursuant to the Rule be reasonably likely to benefit the fund and its shareholders.

¹³ These conditions include a requirement that the payments be made in accordance with a written plan (a “12b-1 plan”) that, along with any agreement with any person relating to implementation of the 12b-1 plan, is initially approved (1) by a majority of the fund’s board of directors, and (2) by a majority of the fund directors who are not interested persons of the fund and who have no direct or indirect financial interest in the operation of the plan or in any related agreements (the “disinterested directors”). The 12b-1 plan must be re-approved on an annual basis by the directors. Fund directors may implement or continue a 12b-1 plan only if the directors who vote in favor of the plan find that there is a reasonable likelihood that the plan will benefit the fund and its shareholders. The Rule requires the directors to make these determinations in the exercise of their reasonable business judgment and in light of their fiduciary duties under Section 36 of the 1940 Act and state law.

¹⁴ *Id.* at 3.

¹⁵ In the Rule 12b-1 Adopting Release, the Commission enumerated the following factors as pertinent to a fund board’s determination of whether to adopt a Rule 12b-1 plan: (1) the need for independent counsel or experts to assist the directors in reaching a determination; (2) the nature of the problems or circumstances which purportedly make implementation or continuation of such a plan necessary or appropriate; (3) the cause of such problems or circumstances; (4) the way in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including, the nature and approximate amount of the expenditures; the relationship of such expenditures to the overall cost structure of the fund; the nature of the anticipated benefits; and the time it would take for those benefits to be achieved; (5) the merits of possible alternative plans; (6) the interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company’s shares, including whether any payments by the company to such other person are made in such a manner as to constitute the indirect financing of distribution by the company; (7) the possible benefits of the plan to any other person relative to those expected to inure to the company; (8) the effect of the plan on existing shareholders; and (9) in the case of a decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the company and its shareholders. Rule 12b-1 Adopting Release, *supra* note 12 at 38-39.

2. Relevant SEC Staff Pronouncements

a) Southeastern Growth Fund, Inc.¹⁶

In 1986, Southeastern Growth Fund, Inc., sought no-action relief from the Staff to permit it to amend its Rule 12b-1 plan to exempt an employee benefit plan from bearing its pro rata portion of the fund's 12b-1 fees under circumstances where bearing such fees might violate the Employee Retirement Income Security Act of 1974 ("ERISA"). According to the fund, WFS Financial Corporation ("WFS"), the parent company of the fund's investment adviser and distributor, wanted the flexibility to invest the assets of an employee benefit plan that it sponsored in shares of the fund. Because the fund's distributor was a party in interest under ERISA that stood to benefit, through the receipt of 12b-1 fees, if the employee benefit plan invested in the fund, the fund believed that a waiver of the distribution fees attributable to the assets of the employee benefit plan was required to avoid a prohibited transaction under ERISA. According to the fund, the waiver would be effected either by having the fund's distributor pay the 12b-1 fees to the employee benefit plan, or alternatively, by reducing the amount of the fee beforehand by an amount representing the plan's investment in the fund. The Staff did not grant the requested relief and stated that the Staff would not provide interpretative responses to requests regarding the merits of a particular 12b-1 plan.¹⁷ The Staff went on to state the following, without elaboration:

As a general matter, however, we believe that any waiver or rebate of an investor's pro rata portion of the expenses incurred under a 12b-1 plan would raise serious concerns under both section 36 of the Act and general fiduciary principles. We also question strongly whether a board of directors could conclude, as required by paragraph (e) of rule 12b-1, that there will be a reasonable likelihood that a 12b-1 plan which provides for such disparate treatment of shareholders will benefit the company and its shareholders. (footnotes omitted.)¹⁸

For the reasons discussed further in II.B., below, we do not believe the Staff's pronouncements in *Southeastern Growth Fund* are applicable to E*TRADE's Program. We note that E*TRADE's Program is readily distinguishable from the arrangement proposed in *Southeastern Growth Fund* in that it does not involve any rebates of 12b-1 fees by a fund or fund affiliate. Furthermore, the Staff's pronouncements were made under circumstances where a fund was seeking, in effect, to charge different shareholders different 12b-1 fees, potentially resulting in discrimination among similarly situated shareholders. By contrast, the Program

¹⁶ SEC Staff No-Action Letter (May 22, 1986).

¹⁷ *Id.*

¹⁸ *Id.*

involves payments by E*TRADE, an independent broker-dealer, out of its own resources, with the result that all fund shareholders will continue to be treated the same by the fund and its affiliates. Because the Program operates independently of any fund or fund affiliate, it does not give rise to any issues regarding discriminatory treatment of the shareholders by the fund or any fund affiliate.

b) Edward Mahaffy

In 2003, Edward Mahaffy, a registered representative of Raymond James Financial Services, Inc., requested no-action relief to enable his customers to receive, without such customers being registered as broker-dealers in accordance with Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), partial refunds of the 12b-1 fees that were attributable to their investments in mutual funds and that were paid to their brokers of record. Mahaffy proposed to solicit mutual fund investors by offering a refund of a portion of the 12b-1 fees attributable to their investment in the mutual funds. The Division of Market Regulation staff granted the no-action relief requested under the Exchange Act, subject to certain conditions.

Although Mahaffy did not ask the SEC whether his proposal implicated any provisions of the 1940 Act, the Staff nevertheless questioned "whether direct or indirect rebates of 12b-1 fees by a fund are consistent with the policies and provisions of the 1940 Act." The Staff reiterated its earlier statement in *Southeastern Growth Fund*, that "any waiver or rebate of an investor's pro rata portion of the expenses incurred under a 12b-1 plan would raise serious concerns under both section 36 of the [1940] Act and general fiduciary principles." The Staff also offered its opinion that "a broker-dealer's practice of rebating to its customers all or a portion of 12b-1 fees paid by the fund to the broker-dealer would be a pertinent factor requiring a board of directors' full consideration in reaching its conclusion with respect to a fund's 12b-1 plan." In addition, as in *Southeastern Growth Fund*, the Staff questioned "whether a 12b-1 plan under which broker-dealers rebate 12b-1 fees to their customers would benefit the fund and its shareholders."

We agree with the Staff's view in *Edward Mahaffy* that the existence of rebating would be a "pertinent factor" requiring a fund board's "full consideration." What constitutes "full consideration" obviously will depend on the facts and circumstances of each particular situation. Certainly, given the potential benefit to funds and their shareholders that rebating can provide, we would expect that fund boards would at least inquire of their distributors whether rebates are available from broker-dealers, whether rebating broker-dealers are currently part of the selling group offering the fund's shares, and if not, the reasons why not.

Fund boards can request information regarding rebating 12b-1 fees from fund distributors, who can then make appropriate inquiries of selling broker-dealers, such as E*TRADE, who can readily furnish such information. In addition to providing a fund or its distributor with information regarding the existence of rebating under the Program, upon request, E*TRADE would provide information about the extent to which E*TRADE rebates to its customers 12b-1 fees paid to it by the fund. We do not believe an inquiry by a fund or its

principal underwriter about the extent to which a broker-dealer rebated 12b-1 fees paid to it by the fund would, by itself, constitute an agreement or arrangement between the broker-dealer and the fund that requires consideration by the board under Rule 12b-1(b).¹⁹

We respectfully note that the Staff in *Edward Mahaffy* was not presented with an opportunity to fully consider the issues surrounding the rebating of 12b-1 fees by an unaffiliated broker-dealer. Specifically, the requestor did not ask the Staff for no-action relief on this point and, therefore, did not provide the Staff either with specific facts or with any legal analysis for the Staff to consider. In the absence of specific facts or legal analysis to consider, the Staff's statements in *Edward Mahaffy* can be fairly read as an expression of the Staff's general concern that a fund's board should be attentive to how the fund's shares are distributed and how the fund's assets are used for distribution. We respectfully submit, for the reasons discussed immediately below, that where an independent broker-dealer, and not the fund or fund affiliate, rebates 12b-1 fees, a fund board could reasonably conclude that there is a reasonable likelihood that a 12b-1 plan would benefit the fund and its shareholders.

B. Basis for Our Request

Some funds or their affiliates have asked that the funds not be included in the Program. We are concerned that these funds or fund affiliates may have interpreted certain statements by the Staff in the *Edward Mahaffy* no-action letter as suggesting that if a broker-dealer rebated 12b-1 fees to its customers, a fund's board could never determine, as required by Rule 12b-1(e), that there is a reasonable likelihood that the 12b-1 plan would benefit the fund and its shareholders. This interpretation of the Staff's position in *Edward Mahaffy* would have the practical effect that broker-dealers could not offer customers rebate programs similar to the Program. We do not believe the Staff intended such a result.

For the reasons discussed below, we respectfully request that the Staff confirm our view that it was not the Staff's intent for its statements in *Edward Mahaffy* to be interpreted to preclude a fund's board from approving a 12b-1 plan or its continuance if an unaffiliated broker-dealer, such as E*TRADE, rebates 12b-1 fees to its customers under the facts and circumstances described in this letter.

1. The Program Operates Independently of Funds and Their 12b-1 Plans

E*TRADE developed the Program independently of any funds. E*TRADE has no affiliation with the funds to which the Program applies or any fund affiliate. No fund or fund

¹⁹ Rule 12b-1(b) requires all agreements with any person relating to implementation of a 12b-1 plan to be approved by a fund's board of directors.

affiliate bears any responsibility for or obligation under the Program. All incentive payments under the Program are solely obligations of E*TRADE.

The Program is offered solely in the context of E*TRADE's business model and for purposes that are consistent with, but nevertheless independent of, a mutual fund's interest in the distribution of its shares. The purpose of the Program is to promote the sale of mutual fund shares to E*TRADE customers, reward customers that hold shares for longer periods, and promote E*TRADE as a source for buying and/or holding mutual fund assets.

E*TRADE alone controls all aspects of the Program. E*TRADE does not and will not seek the approval of any fund or fund affiliate in connection with the implementation or continuation of the Program, nor will it allow them any control over the operation of the Program. E*TRADE retains sole control over the amount of the incentive payments under the Program, the timing of such payments, the scope of the Program, and the length of the Program, which it may offer, amend, or discontinue at any time in its sole discretion. The Program is not and will not be the subject of any agreement or arrangement, written or otherwise, between E*TRADE and any fund or fund affiliate.

E*TRADE funds the Program with its own resources, which may include profits from the Service Fees that it receives. However, E*TRADE also may make the incentive payments out of its profits from another revenue source. The reference to 12b-1 fees is for convenience of calculation.

Given the foregoing facts and circumstances, no fund or fund affiliate can be fairly viewed as acting indirectly through E*TRADE to discriminate among shareholders by selectively conferring benefits upon a particular group of shareholders, as was proposed in *Southeastern Growth Fund*.²⁰ No fund or fund affiliate is in a position to direct a change in the Program.

2. The Program Will be Funded Entirely by E*TRADE

As noted above, E*TRADE funds the Program through its own resources, which may include legitimate profits from 12b-1 fees that it receives. Although funds and fund affiliates will pay Service Fees to E*TRADE, no fund or fund affiliate has the right to dictate to E*TRADE how it may spend its profits from these Fees, including any profits from 12b-1 fees. All aspects of the funding of the Program are exclusively within E*TRADE's control. No fund or fund affiliate bears any obligation for the incentive payments made under the Program.

²⁰ Because no fund is selectively conferring benefits on certain shareholders, we do not believe the Program raise issues under Sections 18(f), 22(d) or 48(a) of the 1940 Act.

The fact that E*TRADE funds the Program out of its own resources firmly argues against attributing the incentive payments under the Program to any fund for purposes of Rule 12b-1. The Commission has acknowledged that the use by service providers, such as advisers, of their legitimate profits from fund fees to pay for distribution or to waive or reimburse expenses for a particular class of fund shares would not constitute an indirect use of fund assets in violation of applicable laws and regulations.²¹ Specifically, in promulgating Rule 12b-1, the SEC took the position that an adviser's payment of fund distribution expenses would not be attributable to the fund (and thus are not an indirect use of fund assets) if the payments are made from the adviser's legitimate profits. In the 1979 release proposing Rule 12b-1, the SEC stated that:

[E]xpenditures by...advisers to further the sale of fund shares...in a great many instances are in the nature of a reinvestment of profits from providing investment advisory services in the development of the adviser's business. ***To the extent that such "profits" are not excessive, they are the adviser's to use as it sees fit.*** Certainly it would be anomalous to suggest that any excess of income from the advisory contract over expenses associated with providing advisory services would be the adviser's money if, for example, it was used to pay dividends, but would be the fund's money if it was used to finance sales of its shares. On the other hand, it clearly would constitute an indirect use of fund assets for distribution if the advisory fee was inflated in order to provide the adviser with funds for that purpose.²²

The SEC reiterated its position in 1980 when it adopted Rule 12b-1, as follows:

[T]here is no indirect use of fund assets if an adviser makes distribution related payments out of its own resources. In determining whether there is an indirect use of fund assets, it is appropriate to relate a fund's payments pursuant to the advisory contract to the adviser's expenditures for distribution and to view such expenditures as having been made from the adviser's profits, if any, from the advisory contract. ***To the extent that such profits are "legitimate" or "not excessive", the adviser's distribution expenses are not an indirect use of fund assets.***²³

²¹ *Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds*, Investment Company Act Release No. 19955 (Dec. 15, 1993) (proposing Rule 18f-3) [hereinafter, "Rule 18f-3 Proposing Release"] at fn. 39 and accompanying text, citing approvingly the Commission's release adopting Rule 12b-1.

²² Investment Company Act Release No. 10862 (Sep. 7, 1979) (proposing Rule 12b-1). (Emphasis added.)

²³ Rule 12b-1 Adopting Release, *supra* note 12 at 31 (emphasis added).

In addition, when the Commission overhauled²⁴ the primary fund disclosure document, namely, the prospectus required by Form N-1A, it eliminated the requirement to disclose third party broker-dealer charges because they were not attributable to the fund. Specifically, the Commission stated as follows:

Third-Party Fees. Form N-1A requires a fund to disclose in the prospectus any fees charged by a bank, broker-dealer or other person in connection with the purchase of the fund's shares, if the fees are charged with the fund's knowledge. The proposed amendments would no longer require this disclosure, *since these fees are not charged by the fund.* [fn. 218] Investors are informed of (and pay) the fees as part of their relationship with, and the services provided by, the third party.²⁵

[fn. 218] In some cases, fees charged by a third party, in effect, represent fees of the fund (*e.g., when the fees are charged to all shareholders* to invest in the fund) and would be required to be disclosed in the prospectus.²⁶

It follows that if third party *charges* are not attributable to a fund, the *rebate* of a fee by a third party likewise should not be attributable to the fund, in particular when the third party is rebating the fee and not the fund. This point is especially true when, as with the Program, the third party pays the rebate out of its own resources.

The foregoing Commission statements support the conclusion that E*TRADE may use its own resources, including legitimate profits from the 12b-1 fees, to fund incentive payments under the Program without attributing incentive payments under the Program to any fund for purposes of Rule 12b-1. E*TRADE can readily demonstrate that any profits it derives from Service Fees are legitimate and not the result of "inflated" fees. In all cases these 12b-1 fees will have been established by the funds prior to their inclusion in the Program. Under such circumstances, a fund cannot fairly be said to have "inflated" its fees in order to provide preferential treatment to fund shareholders who purchase shares through E*TRADE. The rebate of any 12b-1 fees by E*TRADE, therefore, cannot fairly be attributed to any fund for purposes of Rule 12b-1.

²⁴ Investment Company Act Release No. 22528 (Feb. 27, 1997) (proposing release) [hereinafter "N-1A Amendments Proposing Release"]; Investment Company Act Release No. 23064 (Mar. 13, 1998) (adopting release) [hereinafter "N-1A Amendments Adopting Release"]. The Commission overhauled the N-1A in order to provide investors with clearer and more understandable information about funds, including fund fees.

²⁵ See N-1A Amendments Proposing Release, *supra* note 23 at 109 (emphasis added).

²⁶ *Id.* (emphasis added). The footnote, by negative implication, suggests that third party fees are not attributable to funds when the fees are not charged to all shareholders (such as in the Program).

3. The Program Is Consistent with the Primary Purpose of Rule 12b-1 Plans

The primary purpose of Rule 12b-1 plans is to increase sales of fund shares. Typically, this is achieved by broker-dealers providing the distribution services required by the funds under their Rule 12b-1 plans. E*TRADE intends to promote fund distribution not only by providing distribution services required by the funds, but also by providing incentives for its customers to purchase and/or hold fund shares through E*TRADE.

E*TRADE believes the incentive payments under its Program will encourage customers to purchase fund shares through E*TRADE and to continue to hold fund shares at E*TRADE for the duration of the six month eligibility periods under the Program. E*TRADE anticipates that the Program will have the effect of increasing fund assets and/or the retention of fund assets for longer periods of time, which, in turn, may allow the fund to spread fixed fund costs over a larger asset base and achieve additional breakpoints under its advisory agreement or other fee schedules, as well as allow the fund's adviser to manage a more stable base of assets. These benefits would be shared by all fund shareholders.

When approving a 12b-1 plan or its continuance, a fund board must consider all relevant facts and circumstances regarding how a fund spends its 12b-1 fees. The existence and extent of rebating under the Program as well as the existence and extent of rebating by other broker-dealers of a fund's 12b-1 fees would be pertinent factors that a fund board should consider. We believe rebating can provide tangible benefits to a fund and its shareholders in the form of increasing or stable net assets while also lowering the cost of investing for fund shareholders. Under these circumstances, we believe a fund board could conclude there is a reasonable likelihood that a 12b-1 plan would benefit a fund and its shareholders.

4. Marketplace Competition Should Be Allowed to Determine the Appropriate Level of 12b-1 Rebates

Given the differences in broker-dealer cost structures, and recognizing that broker-dealers follow different business models, we respectfully submit that once a fund board has established a level of 12b-1 fees for a particular class of fund shares (as is the case for all funds included in the Program), the appropriate level of any rebating that occurs thereafter should be subject to marketplace competition. Customers who find 12b-1 rebates attractive will be motivated to purchase fund shares through broker-dealers that offer rebates. Seeing E*TRADE's success in this regard, some broker-dealers may decide, within the constraints of their cost structures and business models, to offer competing 12b-1 rebates on the same or different terms, *e.g.*, different amounts, over different lengths of time, etc. Others may decide instead to continue to compete on the basis of service or some other criteria. Such competition will afford consumers with a greater spectrum of choices when buying mutual fund shares.

E*TRADE's ability to offer 12b-1 rebates is a reflection of the fact that the various broker-dealers that distribute a fund's shares each face different cost structures and follow

different business models when providing the services for which they receive 12b-1 fees. For example, as a percentage of net revenues, the operating expenses of E*TRADE FINANCIAL's U.S. retail brokerage business are generally less than that of traditional broker-dealers. E*TRADE's business model emphasizes technologies to gain cost advantages that it can pass along to its customers in the form of lower fees. The cost structures of other broker dealers that do not emphasize technology to the same extent as E*TRADE may not afford them the ability to do so. Simply put, E*TRADE's cost structure and business model allows it to promote fund sales through rebates of 12b-1 fees to its customers to a degree that others might not.

We respectfully submit that interpreting Rule 12b-1 in the manner suggested in this letter would encourage marketplace competition.²⁷

III. CONCLUSION

For the reasons stated above, we respectfully request that the Staff issue an interpretive letter clarifying that it was not the Staff's intent for the language in the *Edward Mahaffy* no-action letter to be interpreted to preclude a fund board from approving a 12b-1 plan when an unaffiliated broker-dealer, such as E*TRADE, rebates to its customers a portion of the 12b-1 fees and service fees it receives under the facts and circumstances described in this letter.

If you have any questions or require further information with respect to this matter, please call me or Marc Duffy at (703) 247-3700 at E*TRADE or Richard Choi at Foley and Lardner LLP at (202) 295-4005.

Very truly yours,



Russell Elmer
General Counsel
E*TRADE FINANCIAL Corporation

²⁷ On a related note, in response to the Commission's request for comments on proposed changes to Rule 12b-1, E*TRADE suggested the creation of a safe harbor in Rule 12b-1 for rebate programs to encourage marketplace competition. See Letter, dated May 11, 2004, from Jarrett Lilien, President and Chief Operating Officer, E*TRADE FINANCIAL Corporation, to Jonathan Katz, SEC Secretary (File No. S7-09-04), commenting on *Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Investment Company Act Release No. 26356 (Feb. 24, 2004).