SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 239, 240, 249, 270 and 274

[Release Nos. 33-9128; 34-62544; IC-29367; File No. S7-15-10]

RIN 3235-AJ94

Mutual Fund Distribution Fees; Confirmations

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("SEC" or "the Commission") is proposing a new rule and rule amendments that would replace rule 12b-1 under the Investment Company Act, the rule that has permitted registered open-end management investment companies ("mutual funds" or "funds") to use fund assets to pay for the cost of promoting sales of fund shares. The new rule and amendments would continue to allow funds to bear promotional costs within certain limits, and would also preserve the ability of funds to provide investors with alternatives for paying sales charges (*e.g.,* at the time of purchase, at the time of redemption, or through a continuing fee charged to fund assets). Unlike the current rule 12b-1 framework, the proposed rules would limit the cumulative sales charges each investor pays, no matter how they are imposed. To help investors make better-informed choices when selecting a fund that imposes sales charges, the Commission is also proposing to require clearer disclosure about all sales charges in fund prospectuses, annual and semi-annual reports to shareholders, and in investor confirmation statements.

As part of the new regulatory framework, the Commission is proposing to give funds and their underwriters the option of offering classes of shares that could be sold by dealers with sales charges set at competitively established rates – rates that could better reflect the services offered

by the particular intermediary and the value investors place on those services. For funds electing this option, the proposal would provide relief from restrictions that currently limit retail price competition for distribution services.

The proposed rule and rule amendments are designed to protect individual investors from paying disproportionate amounts of sales charges in certain share classes, promote investor understanding of fees, eliminate outdated requirements, provide a more appropriate role for fund directors, and allow greater competition among funds and intermediaries in setting sales loads and distribution fees generally.

DATES: Comments must be received on or before November 5, 2010.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-15-10 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Elizabeth Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-15-10. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's

Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT:

With respect to rules and forms under the Investment Company Act and Securities Act, Thoreau A. Bartmann, Senior Counsel, Daniel Chang, Attorney, or C. Hunter Jones, Assistant Director, at 202-551-6792, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

With respect to rule 10b-10 under the Securities Exchange Act, Daniel Fisher, Branch Chief, or Ignacio Sandoval, Attorney, at 202-551-5550, Office of Chief Counsel, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: The Commission is proposing to rescind rule 12b-1 [17 CFR 270.12b-1] under the Investment Company Act of 1940 ("Investment Company Act" or "Act").[1] The Commission is also proposing for comment: new rule 12b-2 [17 CFR 270.12b-2] under the Investment Company Act; amendments to rules 6c-10 [17 CFR 270.6c-10] and 11a-3 [17 CFR 270.11a-3] under the Investment Company Act; amendments to Form N-1A[2] under the

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1 15 U.S.C. 80a. Unless otherwise noted, all references to statutory sections are to the Investment Company Act and all references to rules under the Investment Company Act will be to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270].

2 17 CFR 239.15A and 274.11A.

Investment Company Act and the Securities Act of 1933 (“Securities Act”);[3] amendments to rule 6-07 [17 CFR 210.6-07] of Regulation S-X under the Securities Act; amendments to rule 10b-10 [17 CFR 240.10b-10] and Schedule 14A[4] under the Securities Exchange Act of 1934 (“Exchange Act”);[5] technical changes to rule 10b-10; and technical and conforming changes to various rules and forms under the Investment Company Act.

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3 15 U.S.C. 77a.

4 17 CFR 240.14a-101.

5 15 U.S.C. 78a.

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I. INTRODUCTION

More than 87 million Americans, representing slightly less than half of all households, own mutual funds.[6] Some investors buy fund shares directly from mutual fund sponsors without paying a sales charge.[7] However, most fund investors buy through intermediaries.[8] These intermediaries include broker-dealers, banks, insurance companies, financial planners, and retirement plans. When investors use intermediaries to buy fund shares, they typically will pay (either directly or indirectly) some form of sales charge or service fees to compensate the intermediaries for the services they provide.[9]

Investors use intermediaries for a variety of reasons. Some want help in selecting a particular fund or building a diversified portfolio of investments. Others like the convenience of holding a variety of financial assets together in the same account and receiving a single comprehensive account statement. A growing number of investors use mutual funds as a way to fund their retirement plans, college savings accounts, annuity or life insurance contracts, or other

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6 Investment Company Institute ("ICI"), *Profile of Mutual Fund Shareholders, 2009* (2010) ("Shareholder Profile Report") (http://ici.org/pdf/rpt_profile10.pdf). Mutual funds' share of household financial assets has grown steadily from 3 percent in 1980 to 21 percent in 2009. ICI, 2010 INVESTMENT COMPANY FACT BOOK at 10 (2010) (http://www.ici.org/pdf/2010_factbook.pdf) ("2010 ICI FACT BOOK").

7 These are referred to as "no-load" funds because no sales charge or "load" is charged in connection with the transaction. *See infra* notes 16-17 and accompanying text.

8 According to the ICI, 80 percent of U.S. households that own mutual funds outside of retirement plans hold some portion of their fund shares through financial professionals (including brokers, financial planners, insurance agents, bank representatives, and accountants). 2010 ICI FACT BOOK, *supra* note 6, at 85.

9 Although the use of the term "intermediary" in this Release is not limited to registered broker-dealers, receipt of the fees addressed in this Release may, depending on the services provided, require the recipient to register as a broker-dealer or rely on an exception or exemption from broker-dealer registration. *See also* note 168, *infra*, and accompanying text.

tax-advantaged investment vehicles, which are often offered by an intermediary.[10] In some cases, investors use an intermediary (and pay sales charges) not necessarily for the services they obtain from the intermediary, but simply to be able to invest in shares of a particular fund that they cannot buy directly (*i.e.*, that are sold only through intermediaries).

There are over 9,000 funds available to investors, offering a variety of investment strategies to suit different investment needs.[11] Investors can select among many types of intermediaries from which they can purchase fund shares, and have choices as to how they pay for the services of those intermediaries. They may pay a "sales load" at the time they purchase shares, or a deferred sales load when they redeem shares, or they may invest in a fund that pays ongoing sales charges on behalf of investors from fund assets, otherwise known as 12b-1 fees.[12] As an alternative, they may choose to invest through an intermediary that deducts fees directly from the investor's account by a separate agreement (*e.g.*, "wrap fee programs"). Whether an investor pays sales charges depends upon the fee structure of the fund in which the investor chooses to invest, and how those sales charges are paid depends upon the "class" of fund shares that the investor selects.[13]

These sales charge arrangements are disclosed in fund prospectuses, and are governed by a combination of statutory provisions and rules adopted by the Commission and the Financial

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[10] *See* 2010 ICI FACT BOOK, *supra* note 6, at 97, 118. According to the ICI, U.S. retirement plan assets totaled $16 trillion in 2009. *Id*. The largest individual components were Individual Retirement Accounts ("IRAs") and employer-sponsored defined contribution plans, holding assets of $4.2 trillion and $4.1 trillion, respectively. Mutual funds' share of the IRA market has increased from 22 percent in 1990 to 46 percent in 2009. *Id.* at 98-99. Assets in section 529 college savings plans have grown from $2.6 billion in 2000 to $111 billion in 2009. *Id.* at 118.

[11] 2010 ICI FACT BOOK, *supra* note 6, at 16. This figure represents the total number of registered open-end funds, and includes separate series of a fund and ETFs.

[12] We will use the term "12b-1 fees" generally to describe fees that are paid out of fund assets pursuant to a plan adopted under rule 12b-1 ("12b-1 plan").

[13] *See infra* Section II.C.3 of this Release.

Industry Regulatory Authority, Inc. ("FINRA"), a self-regulatory organization for broker-dealers.[14] These rules have been in place for many years and, as discussed in more detail below, we believe that they may no longer fully reflect the current economic realities of the mutual fund marketplace or best serve the interests of fund investors. In this Release, we first review how these rules developed, our experience in administering them, changes we have observed in how funds distribute their shares, and the evolving needs of shareholders. We then propose a new framework that would continue to allow funds to give investors choices as to how and when to pay for sales charges, improve disclosure designed to enhance investor understanding of those charges, limit the cumulative sales charges each investor pays, and eliminate uncertainties associated with current requirements while providing a more appropriate role for fund directors. Finally, the proposal would offer funds and their underwriters the option of offering a class of shares that could be sold by intermediaries subject to competition in establishing sales charge rates.

II. BACKGROUND

A. Mutual Fund Sales Charges

When the Investment Company Act was enacted in 1940, investors paid most of the costs of selling and promoting fund shares in the form of a sales charge or sales "load" deducted from the purchase price at the time of sale by the fund's principal underwriter (typically the fund's adviser or a close affiliate).[15] The sales load financed brokers' commissions, advertisements, and

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14 FINRA rules do not apply directly to mutual funds, but to registered broker-dealers that are FINRA members, including the principal underwriters of most funds. Most funds therefore structure their sales loads to meet FINRA rules in order for their shares to be distributed and sold by registered broker-dealers in the United States.

15 *See* SEC, *INVESTMENT TRUSTS AND INVESTMENT COMPANIES*, H.R. Doc. No. 279, 76th Cong., 1st Sess., pt. 3, at 813, 823 (1939) ("INVESTMENT TRUST STUDY"). Principal underwriters typically confine themselves to wholesale transactions and leave the public selling to independent retail dealers under sales agreements, although some underwriters have their own "captive" retail sales

other sales and promotional activities. Only a limited number of funds, called "no-load" funds, marketed their shares directly to investors without the assistance of a retail broker, and did not charge sales loads.[16] The selling costs of no-load funds (primarily advertising) typically were subsidized by the funds' investment advisers out of their profits.[17]

In the past, fund sales charges generally were much higher than those customarily charged today and raised concerns for Congress and the Commission.[18] The Commission submitted a report to Congress in 1966 concluding that mutual fund sales charges should be lowered.[19] Following this report, Congress amended the Act in 1970 to give rulemaking authority to the National Association of Securities Dealers, Inc. ("NASD") (now FINRA) to prescribe limits to prevent excessive sales loads.[20] Under this authority, in 1975, the NASD

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organizations. *See* Tamar Frankel, THE REGULATION OF MONEY MANAGERS, § 27.01 (2009 supplement) ("THE REGULATION OF MONEY MANAGERS"). *See also* DIVISION OF INVESTMENT MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 291 (1992) ("1992 STUDY"). Although the principal underwriter collects the sales load, for convenience, throughout this Release, we will simply refer to "funds" as imposing sales loads or determining the amount of sales load payable.

16 *See* INVESTMENT TRUST STUDY, *supra* note 15, at 817-18. Some funds also charged low sales loads of one to two percent. *Id.*

17 *See* 1992 STUDY, *supra* note 15, at 292.

18 During the period of 1927-1935, sales loads for broker-sold funds ranged from five to 10 percent, but by 1935 they were often as high as nine to 10 percent. *See* INVESTMENT TRUST STUDY, *supra* note 15, pt. 2, 216-17. *See also Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 799 (1940) (statement of L.M.C. Smith, Associate Counsel, Investment Trust Study, SEC, discussing the "problem" of high sales loads).

19 The Commission recommended that sales loads be limited to a statutory maximum of five percent from the prevailing typical load of 9.3 percent. *See* SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. at 205, 223 ("PPI REPORT").

20 Investment Company Act Amendments of 1970, Pub. L. No. 91-547, § 12(a), 84 Stat.1413, 1422 (1970) (codified as amended at section 22(b) of the Act). Section 22(b) vested this rulemaking authority in a securities association registered under section 15A of the Exchange Act. The NASD (now FINRA) was and is the only such registered securities association. The Commission supported the amendment. *See Investment Company Amendments Act of 1970: Hearings on S. 34 and S. 296*

adopted a rule placing a ceiling of 8.5 percent on the front-end sales load that a fund distributed by NASD members could charge.[21] Today, few funds impose sales loads that approach the maximum limit, in part because of investor resistance to paying high front-end loads, but also because of the availability of other sources of revenue to pay distribution costs.[22]

B. Adoption of Rule 12b-1

The most significant of these alternative revenue sources came about when the Commission adopted rule 12b-1 in 1980.[23] As described in more detail below, rule 12b-1 permits a fund to use fund assets to pay broker-dealers and others for providing services that are primarily intended to result in the sale of the fund's shares. The Commission adopted rule 12b-1 under its authority in section 12(b) of the Investment Company Act,[24] which authorizes the Commission to regulate the distribution activities of funds that act as distributors of their own securities.[25] Section 12(b) was designed to protect funds from being charged excessive sales and promotional expenses.[26] The requirements of the rule are intended, in part, to address the

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Before a Subcomm. of the Senate Comm. on Banking and Currency, 91st Cong., 1st Sess. 6-8 (1969) (statement of Hugh Owens, SEC Commissioner).

21 Order Approving Proposed Rule Change by NASD, Investment Company Act Release No. 8980 (Oct. 10, 1975) (approving predecessor rule to NASD Conduct Rule 2830).

22 *See* THE REGULATION OF MONEY MANAGERS, *supra* note 15, at § 27.03; ICI, *Trends in the Fees and Expenses of Mutual Funds, 2009* (Apr. 2010) (http://www.ici.org/pdf/fm-v19n2.pdf) ("Fee Trends Report") (noting that in 2009 the average maximum front-end load on stock funds was 5.3 percent).

23 Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980) [45 FR 73898 (Nov. 7, 1980)] ("1980 Adopting Release").

24 Rule 12b-1 was also adopted pursuant to section 38(a) of the Act. *Id.*

25 Section 12(b) makes it unlawful, with certain exceptions, for any mutual fund "to act as a distributor" of its own shares in contravention of any rules the Commission adopts as "necessary or appropriate in the public interest or for the protection of investors."

26 *See* 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) ("House Hearings") (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC) (The purpose of section 12(b) is to prevent mutual funds from incurring "excessive sales, promotion expenses, and so forth.").

conflicts of interest between a fund and its investment adviser that arise when a fund bears its own distribution expenses.[27]

The Commission's adoption of rule 12b-1 arose in the context of two significant developments in the mutual fund market that occurred during the 1970s.[28] First, many funds experienced a prolonged period of net redemptions (*i.e.*, redemptions exceeded new sales), which reduced the amount of fund assets.[29] Fund company representatives asserted that using fund assets to fuel the sale of fund shares could benefit fund shareholders by increasing economies of scale and reducing fund expense ratios.[30] The second was the development of money market funds and no-load fund groups, including internally managed funds, which did not charge sales loads but required a source of revenue to support their direct selling efforts.[31] By offering a less

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27 When a fund pays promotional costs, the fund's investment adviser or distributor is relieved from bearing the expense itself, and the adviser benefits further if the fund's expenditures result in the growth of the fund's assets and a related increase in advisory fees (because an adviser's fees typically are based on a percentage of fund assets). However, commentators have noted that the benefits to existing fund shareholders from these expenditures may be "speculative at best." *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10252 (May 23, 1978) [43 FR 23589 (May 31, 1978)] ("Advance Notice of Proposed Rulemaking") at text following n. 3.

28 *See* Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431 (June 13, 1988) [53 FR 23258 (June 21, 1988)] ("1988 Release") at n.14 and accompanying text.

29 Total redemptions exceeded new sales for six of the seven years between 1971 and 1977. 2010 ICI FACT BOOK, *supra* note 6, at 125.

30 *See* Advance Notice of Proposed Rulemaking, *supra* note 27, at n.3 and accompanying text.

31 *See, e.g.,* Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)]. An investment company is said to have internalized its management functions when most or all of the services traditionally provided by the investment adviser or third parties are performed at cost by salaried employees of the fund or by subsidiaries of the fund. *See* 1988 Release, *supra* note 28, at n.8. When the Commission proposed rule 12b-1, an application was pending from The Vanguard Group for exemptions from the Act to permit Vanguard funds to internalize their marketing and distribution functions and to bear distribution costs through a wholly owned subsidiary of the funds. *See* In the Matter of the Vanguard Group, *et al.*, Opinion of the Commission, Investment Company Act Release No. 11645 (Feb. 25, 1981). The Commission discussed the Vanguard application in the release and asked commenters to address other possible methods whereby funds might be permitted to bear distribution expenses. *See*

expensive way for many investors to become fund shareholders, no-load funds promised to introduce greater price competition in the sale of mutual funds to retail investors, which might lower sales loads for all investors.

Before the rule's adoption, the Commission generally had opposed the use of fund assets for the purpose of financing the distribution of mutual fund shares, noting that existing shareholders of a fund "often derive little or no benefit from the sale of new shares."[32] After engaging in a thorough review of the public policy and legal implications of permitting funds to bear these types of expenses, which included a public hearing and two requests for public comment,[33] the Commission ultimately decided that there may be circumstances in which it would be appropriate for a fund to bear its own distribution expenses.[34]

The Commission remained concerned, however, about the inherent conflicts of interest on the part of the fund adviser.[35] Therefore, in crafting the conditions of the rule, we sought to minimize the role of the adviser and its affiliates in establishing both the amount and uses of

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Advance Notice of Proposed Rulemaking, *supra* note 27, at n.5. The Commission previously had allowed other funds with internalized management functions to pay distribution expenses out of fund assets because it believed these arrangements would significantly reduce the conflicts of interest that otherwise are present when fund assets are used to pay for distribution. *See* 1988 Release, *supra* note 28, at nn.8-10 and accompanying text.

32 *See* Bearing of Distribution Expenses by Mutual Funds: Statutory Interpretation, Investment Company Act Release No. 9915 (Aug. 31, 1977) [42 FR 44810 (Sept. 7, 1977)] (quoting SEC, Future Structure of the Securities Markets (Feb. 2, 1972) [37 FR 5286 (Mar. 14, 1972)]).

33 *See* Investment Company Act Release No. 9470 (Oct. 4, 1976) [41 FR 44770 (Oct. 12, 1976)] (announcement of hearings); Advance Notice of Proposed Rulemaking, *supra* note 27; Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10862 (Sept. 7, 1979) [44 FR 54014 (Sept. 17, 1979)] ("1979 Proposing Release").

34 The Commission noted, however, that it and its staff would "monitor the operation of the rules closely and will be prepared to adjust the rules in light of experience to make the restrictions on use of fund assets for distribution either more or less strict." *See* 1980 Adopting Release, *supra* note 23, at section titled "Discussion."

35 *See id*.

fund assets to support distribution.[36] As adopted, the rule required the fund's board of directors, and in particular its independent directors, to play a key role in deciding the level of the fund's distribution charges and how the revenue would be spent.[37]

Rule 12b-1 requires that, before using fund assets to pay for distribution expenses, a fund must adopt a written plan (a "rule 12b-1 plan") describing all material aspects of the proposed financing of distribution,[38] which must contain provisions similar to several of those the Act requires for advisory contracts between the fund and its investment adviser.[39] The rule 12b-1 plan must be approved initially by the fund's board of directors as a whole, and separately by the "independent" directors.[40] If the plan is adopted after the sale of fund shares to the general public, it also must be approved initially by a vote of at least a majority of the fund's voting securities.[41]

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[36] *See id.* at section titled "Independence of Directors." *See also* 1988 Release, *supra* note 28, at section titled "The Development and Use of 'Compensation' Plans" ("The directors' responsibilities under the rule were designed to provide that the directors, not advisers or underwriters, make the fundamental decisions regarding distribution spending.").

[37] *See* 1980 Adopting Release, *supra* note 23, at section titled "Independence of Directors" ("Since rule 12b-1 does not restrict the kinds or amounts of payments which could be made, the role of the disinterested directors in approving such expenditures is crucial.").

[38] Rule 12b-1(b). The plan must cover *indirect* as well as direct payments for distribution. *See* rule 12b-1(a)(2).

[39] *See* 1980 Adopting Release, *supra* note 23, at section titled "Summary" ("The procedures in the rule by which shareholders and directors would approve a plan to use assets for distribution are generally similar to those prescribed by statute for approval of investment advisory contracts."). *See also* sections 15(a) and 15(c) of the Act.

[40] We generally refer to directors who are not "interested persons" of the fund as "independent directors" or "disinterested directors." The term "interested person" is defined in section 2(a)(19) of the Act. However, rule 12b-1 requires directors to meet an additional test. In order to be considered independent for purposes of voting on a rule 12b-1 plan, directors must also have no direct or indirect economic interest in the operation of the plan or in any agreements related to the plan. Rule 12b-1(b)(2). In this Release, when we discuss the role of independent directors, the applicable standard for independence depends on the context.

[41] Rule 12b-1(b)(1). When we originally adopted rule 12b-1 in 1980, shareholders were required to vote whenever a rule 12b-1 plan was instituted, regardless of whether a public offering of fund shares had occurred. *See* 1980 Adopting Release, *supra* note 23, at section titled "Procedural Requirements."

The rule does not restrict the amounts of the fees that may be approved under the plan.[42] It also does not specify all of the activities that are "primarily intended to result in the sale of shares" and therefore may be paid by a fund only according to a rule 12b-1 plan. Nor does it specifically prohibit a fund from paying for non-distribution expenses under a rule 12b-1 plan.[43] Instead of limits or restrictions, the rule requires directors (including a majority of the independent directors) to conclude, in exercising their reasonable business judgment and in light of their fiduciary duties, that there is a reasonable likelihood that the plan will benefit both the fund and its shareholders.[44] The directors have a duty to request and evaluate as much information as is reasonably necessary for the directors to make an informed business decision.[45] The rule also requires any person authorized to direct payments under the plan or any related agreement (such as the fund's underwriter) to provide quarterly reports to the board of directors of all amounts expended under the plan and the purposes for which the expenditures were made.[46] The fund's board of directors (including a majority of the independent directors) must

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However, if a rule 12b-1 plan is adopted prior to the public offering of shares, a shareholder vote would be a mere procedural formality and approval would be almost automatic because all shareholders voting would typically be the fund's organizers. Any investor who purchased shares in a public offering after the initial adoption of the plan would be on notice that the fund charges 12b-1 fees. Therefore, in 1996 we amended the rule to permit funds to adopt a 12b-1 plan prior to a public offering of shares without a shareholder vote. *See* Technical Amendments to Rule Relating to Payments for the Distribution of Shares by a Registered Open-End Management Investment Company, Investment Company Release No. 22201 (Sept. 9, 1996) [61 FR 49010 (Sept. 17, 1996)].

42 However, as discussed in more detail in Section II.C.1 of this Release, rules adopted by the NASD (now FINRA) prohibit broker-dealers from selling funds that pay more than 0.25 percent (25 basis points) per year of fund assets as "service fees," and more than 0.75 percent (75 basis points) per year of fund assets as "asset-based sales charges," effectively setting the maximum 12b-1 fees at those amounts or less. NASD Conduct Rule 2830(d)(5) and (d)(2)(E).

43 *See* 1988 Release, *supra* note 28, at n.129.

44 Rule 12b-1(e). The rule requires that the fund set forth and preserve in the corporate minutes the factors that the directors considered, together with the basis for the decision to use fund assets for distribution. Rule 12b-1(d).

45 Rule 12b-1(d).

46 Rule 12b-1(b)(3)(ii).

decide each year whether to re-approve the plan based on the same considerations as required initially to adopt the plan.[47] Any material increases in the amounts paid under the plan must be approved by the fund's board, the fund's independent directors, and the fund's shareholders.[48]

In the 1980 Adopting Release, the Commission provided a list of nine factors that were intended to provide guidance to directors in considering whether the use of fund assets for distribution would benefit the fund and its shareholders.[49] The factors included: (i) the need for independent counsel or experts to assist the board; (ii) the "problems" or "circumstances" that make the plan necessary or appropriate; (iii) the causes of such problems or circumstances; (iv) how the plan would address the problems; (v) the merits of possible alternatives; (vi) the interrelationships between the plan and distributors; (vii) the possible benefits of the plan to other persons relative to the benefits to the fund; (viii) the effect of the plan on existing shareholders; and (ix) in deciding whether to continue a plan, whether the plan has produced the anticipated benefits to the fund and its shareholders.[50]

The rule was intended to allow fund boards some latitude to exercise their reasonable business judgment to authorize the distribution arrangements and continue them from year to year as circumstances warranted.[51] The annual re-approval requirement and the factors

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[47] Rule 12b-1(b)(3)(i).

[48] Rule 12b-1(b)(4). Any other material changes to the plan must be approved by the fund's board and the fund's independent directors. Rule 12b-1(b)(2).

[49] We originally included the factors in the text of the rule when we proposed it for public comment. *See* 1979 Proposing Release, *supra* note 33. In order to avoid the appearance of either unduly constricting the directors' decision-making process or of creating a mechanical checklist, we deleted the list of factors from rule 12b-1 at its adoption. Although we decided not to require the directors to consider any particular factors, the adopting release noted that the enumerated factors "would normally be relevant to a determination of whether to use fund assets for distribution." *See* 1980 Adopting Release, *supra* note 23, at section titled "Factors."

[50] *See* 1980 Adopting Release, *supra* note 23, at section titled "Factors."

[51] *Id.* at sections titled "Discussion" and "Independence of Directors." *See also* rule 12b-1(e) (providing that funds may implement or continue 12b-1 plans "only if the directors who vote to approve such

enumerated in our adopting release reflected an expectation that a fund would use the rule in order to address particular distribution problems, such as periods of net redemption.[52] The rule was also designed to allow distribution arrangements to evolve.[53] However, the rule ultimately resulted in distribution practices that we did not originally anticipate, as described below.[54]

C. Developments Following Rule 12b-1's Adoption

Initially, some funds adopted limited 12b-1 plans and used the revenue to pay for advertising and sales materials.[55] In time, however, funds began to adopt 12b-1 plans with higher fees and used the revenue to compensate fund intermediaries for sales efforts, rather than

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implementation or continuation conclude, in the exercise of reasonable business judgment … that there is a reasonable likelihood that the plan will benefit the company and its shareholders"); rule 12b-1(b)(3) (requiring that a 12b-1 plan provide in substance that "it shall continue in effect for a period of more than one year from the date of its execution or adoption only so long as such continuance is specifically approved at least annually" by the fund's board of directors as a whole, and separately by the independent directors).

52 *See* 1980 Adopting Release, *supra* note 23, at section titled "Factors." *See also* DIV. OF INV. MGMT., SEC, REPORT ON MUTUAL FUND FEES AND EXPENSES (2000) (http://www.sec.gov/news/studies/feestudy.htm); Joel H. Goldberg and Gregory N. Bressler, *Revisiting Rule 12b-1 under the Investment Company Act*, 31 SEC. & COMMODITIES REG. REV. 147, 151 (1998) ("Goldberg and Bressler") (factors "presuppose that the 12b-1 plan is designed to solve a particular distribution 'problem' or to respond to specific 'circumstances,' *e.g.*, net redemptions"); Lee R. Burgunder and Karl O. Hartmann, *The Mutual Fund Industry and Rule 12b-1 Plans: An Assessment*, 15 SEC. REG. L.J. 364 (1988) ("although the rule does not state this directly, the historical circumstances surrounding its preparation as well as its legislative history strongly [indicate] that the rule is aimed at the possible problems associated with periods of stagnant growth or net redemptions, especially for relatively small mutual funds").

53 *See* 1980 Adopting Release, *supra* note 23, at section titled "General Requirements" ("Recognizing that new distribution activities may continuously evolve in the future, and in view of the impracticability of developing an all-inclusive list, the Commission maintains that the better approach is to define distribution expenses in conceptual terms ….").

54 *See* 1988 Release, *supra* note 28, at paragraph preceding n.46 ("The use of the rule by the fund industry has resulted in many distribution practices that could not have been anticipated when the rule was adopted.").

55 *See* Goldberg and Bressler, *supra* note 52, at 150. The first 12b-1 plans provided for payments of 0.25 percent or less of average annual net assets and generally were used only to reimburse advisers and underwriters for advertising expenses and the printing and mailing of prospectuses and sales literature. *Id*.

simply defraying promotional costs.[56] These 12b-1 plans often were coupled with contingent deferred sales loads, or "CDSLs," as part of a "spread load" arrangement, and served as an alternative to a front-end sales load.[57]

Unlike a traditional load, which is commonly referred to as a "front-end" load because it is paid at the time of purchase, fund investors pay a CDSL from their proceeds when they redeem shares.[58] The load is "contingent" because the amount payable reduces over time and usually disappears at the end of a stated period. When combined with the payment of 12b-1 fees, a CDSL operates as a deferred payment plan for sales charges.[59] Instead of paying a sales load at the time of purchase, a greater portion of the investor's money is invested in the fund at the outset, and the investor pays sales charges over time, albeit indirectly through charges against fund assets. An investor who redeems early compensates the fund underwriter (which has already advanced payments to intermediaries) by paying the CDSL in place of uncollected revenues from 12b-1 fees attributable to the investor's assets.

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[56] *See* 1992 STUDY, *supra* note 15, at 322.

[57] *See* Exemptions for Certain Registered Open-End Management Investment Companies to Impose Contingent Deferred Sales Loads, Investment Company Act Release No. 16619 (Nov. 2, 1988) [53 FR 45275 (Nov. 9, 1988)] ("Rule 6c-10 Proposing Release") (proposing to permit funds to impose CDSLs, which were often used in combination with 12b-1 plans "as a substitute for charging investors a front-end sales load").

[58] Rule 22c-1 under the Act requires mutual funds to redeem shares at a price based on their net asset value. In order to impose CDSLs, funds sought and we granted exemptions from this and other provisions to permit shareholders to defer their payment of sales charges until redemption. *See, e.g.,* E.F. Hutton Investment Series, Inc., Investment Company Act Release Nos. 12079 (Dec. 4, 1981) [46 FR 60703 (Dec. 11, 1981)] (notice) and 12135 (Jan. 4, 1982) (order). After issuing numerous exemptions, we codified them in rule 6c-10, which permits funds complying with the rule to impose CDSLs without first having to obtain individual exemptions. Exemption for Certain Open-End Management Investment Companies to Impose Contingent Deferred Sales Loads, Investment Company Act Release No. 20916 (Feb. 23, 1995) [60 FR 11890 (Mar. 1, 1995)]. We later amended the rule to permit other types of deferred sales loads, including a form of account-level sales charge we referred to as an "installment load." Exemption for Certain Open-End Management Investment Companies to Impose Contingent Deferred Sales Loads, Investment Company Act Release No. 22202 (Sept. 9, 1996) [61 FR 49011 (Sept. 17, 1996)] ("1996 Rule 6c-10 Amendments").

[59] *See* 1988 Release, *supra* note 28, at n.69 and accompanying text.

These spread load arrangements raised a number of concerns for the Commission. First, the 12b-1 fees were higher than expected[60] and seemed inconsistent with one of the original arguments that fund managers had advanced in support of rule 12b-1, which was to facilitate the creation of economies of scale that would lower expenses for fund shareholders.[61] Moreover, these plans took on the appearance of more permanent arrangements, which threatened to undermine the role of fund directors in managing the use of fund assets for distribution because the arrangements created multi-year business obligations on the part of distributors. As a practical matter, the arrangements limited the ability of fund directors to terminate the plan because ending the plan would deny distributors their future payments.[62]

The Commission responded to these developments by proposing amendments to rule 12b-1 in 1988, which effectively would have prohibited spread load arrangements.[63] Many commenters opposed the proposed amendments, arguing that spread load plans benefited

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60 *Id.* at nn.116-23 and accompanying text. *See also* Goldberg and Bressler, *supra* note 52, at nn.22-24 and accompanying text.

61 *See* Advance Notice of Proposed Rulemaking, *supra* note 27, at n.3 and accompanying text ("Commentators also argued that the use of fund assets to finance distribution activities could lead to increased sales of shares, thereby alleviating the difficulties perceived to result from net redemptions or small asset size," such as higher expense ratios.). The Commission's concern about the changing uses of 12b-1 fees was later reflected in the 1988 proposal to amend rule 12b-1. The amendments would have required annual shareholder approval of 12b-1 plans, because "while shareholders may see good reason to approve a plan in the early years of a fund to stimulate growth to a sufficient level for economies of scale to be achieved, they may have a quite different opinion of the utility of a 12b-1 plan once a fund has matured." 1988 Release, *supra* note 28, at text following n.187.

62 1988 Release, *supra* note 28 at section titled "The Development and Use of 'Reimbursement' Plans." *See also* Goldberg and Bressler, *supra* note 52 ("It would be economic folly ... for a mutual fund underwriter continually to advance sales commissions to selling dealers as part of a CDSL arrangement if it were not virtually certain that the 12b-1 plan would continue in effect indefinitely.").

63 *See* 1988 Release, *supra* note 28, at nn.144-50 and accompanying text. Among other things, the 1988 proposed amendments would have required that payments under a 12b-1 plan be made on a "current basis," which would have restricted the ability of a fund to pay for distribution expenses incurred on the fund's behalf in prior years (such as when the underwriter advances payment of the sales load to the broker after completion of the sale). In addition, the proposed amendments would have required payments made under a rule 12b-1 plan to be tied to specific distribution services actually provided to the fund and its shareholders. *See also* 1992 STUDY, *supra* note 15, at 323.

investors by permitting them to defer their distribution costs and avoid high front-end loads.[64] The Commission never adopted those amendments. Instead, over the years, the Commission sought to address the developing concerns raised by rule 12b-1 by other means, as discussed below.[65]

1. Imposition of Sales Load Caps

In 1992, the Commission approved amendments to NASD Conduct Rule 2830 (the "NASD sales charge rule"), which had the effect of limiting the maximum amount of 12b-1 fees that many funds could deduct from fund assets pursuant to a rule 12b-1 plan, based roughly on

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[64] *See, e.g.*, Comment Letter of the ICI at 9-12 (Sept. 19, 1988) (File No. S7-10-88).

[65] 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 payments could be construed as an indirect use of fund assets for distribution that is unlawful unless made pursuant to a rule 12b-1 plan. *See supra* note 38. 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." *See* 1980 Adopting Release, *supra* note 23, at section titled "General Requirements." In contrast, for example, an indirect use of fund assets may result if advisory fees were increased in contemplation of distribution payments by the adviser. 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 proposed new requirements regarding disclosure of revenue sharing payments in 2004 in connection with our "Point of Sale" proposals. *See* Confirmation Requirements and Point of Sale Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Release No. 26341 (Jan. 24, 2004) [69 FR 6438 (Feb. 10, 2004)]. *See also* Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Release No. 26778 (Feb. 28, 2005) [70 FR 10521 (Mar. 4, 2005)] (reopening of comment period and supplemental request for comment). We are continuing to consider further rule amendments related to revenue sharing.

the then-existing NASD limits on sales loads.[66] While it does not directly regulate what funds can charge, the NASD (now FINRA) sales charge rule bars registered broker-dealers who are members from selling funds that impose combined sales charges that exceed certain limits. The limits vary based on whether the fund has a 12b-1 fee, a "service fee,"[67] rights of accumulation,[68] and other features.

Prior to 1992, the NASD sales charge rule had not been applied to rule 12b-1 fees that funds deducted from assets as a substitute for a front-end sales load. In 1992, the NASD determined that it was appropriate to amend the rule specifically to encompass *all* forms of mutual fund sales compensation, including these "asset-based sales charges."[69]

As amended, the rule caps the *annual* amount of asset-based sales charges that a fund may deduct at 75 basis points.[70] In addition, a fund with an asset-based sales charge is subject to

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[66] NASD Conduct Rule 2830(d). The NASD sales charge rule is currently administered by FINRA. FINRA derives its authority to regulate the level of mutual fund sales charges from section 22(b)(1) of the Act. *See supra* note 20. *See* Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Exchange Act Release No. 30897 (July 7, 1992) [57 FR 30985 (July 13, 1992)] ("1992 NASD Rule Release"). In 2009, FINRA proposed to re-codify the rule, in conjunction with its consolidation of rules issued by the NASD and by the New York Stock Exchange, and to revise the rule with regard to the disclosure of cash compensation. *See* FINRA, Investment Company Securities: FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Investment Company Securities, Regulatory Notice 09-34 (June 2009).

[67] *See infra* note 152 and accompanying text for additional information on service fees.

[68] Rights of accumulation allow investors to qualify for a reduced sales charge (or "breakpoint") based on the aggregate value of shares previously purchased or owned plus the securities being purchased. NASD Conduct Rule 2830(b)(7).

[69] The NASD explained that the changes were necessary to: (i) assure a level playing field among all members selling mutual fund shares; and (ii) prevent the circumvention of its sales charge caps through the use of rule 12b-1 plans, because it had become possible for funds to use 12b-1 plans to charge investors more for distribution than could have been charged as a front-end sales load under the existing sales charge rule. *See* NASD Notice to Members 92-41; 1992 NASD Rule Release, *supra* note 66. In its comment letter, the ICI agreed that the proposed expansion of the NASD rule to include asset-based sales charges "appropriately recognizes that Rule 12b-1 fees ... alone or in combination with [CDSLs], generally serve as the functional equivalent of traditional front-end sales loads." Comment Letter of the ICI (May 10, 1991) (File No. SR-NASD-90-69).

[70] NASD Conduct Rule 2830(d)(2)(E)(i).

an *aggregate* cap of 6.25 percent of new gross sales (rising to 7.25 percent of new gross sales if the fund does not pay a service fee), plus interest, on the total sales charges levied (*e.g.,* asset-based, front-end, and deferred).[71] This aggregate cap requires a fund with an asset-based sales charge to keep a running balance from which all sales charges imposed by the fund are deducted.[72] Because it is calculated at the fund level based on the amount of aggregate new fund shares sold, the aggregate cap does not limit the actual amount of sales charges that a particular investor may pay.[73] Thus, it is possible for a long-term shareholder in a fund with an asset-based sales charge to pay more in total sales charges than would have been the case if that investor had paid a traditional front-end load.[74]

As amended, the NASD rule also places a cap of 25 basis points on the amount of a service fee that a fund may deduct annually from fund assets in order to pay intermediaries for

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71 New gross sales excludes sales from the reinvestment of distributions and exchanges of shares between investment companies in a single complex, between classes of an investment company with multiple classes of shares, or between series of a series investment company. NASD Conduct Rule 2830(d)(2)(A) and (B).

72 In effect, so long as a fund with asset-based sales charges continues to have new sales, it may never exceed the aggregate cap.

73 For convenience, in this Release we refer to the aggregate cap as a fund-level cap, but FINRA members may treat each class of shares and each series of a fund as a separate investment company for purposes of the sales charge rule and these calculations. *See* NASD Notice to Members 93-12 at n.1 (1993) ("NASD Sales Charge Rule Q&A").

74 In our statement on the proposed rule change, we acknowledged this possibility. *See* 1992 NASD Rule Release, *supra* note 66, at discussion following n.16 ("Because the proposed rule change contemplates a minimum standard of fund-level accounting rather than individual shareholder accounting, it is possible that long-term shareholders in a mutual fund that has an asset-based sales charge may pay more in total sales [charges] than they would have paid if the mutual fund did not have an asset-based sales charge."). However, we also noted that individual shareholder accounting would be permitted under the rule amendment, and encouraged its use. *See* Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Exchange Act Release No. 29070 (April 12, 1991) [56 FR 16137 (Apr. 19, 1991)] ("NASD Notice of Proposed Rule Change") at section titled "Method of Calculating the Total Sales Charges" ("It is the NASD's intention that fund-level accounting be required at a minimum, thereby not precluding the use of more protective methods. A fund, based upon its particular circumstances and economic perspective, may choose the option of individual shareholder accounting.").

providing follow-up information and account services to clients over the course of their investment in the fund.[75] Unlike the asset-based sales charge, the service fee is not limited by an aggregate cap and, as a result, is almost always paid for an indefinite period (*i.e.*, for as long as the investor holds the shares).[76]

2. Enhanced Disclosure

Over the years, the Commission has taken several steps designed to improve investor understanding of 12b-1 fees and the impact they have on fund expenses and investor returns. We required funds to include a fee table in the prospectus identifying, among other things, the amount of any 12b-1 fee paid.[77] As part of the 1992 amendments to the NASD sales charge rule, we also approved a new provision prohibiting registered broker-dealers from describing funds as "no-load" funds if the funds charged 12b-1 fees greater than 25 basis points.[78] We amended our proxy rules to require funds to better describe material facts to shareholders when requesting approval of a rule 12b-1 plan or an amendment to the plan.[79] Through our Web site, we have also provided investors with information and tools designed to enhance their understanding of the fees and distribution expenses they pay as a consequence of owning mutual funds.[80]

3. Multiple Classes

We also permitted funds to offer multiple "classes" of shares, each with its own

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75 NASD Conduct Rule 2830(d)(5).

76 *See* 1992 NASD Rule Release, *supra* note 66, at section III.A.

77 *See* Consolidated Disclosure of Mutual Fund Expenses, Investment Company Act Release No. 16244 (Feb. 1, 1988) [53 FR 3192 (Feb. 8, 1988)].

78 *See* 1992 NASD Rule Release, *supra* note 66. *See also* NASD Conduct Rule 2830(d)(4).

79 Amendments to Proxy Rules for Registered Investment Companies, Investment Company Act Release No. 20614 (Oct. 13, 1994) [59 FR 52689 (Oct. 19, 1994)].

80 *See* Mutual Fund Cost Calculator (http://www.sec.gov/investor/tools/mfcc/mfcc-intsec.htm).

arrangement for the payment of distribution costs and related shareholder services.[81] These multiple class arrangements were designed to give investors a choice of ways to pay for sales charges.[82] Investors in one class of shares have the same investment experience as investors in the other classes, except for expenses related to distribution and shareholder services. These multiple class arrangements have been adopted by most fund groups that sell through intermediaries.[83]

Class designations are not standardized by law, although funds often use similar nomenclature.[84] Class "A" shares generally are sold with a front-end sales load, and also often have a 12b-1 fee of about 25 basis points.[85] Class "B" shares typically are sold without a front-end load but charge a spread load consisting of a 12b-1 fee of 100 basis points (the maximum rate under NASD Conduct Rule 2830, including a service fee) and a declining CDSL.

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81 *See* Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, Investment Company Act Release No. 20915 (Feb. 23, 1995) [60 FR 11876 (Mar. 2, 1995)] (adopting rule 18f-3). Rule 18f-3 contains requirements that protect the rights and obligations of each class as against all other classes, particularly with regard to shareholder voting rights, and prescribes methods for allocating income, expenses, realized gains and losses, and unrealized appreciation and depreciation among classes in a multi-class fund.

82 *See* 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, at section titled "Background" (Dec. 15, 1993) [58 FR 68074 (Dec. 23, 1993)] (stating that some funds use different classes "to offer investors a choice of methods for paying for the costs of selling fund shares"). *See also* Z. Jay. Wang, Vikram K. Nanda & Lu Zheng, *The ABCs of Mutual Funds: On the Introduction of Multiple Share Classes*, EFA 2005 Moscow Meetings Paper (Feb. 2005) (http://ssrn.com/abstract=676246); Vance P. Lesseig, D. Michael Long & Thomas I. Smythe, *Gains to Mutual Fund Sponsors Offering Multiple Share Class Funds*, 25 J. FIN. RES. 81 (2002).

83 *See* ICI, *Mutual Fund Distribution Channels and Distribution Costs* (July 2, 2003) (http://www.ici.org/pdf/per09-03.pdf).

84 The Commission staff has prepared information on mutual fund share classes, available on the Commission's Web site. *SEC, Mutual Fund Classes* (http://www.sec.gov/answers/mfclass.htm). While there are many variations, for convenience, throughout this Release we use the terms "A shares," "B shares," and "C shares" to refer to the typical share class structures, as described in the text above.

85 Class A shares may also be sold with the load waived. *See infra* note 93 and accompanying text.

Class B shares usually convert automatically to class A shares after a fixed period of time has elapsed (commonly six to eight years from the date of purchase).[86] Class "C" shares typically charge a "level load" consisting of a 100 basis point 12b-1 fee that is imposed for as long as the investor owns the shares, and also may charge a small CDSL of one percent if a shareholder redeems within the first year, but seldom convert to class A shares with lower 12b-1 fees.[87] Other classes may be available only to certain types of investors, such as those who invest in retirement plans, are institutional investors, or purchase through a particular intermediary or type of intermediary, such as a financial planner.[88]

D. The Current Role of 12b-1 Fees

Rule 12b-1 plans continue to play a significant role in paying for fund distribution costs. The majority of funds have adopted rule 12b-1 plans, which paid a total of $9.5 billion in 12b-1 fees in 2009 (down from a high of $13.3 billion in 12b-1 fees in 2007).[89]

There has been a trend in fund class share ownership away from those that impose the highest sales loads and 12b-1 fees. In recent years, no-load share classes have attracted more net

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[86] *See* 2010 ICI FACT BOOK, *supra* note 6, at 74. While there is no legal requirement for conversion, funds typically provide it. The conversion feature reflects the underlying economics of class B shares. When the underwriter recoups the commission it has advanced to the selling broker, the shareholder is considered to have paid his share of distribution costs. (If the underwriter has advanced a commission to the intermediary, it would retain 75 basis points of the 100 basis points it collects in 12b-1 fees and forward only the 25 basis points to the intermediary.)

[87] *See supra* note 84.

[88] *Id.*

[89] *See* 2010 ICI FACT BOOK, *supra* note 6, at 75. This figure excludes 12b-1 fees deducted from assets of funds underlying insurance company separate accounts offering variable annuities and mutual funds that invest primarily in other mutual funds. *See also* Comment Letter of the ICI at Appendix I (July 19, 2007) (File No. 4-538). Unless otherwise noted, references to comment letters in this Release are to letters submitted in response to the Commission's request for comments in connection with a 2007 Commission roundtable on rule 12b-1. *See* SEC Press Release, Commission Announces Roundtable Discussion Regarding Rule 12b-1 (May 29, 2007) (http://www.sec.gov/news/press/2007/2007-106.htm). These comment letters are available in File No. 4-538 (http://www.sec.gov/comments/4-538/4-538.shtml).

new cash flow than load share classes.[90] According to Investment Company Institute ("ICI") figures, in 2009, $323 billion flowed into no-load share classes of long-term mutual funds, while in comparison, load share classes only received $39 billion in net new cash flow.[91] In 2009, class B shares experienced net outflow for a seventh consecutive year, with total net outflow of approximately $24 billion.[92] In contrast, net new investment in class A shares was approximately $19 billion, and net new investment in class C shares was approximately $37 billion.[93]

Although more investors appear to be investing in no-load funds and share classes, these statistics do not reflect a trend away from using intermediaries.[94] According to the ICI, 80 percent of investors who own funds outside of a retirement plan use an intermediary that

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[90] *See* 2010 ICI FACT BOOK, *supra* note 6, at 76.

[91] *Id.* at 76.

[92] *Id*. at 76. Net outflow from B share classes can result from purchases being exceeded by: (i) redemptions; and (ii) shares converting to another class after a certain period of time. As a result of their (typically) automatic conversion feature, B shares generally are self-limiting as a class unless they continue to be sold at the same rate as they were sold previously.

[93] *Id.* at 76. Many class A shares today are sold with the load waived or substantially reduced. For example, many funds permit broker-dealers to sell their shares with the front-end load waived or substantially reduced, for use in wrap fee programs. In wrap fee programs, instead of paying a one-time sales charge for each investment purchase, a customer pays the broker an annual percentage of the assets held through that broker in exchange for the ability to buy and redeem securities without additional sales charges. According to one study, in 2008, 60 percent of class A shares were sold at NAV with the load waived. Strategic Insight Mutual Fund Research and Consulting, LLC, *Perspectives on Intermediary Sales: Trends in Fund Sales by Distribution Channel and Share Class* (May 2009). The ICI found that, although the average maximum front-end sales load on stock funds in 2009 was 5.3 percent, the average sales load actually paid by investors was only 1.0 percent, due to the impact of load-waived class A shares. *See* 2010 ICI FACT BOOK, *supra* note 6, at 65.

[94] Among households owning mutual funds, only 20 percent of these investors purchased directly from mutual funds in 2009. *See* Shareholder Profile Report, *supra* note 6, at 27. The prevalence of mutual fund "supermarkets" (described in note 96, *infra*), employer-sponsored retirement plans, and fee-based financial advisers (advisers who charge investors separately for their services rather than through a load or fee assessed at the fund level) has provided investors alternative means of purchasing no-load funds. *See* 2010 ICI FACT BOOK, *supra* note 6, at 65. Many investors now purchase no-load funds through these intermediaries.

provides professional financial assistance ("financial advisor").[95] Of those investors, almost half own funds purchased solely through financial advisors, while the rest own funds purchased through financial advisors as well as directly from fund companies, mutual fund supermarkets, or discount brokers.[96] The data suggest a growing predominance of no-load or load-waived classes in funds that traditionally were sold with a load.[97] In these circumstances, investors do not pay a sales load, but pay distribution expenses through a separate fee arranged between the intermediary and the investor, and/or through the payment of ongoing "service fees."[98]

A significant use of 12b-1 fees today is for what is typically characterized as "services" provided to investors after the sale by the broker-dealers and other intermediaries who sell the fund. According to the Investment Company Institute, more than half of all 12b-1 fees paid by funds are used for this purpose,[99] with broker-dealers and bank trust departments being the primary recipients. Under the NASD sales charge rule discussed above, up to 25 basis points of fund assets annually may be paid to members as a "service fee."[100]

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95 *See* 2010 ICI FACT BOOK, *supra* note 6, at 85.

96 *Id*. at 85. Mutual fund supermarkets, which are sponsored by brokerage firms, "permit investors to purchase and hold a broad range of funds from many different fund sponsors through a single brokerage account." ROBERT C. POZEN, THE MUTUAL FUND BUSINESS (2d Ed., 2002), at 304. The primary benefit of this "one-stop shopping venue" is simplicity: an investor can buy funds from different fund families and receive all of their statements in a single report. Discount brokers allow investors to trade securities at a lower commission rate but provide less individualized service.

97 *See* 2010 ICI FACT BOOK, *supra* note 6, at 76.

98 *See generally* CAROL GEHL, ET AL., MUTUAL FUND REGULATION § 18:6.1 (May 2008); Fee Trends Report, *supra* note 22, at 6 (noting that although in the 1980s and 1990s sales loads were a primary means of compensating brokers for services provided to investors, in recent years brokers have increasingly been compensated through "asset-based" fees).

99 *See* 2010 ICI FACT BOOK, *supra* note 6, at 73.

100 NASD Conduct Rule 2830(d)(5). The NASD rule defines "service fees" as "payments by [a fund] for personal service and/or the maintenance of shareholder accounts." NASD Conduct Rule 2830(b)(9). These services could include responding to customer inquiries, providing information on investments, and reviewing customer holdings on a regular basis, but would not include sub-transfer agency services, sub-accounting services, or administrative services. *See* NASD Sales Charge Rule Q&A, *supra* note 73, at Question #17. The NASD rule does not address whether "service fees" are required

Amounts deducted from assets in excess of a service fee are typically charged to support the fund's distribution efforts and operate as an alternative to a front-end sales load.[101] These 12b-1 fees, which are used to pay the selling costs of B and C share classes, are "asset-based sales charges" under the NASD sales charge caps and are limited to a maximum of 75 basis points of fund assets, annually, as discussed above.

A common use of 12b-1 fees is to pay for the fund to be included on third-party platforms for purchasing mutual funds, such as employer-sponsored retirement plans and fund supermarkets. Supermarkets and retirement plans have become major avenues by which investors purchase mutual funds. They have assumed many of the recordkeeping and ongoing servicing and support functions for shareholders that funds otherwise would perform, and these are often paid for, at least partially, through 12b-1 fees.[102] Under the NASD sales charge rule, no-load funds are able to compensate discount brokers and supermarkets for the costs of servicing shareholders in those channels through asset-based fees of up to 25 basis points annually of the value of fund shares that are held in the intermediary's client accounts.[103] Funds

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to be included in 12b-1 plans. *Id.* at Question #25. However, 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).

[101] According to the ICI, approximately 40 percent of 12b-1 fees are used for this purpose. *See* 2010 ICI FACT BOOK, *supra* note 6, at 73.

[102] *See infra* note 153. A representative of a large fund supermarket commented at our roundtable on rule 12b-1 that some fund advisers also pay supermarket fees through revenue sharing arrangements. *See* Roundtable Transcript, *infra* note 109, at 84-87 (John Morris, Charles Schwab & Co.). *See also supra* note 65; *infra* paragraph following note 286 (requesting comment whether investors in omnibus accounts receive equivalent levels of service relative to investors in retail accounts with similar 12b-1 fees).

[103] *See* NASD Conduct Rule 2830(d)(4). Discount brokers and fund supermarkets typically hold one account with the fund in the name of the broker, and then provide sub-accounting for individual shareholder holdings of fund shares. *See* Mutual Fund Redemption Fees, Investment Company Act

that are offered as investment options in defined contribution retirement plans also may pay 12b-1 fees (often 50 basis points or more annually) to the plan administrator to offset some of the costs of servicing shareholders (and perhaps other participants) who invest through those plans.[104]

A minor use of 12b-1 fees is to pay expenses of the fund's principal underwriter and for advertising and promotions. Although this was one of the main purposes for which 12b-1 plans originally were intended, in recent years, only about two percent of 12b-1 fees have been used to pay these types of expenses.[105]

E. Additional Commission Consideration of Rule 12b-1

In 2004, the Commission amended rule 12b-1 to prohibit fund advisers from directing fund brokerage to compensate broker-dealers for selling fund shares.[106] When we proposed those amendments, we invited comment on whether the Commission should consider additional changes to the rule, including potentially rescinding it.[107] We made this request after observing

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Release No. 26782 (Mar. 11, 2005) [70 FR 13328 (Mar. 18, 2005)] at text following n.10 ("Rule 22c-2 Adopting Release").

[104] *See* Comment Letter of Charles P. Nelson (June 19, 2007). Employers sponsoring defined contribution plans typically hire third-party administrators to advise them in selecting the investment options offered to employees, perform recordkeeping and administrative functions (*e.g.*, producing account statements and recording transactions), provide educational materials and seminars, and maintain call centers and Internet Web sites for use by plan participants. *See* ICI, *Mutual Fund Distribution Channels and Distribution Costs*, *supra* note 83.

[105] *See* 2010 ICI FACT BOOK, *supra* note 6, at 73.

[106] Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26591 (Sept. 2, 2004) [69 FR 54728 (Sept. 9, 2004)] ("2004 Rule 12b-1 Amendments Adopting Release"). Although fund advisers may choose which brokers will execute the fund's transactions when buying and selling portfolio securities, fund brokerage is an asset of the fund. We prohibited the practice of using brokerage to reward sales of fund shares because it produces powerful incentives for advisers, is potentially harmful to fund investors, and "reliance on fund directors to police the use of fund brokerage to promote the sale of fund sales is not sufficient." *Id.* at text following n.16.

[107] *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26356 at section IV (Feb. 24, 2004) [69 FR 9726 (Mar. 1, 2004)] ("2004 Rule 12b-1

that the current practice of using 12b-1 fees as a substitute for a sales load was a departure from the rule as envisioned in 1980.[108]

To further explore the available options for reforming the rule, we held a roundtable on rule 12b-1 on June 19, 2007, to solicit the views of investor advocates, fund industry representatives, independent directors, current and former regulators, representatives from broker-dealers and other intermediaries who sell fund shares, and interested observers.[109] The participants responded to Commissioners' questions regarding the costs and benefits of 12b-1 plans, the role of 12b-1 plans in current fund distribution practices, and options for reform. The roundtable discussions and the nearly 1,500 comment letters we received on the topic greatly informed our understanding of the operation of rule 12b-1 and the role it plays in the distribution of mutual funds today.

Many of the panelists and commenters representing fund management companies and intermediaries contended that the rule had benefited both funds and investors in substantial ways, and that the central problem lay with the rule's outdated requirements.[110] Some of these commenters asserted that rule 12b-1 provides a cost-efficient way of paying for services that investors want and need (*i.e.,* by "mutualizing" them), including ongoing services from financial

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Amendments Proposing Release"). Comments are available in File No. S7-09-04, at http://www.sec.gov/rules/proposed/s70904.shtml.

108 *Id.* *See also* John A. Haslem, *Investor Learning and Mutual Fund Advertising and Distribution Fees*, J. INVESTING 53 (Winter 2009) ("Haslem") (noting "the transformation of 12b-1 fees from their original primary use for advertising and promotion" and concluding that "Rule 12b-1 fees are now used primarily to reward brokers for sales of adviser mutual fund shares").

109 *See* http://www.sec.gov/spotlight/rule12b-1.htm (which provides links to various materials relating to the rule 12b-1 roundtable). An unofficial transcript of the June 19, 2007 Rule 12b-1 Roundtable is available at http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf ("Roundtable Transcript").

110 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 172 (Michael Sharp, Citi Global Wealth Management); Comment Letter of the Independent Directors Council (July 19, 2007) ("IDC supports retaining the framework of Rule 12b-1 and believes that changes to the rule should take the form of enhancements and clarifications to adapt the rule to the modern world of fund distribution.").

professionals and access to funds through fund supermarkets and retirement platforms.[111] Several participants thought that investors preferred paying rule 12b-1 fees to paying front-end loads, and equated a decision to invest in a class of shares with a 12b-1 fee with a decision to pay a sales load over time.[112] They asserted that rule 12b-1 fees were, at least in part, responsible for bringing down the overall cost of investing in funds.[113]

Many of these panelists emphasized the importance of 12b-1 fees to pay for services that matter to investors.[114] They noted that platforms such as supermarkets and retirement plans use 12b-1 fees to support their service infrastructures, including interactive Web sites, investment allocation tools, and other educational materials that are currently made available to, and benefit, fund investors in those channels.[115] Several roundtable participants and commenters also noted that 12b-1 fees paid to platforms have enabled small funds and no-load funds to compete successfully for a broader segment of the investing population in many distribution channels, which is critical to their distribution strategies.[116] This development, they contended, has been beneficial because it increases competition and helps spur innovation.[117]

Other panelists were not as sanguine about rule 12b-1. They argued that even though 12b-1 fees may pay for worthwhile services to investors, the costs of those services are obscured

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[111] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 111-113 (Paul Haaga, Capital Research Management).

[112] *See, e.g.*, *id.* at 64 (Martin Byrne, Merrill Lynch).

[113] *See, e.g.*, *id.* at 171 (Michael Sharp, Citi Global Wealth Management).

[114] *See, e.g.*, *id.* at 118-19 (Joseph Russo, Advantage Financial Group); *id.* at 180 (Barbara Roper, Consumer Federation of America). Commenters also emphasized the importance of 12b-1 fees for investor servicing. *See, e.g.*, Comment Letter of the National Association of Insurance and Financial Advisors (July 13, 2007); Comment Letter of the ICI (July 19, 2007).

[115] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 218 (Don Phillips, Morningstar).

[116] *See, e.g.*, *id.* at 67 (Mellody Hobson, Ariel Capital Management) ("We could not exist without the 12b-1 fee to grow the funds.").

[117] *See, e.g.*, Comment Letter of the ICI (July 19, 2007); Comment Letter of the Securities Industry and Financial Markets Association (July 19, 2007).

in the fund's expense ratio in a way that makes the costs less transparent and the services less likely to be priced competitively.[118] They questioned the necessity of having these types of distribution charges embedded as a fund expense. In addition, they questioned whether investors are aware of and making informed choices about the services they pay for through the 12b-1 fee, which many panelists agreed lacks the prominence of a front-end load.[119] Most commenters believed that better disclosure and more effective communication of 12b-1 fees, and the manner in which they are used, would be useful to investors.[120]

One panelist argued that 12b-1 fees have the effect of increasing expense ratios and decreasing investment returns for investors.[121] Some suggested that the Commission encourage (or require) that fees to compensate distributors be paid by investors as an account charge (through "demutualization" or "externalization").[122] They argued that externalizing these "bundled costs" would make them more visible to shareholders and that unbundling costs and

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118 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 181 (Barbara Roper, Consumer Federation of America) and 185 (Richard Phillips, K&L Gates). *See also* Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007); Comment Letter of Andrew Reyburn (July 20, 2007).

119 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 121 (Brad Barber, Univ. of Cal., Davis) ("And I think what you hear from the industry – and the message I hear over and over again – is that investors do not like front-end loads. There is a simple psychological reason for that. It's an in-your-face fee. When you pay a load fee, it comes immediately out and off the top. Whereas, if you pay a spread fee over time, it's less obvious and less salient."). *See also* Comment Letter of Michael R. Clancy (June 13, 2007) ("Very few if any clients actually understand the [12b-1] fee, or even know that they are paying it. Of the few who actually understand a front-end load, the overwhelming majority of those clients don't know that there is an ongoing fee as well.").

120 *See, e.g.*, Comment Letter of National Association of Personal Financial Advisors (July 17, 2007); Comment Letter of Donald H. Pratt (July 19, 2007); Comment Letter of the ICI (July 19, 2007).

121 *See* Roundtable Transcript, *supra* note 109, at 119-120 (Shannon Zimmerman, Motley Fool).

122 *See, e.g.*, *id.* at 103 (Thomas Selman, FINRA). *See also* Comment Letter of Michael R. Clancy (June 13, 2007); Comment Letter of Neil J. McCarthy, Jr. (June 19, 2007); Comment Letter of Michael Murray (June 21, 2007).

services promotes more efficient pricing of those services.[123] Representatives of fund management companies and others countered that such a fee structure already exists in the form of a mutual fund "wrap" account and other types of fee-based service arrangements that charge fees comparable to the maximum 100 basis point 12b-1 fee. They argued that it is more cost-effective and tax-efficient for funds to collect 12b-1 fees and credit the intermediaries, than it is for the intermediaries to charge their clients directly through wrap accounts.[124] As discussed above, although more investors today invest in no-load funds and share classes, this trend does not reflect the decreasing use of intermediaries, but rather the growing use of wrap accounts and other arrangements between intermediaries and investors that entail separate fees.[125]

Several participants suggested that the term "12b-1 fee" causes confusion because it encompasses so many different activities.[126] Most roundtable participants agreed that greater transparency and better communication of what 12b-1 fees are and how they are used are vital to enabling investors to make optimal choices among the alternatives offered to them.[127] Some panelists were troubled that, according to academic studies, many investors do not appear to have

[123] *See, e.g.,* Roundtable Transcript, *supra* note 109, at 132 (Shannon Zimmerman, Motley Fool); 204-07 (Richard M. Phillips, K&L Gates). *See also* Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007) ("Mutualization of [12b-1] fees inhibits an investor from having the necessary information on price vs. value to make economic choices across service providers. This distorts fundamental, free-market economics and restricts valuable competition in the intermediary channel.").

[124] *See, e.g.,* Roundtable Transcript, *supra* note 109, at 170-72 (Michael Sharp, Citi Global Wealth Management). *See also* Comment Letter of the ICI (July 19, 2007) ("There are significant tax and operational disadvantages to imposing 12b-1 fees at the account-level that likely would outweigh the benefits of this approach.").

[125] *See supra* text accompanying notes 97 and 98.

[126] *See, e.g.,* Roundtable Transcript, *supra* note 109, at 58 (Paul Haaga, Capital Research Management). *See also* Comment Letter of the Independent Directors Council (July 19, 2007) ("IDC recognizes that one term may not be sufficient given the wide variety of usage of 12b-1 fees ….").

[127] *See, e.g.,* Roundtable Transcript, *supra* note 109, at 141-54 (multiple commenters). *See also* Comment Letter of the ICI (July 19, 2007) ("Many commentators … questioned the extent to which investors are aware of the nature and purpose of 12b-1 fees and suggested that disclosure of the fees and other distribution related costs can and should be improved. We agree.").

a strong understanding of fund fees and expenses or their impact on investment returns. In particular, some participants were concerned that, because 12b-1 fees are paid automatically in small increments over time, they are much less obvious to investors than front-end sales loads.[128] Unlike traditional loads, 12b-1 fees are deducted from fund assets, and are reflected in lower investment returns, rather than deducted directly from shareholder accounts.[129] As a result, they may not be fully appreciated as a sales charge.[130] In addition, the expanding number of share classes and the overall complexity of fund load structures can further overwhelm and confuse investors.[131]

Many roundtable participants and commenters agreed that rule 12b-1 would benefit from revision, but they differed on the best course for going forward. Many participants and

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[128] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 121-22 (Brad Barber, Univ. of Cal., Davis).

[129] One panelist remarked that the spread load exists because "it provided a distribution channel for brokers, one that was an alternative and has many positive characteristics, but also makes the costs quite non-transparent. And I don't think that is a coincidence. The growth and use of these funds, at a time when there was a lot of press around no-load funds, I think there was a reason brokers wanted to receive their compensation for the services they provided in a way that did not allow investors to easily put a price tag on those services." *Id.* at 180-81 (Barbara Roper, Consumer Federation of America). *See also* Comment Letter of the National Association of Personal Financial Advisors (July 17, 2007) ("We believe that individual investors are confused about the purpose of 12b-1 fees and their impact upon their own returns.").

[130] *See* GENERAL ACCOUNTING OFFICE ("GAO"), MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 75 (June 2000) (observing that investors are more aware of sales loads than operating expense fees, and are increasingly resistant to paying the higher front-end loads). *See also* Todd Houge and Jay Wellman, *The Use and Abuse of Mutual Fund Expenses* (Jan. 31, 2006) (academic working paper) (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880463) ("While mutual fund investors are often aware of up-front charges like sales loads, research shows they are often less cognizant of annual operating expenses, even though both types of fees are deadweight costs.").

[131] *See, e.g.*, Comment Letter of Mark Freeland (June 19, 2007) ("The complexity of pricing structures makes it more difficult for the small investor to compare prices and services of different advisers."). One commenter expressed concern that the proliferation of share classes may increase costs to funds and thereby hinder shareholder returns. *See* Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007) ("[T]his increase in share classes increases the fund's cost of accounting, filings, shareholder servicing (e.g., prospectus review, drafting, printing, mailing), blue sky registration, transfer agency, board review, etc. These costs are a drain to shareholder returns.").

commenters suggested that the Commission merely revise the factors for board consideration, or refashion the role of the board in overseeing 12b-1 fees, to better reflect the economic realities of fund distribution in today's market.[132] Others recommended that the Commission improve disclosure of 12b-1 fees by changing the name of the fees or, more significantly, by requiring individualized account statement disclosure of the amount of 12b-1 fees actually paid by individual shareholders.[133] Some suggested, as discussed above, that 12b-1 fees should be "externalized," that is, deducted directly from shareholder accounts rather than fund assets.[134] Finally, some commenters argued that rule 12b-1 has outlived its original purpose, and should be substantially revised or repealed.[135]

Roundtable participants generally agreed that 12b-1 fees currently are used to an extent

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132 *See, e.g.,* Roundtable Transcript, *supra* note 109. at 50-51 (Joel Goldberg, Willkie Farr & Gallagher) and 201-02 (Mark Fetting, Legg Mason, Inc.).

133 *See, e.g., id.* at 222-23 (Avi Nachmany, Strategic Insight) and 154 (John A. Hill, Putnam Funds); Comment Letter of Access Data Corp. (July 19, 2007) (account-level disclosure of 12b-1 fees is not cost-prohibitive, and would "ensure that shareholders have full disclosure and fee transparency so that they can make an informed decision related to the fees they pay versus the services they receive."). *See also* GAO, MUTUAL FUNDS: GREATER TRANSPARENCY NEEDED IN DISCLOSURES TO INVESTORS at 54 (GAO-03-763) (June 9, 2003) (providing investors with specific dollar amounts of expenses paid or placing fee-related disclosure in quarterly account statements could increase fee transparency). *But see* Comment Letter of W. Hardy Callcott (June 18, 2007) (individualized disclosure of 12b-1 fees would entail significant costs and would not, standing alone, be meaningful to investors). We discuss the costs associated with rule 12b-1 and our proposed amendments in the Cost Benefit Analysis Section of this Release. *See infra* Section V.

134 *See, e.g*., Roundtable Transcript, *supra* note 109, at 204-06 (Richard Phillips, K&L Gates); Comment Letter of CFA Institute (Aug. 9, 2004) (File No. S7-09-04) ("We also recommend that funds be required to deduct distribution-related costs directly from shareholder accounts as a separate line item, rather than from fund assets.").

135 *See, e.g.,* Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007); Comment Letter of Lauren Garland (June 2, 2007); Comment Letter of Andrew Gross (June 9, 2007); Comment Letter of Melvyn H. Mark (June 17, 2007); Comment Letter of Michael Murray (June 21, 2007). *See also* Comment Letter of JoNell Hermanson (July 9, 2007) (stating that variable insurance products should not be permitted to charge 12b-1 fees); Comment Letter of Steve Wiands (Aug. 6, 2007) (stating that funds closed to new investors should not be permitted to charge 12b-1 fees).

and in ways that are different than originally envisioned.[136] This has caused a "disconnect" to develop between the requirements of the rule and its application. For example, roundtable participants were in general agreement that the nine "factors" that the Commission provided as guidance to the board are no longer as relevant to the current uses of 12b-1 fees. They stated that the ensuing legal uncertainties have made it more difficult for directors to perform their duties and make their required findings under the rule.[137] They also said that, although directors complete the required analysis, they tend to view 12b-1 fees as a necessity – either to recoup outlays already made or to pay intermediaries at a rate already decided by the intermediary or the marketplace – to the point that 12b-1 plans tend always to be continued from year to year.[138]

Fund directors also observed that, in many instances, they and their funds lack the bargaining power to effectively negotiate the level of fees that are paid to financial intermediaries through 12b-1 plans and other sources.[139] This is particularly true in the case of fund supermarkets, where the sponsor may charge all participating funds according to the same rate schedule. These and other statements made at the roundtable and in the comment letters suggest that one of the fundamental premises of rule 12b-1 – that independent directors would play an active part in setting distribution fees – does not reflect the current economic realities of fund distribution and the role 12b-1 fees play in it.

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[136] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 192 (Richard Phillips, K&L Gates) and 194 (Mark Fetting, Legg Mason, Inc.).

[137] *See, e.g.*, *id.* at 105 (Robert Uek, MFS Funds) and 158 (John Hill, Putnam Funds). One panelist did not view the factors as posing a significant obstacle to current distribution arrangements, however. *Id.* at 33-34 (Matthew Fink, Former President, ICI) ("The rule expressly says these factors are suggestions…So the fact that you may be approving a plan that the purported or suggested factors don't fit, it's totally irrelevant.").

[138] *See, e.g.*, *id.* at 140 (Jeffrey Keil, Keil Fiduciary Strategies).

[139] *Cf.* Comment Letter of the Independent Directors Council (July 19, 2007) ("We are not aware of any board that has failed to renew a 12b-1 plan (or is likely to do so) ….").

III. DISCUSSION

We have carefully considered these and other views that emerged from the roundtable discussion and the many comment letters we subsequently received. Many of the letters highlighted issues that have arisen with the current operation of the rule.[140] We heard arguments advocating substantial change in how investors pay distribution costs, most of which are, at their core, arguments for greater transparency. We also heard concerns that significant changes could disrupt arrangements that are today deeply embedded in mutual fund sales and distribution networks, including those that finance the operation of fund supermarkets, retirement plan platforms, and financial planning. These arguments supported the preservation of business models that were developed around an existing regulatory framework, but tended to discount some of the more troubling aspects of distribution arrangements that affect millions of American investors. We have evaluated all of these views in developing this proposal, which is designed, as discussed further below, to enhance transparency and fairness to the benefit of investors.

We do not believe that it would benefit fund investors to return to the era in which they paid a substantial front-end sales load and did not have access to various alternative forms of distribution payment arrangements. Denying investors the ability to select alternate distribution methods or to pay for distribution services over time is not a goal of this rulemaking. Thus, we are not proposing in this rulemaking to prohibit the use of fund assets to pay sales costs. We remain concerned, however, about the conflicts of interest that arise when fund assets are used

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[140] *See supra* note 89. Of the nearly 1500 comment letters we received, over 1400 were sent by financial planners and registered broker-dealers who opposed substantive reform of rule 12b-1. Of these 1400 letters, almost 1000 were form letters. *See* Comment Letter Type A; Comment Letter Type B. We received approximately 25 letters from mutual funds, large broker-dealer firms, insurance companies, industry associations, and law firms. The majority of these letters also opposed significant rule reform, but expressed various levels of support for changing the name of the fee, requiring additional disclosure, and revising the role of the fund board in approving the plan. We received approximately 10 letters from investors, most of whom supported substantive reform or repeal of the rule.

for distribution, and that fund directors monitor those conflicts. We also do not believe that merely modifying the "factors" for director consideration in order to accommodate existing industry practices would sufficiently address the issues we have identified with the use of fund assets to pay for distribution under rule 12b-1.

Therefore, we are proposing a new approach to asset-based distribution fees (*i.e.*, 12b-1 fees) that is designed to benefit fund shareholders while minimizing disruption of current arrangements. Specifically, our proposal would explicitly recognize that a portion of asset-based distribution fees (*i.e.*, asset-based sales charges) functions like a sales load that is paid over time, and thus should be subject to the requirements and limitations that apply to traditional sales loads.[141] Limits on asset-based sales charges would be applied to the amounts paid by each investor (rather than amounts paid by the fund) in order to assure that each shareholder would pay only his or her proportionate share of distribution related costs. In addition, we propose to require funds to identify for shareholders that portion of asset-based distribution fees (today's 12b-1 fees) that operates as a substitute for a sales load and thus facilitate comparison with the distribution related costs of other funds or classes of shares. The proposed new rule and rule amendments would replace current rule 12b-1.

We describe the details of our proposals in the next sections of this Release. In Section III.M of this Release, we describe the anticipated impact of these proposals on investors, fund managers and directors, broker-dealers, and other intermediaries.

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141 We acknowledged this, at least implicitly, when we approved the NASD sales charge rule amendments in 1992. We observed that the "purpose of the revised maximum sales charge rule is to create 'approximate economic equivalency' as to the maximum sales charges for different types of mutual funds." *See* 1992 NASD Rule Release, *supra* note 66, at section V. The Commission believed the amendments would, among other things, promote fairness by assuring "some degree of parity" between the sales and sales-promotion expenses charged by traditional load classes and classes that assess 12b-1 fees. *Id.*

A. Summary of Our Proposals

The new approach we propose would, like NASD Conduct Rule 2830, differentiate between the two constituent parts of current 12b-1 fees (asset-based sales charges and service fees). Under proposed new rule 12b-2, funds could continue to use a limited amount of fund assets to pay for distribution related expenses.[142] The maximum amount of this "marketing and service fee" would be tied to the service fee limit imposed by the NASD sales charge rule (currently 25 basis points per year).[143] Unlike the service fee, however, funds could use this portion of fund assets for any distribution related expenses. This approach would serve the interests of investors and other members of the fund marketplace by providing a means of paying for participation in fund supermarkets and the maintenance of shareholder accounts, among other things, and allowing funds to support their own marketing and distribution strategies.

We also propose to permit funds to deduct from fund assets amounts *in excess of* the marketing and service fee, and we would treat these amounts as an alternative means to pay a front-end sales load. To accomplish this, we propose to amend rule 6c-10 (which permits funds to charge deferred loads) to permit this asset-based sales charge, which we would call an "ongoing sales charge." The proposed amendments in effect would treat ongoing sales charges as another form of sales load.

Our proposed amendment to rule 6c-10 would not require any special board findings (such as those required by rule 12b-1), a written plan, annual renewal, or automatic termination provisions, or impose fund governance requirements. Instead, we would apply limits on asset-based sales charges by referencing the front-end load imposed by the fund or, if none, by referencing the aggregate sales load cap imposed under the NASD sales charge rule for funds

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142 Proposed rule 12b-2(b).

143 Proposed rule 12b-2(b)(1); NASD Conduct Rule 2830(d)(5).

with an asset-based sales charge and service fee (currently 6.25 percent).[144]

These limits would be based on the cumulative amount of sales charges that an investor pays in any form (front-end, deferred, or asset-based). Under the proposed rule amendment, a fund imposing an ongoing sales charge would be required to automatically convert fund shares to a class of shares without an ongoing sales charge no later than when the investor has paid cumulative charges that approximate the amount the investor otherwise would have paid through a traditional front-end load (or, if none, the NASD rule 6.25 percent cap).[145] The proposed amendment would shift the focus of the limits from how much fund underwriters may collect in asset-based sales charges (a fund-level cap) to how much individual shareholders will pay either directly or indirectly (a shareholder account-level cap).

We are also proposing to amend rule 6c-10 to permit an alternative, elective distribution model. In this new model, intermediaries of funds could impose charges for sales of the fund's shares at negotiated rates, much like they charge commissions on sales of exchange-traded funds (ETFs)[146] and other equity securities. The proposed rule would permit fund intermediaries to charge sales loads other than those established by the fund underwriter and disclosed in the fund prospectus.

B. Rescission of Rule 12b-1

We propose, first, to rescind rule 12b-1 in its entirety.[147] As we discussed in detail above,

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[144] NASD Conduct Rule 2830(d)(2)(A).

[145] *See infra* note 171 and accompanying text.

[146] ETFs are registered investment companies that offer public investors an undivided interest in a pool of securities. They are similar in many ways to traditional mutual funds, except that shares in an ETF can be bought and sold throughout the day through a broker-dealer, like stocks traded on an exchange.

[147] As discussed in more detail in Section III.N of this Release, we are proposing a grandfathering provision that would permit funds to deduct existing 12b-1 fees with respect to shares issued prior to

rule 12b-1 was adopted in response to a set of problems identified by the Commission in the late 1970s. But many of the assumptions underlying the rule appear to no longer reflect current marketplace realities, including the role that 12b-1 fees play in the distribution of fund shares and the tasks that directors should be required to undertake in considering whether to approve 12b-1 fees. Moreover, the rule has confounded many investors who remain unsure what a "12b-1 fee" is, how it impacts their account, and whether they should be willing to invest in a fund that imposes such a fee. Finally, the application of rule 12b-1 today reflects the confusion that has accumulated over the years as lawyers have sought to provide answers to questions that have arisen in the course of the rule's evolution.

Therefore, we have decided not to propose to amend existing rule 12b-1, but to propose a new regulatory framework to address how fund assets may be used to finance distribution costs.[148] We believe the proposed rules, as described in more detail below, would better address current investor protection concerns raised by the use of fund assets as alternatives to sales loads and as a means of financing other types of distribution costs.

We note that Regulation R under the Exchange Act,[149] which provides banks exceptions and exemptions from broker-dealer registration, specifically references fees that banks and their employees receive pursuant to plans under rule 12b-1.[150]

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the compliance date for the proposed new rule and rule amendments, which we anticipate would be at least 18 months from the effective date in the adopting release.

[148] Although we propose to rescind rule 12b-1, proposed rule 12b-2 retains the section in rule 12b-1 that restricts certain directed brokerage practices. *See* 2004 Rule 12b-1 Amendments Adopting Release, *supra* note 106. We believe that the concerns we discussed in that adopting release regarding using directed brokerage to finance the distribution of fund shares continue to apply under our new proposal, and we propose to retain the section we adopted in 2004 unchanged. *See* proposed rule 12b-2(c).

[149] 17 CFR Part 247.

[150] 17 CFR 247.721(a)(4)(iii)(A), 247.760(c).

- We have not intended that the proposed rule affect those exceptions and exemptions, and we request comment on whether further rulemaking, clarification, or interpretive guidance is necessary or appropriate in this regard.

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

We propose a new rule 12b-2, which would permit funds, with respect to any class of fund shares, to deduct a fee of up to the NASD service fee limit (which is 25 basis points or 0.25 percent annually) from fund assets to pay for distribution activities, without being subject to the limitations on sales loads that we describe in the next section of this Release.[151] Although the fee could be used for any type of distribution cost, we anticipate it primarily would be used to pay for servicing fees of the type currently permitted by the NASD sales charge rule,[152] trail commissions to broker-dealers selling fund shares, and other expenses, such as fees paid to fund supermarkets, that may in part be distribution related.[153] This proposed rule would permit funds

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151 Proposed rule 12b-2(b).

152 *See* NASD Sales Charge Rule Q&A, *supra* note 73, at question 17 (explaining the types of activities for which services fees may be used).

153 As discussed above, we have previously stated that funds may pay for non-distribution expenses under rule 12b-1 plans. *See supra* note 43 and accompanying text. Fund expenditures under current 12b-1 plans often pay for a mixture of distribution and administrative services. For example, some funds may pay their entire fund supermarket fee under a rule 12b-1 plan, even though portions of the fee may pay for administrative services that are not distribution related. A fund need not determine which portion of the fee is primarily for distribution services or which portion is primarily for administrative services, and it may be impractical and burdensome to require funds to allocate expenses. *See* Martin G. Byrne, *The Payment of Fund Supermarket Fees By Investment Companies*, 3 INVESTMENT LAW. 2 (1996) ("[B]ecause the services that are provided to a fund in a supermarket are a combination of distribution, subaccounting, administrative, account maintenance, and other shareholder services, some portion of [a supermarket fee] may be considered a payment 'primarily intended' to result in sales of a fund's shares pursuant to Rule 12b-1 …. Because a fund with a Rule 12b-1 plan is expressly permitted to pay for distribution services, it is not critical to determine whether a particular service it pays for in connection with [a supermarket fee] is or is not for distribution."). Similarly, proposed rule 12b-2 would not preclude funds from paying for these types of mixed expenses under rule 12b-2. 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. *See* 1988 Release, *supra* note 28, at n.126 ("[T]o the extent a fund is paying for legitimate non-

to bear expenses similar to those that fund boards generally approved shortly after our adoption of rule 12b-1 in 1980.[154]

Unlike rule 12b-1, rule 12b-2 would not require directors to adopt or renew a "plan" or make any special findings.[155] Rather, fund boards would have the ability to authorize the use of fund assets to finance distribution activities consistent with the limits of the rule and their fiduciary obligations to the fund and fund shareholders.[156] A plan would not be required under our proposal because the proposed rules and rule amendments are structured to impose limits and safeguards on the use of fund assets for distribution, without the need for board approval of a plan. We intend that the board (including the independent directors) would oversee the amount

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distribution services, such payments need not be made under a 12b-1 plan, even if the recipient of the payments is also involved in the distribution of fund shares."). *See also supra* Section III.C of this Release. Conversely, simply characterizing an activity as "administrative" would not permit a fund to pay for it entirely outside of proposed rule 12b-2 if all or a portion of the fee is distribution related. *See, e.g.*, In the Matter of BISYS Fund Services, Inc., Investment Company Act Release No. 27500 (Sept. 26, 2006) (Commission order instituting settled administrative and cease-and-desist proceedings arising out of the improper use of fund assets for marketing and other expenses).

[154] *See supra* note 55.

[155] Some funds and fund boards have adopted so-called "defensive" rule 12b-1 plans that do not impose distribution fees on the fund, but are designed to ensure that the board and the fund do not violate the Act if fund expenditures are subsequently determined to be primarily intended to result in the sale of fund shares. *See* ICI, *Report of the Working Group on Rule 12b-1* at n.71 (May 2007) (http://www.ici.org/pdf/rpt_07_12b-1.pdf). Although 12b-1 plans (including "defensive" ones) would no longer be required to be entered into under our proposed amendments, the exemption provided by rule 12b-2 could serve the same purpose as a defensive plan to the extent that the amount of assets permitted to be used for distribution under rule 12b-2 has not otherwise been fully utilized.

[156] Section 36(a) of the Act "establishe[s] a federal standard of fiduciary duty" in dealings between a mutual fund and certain other persons, including its adviser, principal underwriter, officers and directors, among others. *See Tannenbaum v. Zeller*, 552 F.2d 402, 416 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977). Section 36(a) applies to acts or practices constituting a breach of fiduciary duty involving "personal misconduct" on the part of the person acting for or serving the fund in the enumerated capacities. This federal standard is at least as stringent as standards of care prescribed for fiduciaries under common law, such as the duty of care and the duty of loyalty. *See id.* at n.20. *See also* Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, Investment Company Act Release No. 28345 (July 30, 2008) [73 FR 45646 (Aug. 6, 2008)] at section titled "Summary of Law Regarding Fiduciary Responsibilities of Investment Company Directors" (discussing state and federal law fiduciary obligations of fund directors).

and uses of these fees in the same manner that it oversees the use of fund assets to pay any other fund operating expenses, particularly those that create a potential conflict of interest for the fund's investment adviser or other affiliated persons.[157] The rule would recognize that funds bear *ongoing* expenses that, although they are distribution related, may benefit the fund and existing fund shareholders in a variety of ways. The marketing and service fee would be specifically identified and fully disclosed in the fund prospectus fee table as a type of operating expense.[158]

Funds may use the proceeds of the marketing and service fee to pay for, for example, the ongoing cost of participation on a distribution platform such as a fund supermarket, giving investors a convenient way of buying shares; for paying trail commissions to broker-dealers in recognition of the ongoing services they provide to fund investors; or for paying retirement plan administrators for the services they provide participants (and which relieve the fund from providing such services). In addition, funds (including no-load funds) may use the marketing and service fee to pay for shareholder call centers, compensation of underwriters, advertising, printing and mailing of prospectuses to other than current (*i.e.*, prospective) shareholders, and other traditional distribution activities.[159]

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157 Congress intended that independent directors play a critical role in overseeing fund operations and protecting the interests of shareholders in view of the substantial conflicts of interest that exist between a fund and its investment adviser. *See House Hearings*, *supra* note 26, at 109; *Burks v. Lasker*, 441 U.S. 471 (1979). When possible conflicts are present, fund management is under a duty to fully and effectively disclose information sufficient for the independent directors to exercise informed discretion on the matters put before them. *See, e.g.*, *Tannenbaum*, 522 F.2d at 417, citing *Fogel v. Chestnutt*, 533 F. 2d 731, 745 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976) and *Moses v. Burgin*, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971).

158 We are proposing amendments to the prospectus fee table, which are discussed in Section III.J of this Release, *infra*. We are also proposing to require funds imposing a new marketing and service fee, or increasing the rate of an existing 12b-1 fee that would be used as a marketing and service fee, to obtain the approval of their shareholders. This requirement is discussed in Section III.F of this Release, *infra*.

159 *See* proposed rule 12b-2(b), (e).

Under the proposed rule, the marketing and service fee could not, on an annual basis, exceed the limits on service fees prescribed by the NASD sales charge rule (currently 0.25 percent of fund net assets annually). Any charge in excess of 0.25 percent per year would be considered an asset-based sales charge and subject to the overall sales load limitations established by the NASD sales charge rule and other requirements, as discussed in the next section of this Release. We chose to propose this limit because it would permit, without change, the continuation of many important uses of 12b-1 fees that may benefit investors. It also represents the line the NASD sales charge rule draws between a limited distribution fee and a sales charge – 25 basis points currently is the limit that a fund may deduct and still call itself a "no-load" fund.[160] The NASD drew upon its knowledge and expertise as the self-regulatory organization of the brokerage industry to develop these limits, which we approved as an appropriate exercise of the NASD's congressional mandate to prevent excessive sales charges on mutual fund shares.[161] Accordingly, we have used the NASD limit on service fees in formulating our proposal to distinguish a limited distribution fee from a sales charge.

We request comment on the proposal to limit the marketing and service fee to the maximum service fee permitted under the NASD sales charge rule.

- Would a different term, such as "sales/service fee," be more appropriate? If so, why? Would a different limit be more appropriate? Should the limit be higher (*e.g.*, 30 or

[160] Specifically, NASD Conduct Rule 2830(d)(4) prohibits any member from describing a fund as "no-load" if the fund has combined asset-based sales charges and services fees of more than 0.25 percent of average annual net assets. This provision is intended to help investors distinguish between funds that use relatively small 12b-1 fees to finance advertising and other sales promotion activities, similar to traditional no-load funds, and funds that use larger 12b-1 fees as alternatives to front-end sales loads. *See* 1992 NASD Rule Release, *supra* note 66. *See also* The Vanguard Group, *supra* note 31 (order permitting the Vanguard Group to call its funds no-load even though they made small distribution payments of 0.20% of average annual net assets).

[161] *See* 1992 NASD Rule Release, *supra* note 66, at section V; 15 U.S.C. § 80a-22(b).

50 basis points) or lower (*e.g.*, 10 or 20 basis points)? If so, why? Should the limit be set with reference to the NASD rule, which would allow the NASD (now FINRA) to change the level, pending approval by the Commission?

We understand that many share classes either do not currently charge 12b-1 fees in an amount that exceeds 25 basis points, or charge none at all.[162] Many funds use these fees to compensate intermediaries for providing customers with follow-up information and account maintenance services pursuant to the NASD sales charge rule. In such cases, the shareholder service fees may in fact have a significant distribution component, which is why funds often pay them pursuant to a rule 12b-1 plan.[163] We do not propose, however, to limit the use of the marketing and service fee to these types of services (*i.e.*, those described in the NASD sales charge rule), so that funds may continue to use fund assets to pay for promotional and advertising expenses.

- Should we limit the marketing and service fee to expenses incurred for "shareholder services" as defined in the NASD sales charge rule? More generally, do investors in omnibus accounts receive equivalent levels of service relative to investors who invest directly and pay similar 12b-1 fees? Is there a disparity in service, and if so, why? What implications does this have for our proposal?

Under the proposal, "distribution activity" would be defined as "any activity that is primarily intended to result in the sale of shares issued by the fund, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing

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162 *See infra* Section III.M.2 of this Release.

163 *See* SEC, MUTUAL FUND FEES AND EXPENSES (2007) (http://www.sec.gov/answers/mffees.htm). Funds may decide that the stream of payments to a broker-dealer for providing client services (that it would have provided anyway) could be viewed as an incentive for the broker-dealer to continue selling the fund.

and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature."[164] The proposed rule does not attempt to delineate permissible distribution expenses because our experience with rule 12b-1 has shown that new distribution methods continually evolve.

- Are the identified activities appropriately considered "distribution activities"? Should we provide more guidance regarding specific expenditures that are distribution expenses and others that are not, as some commenters have suggested?[165] Should we define "distribution activity" differently? If so, how should we define it? Should funds be permitted to classify only certain expenses as marketing and service fees?[166] If so, what types of expenses?

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

The proposed amendments to rule 6c-10 would permit funds to deduct asset-based distribution fees *in excess of* the amount permitted under rule 12b-2 (*i.e.,* 25 basis points annually), provided that the excess amount is considered an "ongoing sales charge" subject to the sales charge restrictions described below, including an automatic conversion feature.[167] Funds

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[164] Proposed rule 12b-2(e)(2). The proposed definition of "distribution activity" is identical to the description of distribution in rule 12b-1. *See* rule 12b-1(a)(2). Because funds continually market themselves to investors, many types of activities may potentially be construed as "primarily intended" to result in fund sales. Although the definition provides flexibility, similar to rule 12b-1, distribution activities paid for through asset-based distribution fees under proposed rule 12b-2 and the proposed amendment to rule 6c-10 (as under rule 12b-1) must represent legitimate expenses of the fund. *See, e.g.,* Exemptions for Certain Registered Open-End Management Investment Companies to Impose Deferred Sales Loads, Investment Company Act Release No. 16619 at n. 3 (Nov. 2, 1988) [53 FR 45275 (Nov. 9, 1988)].

[165] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 167 (Jeffrey Keil, Keil Fiduciary Strategies) ("[D]istribution expenditures should be defined in some way, shape, or form, or [the rule should] say what's not a distribution expenditure.").

[166] *See, e.g.*, 2004 Rule 12b-1 Amendments Adopting Release, *supra* note 106.

[167] Proposed rule 6c-10(b). We would title this section of the rule "Fund-Level Sales Charge" to distinguish it from a current provision of rule 6c-10 that provides an exemption to permit funds to deduct a "Deferred Sales Load" (*e.g.*, CDSL) (rule 6c-10(a) from shareholder accounts, and a

would not have to adopt a "plan" in order to impose an ongoing sales charge, and fund boards would not be required to make any special findings. In short, the proposed rule would treat ongoing sales charges as another form of deferred sales load.[168]

Under the proposed provision, a fund could deduct an ongoing sales charge to finance distribution activities at a rate established by the fund, provided that the cumulative amount of sales charges the investor pays on any purchase of fund shares does not exceed the amount of the highest front-end load that the investor would have paid had the investor invested in another class of shares of the same fund.[169] For example, if a fund has class A shares with a six percent front-end sales load, the fund could pay as much as six percent in total ongoing sales charges in class B shares. If another class of shares charges a front-end sales load of, for example, two percent, a total ongoing sales charge of as much as four percent could also be charged (six percent minus the two percent front-end load) with respect to that class.

We seek comment on whether the Commission should treat ongoing sales charges as a form of deferred sales load subject to the NASD sales charge limitations. We also seek comment on whether the proposed amendments to rule 6c-10, as described in more detail below, accomplish this goal.

- Do the sales charge limitations, as we propose to apply them, adequately protect investors from excessive sales loads in accordance with the objectives of section 22(b) of the Act? Would any aspect of these proposed sales charge limitations

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proposed alternative that would provide an exemption from section 22(d) of the Act to permit broker-dealers to deduct "Account-Level Sales Charges" (proposed rule 6c-10(c)).

168 As a form of deferred sales load, all payments of ongoing sales charges to intermediaries would constitute transaction-based compensation. Intermediaries receiving those payments thus would need to register as broker-dealers under section 15 of the Exchange Act unless they can avail themselves of an exception or exemption from registration. Marketing and service fees paid to an intermediary may similarly require the intermediary to register under the Exchange Act.

169 Proposed rule 6c-10(b)(1).

encourage broker-dealers to recommend "switching" between fund families once an investor has reached the ongoing sale charge limits? If so, does this proposal raise any issues (that do not already exist with regard to other classes) that would encourage such switching, in light of current NASD sales charge limits? What effect could the proposed rule have on the various types of share classes currently offered by funds? For example, would funds or distributors reduce, eliminate, or increase the offering of share classes with asset-based sales charges? To the extent that broker-dealers rely on ongoing sales charges as compensation for ongoing services to investors, could the quantity or quality of the services provided change if the rule results in limits on cumulative ongoing sales charges?

1. Automatic Conversion

Under the proposed amendments, funds or fund intermediaries would not be required to keep track of the actual dollar amount of ongoing sales charges paid by each individual shareholder account (although they may choose to do so) to avoid exceeding the rule's maximum sales charge limitation.[170] A fund could satisfy the maximum sales charge limitation by providing that the shares purchased would automatically convert to another class of shares without an ongoing sales charge *no later than* the end of the month during which the fund would have paid on behalf of the investor the maximum amount of permitted sales load based on the cumulative rates charged each year.[171] In addition, a fund could impose a CDSL in combination

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[170] We understand that many funds lack the ability to track dollar amounts of distribution expenses charged to purchases by individual investors.

[171] Proposed rule 6c-10(b)(1)(i) (providing that a fund may comply with the maximum sales charge limits by converting shares on or before the end of the conversion period); proposed rule 6c-10(d)(2) (defining "conversion period" as "the period beginning on the day that shares are purchased and ending on the last day of the calendar month during which the cumulative ongoing sales charge rates exceed the shareholder's maximum sales load rate"). The rule would permit conversion periods to be

with an ongoing sales charge, but total sales charges could not exceed the maximum sales charge limitation.[172]

The maximum number of months a shareholder could remain invested in a class of shares paying an ongoing sales charge would depend both on the maximum sales load and the rate of the ongoing sales charge. Thus, for example, if the maximum sales load for the fund is three percent, the ongoing sales charge could be 50 basis points annually for six years. Alternatively, the fund could collect 25 basis points annually for 12 years, 75 basis points annually for four years, 150 basis points annually for two years, and so on.

We have designed the conversion provisions of the rule so that the maximum conversion date is easily determinable at the time the investor purchases fund shares (as is a front-end sales load).[173] As a result, the fund or intermediary would be able to provide this information to an investor or a prospective investor at the time he or she makes or is considering making an

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computed as of the end of the calendar month because that would conform to the way most funds presently compute conversion periods with respect to class B shares.

Thus, for example, the provision would operate as follows: Assume that a fund offers a class A share with a 6% front-end load and no ongoing sales charge. The same fund could also offer a class of C shares with an annual ongoing sales charge of 0.75%, provided that: (i) the class C shares convert to class A shares in 96 months or earlier ([6.0% ÷ 0.75%] x 12 = 96 months or 8 years); and (ii) the class C shares do not impose any other loads.

[172] Using the example in note 171, *supra*, a fund offering a class A share with a 6% front-end load could also offer a class B share that is subject to an annual ongoing sales charge of 0.75% with a declining CDSL. The maximum CDSL that the fund could charge on a purchase of class B shares would be 5.25% in the first year, 4.5% in the second year, 3.75% in the third year, and so on. At the end of the eighth year following the purchase, the fund would be required to convert the class B shares to a share class that does not charge an ongoing sales charge. Thus, regardless of when the shareholder redeems shares, the shareholder's total sales load rate would never exceed 6%, the maximum class A front-end load rate.

[173] Funds could sell shares subject to a shorter conversion period than the maximum conversion period as defined under the proposed rule. In addition, funds could offer scheduled variations in the conversion period to a particular class of shareholders or transactions if the fund has satisfied the conditions in rule 22d-1. Proposed rule 6c-10(b)(1)(iii). Nothing in the rule would prevent a fund from offering to existing shareholders a new scheduled variation that would reduce the conversion period. Proposed rule 6c-10(b)(2). These provisions are similar to provisions that currently apply to deferred sales loads under rule 6c-10, and which are included in proposed rule 6c-10(a). *See* proposed rule 6c-10(a)(1)(iii) and (a)(2).

investment in the fund.[174] We propose monthly conversions because they reflect the current practices of many funds and fund transfer agents, which we anticipate would reduce costs associated with complying with the proposed rules.

- We request comment on alternatives, such as daily, weekly, or quarterly conversions.

a. Differences from NASD Cap

Our proposed *shareholder account-level cap* would effectively replace the NASD *fund-level* cap on asset-based sales charges.[175] In proposing a fund-level cap in 1991, the NASD explained that it had considered a shareholder account-level cap but, at the time, it believed that an account-level cap would require individual shareholder accounting, and in light of the difficulties involved with individual shareholder accounting, concluded that an account-level cap was not feasible.[176] The NASD acknowledged, however, that while its' approach "protects a majority of shareholders," it also "may result in a minority of long-term shareholders paying more than the maximum sales charge."[177] To illustrate, a fund shareholder paying a five percent front-end load on an investment of $10,000 in a fund will pay a $500 sales load, but the same investor investing in a fund with a (not uncommon) 12b-1 fee of 100 basis points, over a period of 10 years, could pay more than $800 in distribution related sales charges (resulting from the 75

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[174] *See infra* Section III.D.1.b of this Release.

[175] *See supra* Section II.C.1 of this Release.

[176] *See* NASD Notice of Proposed Rule Change, *supra* note 74, at section titled "Method of Calculating the Total Sales Charges" ("Requiring the individual shareholder accounting method would mandate extensive and expensive changes in the recordkeeping methods and procedures utilized by mutual funds, would disrupt current processing of sales and redemptions, and would take several years for the industry to achieve.").

[177] *Id.* The NASD considered fund-level accounting to be the "best alternative as a minimum standard at [the] time." *Id.* The NASD also noted that the industry as a whole would not be prevented from adopting "more protective methods" in the future. *Id*.

basis point asset-based sales charge component).[178] After 20 years, the difference becomes more significant: the shareholder would have paid $2292 in asset-based sales charges compared with the $500 front-end load.

The NASD's Mutual Fund Task Force, in its report on mutual fund distribution issues, expressed similar concerns when it identified limitations on the length of B share conversion periods as a potential area for regulatory reform.[179] Our proposal would address both the fairness concerns raised by the NASD Task Force in 2005 and the operational concerns raised in 1991 by avoiding the need for individual shareholder accounting. We view our proposal in many respects as the further development of the NASD sales charge rule, which was intended to bring total 12b-1 fees into "approximate economic equivalency" with traditional loads, although this equivalency would not be exact, as a result of potential varying volume discounts between share classes and differing market returns.[180]

b. <u>Implications on Fund Operations</u>

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

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178 Assuming a $10,000 initial investment and an annual return of five percent, the front-end load shareholder would have an account balance after ten years of $15,474; the shareholder in the fund with the 12b-1 fee would have an account balance of $15,162 – a deficit of $312 that is attributable to the 75 basis point asset-based sales charge component of the 12b-1 fee. Put another way, rather than paying a $500 sales load, the shareholder has paid over $800 in asset-based sales charges.

179 *See* NASD, *Report of the Mutual Fund Task Force: Mutual Fund Distribution* at 18 (2005) (http://www.finra.org/web/roups/rules-regs/documents/rules-regs?p013690.pdf).

180 *See* NASD Notice of Proposed Rule Change, *supra* note 74.

could be easily adjusted to do so.[181] In addition, we have sought to provide funds the flexibility to design different sales load structures that meet the needs of fund investors, funds, and their distribution systems. Accordingly, we do not propose to specify the annual maximum rate at which a fund could deduct annual ongoing sales charges.[182]

We request comment on the operational implications of the proposed automatic conversion.

- Can existing fund and intermediary systems be adapted so that conversion periods could be readily determined and implemented at the time of purchase? How easy or difficult would this adaptation be? How difficult would it be for funds that don't currently offer B shares to develop such systems? Is the flexibility we propose advantageous, or would a more standardized approach be more easily understood by, and in the interest of, investors? How would a more standardized approach work?

c. Implications on Transferability of Shareholder Accounts

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 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

[181] As discussed above, funds today are selling many fewer B class shares than just a few years ago. Because systems must remain in place to meet the operational requirements of a single outstanding B class share, this trend should not affect the ability of fund management companies or their service providers to make use of existing systems to convert existing class C shares or other classes.

[182] The NASD sales charge rule currently caps these fees at 75 basis points annually. However, if our proposed rule changes are adopted, the annual cap may be unnecessary because the cumulative amount of ongoing sales charges would be capped.

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.[183] We understand that fund intermediaries today have the ability to transfer share lot histories in order to: (i) service class B shares or classes with contingent deferred sales loads, and (ii) meet tax reporting requirements. Thus, we do not believe that our proposals would interfere with the ability of a shareholder to transfer shares from one intermediary to another.

We request comment on our assumptions in this area.

- Would the proposed rule's conversion requirement present any special problems when shares are transferred between customer accounts held at different intermediaries? Are there different implications with respect to different types of intermediaries and, if so, what are they? Is there any reason that some intermediaries would not be capable of transferring share lot history?[184] Are there other provisions that we should consider that would facilitate transferability?

2. The Maximum Load

a. <u>The Reference Load</u>

We propose that the maximum sales load that would apply to any purchase of shares in a fund class subject to an ongoing sales charge would be the highest front-end load of another class of that fund that does not charge an ongoing sales charge, and which would act as a "reference

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[183] Such a transfer is unlikely to be an "offer of exchange" under section 11 of the Act, which applies only to offers by a fund or a principal underwriter of a fund. Accordingly, the "tacking" provisions of rule 11a-3 would not apply, and any aging of fund shares that a new intermediary might do would not be done to satisfy any requirement of the Act. *See infra* Section III.K of this Release.

[184] We understand that some intermediaries, such as retirement plans and insurance companies, may not even track share lot history. Those situations present additional issues, which are discussed in Sections III.H and III.M.5 of this Release, *infra*.

load."[185] If a fund offers a class of A shares, the maximum amount of sales charges it could collect from an investor in B or C share classes would be the amount the investor would have paid had the investor invested in A shares with the maximum front-end load.[186] By setting the maximum front-end load, the fund, its board, and the principal underwriter would also establish the maximum amount of the cumulative ongoing sales charge.[187]

As we noted above, sales loads rarely approach the maximum of 8.5 percent permitted under the NASD sales charge rule,[188] yet we understand that rule 12b-1 fees often are charged at the maximum rate permitted, currently 100 basis points annually.[189] One reason may be that 12b-1 fees are deducted in smaller amounts, over longer periods of time, and indirectly from fund assets, and thus, to investors, they may be less salient and not as well understood when compared to front-end sales loads, and the fees themselves appear to be subject to less market

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[185] Proposed rule 6c-10(d)(14)(i). In the case of shares exchanged within the same fund group, the proposed rule provides that the reference load is the highest applicable sales load of the exchanged or acquired security. Proposed rule 6c-10(d)(14)(ii).

[186] Under the proposed rule, the shareholder's maximum sales load would be reduced if the shareholder previously paid a sales load on fund shares that the shareholder subsequently exchanged for shares of the current fund. Fund shareholders would also be credited for any other sales loads they paid on a particular share purchase. Thus, the maximum sales load rate that an investor could be charged would be defined under the proposed rule as the reference load minus the sum of the rates of: (i) any sales load incurred by the shareholder in connection with the purchase of fund shares, and (ii) any other sales loads or ongoing sales charges attributable to exchanged shares. Proposed rule 6c-10(d)(10). This approach is consistent with the approach the Commission has taken in implementing section 11 of the Act. Specifically, rule 11a-3 governs sales loads and other charges that may be imposed on an exchange between funds within the same fund group, and is intended to help ensure that shareholders receive credit for all sales charges incurred on a particular purchase of fund shares and are protected from the sales practice abuse of switching, *i.e.*, the practice of inducing shareholders of one fund to exchange their shares for those of a different fund solely for the purpose of exacting additional sales charges. *See* Offers of Exchange Involving Registered Open-End Investment Companies, Investment Company Act Release No. 17097 (Aug. 3, 1989) [54 FR 35177 (Aug. 24, 1989)] ("Rule 11a-3 Adopting Release"). We have also proposed conforming changes to rule 11a-3, as discussed in Section III.K of this Release, *infra*.

[187] *See also infra* Section III.D.2.d.4.

[188] *See* NASD Conduct Rule 2830(d)(1)(A).

[189] *See supra* note 42. According to statistics compiled by our staff, 27 percent of funds that impose 12b-1 fees charge a rate of exactly 100 basis points.

pressure.[190] Thus, some of our roundtable panelists and commenters urged that the Commission "externalize" asset-based sales charges (*i.e.*, require that such charges be paid *directly* from a shareholder's account, rather than *indirectly* from fund assets) so that the amounts investors are paying would be more noticeable and transparent.[191] Our proposed approach in rule 6c-10(b) would, instead, tie the maximum amount of the ongoing sales charge to the front-end load. To the extent that competitive pressures result in funds imposing lower front-end loads, these pressures should transfer to ongoing sales charges and could result in lower charges or charges that more accurately reflect the value of the distribution services provided. In addition, this proposed approach is designed to reduce the potential that some long-term shareholders will pay a significantly disproportionate share of the distribution costs of a fund.

We request comment on the definition and function of the reference load.

- Should we establish a maximum limit on the amount of ongoing sales charge that may be deducted? Could this approach encourage funds to offer a share class with a high front-end sales load in order to charge a higher cumulative ongoing sales charge on other classes? Are the NASD rule's limits on sales charges a sufficient or appropriate guide for the reference load? The NASD sales charge limits apply at the fund level on an aggregate basis, whereas the ongoing sales charge limits of our rule proposal would apply at the level of individual accounts to limit the cumulative asset-based sales charge paid by any single investor. Should the proposed rule's reliance

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190 *See* Brad M. Barber, Terrance Odean, and Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095 (Dec. 2003) (mutual fund investors are less willing to pay higher front-end loads because they are more obvious and salient, but are less sensitive to annual operating expenses, including rule 12b-1 fees).

191 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 184-85 (Richard Phillips, K&L Gates). *See infra* Section III.I of this Release regarding an alternative approach we are proposing that would permit externalized sales charges at the election of funds and their underwriters.

on the NASD sales charge limits be adjusted to take into account the difference in application? For example, would the proposal's cap have a more constraining effect on the amount of cumulative ongoing sales charges deducted by a fund? If so, should the proposal's cap be increased above the NASD cap to compensate for this? If not, what should the limits be?

- Alternatively, should we assign fund boards the responsibility of establishing the maximum amount of ongoing sales charges that a fund may deduct? If so, what standards or factors would be relevant to their determination?

b. Funds Without a Front-End Load Class

Some funds, of course, might not offer a class of shares with a front-end load, or might offer the front-end load class with asset-based distribution fees of more than 25 basis points (thus disqualifying the front-end load from acting as a reference load). We are proposing that, in these circumstances, the reference load would be the maximum sales charge permitted under NASD Conduct Rule 2830(d)(2) for funds with an asset-based sales charge and a service fee, which currently is 6.25 percent of the amount invested.[192]

We chose this rate because it is the current limit for funds with this type of sales charge structure under the NASD rule, which we approved in 1992 as not being excessive.[193] We believe linking the reference load to the NASD limits may minimize operational burdens of the amendment because funds, their underwriters, and broker-dealers are already familiar with the NASD sales charge rule limits and have structured their systems accordingly.[194] Under our

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192 Proposed rule 6c-10(d)(14)(iii). Some funds, for example, offer only a single class of C shares. *See also* Section II.C.1 of this Release, *supra,* for a discussion of the caps under the NASD sales charge rule.

193 *See supra* Section II.C.1 of this Release.

194 *See supra* note 161 and accompanying text.

proposal, funds could provide for lower sales loads (through shorter conversion periods) if they wish.[195]

- We request comment on whether the rule should permit the NASD maximum sales charge of 6.25 percent to serve as a default reference load for funds that do not offer a class of shares without an ongoing sales charge. If the rule should not permit this limit, what should be the limit? We are not proposing to use the limits in the NASD sales charge rule for investment companies *without* an asset-based sales charge (as much as 8.5 percent).[196] This is because, under our proposed rule, each fund charging an ongoing sales charge by definition charges an asset-based sales charge of more than 25 basis points. Would there be any reason to designate these higher limits as a default reference load under our proposed rule amendment? We note that doing so may further extend conversion periods and, thus, the period of time that some investors may pay ongoing sales charges.
- Under our proposal, funds would be permitted to deduct total sales charges up to the maximum sales charge permitted under the NASD sales charge rule. Would our proposed use of the 6.25 percent NASD limit as a default reference load give an advantage to funds that do not offer a class of A shares? To avoid this result, should the Commission identify a "typical" maximum front-end sales load that more closely tracks current industry practice (*e.g.*, four, five or six percent) and rely on such a sales load as a default reference load when a fund does not offer a class of A shares? If so,

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[195] The rule requires that, at a minimum, shares must convert *on or before* the end of the maximum conversion period. Proposed rule 6c-10(b)(1)(i). *See also supra* notes 171-173 and accompanying text.

[196] NASD Conduct Rule 2830(d)(1)-(2) (describing the different sales load limits, ranging between 8.5% and 6.25%, depending on whether the fund charges an asset-based distribution fee and offers rights of accumulation and quantity discounts).

what should that default reference load be?

- We note that in recent years, the costs of trading equity securities have declined significantly.[197] In this regard, should the Commission consider proposing a rule that would establish a new limit on sales charges, in light of changes in technology and the markets?
- As an alternative, should we treat the NASD sales charge limit of 6.25 percent as the reference load for purposes of determining the maximum amount of ongoing sales charge in all cases, even if a fund has a front-end load class of shares that can serve as the reference load? Such an approach would provide economically equivalent treatment of funds that offer a class of A shares and those that do not. It would not, however, provide equivalent treatment of investors who choose to pay a front-end sales load with those that pay an ongoing sales charge. If the maximum front-end sales load is lower than 6.25 percent, shareholders in classes with an ongoing sales charge may bear a disproportionate amount of distribution costs (compared to shareholders in class A shares).

c. Treatment of Scheduled Variations

The proposed amendments to rule 6c-10 would not require (but would permit) 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. Investors who pay asset-based sales charges today as a substitute for a front-end load generally are not offered

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[197] *See* United States Government Accountability Office, Securities Markets: Decimal Pricing Has Contributed to Lower Trading Costs and a More Challenging Trading Environment, 8-29 (May 2005) (http://www.gao.gov/new.items/d05535.pdf); *see also* JAMES ANGEL, LAWRENCE HARRIS & CHESTER S. SPATT, EQUITY TRADING IN THE 21ST CENTURY, 8-13 (USC Marshall School of Business May 18, 2010) (http://ssrn.com/abstract=1584026).

any discounts or variations in the amount of fees they pay indirectly through their investment in the fund.[198] We are concerned that requiring funds and their intermediaries to calculate a different reference load for each purchase of fund shares would introduce greater cost and complexity and could affect the willingness of funds and their underwriters to offer quantity discounts or scheduled variations on front-end sales loads to investors.

We request comment on whether funds should be required to incorporate scheduled variations in the front-end load when determining a shareholder's reference load.

- How would funds likely react to this requirement if we adopted it? Would this requirement discourage funds from offering scheduled variations in the front-end load? Would it cause some funds to discontinue front-end load share classes entirely? Would it encourage funds to offer share classes with high front-end sales loads that effectively operate to increase the amount of ongoing sales charges the fund collects in other share classes?[199] How would investors react? Would this requirement affect the number of fund investors selecting the ongoing sales charge class?

d. Sales Load on Asset Growth

Proposed rule 6c-10(b) would operate so that a fund and its investors could determine the conversion period at the time the investor makes a purchase of shares. Each purchase (or each "lot") would have a separate conversion period, and the shares associated with each lot would be

[198] Investors nevertheless may prefer to defer the payment of sales charges rather than paying a front-end sales load in some circumstances, because a greater portion of their money is invested immediately in the fund. *See* Rule 6c-10 Proposing Release, *supra* note 57, at section titled "Discussion."

[199] This could occur, for example, if a fund offered a share class with a front-end load of 8.5 percent but with scheduled variations at low investment thresholds for investors actually purchasing that class. This result may be unlikely, however, because funds would have to disclose the maximum front-end load in fund performance advertisements and use it to compute the fund's performance. *See, e.g.,* Rule 482 under the Securities Act [17 CFR 230.482], Rule 34b-1 under the Investment Company Act, and Item 26(b) of Form N-1A. *See also* NASD Conduct Rule 2210.

programmed to convert on a particular date. The maximum length of the conversion period would be unaffected by any subsequent increase or decrease in the value of the shares purchased. As a result, the fund underwriter would collect more ongoing sales charges if the value of the fund shares increased and collect less if the value decreased.[200] Shareholders would also benefit from the growth (or bear the losses) in the value of the fund shares that would not have otherwise been purchased had the shareholder paid a front-end sales load.

We believe that this approach is straightforward, is easy for investors to understand, is easy to administer, protects shareholders' interests in the allocation of risks and benefits between the shareholder and the fund's principal underwriter, and permits funds to deduct fees for distribution in the same manner that they currently deduct 12b-1 fees. This approach is different, however, from the approach currently taken by rule 6c-10 with respect to determining the maximum amount of a deferred sales load such as a CDSL.[201] Rule 6c-10(a)(1) limits the maximum amount of a deferred sales load to an amount specified at the time the shares were purchased.[202] Thus, in the case of deferred sales loads, investors never pay a higher amount as a result of fund performance.

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[200] For example, assume that an investor purchased $10,000 of a class of shares with no front-end sales load and an ongoing sales charge of 0.75% with an eight-year conversion period. If the investor obtained an annual rate of return of 5%, he or she would pay $697 in ongoing sales charges over eight years and have an account balance of $13,951. If the investor received an annual return of 10%, he or she would pay $835 in ongoing sales charges and have an account balance of $20,294. If the investor received a negative annual return of -5%, he or she would pay $492 in ongoing sales charges and have an account balance of $6,227 after eight years.

[201] We are also proposing to make certain non-substantive changes to the heading of current rule 6c-10, and parts of 6c-10(a), designed to clarify the names and use of the type of sales load practice discussed, including deferred, fund level, and account-level sales loads.

[202] *See* 1996 Rule 6c-10 Amendments, *supra* note 58. Prior to the amendment, rule 6c-10 had required that CDSLs be based on *the lesser of* the NAV of the shares at the time of purchase or the NAV at the time of redemption. We eliminated this requirement, deferring to the NASD to address such matters in its sales charge rule. At the same time, we required that the amount of a deferred sales load not exceed a specified percentage of the NAV of the fund's shares at the time of purchase so that investors "be given the benefit, if any, of deferring the load payment should there be an increase in the shares' NAV." *Id.* at n.16 and accompanying text.

- Given that our goal is to treat asset-based sales charges the same as other deferred sales loads, should we use the same approach for both? If so, which method should be used? If we require that ongoing sales charges be based on an amount determined at the time of purchase, would funds in effect be required to track each individual shareholder dollar paid in ongoing sales charges? Should we instead propose to amend rule 6c-10 (proposed rule 6c-10(a)) to permit underwriters to collect higher deferred sales loads as a result of fund performance?

3. *Reinvestment of Dividends and Other Distributions*

The proposal would permit funds to offer to invest shares acquired pursuant to a reinvestment of dividends or other distribution in the same share class as the shares on which the dividend or distribution was declared. If the share class has an ongoing sales charge, however, the reinvested shares would have the same conversion period as the shares on which the dividend or distribution was declared.[203] As a result, reinvested shares may incur an ongoing sales charge, but would convert to a share class without an ongoing sales charge no later than the conversion date of the shares on which the dividend or distribution was declared.[204] This approach would directly benefit investors, compared to the current approach under the NASD sales charge rule (which does not limit asset-based distribution fees from being charged on reinvested dividends indefinitely), because any ongoing sales charge deducted on reinvested dividends would no longer be charged after the conversion date of the original shares. This approach also reflects what we understand to be the practice most fund groups use to account for reinvestment of distributions on class B shares, and thus would permit them to avoid incurring costs associated with revising current fund systems – costs that may ultimately be borne by fund shareholders.

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[203] *See* proposed rule 6c-10(b)(1)(ii).

[204] *Id.*

Our proposed approach would be different, however, from the NASD sales charge rule, which prohibits funds from imposing front-end sales loads and CDSLs on reinvested dividends.[205] The reinvestment of dividends does not involve the expenditure of sales-related efforts, and the NASD viewed such loads as "duplicative."[206]

- In view of the NASD rule and our intention to treat ongoing sales charges as another form of sales load, should we instead require funds to reinvest dividends and other distributions in a share class that does not have any ongoing sales charge?[207]
- We request comment on whether we should adopt the proposed approach or, alternatively, that of the NASD sales charge rule. Would there be significant costs associated with reinvesting small amounts of retail investor accounts in a different share class? If we adopt the proposed approach, should shares acquired through a dividend reinvestment plan be required to convert before, after, or at the same time as, the shares on which the dividend or distribution was declared?
- More generally, what are the prevailing market practices with regard to reinvested dividends and other distributions? What is the annual volume of dividends and distributions offered by funds, and reinvested by shareholders? What is the magnitude of fees currently paid by investors on reinvested dividends? Do funds currently offer the option for investors to reinvest dividends in other share classes?

4. Role of Directors – Proposed Guidance

Unlike rule 12b-1, the proposed amendments to rule 6c-10 would not impose any explicit

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205 Proposed rule 6c-10(b)(1)(ii) would address the terms under which a fund with an ongoing sales charge could reinvest dividends and other distributions in shares of a class with an ongoing sale charge.

206 NASD Notice to Members 97-48 (Aug. 1997).

207 *See* NASD Conduct Rule 2830(d)(6)(B).

responsibilities on fund boards of directors to approve (or re-approve) asset-based sales charges under the proposed rule, although we fully expect fund boards would continue to play an important role in protecting fund investors, as discussed more fully below. Directors would continue to have fiduciary duties with respect to the oversight of the use of fund assets under state law and under section 36(a) of the Act.[208] When the Commission adopted rule 12b-1 in 1980, we sought to address statutory concerns about the conflict of interest between fund advisers (who benefit from an increase in the amount of fund assets) and fund investors (who may not).[209] We were concerned about whether a fund and its shareholders would benefit from a decision to pay distribution costs from fund assets, and viewed such a decision as "a particularly difficult business judgment" that is complicated by the conflicts of interest which are present.[210] Therefore, we made these arrangements subject to the careful scrutiny of fund directors.[211] Under our proposed approach, each shareholder would pay indirectly through the deduction of ongoing sales charges by the fund only the proportionate expenses associated with the sale of his or her fund shares. When those costs are paid, the shares purchased would automatically convert to a class of shares not paying an ongoing sales charge. The fund paying an ongoing sales charge would, in a sense, operate merely as the vehicle by which the fund shareholder pays the underwriter what the investor would have paid in the form of a front-end load at the time shares were purchased. Funds and fund underwriters would have little incentive to collect ongoing sales charges at excessive rates – a class of shares paying a higher rate of ongoing sales charge would simply convert earlier to a class that does not pay an ongoing sales charge.

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[208] *See supra* note 156.

[209] *See* 1980 Adopting Release, *supra* note 23, at section titled "Discussion."

[210] *Id.* at section titled "Independence of Directors."

[211] *See* rule 12b-1(e).

We view the treatment of the ongoing sales charge as another form of sales load (together with the automatic conversion requirement) as critical in our decision not to propose a specific role for the board of directors, while addressing the underlying concerns of section 12(b) of the Act. Directors will, however, continue to have fiduciary obligations under state law and section 36(a) of the Act to consider whether use of the fund's assets to pay ongoing sales charges, within the proposed caps, is in the best interest of the fund and fund investors.[212] We expect to provide guidance in our adopting release for this proposal, to assist fund directors in satisfying their fiduciary duties.

- We request comment on the following proposed guidance.

We believe that fund directors should consider the amount of the ongoing sales charge and the purposes for which it is used according to the same procedures they use to consider and approve the amount of the fund's other sales charges in the underwriting contract under section 15(c) of the Act.[213] We further believe that directors can and should view these asset-based distribution fees as integral parts of the fund's sales load structure to which they give their assent when they annually approve the fund's underwriting contract. In determining whether to approve (or re-approve) the underwriting contract, the directors must exercise their reasonable business judgment to decide, among other things, whether the terms of the contract benefit the fund (or its relevant class) and its shareholders, whether the underwriter's compensation is fair and reasonable (considering the nature, scope and quality of the underwriting services rendered),

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[212] *See also supra* note 156.

[213] Section 15(c) provides, in relevant part, that "it shall be unlawful for any registered investment company … to enter into, renew, or perform any contract or agreement…whereby a person undertakes regularly to serve or act as … principal underwriter for such company unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party …."

and whether the sales loads (including the ongoing sales charge) are fair and reasonable in light of the usual and customary charges made by others for services of similar nature and quality. In evaluating the "fairness and reasonableness" of the contract, the directors should consider any factors that may be relevant, including whether the fund's distribution networks and overall structure are effective in promoting and selling fund shares given current economic and industry trends, any available breakpoints on advisory fees that may be attained from future growth in fund assets, and any economies or diseconomies of scale that may arise from continued growth of fund assets.[214]

- Is this proposed guidance appropriate? Does it provide assistance to fund directors in evaluating ongoing sales charges? Are there other factors that would be relevant to the guidance we propose to provide? Should the guidance link board approval of the principal underwriting contract to board oversight of the use of fund assets for an ongoing sales charge? If not, what standard or requirements should apply to board oversight of ongoing sales charges?
- We request comment on our proposed overall approach to refashioning the role of the board of directors in overseeing asset-based distribution fees.[215] Is there a better approach we could take? Should we retain a formal role for directors in any rule permitting funds to pay for distribution expenses from fund assets? If so, what should that role be? Should we retain the current rule 12b-1, but update the suggested factors for director consideration in order to provide directors with additional guidance? For

[214] We understand that many fund boards currently consider these, or similar, factors when evaluating funds' underwriting contracts.

[215] Throughout this proposal we use the term "Asset-Based Distribution Fee" to mean any fee deducted from fund assets to finance distribution activities pursuant to rule 12b-2(b) (Marketing and Service Fee), rule 12b-2(d) (Grandfathered 12b-1 Shares), or rule 6c-10(b) (Ongoing Sales Charge).

example, should the factors specifically recognize that directors may consider that ongoing sales charges provide an alternative to a front-end sales load and, in that sense, benefit shareholders who choose to invest in a share class that has an ongoing sales charge? Should directors, in addition, consider whether these arrangements are structured so that individual shareholders do not bear a disproportionate share of distribution expenses? In this regard, we are particularly interested in the views of fund directors.[216]

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

Rule 10b-10 under the Securities Exchange Act requires broker-dealers to disclose specific information to their customers about securities transactions, including the price at which the transaction was effected, remuneration such as sales charges paid by the customer to the broker-dealer (if it is acting in an agency capacity), and in certain circumstances remuneration received by the broker-dealer from third parties such as a mutual fund or its affiliates.[217] The

[216] Our proposed approach was informed by input from independent director representatives. *See* Comment Letter of the Independent Directors Council (July 19, 2007) ("IDC believes that the role of directors in overseeing 12b-1 plans should be consistent with the role of directors in overseeing front-end sales loads and fund distribution practices generally."); Letter from the Mutual Fund Directors Forum to Andrew J. Donohue, Director of the Division of Investment Management, Securities and Exchange Commission (May 2, 2008) (http://www.mfdf.com/images/uploads/resources_files/Director_Duties_MFDF_Letter_May_2_2008.pdf) ("the quarterly review of expenditures under a fund's 12b-1 plan by directors serves little purpose, particularly since directors can have little impact in the first place on 12b-1 costs incurred by funds").

[217] 17 CFR 240.10b-10. Rule 10b-10 generally requires broker-dealers that effect transactions for customers in securities, other than U.S. savings bonds or municipal securities, which are covered by Municipal Securities Rulemaking Board ("MSRB") rule G-15 (which applies to all municipal securities brokers and dealers) to provide customers with written notification, at or before the completion of each transaction, of certain basic transaction terms. This transaction confirmation must disclose, among other information: the date of the transaction; the identity, price and number of shares bought or sold (*see* 17 CFR 240.10b-10(a)(1) (the confirmation must also include either the time of the transaction or the fact that it will be furnished upon written request)); the capacity of the broker-dealer (*see* 17 CFR 240.10b-10(a)(2)); the net dollar price and yield of a debt security (*see* 17 CFR 240.10b-10(a)(5) and (6)); and, under specified circumstances, the amount of compensation paid by the customer to the broker-dealer, whether the broker-dealer is receiving any other remuneration in

Commission and its staff have taken the position, with respect to mutual fund transactions, that a broker-dealer may satisfy its rule 10b-10 obligations without providing customers with a transaction-specific document that discloses information about sales charges or third-party remuneration, so long as the customer receives a fund prospectus that adequately discloses that information.[218] Today, in connection with the other amendments we are proposing to limit cumulative sales charges and help investors make better choices when selecting a fund that imposes sales charges, we are also proposing amendments to rule 10b-10 to require disclosure of additional information on transaction confirmations in connection with transactions involving securities issued by mutual funds.[219] In addition, we are proposing to amend rule 10b-10 to

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connection with the transaction, and whether the broker-dealer receives payment for order flow (*see, e.g.*, 17 CFR 240.10b-10(a)(2)(i)(B), (C), and (D)).

The rule's requirements, portions of which have been in effect for over 60 years, provide basic investor protections by conveying information that allows investors to verify the terms of their transactions, alerts investors to potential conflicts of interest with their broker-dealers, acts as a safeguard against fraud, and provides investors a means to evaluate the costs of their transactions and the execution quality. *See* Exchange Act Release No. 34962 (Nov. 10, 1994) [59 FR 59612, 59613 (Nov. 17, 1994)].

218 *See* Exchange Act Release No. 49148 (Jan. 29, 2004) [69 FR 6438 (Feb. 10, 2004)] at section IV.A.2. *See also* Investment Company Institute, SEC Staff No-Action Letter (pub. avail. Apr. 18, 1979) ("ICI Letter"). In this letter, the staff of the Commission's Division of Market Regulation (now known as the Division of Trading and Markets) stated that it would not recommend enforcement action against broker-dealers that did not provide transaction-specific disclosure about mutual fund loads and related charges, so long as the customer received a prospectus that "disclosed the precise amount of the sales load or other charges or a formula that would enable the customer to calculate the precise amount of those fees." This letter reflected a position that the Commission took when it adopted rule 10b-10, when it articulated the view that, in the case of registered securities offerings, separate confirmation disclosure of third-party remuneration would be redundant if the customer received a final prospectus disclosing that information. *See* Exchange Act Release No. 13508 at n.41 (May 5, 1977) [42 FR 25318 (May 17, 1977)].

219 We proposed more comprehensive changes to the broker-dealer confirmation requirements in 2004 through proposed Exchange Act rule 15c2-2 as part of a broader initiative regarding disclosures made to investors at the time an investment decision is made. *See* Securities Exchange Act Release No. 49148, (Jan. 29, 2004) [69 FR 6438 (Feb. 10, 2004)]. *See also* Securities Exchange Act Release No. 51274 (Feb. 28, 2005) [70 FR 10521 (Mar. 1, 2005)] (reopening of comment period). Proposed rule 15c2-2 would have governed transactions in mutual funds, unit investment trust ("UIT") interests and 529 college savings plans, and in contrast to rule 10b-10, would have prescribed a specific form to be used for confirmation disclosure. The more targeted confirmation changes we are proposing today, unlike our earlier proposal, involve amendments to rule 10b-10 rather than a new confirmation rule

require disclosures related to callable debt securities, and to eliminate outdated transition provisions.[220]

1. Confirmation Disclosure of Sales Charges and Fees

We are proposing to amend rule 10b-10 to require confirmations to set forth information regarding front-end and deferred sales charges, as well as ongoing sales charges and marketing and service fees (as defined in proposed Investment Company Act rules 6c-10 and 12b-2) associated with transactions involving mutual fund securities.[221]

In making this proposal, we are mindful that while improving confirmation disclosure of such fees can be expected to make the confirmation a more complete record of the transaction and to promote investor understanding of the fees, customers do not receive confirmations until after completing their purchases of mutual funds; accordingly, providing for improved disclosure of cost information prior to the sale may be an additional step that we could consider to help investors make better informed investment decisions.[222]

Under the proposal, transaction confirmations for purchases of those securities would

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and confirmation form. This in part reflects comments we received on the rule 15c2-2 proposal, including commenters' concerns as to the cost of requiring a separate confirmation rule and confirmation form for certain securities. *See, e.g.*, Comment Letter of Securities Industry Association (Apr. 12, 2004) (File No. S7-06-04) ("brokerage firms would have to bifurcate what is now a single stream of confirmations, and create an entirely new stream of information for mutual fund confirmations and a different stream for all other securities transactions").

220 *See infra* Section III.E.2 of this Release.

221 The term "mutual fund security" would be defined by reference to the definition of "open-end company" in section 5(a)(1) of the Investment Company Act (15 U.S.C. 80a-5(a)(1)). While exchange-traded funds are typically organized as open-end companies, we understand that exchange-traded funds do not typically impose the sales charges or other fees that would be subject to these disclosure requirements.

222 In this regard, the staff is considering recommendations for our future consideration to enhance the information provided at the point of sale. We also note that Section 919 of the Dodd-Frank Wall Street Reform and Consumer Protection Act states "[n]otwithstanding any other provision of the securities laws, the Commission may issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor."

disclose the amount of any sales charge that the customer incurred at the time of purchase, in percentage and dollar terms, along with the net dollar amount invested in the security and the amount of any applicable breakpoint or similar threshold used to calculate the sales charge.[223] This information would be expected to help make the confirmation a more complete record of the transaction and promote investor understanding of associated costs, as well as helping customers identify any errors associated with the front-end sales charges they incur; inclusion of breakpoint information on the confirmation particularly should assist investors in conveniently identifying any breakpoint-related errors in the sales charges they incurred.[224]

Also, if the customer may pay a deferred sales charge upon redemption of the shares (such as a contingent deferred sales charge), a transaction confirmation provided to the customer at the time of purchase would disclose the maximum amount of any deferred sales charge that the customer may pay in the future.[225] The amount would be expressed as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable.[226] This proposed requirement is designed to provide a customer more complete information about the deferred sales charge (which may serve as an economic substitute for the front-end sales charge)

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[223] *See* proposed new paragraph (a)(10)(i) of rule 10b-10. For purposes of these rule 10b-10 amendments, the term “sales charge” is intended to be comparable to the term “sales load,” which the Investment Company Act generally defines to mean the difference between the public price of a security and the portion that is invested (less deductions for certain fees). *See* section 2(a)(35) of the Act.

[224] *See* Report of the Joint NASD/Industry Task Force on Breakpoints (July 2003) (“Breakpoint Report”) (http://www.finra.org/web/groups/industry/@ip/@issues/@bp/documents/industry/p006434.pdf) (“Confirmations should reflect the entire percentage sales load charged to each front-end load mutual fund purchase transaction. This information would enable investors to verify that the proper charge was applied.”).

[225] *See* proposed rule 10b-10(a)(10)(ii).

[226] *Id.* A mutual fund could decide to calculate the deferred sales load as the lower of the net asset value at the time of purchase or at the time of redemption. Under rule 6c-10 under the Investment Company Act, a deferred sales charge may not exceed “a specified percentage of the net asset value or the offering price at the time of purchase.” Rule 6c-10(a)(1).

that the customer may be obligated to pay in the future.

In addition, if, after the time of purchase, the customer will incur any ongoing sales charge or marketing and service fee, purchase confirmations would disclose the following information: the annual amount of that charge or fee, expressed as a percentage of net asset value; the aggregate amount of the ongoing sales charge that may be incurred over time, expressed as a percentage of net asset value; and the maximum number of months or years that the customer will incur the ongoing sales charge. We anticipate that this disclosure could be made relatively simply, for example: "You will pay a maximum total ongoing sales charge of 5%, deducted from the assets of the fund in which you are investing at an annual rate of 1% over the next 5 years. You also will pay marketing and service fees of 0.25% for as long as you own the fund."[227]

Confirmations further would include the following statement (which may be revised to reflect the particular charge or fee at issue): "In addition to ongoing sales charges and marketing and service fees, you will also incur additional fees and expenses in connection with owning this mutual fund, as set forth in the fee table in the mutual fund prospectus; these typically will include management fees and other expenses. Such fees and expenses are generally paid from the assets of the mutual fund in which you are investing. Therefore, these costs are indirectly paid by you."[228] This proposal generally is intended to help make transaction disclosure more

[227] To the extent that the rate of the marketing and service fee associated with a particular mutual fund were to increase or decrease following the customer's purchase, rule 10b-10 would not require the broker-dealer to provide an updated confirmation statement to the customer. This information is typically disclosed in a supplement to a fund's prospectus filed under rule 497 under the Securities Act.

[228] *See* proposed new paragraph (a)(10)(iii)(B) of rule 10b-10. As discussed above, the term "ongoing sales charge" would be defined in proposed rule 6c-10 under the Investment Company Act of 1940, 17 CFR 270.6c-10, and the term "marketing and service fee" would be defined in proposed rule 12b-2 under that Act, 17 CFR 270.12b-2.

complete by helping to ensure that customers are informed about the use of ongoing sales charges that serve as a substitute for front-end sales charges, as well as additional uses of mutual fund assets to pay for distribution. The statement about the presence of additional charges is intended to help address the risk that confirmation disclosure of *some* ongoing charges or fees may cause some customers to wrongly infer that those charges or fees are all the ongoing costs that the customers would incur in connection with owning a mutual fund security.[229]

Finally, confirmations for transactions in which a customer redeems or sells a mutual fund security the customer owns would disclose the amount of any deferred sales charge the customer has incurred or will incur, expressed in dollars and as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable.[230] This information also would be expected to help make the confirmation a more complete record of the transaction and help customers identify any errors.

We are proposing corresponding changes to the alternative periodic reporting provisions of rule 10b-10(b), which in part permit quarterly reporting for transactions involving investment company plans.[231] As revised, such periodic statements involving mutual fund security transactions would include disclosure of sales charges consistent with the proposed requirements

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229 We are not proposing to require that purchase confirmations disclose management fees or other operating expenses, as those costs are disclosed in the prospectus fee table and are not directly implicated by the transaction. 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.

230 *See* proposed new paragraph (a)(11) of rule 10b-10.

231 *See* rule 10b-10(b) (permitting the disclosure of transaction-related information in periodic account statements rather than in confirmations for securities purchased or sold on a periodic basis through "investment company plans"); rule 10b-10(d)(6) (defining "investment company plan" to include individual retirement or pension plans and individual contractual arrangements that provide for periodic purchases or redemptions of investment company securities).

for other confirmations.[232]

In sum, these proposed requirements are intended to help make the confirmation a more complete record of the transaction, help investors in mutual fund securities be more fully aware of the sales charges they pay, and assist investors in verifying whether they paid the correct sales charge set forth in the prospectus. In that regard, these proposed requirements seek to take into account support that commenters previously have expressed for improved confirmation disclosure of sales charges, while also taking into account commenters' concerns regarding the costs that would be associated with more extensive changes to confirmation disclosure requirements.[233] We understand that some broker-dealers may already provide disclosures about

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[232] In particular, paragraph (b)(2) of rule 10b-10, as revised, would require disclosure of "any ongoing sales charges or marketing and service fees incurred in connection with the purchase or redemption of a mutual fund security." Consistent with the proposed requirements of paragraphs (a)(10) and (a)(11), this would encompass disclosure of front-end, deferred, and ongoing sales charges.

[233] Investor advocates who commented on proposed rule 15c2-2 generally supported confirmation disclosure of costs. *See* Comment Letter of the Consumer Federation of America, Fund Democracy, Consumer Action, and the Consumers Union (Apr. 21, 2004) (File No. S7-06-04) ("Confirmation and other post-sale disclosure should quantify the costs incurred as a result of the transaction, including any costs or payments that may have been estimated in pre-sale disclosures."). More generally, the Commission also received a number of comments from the public that supported our proposals for improving disclosure. *See, e.g.*, Comment Letter of T. Booy (Mar. 16, 2004) (File No. S7-06-04); Comment Letter of R. Barndt (Mar. 15, 2004).

While securities-industry commenters generally opposed expanding the scope of confirmation disclosures in other ways (and, as noted above, stated that extensive changes to existing broker-dealer confirmation systems would be particularly expensive), a number of those commenters supported confirmation disclosure of front-end sales charges, while not supporting confirmation disclosure of ongoing costs of ownership. In the view of those commenters, confirmations fundamentally are records of transactions that are provided too late to assist investors in making decisions. *See, e.g.*, Commenter Letter of Securities Industry Association (Apr. 4, 2005) (File No. S7-06-04) (supporting confirmation disclosure of sales charges in dollar and percentage terms, which would help investors determine whether they received correct breakpoint discounts; opposing confirmation disclosure of information about ongoing fees and conflicts of interest as costly, repetitive and too late to be useful); Comment Letter of Legg Mason Wood Walker Inc (Apr. 4, 2005) (File No. S7-06-04) (opposing addition of items other than sales charge information on confirmations as duplicative and as providing information too late to be useful for investors; based on their experience, investors look to the confirmation for information about the date, amount and price of their mutual fund investments); Comment Letter of Charles Schwab & Co., Inc. (Apr. 4, 2005) (File No. S7-06-04) (supporting confirmation disclosure of transaction-specific sales fees in dollar and percentage terms; opposing disclosure on purchase confirmations of disclosure of contingent deferred sales charges, and strongly front-end sales charges in their mutual fund confirmations, in part in response to the recommendations of the Joint NASD/Industry Task Force on Breakpoints.[234]

In the event we adopt these amendments to provide for confirmation disclosure of such sales charges, we intend to withdraw a no-action letter that the Commission's staff issued to the Investment Company Institute in 1979, related to confirmation disclosure of mutual fund sales loads and related fees, as that letter would no longer be consistent with the rule.[235]

We request comment on all aspects of these proposals, including the following:

- Would the information we propose to include in transaction confirmations be useful to investors? Would confirmation disclosure of quantified information about ongoing sales charges and marketing and service fees, without quantified information of other ongoing costs associated with owning mutual funds, imply that no other ongoing fees would be associated with their purchase? Would it imply that other ongoing fees are smaller or otherwise less important? If so, should confirmations also set forth the percentage amount of other ongoing expenses, including, but not limited to: (a) other shareholder fees, as disclosed in the mutual fund prospectus fee table pursuant to Item 3 of Form N-1A; (b) management fees, as disclosed in the mutual fund prospectus fee table pursuant to Item 3 of Form N-1A; and (c) any other expenses, disclosed in the mutual fund prospectus fee table pursuant to Item 3 of Form N-1A?
- Conversely, given that marketing and service fees (unlike ongoing sales charges) would not act as economic substitutes for front-end sales charges, should we amend

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opposing confirmation disclosure of comprehensive annual costs and of conflict of interest information).

234 *See* Breakpoint Report, *supra* note 224.

235 *See* ICI Letter, *supra* note 218; *see also* Breakpoint Report, supra note 224 (“In connection with this recommendation, the Task Force also recommends that the SEC staff revisit its April 18, 1979 No-Action Letter, which permits the omission of sales charge information from confirmations.”)

rule 10b-10 to require disclosure of quantified information about marketing and service fees? Could requiring confirmation disclosure of marketing and service fees lead to disparate disclosure to the extent that mutual funds follow disparate practices with regard to whether they use the proceeds of marketing and service fees to pay for certain types of services?

- Would the statement set forth in proposed rule 10b-10 (a)(10)(iii)(B) be sufficient to put investors on notice that they will be subject to additional costs over and above the disclosed front-end, deferred and ongoing charges and fees? Alternatively, should such ongoing fees be disclosed in some document other than the transaction confirmation? For example, would the account statement required by self-regulatory organization ("SRO") rules[236] be a more appropriate document for disclosures of ongoing costs, or for information about the source and amount of broker-dealer remuneration in connection with the mutual fund?
- Would it be helpful to investors to require disclosure of front-end and deferred sales charges in dollar terms? Would limiting the disclosure to percentage terms be a cost-effective way of permitting customers to check the terms of the transaction? Would it be helpful to investors to require that confirmations for mutual fund purchase transactions set forth the maximum amount of any deferred sales charge that the customer may incur upon redeeming the mutual fund?[237]
- Should rule 10b-10 also specify the format and presentation of how such cost and fee information should be disclosed (*e.g.*, specifically requiring that such information be

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236 *See* NASD Conduct Rule 2340 (Customer Account Statements).

237 FINRA rules currently require broker-dealers to include the following disclosure in transaction confirmations for investment company purchases: "On selling your shares, you may pay a sales charge. For the charge and other fees, see the prospectus." *See* NASD Conduct Rule 2830(n).

highlighted on the confirmation, or placed in the front of a confirmation if a paper-based confirmation is used, or be subject to a minimum font size)?

- Should transaction confirmations – or some other document – seek to quantify the total amount of front-end, ongoing and deferred fees the specific investor may expect to incur over time under reasonable assumptions; if so, how could such an "all in" fee be presented most effectively?
- Should purchase confirmations for mutual funds also be specifically required to set forth quantified information about the source and amount of all remuneration that the broker-dealer directly or indirectly receives in connection with the mutual fund, including, for example, "revenue sharing" received from a fund's adviser?
- In addition, we request comment on whether the proposed disclosures should be applicable to transactions in other securities that may carry sales charges, such as UIT interests, real estate investment trust interests or direct participation plan interests. Commenters particularly are asked to address any disclosure issues that are particular to each of those products; UIT interests, for example, may carry a combination of initial sales charges, deferred sales charges (deducted in periodic installments) and so-called "creation and development" fees. To the extent these amendments are applicable to UIT interests, would special provisions be needed to address transactions involving variable insurance products?
- We further request comment on whether the proposed requirement for disclosure of front-end sales charges also should require disclosure of equivalent costs (*i.e.*, the difference between the public price and the resulting amount invested) incurred in connection with purchases made during primary offerings of closed-end funds. In

addition, we request comment on whether the confirmation requirements of rule 10b-10 should be revised to encompass transactions in 529 college savings plan interests, which, as municipal securities, currently are excluded from the application of rule 10b-10.

2. Additional Changes to the Confirmation Rule

In addition to proposing confirmation rule changes in connection with our proposed replacement of rule 12b-1 with a new regulatory scheme, we are also proposing to amend rule 10b-10 to require disclosure of the first date on which certain debt securities may be called.[238] Disclosure of the first date upon which a debt security may be called will provide customers with meaningful information that is intended to help avoid any confusion for investors who are not otherwise aware that a bond may be called on a date earlier than the one specified on the confirmation. In particular, the rule as revised would require disclosure of the first date on which the security may be called when a broker-dealer effects a transaction in a debt security on the basis of yield-to-call.[239] Currently, the rule requires a broker-dealer that had effected a transaction in a debt security on the basis of yield-to-call to disclose, among other information, the type of call, the call date, and the call price. A bond may be subject to call on a series of dates; as a result, although a confirmation may have stated what the bond's yield-to-call would be if the bond is called on one of those dates, the confirmation may not have informed a customer about the first possible date on which a bond is subject to call. That may confuse

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[238] This proposal is consistent with proposed amendments to rule 10b-10 that we made in 2004 in conjunction with proposed rule 15c2-12. *See* note 219, *supra.* We received no comments on this aspect of the proposal. At that time, we also proposed to amend rule 10b-10 to require broker-dealers that effect transactions in callable preferred stock to disclose to their customers that the stock may be repurchased at the election of the issuer and that additional information is available upon request. We are not reproposing that amendment at this time, but will continue to consider the need for such a requirement.

[239] *See* proposed paragraph (a)(6)(i) of rule 10b-10.

investors who are not otherwise aware that a bond may be called on a date earlier than the one specified on the confirmation. The possibility of earlier call can subject the investor to additional reinvestment risk, because the investor may have worse alternatives for reinvesting the proceeds if the issuer calls the security when prevailing interest rates decline.

- We request comment on whether this proposal would provide useful information to investors.

Finally, we propose to delete paragraph (e)(2) of rule 10b-10, which sets forth transitional provisions related to confirmation requirements for security futures products, and which expired in 2003.[240]

- We request comment on this technical amendment.

F. Shareholder Approval

Marketing and Service Fee. Under proposed new rule 12b-2, a fund would be required to obtain the approval of a majority of its shareholders before it could institute, or increase the rate of, a marketing and service fee.[241] However, shareholder approval would not be required for a fund to institute a marketing and service fee with respect to a new class of fund shares, allowing a fund to institute (or increase) a marketing and service fee and apply it only to investments in the new class and avoid the cost of soliciting proxies to obtain shareholder approval.[242]

An existing shareholder in a share class that institutes a marketing and service fee may have invested in reliance on disclosure that the fund does not charge such fees or charges them at a lower rate. In order to avoid paying new marketing and service fees, the shareholder's only

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240 Consistent with that deletion, we also propose to redesignate paragraphs (e)(1)(i) through (e)(1)(iv) as paragraphs (e)(1) through (e)(4).

241 *See* proposed rule 12b-2(b)(2).

242 Under the proposed rule, shareholder approval would only be necessary with respect to the class or series affected by the fee increase.

recourse would be to redeem his shares and risk incurring significant additional costs, including potential capital gains taxes. Less vigilant investors may only discover new marketing and service fees after paying them for some time. Thus, we believe that these charges should not be imposed or increased without shareholder approval.[243]

For similar reasons, rule 12b-1 currently requires shareholder approval when a 12b-1 plan is adopted or is amended to increase materially the amount to be spent for distribution,[244] and thus in this regard our proposal would not significantly change the rights of fund shareholders or the obligations of funds and fund underwriters. Fund directors would not (as discussed above) be specifically required by the rule to approve the fees, although fund directors may determine to solicit proxies in support of (or in opposition to) the imposition of the fee or an increase in the fee.

Ongoing Sales Charge. Ongoing sales charges would be treated differently, however. Under the proposed amendments to rule 6c-10, a fund would not be permitted to institute, or increase the rate of, an ongoing sales charge, or lengthen the period before shares automatically convert to another class of shares that does not incur an ongoing sales charge, after any public offering of the fund's voting shares or the sale of such shares to persons who are not organizers of the fund.[245] A new fund (*i.e.*, a fund that has not made a public offering), or an existing fund with respect to a new class of shares, would not need to obtain shareholder approval before instituting a marketing and service fee or an ongoing sales charge (because no shareholders that

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[243] *See* section 1(b)(1) of the Act, which provides, in relevant part, that "the national public interest and the interest of investors are adversely affected — (1) when investors purchase...securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities ...."

[244] Rules 12b-1(b)(1) and (b)(4).

[245] *See* proposed rule 6c-10(b)(3).

are not affiliated with the fund's sponsor would be affected).[246] However, after the fund or class has been sold to the public, an ongoing sales charge would not be permitted to be instituted or raised with regard to that fund or class.

We believe that ongoing sales charges should not be instituted or increased in existing funds, or lengthened in duration, regardless of shareholder approval. The current regulatory framework does not allow for sales charges to be retroactively imposed or increased with regard to prior investments, and we believe that permitting increases in ongoing sales charges in existing share classes would negatively impact investors. Shareholders may select a fund in part based on the level of the ongoing sales charge, if any, and the level of services they received from the intermediary receiving the ongoing sales charge. Under the proposed rules, an institution or increase of an ongoing sales charge after a shareholder has agreed to pay a defined cumulative ongoing sales charge would be akin to retroactively renegotiating the terms of the contract without the explicit consent of the particular shareholder affected.

We request comment on the shareholder approval requirements.

- Should we require shareholder approval to institute or increase a marketing and service fee? Would permitting funds to institute, increase, or lengthen the period of ongoing sales charges negatively impact investors? Should we permit shareholder approval to institute, or increase the rate of, an ongoing sales charge, or lengthen the period before shares automatically convert to another class of shares that does not incur an ongoing sales charge? Should the rule specify who should bear the cost of soliciting shareholder proxies to approve or increase the rate of an asset-based

[246] Similar to rule 12b-1, a fund would not be required to obtain shareholder approval for marketing and service fees or ongoing sales charges that are implemented prior to the sale of fund shares to the public. Rule 12b-1(b)(1). *See also supra* note 41.

distribution fee? If so, should the fund or the fund underwriter bear the cost?

G. Application to Funds of Funds

We propose provisions in both rules 12b-2 and 6c-10 that would address asset-based distribution fees that could be deducted when one fund (the "acquiring fund") invests in shares of another (the "acquired fund"). Section 12(d)(1)(A) of the Act, our rules, and the NASD sales charge rule currently include provisions that restrict the layering of sales loads, asset-based sales charges and service fees in so called fund of funds arrangements, in which one investment company invests in the shares of another.[247] As described further below, we would include

[247] Section 12(d)(1)(A) of the Act prohibits a registered investment company (and any investment companies it controls) from: (i) acquiring more than 3 percent of the outstanding voting securities of any other investment company; (ii) investing more than 5 percent of its total assets in any one acquired investment company; or (iii) investing more than 10 percent of its total assets in all acquired investment companies. Section 12(d)(1)(B) prohibits a registered open-end investment company (*i.e.* an acquired fund) from: selling securities to any acquiring investment company if, after the sale the acquiring investment company (together with investment companies it controls) would (i) own more than 3 percent of the acquired fund's outstanding voting securities or (ii) together with other acquiring investment companies (and investment companies they control) own more than 10 percent of the acquired fund's outstanding voting securities. Section 12(d)(1)(F) of the Act provides an exemption from the limitations of section 12(d)(1) that allows a registered investment company to invest all its assets in other investment companies if, among other things, the sales load charged on the acquiring investment company's shares is no greater than 1.5 percent. Rule 12d1-3 allows acquiring investment companies relying on section 12(d)(1)(F) to charge sales loads greater than 1.5 percent provided that the sales charges and service fees charged with respect to the acquiring investment company's securities do not exceed the limits of the NASD sales charge rule applicable to funds of funds. Rule 12d1-3(a). The NASD sales charge rule requires funds of funds to aggregate sales charges and services fees paid by both the acquiring and acquired funds in complying with its limits. *See* NASD Conduct Rule 2830(d)(3).

Section 12(d)(1)(G) provides a similar exemption that permits a registered open-end fund or UIT to acquire an unlimited amount of shares of registered open-end funds and UITs that are part of the same "group of investment companies" as the acquiring fund. The provision is available only if either: (i) the acquiring fund does not pay (and is not assessed) sales loads or distribution related fees on securities of the acquired fund (unless the acquiring fund does not itself charge sales loads or distribution related fees); or (ii) the aggregate sales loads or distribution related fees charged by the acquiring fund on its securities, when aggregated with any sales load and distribution related fees paid by the acquiring fund on acquired fund securities, are not excessive under rules adopted under section 22(b) or 22(c) of the Act by a securities association registered under section 15A of the Exchange Act, or the Commission. The NASD has adopted limits on sales loads and distribution related fees applicable to funds as well as to funds of funds. *See* NASD Conduct Rule 2830. *See also* Section II.C.1 of this Release.

similar provisions to restrict the layering of marketing and service fees and ongoing sales charges in the amendments we are today proposing.

1. Marketing and Service Fee

Proposed rule 12b-2 would permit both an acquiring fund and an acquired fund in a fund of funds arrangement to charge a marketing and service fee, as long as the total of the fees charged by the funds together does not exceed the NASD service fee limit (25 basis points).[248] Thus, under proposed rule 12b-2(b)(2), if an acquiring fund deducts a marketing and service fee of 10 basis points, it would be limited to investing in other funds that deduct a marketing and service fee of no more than 15 basis points. This is the same approach as that taken by the NASD sales charge rule, which limits a fund of funds to a combined service fee of 25 basis points, and which limits a fund of funds that wishes to hold itself out as a no-load fund to combined service fees and asset-based sales charges (12b-1 fees) of 25 basis points.[249]

We request comment on our approach to applying rule 12b-2 to fund of funds

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Under the NASD sales charge rule's provision for funds of funds, if neither the acquiring nor acquired investment company has an asset-based sales charge (12b-1 fee), the maximum aggregate sales load that can be charged on sales of acquiring investment company and acquired investment company shares cannot exceed 8.5 percent (or 7.25 percent if the company pays a service fee). *See* NASD Sales Charge Rule 2830(d)(3)(A). Any acquiring or acquired investment company that has an asset-based sales charge must individually comply with the sales charge limitations on investment companies with an asset-based sales charge, provided, among other conditions, that if both companies have an asset-based sales charge, the maximum aggregate asset-based sales charge cannot exceed 75 basis points per year of the average annual net assets of both companies; and the maximum aggregate sales load may not exceed 7.25 percent of the amount invested (or 6.25 percent if either company pays a service fee). *See* NASD Conduct Rule 2830(d)(3)(B). The rule is designed so that cumulative charges for sales related expenses, no matter how they are imposed, are subject to equivalent limitations. *See* 1992 NASD Rule Release, *supra* note 66, at text accompanying n.9. *See also* NASD Notice to Members 99-103 (Dec. 1999) (http://www.finra.org/RulesRegulation/NoticestoMembers/1999NoticestoMembers/P004026) ("We have amended the [sales charge rule] to ensure that, if both levels of funds in a fund of funds structure impose sales charges, the combined sales charges do not exceed the maximum percentage limits currently contained in the rule.").

248 Proposed rule 12b-2(b)(2).

249 NASD Conduct Rule 2830(d)(3)(C).

arrangements.

- Should we, instead, preclude either acquiring funds or acquired funds from charging a marketing and service fee rather than cumulating the amounts? In the case of an acquiring fund investing in multiple acquired funds charging different marketing and service fee rates, should the rule's limits apply to the weighted average of the marketing and service fees rather than the maximum fee?[250] Would this be feasible? If so, how often should the acquiring fund determine such a weighted average for purposes of complying with the limits on marketing and service fees in proposed rule 12b-2? What other methods could be used to ensure that shareholders in funds of funds do not pay excessive fees under proposed rule 12b-2?

2. Ongoing Sales Charges

We are also proposing that an acquiring fund and an acquired fund could not *both* charge an ongoing sales charge. Under proposed rule 6c-10(b)(1)(iv), an acquiring fund that relies on the rule to deduct an ongoing sales charge could not acquire the securities of another fund that imposed an ongoing sales charge.[251] An acquiring fund that did not charge an ongoing sales charge would not be subject to this restriction and would therefore be free to invest in funds imposing an ongoing sales charge.

We understand that the classes of shares of most acquired funds do not carry 12b-1 fees or, if they do, carry a 12b-1 fee of less than 25 basis points. We also understand that when funds

[250] *See* proposed rule 12b-2(b)(2). We understand that the NASD sales charge rule's limits on cumulative service fees and asset-based sales charges (for no-load funds) does not permit weighted averaging, and thus applies the maximum rate as would our proposed rule. *See* NASD Conduct Rule 2830(d)(3).

[251] An acquiring fund would determine its ongoing sales charge as the amount it deducts from fund assets in excess of *its* marketing and service fee, without regard to any acquired fund's marketing and service fee. Proposed rule 6c-10(d)(11).

do acquire shares of other funds with a sales load or 12b-1 fee, they often do not charge loads or 12b-1 fees themselves.[252] Thus, if our proposal were adopted, we do not expect that it would affect the structure or operation of most funds of funds.

- We request comment on our understanding, and how our proposal would affect funds of funds.

Our approach to applying proposed rule 6c-10(b) to funds of funds is not the same as the approach taken by the NASD sales charge rule, which permits asset-based sales charges at both levels but requires the rates to be accumulated in determining compliance with the relevant limits.[253] We have not taken this approach because it would involve substantial complexities when an acquiring fund invests in (and over time purchases and sells) multiple acquired funds (with different ongoing sales charges) that would have to be factored into the length of conversion periods that would be required by proposed rule 6c-10(b).

- We request comment on this proposed approach. We request that commenters who favor an approach that would require accumulating of ongoing sales charges (rather than restricting ongoing sales charges on either the acquiring or acquired fund), address how accumulation might work in a way that is not unduly complicated.

H. Application to Funds Underlying Separate Accounts

Our proposed rule and rule amendments would apply to funds that serve as investment vehicles for insurance company separate accounts that offer variable annuities or life insurance

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[252] *See, e.g.,* New Century Portfolios, Prospectus at 18 (http://www.newcenturyportfolios.com/Documents/Prospectus%203.01.09%20-%20New%20Century%20Portfolios%20Final.pdf) (acquiring funds do not charge a sales load, and 12b-1 fees for the five series range from 0.10% to 0.22%).

[253] NASD Rule 2830(d)(3)(B)(ii).

contracts.[254] Separate accounts are typically organized as unit investment trusts.[255] They invest the proceeds of premium payments made by contract owners in one or more mutual funds (underlying funds) that manage the assets that support the insurance contracts.

Owners of variable insurance contracts may pay substantial distribution costs[256] in the form of a front-end load, a contingent deferred load, or ongoing charges that are deducted from the assets held by the separate account, or a combination of these charges.[257] In addition, directors of some underlying funds have approved adoption of rule 12b-1 plans to support various distribution and shareholder servicing activities.[258] We understand that in most cases these charges do not exceed 25 basis points annually.

Under our proposed rule changes, underlying funds would be treated like other mutual funds. Thus, an underlying fund could charge a marketing and service fee up to the NASD sales

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[254] *See* section 2(a)(37) of the Act (defining "separate account").

[255] *See* section (4)(2) of the Act (defining "unit investment trust"). *See, e.g.*, Wendell M. Faria, Variable Annuities & Variable Life Ins. Reg. § 3:4.2 (Dec. 2009) ("[P]ractically all separate accounts are organized as unit investment trusts under a two-tier structure in which the separate account invests in an affiliated or unaffiliated underlying fund (or funds) organized as an open-end management investment company.").

[256] The FINRA sales charge rules do not place a maximum sales charge limitation on variable contracts. *See* NASD Notice to Members 99-103; Order Granting Approval of and Notice of Filing and Order Granting Accelerated Approval of Amendments Nos. 4, 5, and 6 to the Proposed Rule Change Relating to Sales Charges and Prospectus Disclosure for Mutual Funds and Variable Contracts, Exchange Act Release No. 42043 (Oct. 20, 1999) [64 FR 58112 (Oct. 28, 1999)] (approving NASD rule change eliminating maximum sales charge limitations on variable contracts). Until 1996, section 27 of the Act effectively limited the amount of the sales load that could be charged on a variable contract. When Congress enacted the National Securities Market Improvement Act of 1996, it amended section 27 to provide an exemption for variable contracts. Pub. L. No. 104-290 (1996).

[257] *See* Goldberg and Bressler, *supra* note 52, at n.28 ("While variable insurance products, like mutual funds, did not pay distribution fees prior to the adoption of rule 12b-1, they paid mortality and expense charges. These provided a source of revenue to reimburse the insurance company for the portion of the sales commission not covered by a CDSL.").

[258] *See* Comment Letter of Sutherland, Asbill & Brennan, on behalf of the Committee of Annuity Insurers (July 19, 2007) (similar to traditional mutual funds, underlying funds charge 12b-1 fees to support activities such as promoting underlying funds to prospective contract owners, printing underlying fund prospectuses, and training and educating agents).

charge rule limit on service fees. Asset-based distribution fees in excess of the marketing and service fee would be deemed ongoing sales charges and subject to the requirements of the proposed amendments to rule 6c-10. Like other mutual funds, in order to impose an ongoing sales charge under proposed rule 6c-10(b), an underlying fund (or the insurance company sponsor) would have to keep track of share lots attributable to contract owner purchase payments, and provide for the automatic conversion of shares by the end of the conversion period. We understand that insurance company separate accounts may not currently track and age shares because they generally do not offer underlying funds with contingent deferred sales loads. Under our proposal, insurance companies would either have to develop this capability or offer only shares of classes that do not impose an ongoing sales charge.[259]

We request comment on whether we should treat underlying funds differently than other funds.

- Given that most distribution activities occur at the separate account-level, is it appropriate to permit underlying funds to impose the marketing and service fee or ongoing sales charges?[260] How would these fees be used? Should we limit underlying funds to the marketing and service fee? Should we consider some other structure for limiting fees charged by underlying funds?

I. Proposed Amendments to Rule 6c-10: Account-Level Sales Charge

We are also proposing to amend rule 6c-10 to provide funds with an alternative approach

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[259] We discuss this issue as it arises in the context of retirement plans in Section III.M.5 of this Release, *infra*. We discuss the potential costs of implementing a conversion feature in Section IV of this Release, *infra*.

[260] *See, e.g.*, Comment Letter of JoNell Hermanson (July 9, 2007) (urging elimination of 12b-1 fees for variable products because “12b-1 fees have become a ‘shell game’ for insurance companies and have allowed them to camouflage their profit margin as investment management fees.”).

to distributing fund shares through dealers if the fund so chooses.[261] 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.

1. Section 22(d): Retail Price Maintenance

Section 22(d) of the Investment Company Act prohibits mutual funds, their principal underwriters, and dealers from selling mutual fund shares to the public except at a current public offering price as described in their prospectus. Because mutual fund sales loads are part of the selling price of the shares,[262] this provision essentially fixes the price at which mutual fund shares may be sold because all dealers in a fund's shares must sell shares at the same sales load disclosed in the prospectus.[263] By requiring that all dealers sell shares of a particular fund to the public only at uniform prices as established by the fund, section 22(d) effectively prohibits

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[261] Proposed rule 6c-10(c).

[262] *See also* section 2(a)(35) of the Act (defining "sales load" to mean "the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer (or in the case of a unit investment trust, by the depositor or trustee), less any portion of such difference deducted for trustee's or custodian's fees, insurance premiums, issue taxes, or administrative expenses or fees which are not properly chargeable to sales or promotional activities").

[263] *See* Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices that Reflect Different Sales Loads, Investment Company Act Release No. 13183 (Apr. 22, 1983) [48 FR 19887 (May 3, 1983)] ("Rule 22d-1 Proposing Release") ("This section effectively prohibits price competition in sales loads on mutual fund shares at the retail level.").

competition in sales loads on mutual fund shares at the retail level.[264]

Our rules have provided limited exemptions from this provision, for example, by permitting funds to establish "scheduled variations" in sales loads that allow for volume discounts, although the amount and terms of these discounts must be uniform and set forth in their prospectuses.[265] Section 22(d) continues, however, to preclude dealers from competing with each other by establishing their own pricing schedules or negotiating different terms with their customers. Dealers may offer their customers a choice of alternate funds with differing sales loads; they may not, however, offer discounts on sales loads established by the funds whose shares they sell.

In enacting section 22(d) as part of the original Act in 1940, Congress gave funds authority to control their distribution to a degree denied most commercial enterprises by the federal antitrust laws.[266] The reasons Congress might have had to achieve such a result are unclear, due to the paucity of legislative history or other clear indications about Congress's intent

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[264] By its terms, section 22(d) only applies to principal underwriters and dealers in fund shares and does not apply to brokers. *See United States v. National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 715 (1975). The securities laws draw a distinction between dealers and brokers. Generally, a dealer buys and sells securities for its own account as part of a regular business; a broker acts as an agent by matching buy and sell orders between other investors. The same intermediary may act as either a broker or a dealer, depending upon the transaction. *See* 15 U.S.C. § 78a-3(a)(4), (a)(5); 15 U.S.C. § 80a-2(a)(6), (a)(11). Although section 22(d) only applies to principal underwriters and dealers in fund shares, funds also are able to maintain control over their distribution networks through share transfer restrictions permitted under section 22(f) of the Act. *See National Ass'n of Sec. Dealers, Inc.*, 422 U.S. at 729.

[265] *See* rule 22d-1; Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices that Reflect Different Sales Loads, Investment Company Act Release No. 14390 (Feb. 22, 1985) [50 FR 7909 (Feb. 27, 1985)]. We have also provided an exemption from section 22(d) for certain insurance company separate accounts, and in other circumstances. *See, e.g.,* rule 22d-2 under the Act.

[266] *See* the Sherman and Clayton Acts, 15 U.S.C. § 1-7; 15 U.S.C. § 12-27; 29 U.S.C. § 52, 53. Although such restrictions on price competition would normally be a violation of the antitrust laws, section 22(d) provides antitrust immunity for such restrictions. *See National Ass'n of Sec. Dealers, Inc.*, 422 U.S. at 701 ("… §22(d) of the Investment Company Act requires broker-dealers to maintain a uniform price in sales in this primary market to all purchasers except the fund, its underwriter, and other dealers. And in view of this express requirement, no question exists that antitrust immunity must be afforded these sales.").

when it adopted the provision.[267] Section 22(d) has been the subject of considerable debate because it tends to restrict rather than foster competition. Some, including roundtable participants and commenters, have identified section 22(d) as inhibiting competition and contributing to high distribution charges.[268]

Commenters have suggested a number of rationales for the enactment of section 22(d), including: (i) eliminating certain "riskless" trading practices by fund insiders; (ii) preserving an orderly distribution of mutual fund shares; and (iii) protecting shareholders from price discrimination.[269] Regulatory and marketplace developments that have occurred since 1940, however, have addressed the rationales that have been attributed to section 22(d). The Commission addressed the harms of riskless trading abuse in 1968 when it adopted rule 22c-1, which requires the "forward pricing" of mutual fund shares.[270] The Supreme Court also found in

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267 *See, e.g.*, Rule 22d-1 Proposing Release, *supra* note 263 ("[T]here is relatively little in the Act's legislative history to explain the purpose of section 22(d) ….").

268 *See, e.g.*, Comment Letter of the Consumer Federation of America, *et al.*, (May 10, 2004) (File No. S7-09-04) ("The reality, however, is that while competition flourishes, that competition does not necessarily serve to benefit investors. In fact, in the broker-sold portion of the market, funds compete to be sold, not bought. When funds compete to be bought, they compete by offering a good product and good service at a reasonable price. When funds compete to be sold, they do so by offering generous financial incentives to the sales force. Far from benefiting investors, this reverse competition tends to drive costs up, not down, and it allows mediocre high-cost funds to survive, and even thrive. The primary reason investors are being denied the benefits of competition is the legal requirement that funds set the compensation that brokers are paid for the services that those brokers provide to the investor."); Roundtable Transcript, *supra* note 109, at 103 (Thomas Selman, FINRA) ("One [area in need of revisiting] is 22(d), the retail price maintenance provision in the '40 Act, which, for example, prohibits a broker-dealer from simply charging its own commission for the sale of a fund at NAV, like they would a stock. There is no reason, really, why that restriction still should be in place.").

269 *See* Rule 22d-1 Proposing Release, *supra* note 263 at text accompanying nn.5-8.

270 *See id.*, at section 1.b; Adoption of Rule 22c–1 under the Investment Company Act of 1940 Prescribing the Time of Pricing Redeemable Securities for Distribution, Redemption, and Repurchase, and Amendment of Rule 17a–3(a)(7) under the Securities Exchange Act of 1934 Requiring Dealers to Time-Stamp Orders, Investment Company Act Release No. 5519 (Oct. 16, 1968) [33 FR 16331 (Nov. 7, 1968)]. Rule 22c-1 requires that mutual fund purchases and redemptions be executed at the price next computed after receipt of the order. *See* rule 22c-1(a). The execution of transactions at prices *previously* computed (which had been permitted in the past) thus

1975 that section 22(f) of the Act permits funds to manage any secondary market in fund shares and preserve an orderly distribution system.[271] Finally, as we noted in 1983 in connection with a rule proposal under section 22(d), the concern of unjust price discrimination among purchasers has been substantially dispelled by the results achieved from the unfixing of brokerage commission rates in 1975 after our adoption of rule 19b-3 under the Securities Exchange Act of 1934.[272] That rule prohibits national securities exchanges from requiring members to charge fixed brokerage commissions, and market experience after the rule showed that commission rates fell into rational patterns that reflect the sales costs involved and the services provided.[273]

As discussed in detail below, we are proposing an elective account-level sales charge alternative that would exempt certain funds from the requirements of section 22(d). We are proposing this account-level sales charge alternative pursuant to section 6(c) of the Act, which provides broad authority for the Commission to exempt any class of persons, securities, or transactions from the Act to the extent that such an exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."[274] For the reasons discussed in this section and below, we

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would violate rule 22c-1, in addition to other applicable provisions such as anti-fraud provisions. *See, e.g., In the Matter of Charles Schwab & Co., Inc.*, Investment Company Act Release No. 26595 (Sept. 14, 2004) (settlement of a case where a broker-dealer permitted certain favored clients to submit "substitute" mutual fund trades past the 4 pm fund pricing deadline).

[271] *See* United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1975).

[272] *See* Rule 22d-1 Proposing Release, *supra* note 263, at section 1.b of Discussion.

[273] *See id*.; Charles M. Jones & Paul J. Seguin, Transaction Costs and Price Volatility: Evidence from Commission Deregulation, 87 AMER. ECON. REV. 728, 730 (1997) ("Evidence from Commission Deregulation").

[274] 15 U.S.C § 80a-6(c). In addition to the authority granted us by section 6(c), section 22(d)(iii) of the Act provides an exception from retail price maintenance for sales made "in accordance with rules and regulations of the Commission made pursuant to subsection (b) of section 12." We are also proposing the account-level sales charge alternative pursuant to our authority in section 22(d)(iii), although for ease of reference we have included the proposed provision in rule 6c-10.

anticipate that this proposed 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. Thus, we believe that the account-level sales charge approach we are proposing today would be necessary and appropriate in the public interest, and is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

2. Account-Level Sales Charges

Proposed rule 6c-10(c) would permit a fund in certain circumstances to offer its shares or a class of its shares at a price other than the current public offering price stated in the prospectus. A fund class could offer shares to dealers who would then be free to establish and collect their own commissions or other types of sales charges to pay for distribution. The amount of these fees (and the times at which they would be collected) would not be governed by the Act.[275] Thus, for example, this fee could be paid directly by the investor or could be charged to the investor's brokerage account, depending on the arrangement between the intermediary and investor. The intermediary could charge this fee at the time of sale, over time, or upon redemption.

This type of sales load arrangement would be similar to the "externalized sales charge" concept on which we requested comment in 2004,[276] and which was discussed extensively at our

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[275] Intermediaries registered with FINRA would continue to be subject to existing limits on excessive compensation under NASD Conduct Rules 2830 and 2440.

[276] *See* 2004 Rule 12b-1 Amendments Proposing Release, *supra* note 107. In particular, we asked comment on one approach of refashioning rule 12b-1 to provide that funds deduct distribution related costs directly from shareholder accounts rather than from fund assets. We received over 1700 comment letters in response to the release's request for comment, many of which presented alternatives and suggestions that warranted additional review. We deferred proposing any further changes at that time. *See* 2004 Rule 12b-1 Amendments Adopting Release, *supra* note 106, at section II.C.

2007 12b-1 roundtable.[277] In light of the many concerns raised by commenters, we are not proposing to require funds to externalize their distribution expenses.[278] Rather, we propose to make this available as an option for funds that so elect. The commissions or fees charged by the dealers to their customers could be determined in the same manner as commissions and fees charged on other types of financial products.[279]

We believe this alternative approach to distribution may be attractive to dealers, funds, and fund shareholders. Dealers offering an array of funds from different fund groups could sell each fund to their customers according to a single price schedule, which could take into consideration the volume of transactions with that dealer (rather than the size of the purchase of shares of the particular fund), the level and type of services provided, and the type of fund offered. Currently, investors pay the same costs for distribution when purchasing a fund, regardless of the quality or type of services provided by a dealer. Under our proposal, if the

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[277] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 103 (Thomas Selman, FINRA), 157, 165 (John Hill, Putnam Funds), 204-07 (Richard Phillips, K&L Gates), and 207-13 (Avi Nachmany, Strategic Insight; Barbara Roper, Consumer Federation of America).

[278] Among other issues, commenters were concerned that requiring all funds to externalize their distribution systems would result in high transition costs, significant disruptions to current distribution systems, higher distribution costs for small investors, and adverse tax consequences. *See*, *e.g.*, Comment Letter of the ICI (May 10, 2004) (File No. S7-09-04); Comment Letter of the Financial Planning Association (May 10, 2004) (File No. S7-09-04). *See also* Roundtable Transcript, *supra* note 109, at 207-209 (Avi Nachmany, Strategic Insight). *But see id.* at 207 (Richard Phillips, K&L Gates). Some commenters objected to our requiring externalized distribution fees because they assumed that externalization would force shareholders to liquidate fund shares to pay the fees, which would cause investors to realize capital gains (or losses). *See*, *e.g*., Comment Letter of Terry Curnes (May 3, 2004) (File No. S7-09-04); Comment Letter of Legg Mason, Inc. (May 10, 2004) (File No. S7-09-04). In most cases, however, intermediary-sold funds are held in accounts that have alternative sources of cash to pay distribution fees, *e.g.*, interests in a money market fund, the use of which would not result in adverse tax consequences to investors. *See* EGON GUTTMAN, 28 MODERN SECURITIES TRANSFERS § 4:15 (3d ed. 2009).

[279] The antitrust immunity provided by section 22(d) for the fund's other distribution channels, if any, would not be disturbed by this proposed exemption. *See, e.g.*, Rule 22d-1 Proposing Release, *supra* note 263 ("Since the proposed rule would exempt investment companies, principal underwriters, and dealers only to the extent and under such conditions as determined by the Commission to be consistent with the protection of investors, in the Commission's view, existing antitrust immunity afforded by section 22(d) would not be affected by the proposed rule.").

dealer and the fund elect to permit it, investors would be able to choose the level of dealer services they want and pay only for their chosen services. Investors might, for example, choose low-cost, low-service plans; high-cost, high-service plans; or something in between that better matches their preferences.

Such an approach could also simplify the operations of the dealer, which could process transactions based on a single, uniform fee structure. Such a structure could eliminate or reduce the need to educate employees (*e.g.*, broker-dealer representatives) on the myriad distribution arrangements offered in today's market, and help avoid mistakes that may harm customers and expose the dealer to liability when employees make errors.[280] And it could eliminate (or at least ameliorate) dealer conflicts that may lead them (or their employees) to recommend funds to customers based on the amount of the compensation received from selling the funds, rather than on the customer's needs.[281]

An externalized fee structure may appeal to some fund groups as well, including small

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[280] On occasion, the complexity and variety of sales load arrangements has contributed to the failure of some intermediaries to provide their customers with the breakpoints to which they were entitled. REPORT OF THE JOINT NASD/INDUSTRY TASK FORCE ON BREAKPOINTS at 7 (July 2003) (http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p006434.pdf) ("Thus, a broker-dealer that sells funds offered by multiple mutual fund families must understand the aggregation opportunities offered by each fund family in order to deliver all appropriate breakpoint discounts to its customers. As broker-dealers increase the number of fund families whose funds they offer, fulfilling the obligation to understand the aggregation opportunities becomes an increasingly complex and burdensome task."). Another example of the difficulties that can arise from a multiplicity of differing fund policies and fees was brought to our attention when a number of intermediaries commenting on the redemption fee rule supported a uniform redemption fee as a means of eliminating the complexity associated with these fees. *See* Rule 22c-2 Adopting Release, *supra* note 103, at text following n.93.

[281] *See, e.g.,* REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES at 7 (Apr. 10, 1995) (http://www.sec.gov/news/studies/bkrcomp.txt) ("Some product sales or transactions offer much higher commission payouts to [registered representatives] than others. $10,000 invested in the typical front-end 'load' stock mutual fund, for instance, produces over twice as much immediate commission revenue to the registered representative as an equal amount invested in exchange-listed stocks."). *See also* Ruth Simon, *Why Good Brokers Sell Bad Funds*, MONEY, July 1991 (http://money.cnn.com/magazines/moneymag/moneymag_archive/1991/07/01/86657/index.htm).

funds and new entrants to the market that are eager to attract dealers that wish to sell shares based on their own fee schedules. Funds that choose to sell their shares only through an externalized fee structure could significantly simplify their operations and shorten their prospectuses by eliminating the need for multiple classes of shares.

Fund investors may benefit from buying funds through dealers that entered into these distribution arrangements in several ways. By reducing conflicts for dealers, these arrangements would reduce the risk that investors would be placed in funds that are not suitable for their particular circumstances. Sales charges would be more transparent and could be imposed or deducted in a manner and at a time that is most attractive to the investor.[282] Investors may be able to negotiate lower loads with their dealers by, for example, forgoing some of the services that they would otherwise pay for with the distribution charges, or by engaging in a substantial amount of business with the dealer (although not necessarily with the particular fund or fund family). Moreover, externalized fee structures may permit investors to invest in dealer-sold funds without purchasing associated (and unwanted) services. If negotiable account-level sales charges are accepted by market participants, increased competition among dealers may result in lower overall distribution costs or more attractive services for investors.[283]

Externalized fee arrangements are currently used in a number of other contexts and thus appear to be operationally feasible. For example, separately managed accounts and wrap

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[282] Some participants in our roundtable identified disadvantageous tax consequences as a reason for retaining asset-based sales charges rather than externalized sales charges. *See, e.g.,* Roundtable Transcript, *supra* note 109, 208-09 (Avi Nachmany, Strategic Insight). Under the proposed approach, however, investors purchasing through intermediaries could select a method of payment that would yield the best after-tax result for them.

[283] *See* Comment Letter of Bridgeway Funds, Inc., and Bridgeway Capital Management (July 19, 2007); *see also* Hannah Glover, *Schwab Slashes ETF Expenses in Challenge to Vanguard, BlackRock*, IGNITES (June 15, 2010) (noting that ETF distribution model, which similarly permits the unbundling of the sales charge components of distribution from fund shares, has seen steady decreases in fees and commissions).

accounts operate on an externalized distribution model.[284] In each case, at least part of the distribution costs is paid out of the assets of the account. As discussed above, recent years have seen the growing predominance of wrap accounts and other arrangements that entail separate fees paid by investors to intermediaries.[285] 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.[286]

- Should this be of concern to us as we consider this rulemaking? Are those higher charges related to additional services and features that these products and accounts provide, and therefore not comparable to the externalized sales charge alternative we are proposing?

We request comment on the advantages and disadvantages of allowing an externalized alternative distribution model.

- Would fund investors benefit from this distribution model? If so, how would they benefit or otherwise be affected? Are there significant drawbacks to investors to permitting this distribution model and, if so, what are they? What competitive or anti-competitive effects could result from such a model? Would our proposed alternative distribution model allow investors to effectively choose among dealers for

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284 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 76-78 (Martin Byrne, Merrill Lynch).

285 *See supra* text preceding notes 97 and 98.

286 *See, e.g.*, Roundtable Transcript, *supra* note 109. at 207-13 (Avi Nachmany, Strategic Insight; Barbara Roper, Consumer Federation of America). *See also* Comment Letter of the ICI (July 19, 2007); Comment Letter of Gary Roth (June 13, 2007); Comment Letter of Rick Sany (June 13, 2007). *But see* Comment Letter of Mark Freeland (June 19, 2007) ("But why should a mutual fund wrap account cost more if it is only providing the same level of service? Moreover, if the levels of service are indeed different, couldn't advisers create another tier of service for a lower fee, much as mutual fund wrap accounts typically charge less than equity wrap accounts?").

the right balance of price and service when buying mutual funds? How else might the availability of this distribution model affect investor behavior? We are interested in hearing from retirement plan administrators and trustees whether this distribution alternative might offer the beneficiaries of the plans increased transparency.

- We request comment on whether the availability of a class of fund shares that does not carry fixed distribution charges would increase competition among dealers and lead to lower sales charges for investors. Since 1975, when we abolished fixed brokerage commission rates, the cost of brokerage has decreased significantly for both institutional and retail brokerage customers.[287] Could we expect a similar result for fund investors if we permit retail price competition for at least some classes of shares of mutual funds?
- How would other market participants react to our proposed exemption? Would fund managers take advantage of this distribution model? Would competition among funds for the interest of dealers induce fund managers to offer a class of shares permitting dealers to control distribution pricing? Would discount broker-dealers begin offering funds that had previously been sold only through "full-service" brokers? Would "full-service" broker-dealers begin offering a class of the same shares at lower cost to their customers who, for example, bought and sold funds without the assistance of their representatives? Would dealers view our proposed exemption as providing an alternative that would help them reduce complexities and conflicts in selling fund shares? Would the exemption help reduce conflicts of interest by permitting dealers to eliminate differences in compensation and thus

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[287] *See, e.g.*, Evidence from Commission Deregulation, *supra* note 273.

encouraging recommendations based solely on the best interests of their customers? If many funds rely on the proposed rule, what would be the effects on distribution arrangements, and on distributors that do not rely upon the rule?

3. Account-Level Sales Charges: Terms of Proposed Rule 6c-10(c)

The account-level sales charge alternative would be available to any fund with respect to all of its shares, or any class of its shares.[288] As we discussed above, the exemption is optional, and funds may choose not to take advantage of it and continue to distribute their shares only with sales charges established by the fund.

In order for a fund to rely on the section 22(d) exemption provided in proposed rule 6c-10(c), it would have to meet two conditions. First, the fund (with respect to that share class) would not be permitted to impose an ongoing sales charge as defined in proposed amendments to rule 6c-10.[289] We are proposing the account-level sales charge as an alternative to an ongoing sales charge rather than as a supplement to it. The fund could, however, charge a marketing and service fee pursuant to proposed rule 12b-2.[290] Second, the fund would have to disclose in its registration statement that it has elected to rely on the exemption, which would allow interested investors the ability to better understand the distribution structure of the fund.[291] A fund relying on proposed rule 6c-10(c) would be permitted to use the marketing and service fee to support the fund's marketing and sales efforts, including advertising, sales material, and call centers, while permitting dealers to collect loads, fees, and other account-based charges to support the dealers' sales assistance and other services provided to its customers.

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[288] Proposed rule 6c-10(c).

[289] Proposed rule 6c-10(c)(1).

[290] *See* proposed rule 12b-2(b).

[291] *See* proposed rule 6c-10(c)(2). The disclosure would appear in the fund's Statement of Additional Information ("SAI"). *See* proposed Item 25(d) of Form N-1A.

We request comment on all aspects of proposed rule 6c-10(c).

- Should we require that each fund class charge a marketing and service fee in order to rely on proposed rule 6c-10(c), or should a fund instead be able to offer a class of its shares in reliance on rule 6c-10(c) without charging such a fee? Alternatively, as we have proposed, should proposed rule 6c-10(c) be available to all funds, regardless of whether they use fund assets to finance distribution pursuant to proposed rule 12b-2? We also request comment on the condition that the fund class not deduct an ongoing sales charge pursuant to proposed rule 6c-10(b). Are there any circumstances under which a fund should be permitted to rely on the exemption under proposed rule 6c-10(b) *and* charge an ongoing sales charge under proposed rule 6c-10(c)?
- We request specific comment on whether the fund's election to rely on proposed rule 6c-10(c) should be disclosed anywhere other than the registration statement. We also request comment on where the fund's election should appear in the registration statement. As proposed, the election would be disclosed in the fund's Statement of Additional Information.[292] Should it appear in the fund's prospectus or summary prospectus? Should the fund's board be required to make or specifically approve the election?
- Are any other conditions appropriate? Should we limit the exemption to funds that sell their shares to dealers at net asset value? Are there any additional benefits or problems associated with proposed rule 6c-10(c)?
- We also request comment on the interaction between proposed rule 6c-10(c) and the other amendments we are proposing in this Release. For example, if the Commission

[292] Proposed Item 25(d) of Form N-1A.

does not adopt proposed rule 12b-2, proposed rule 6c-10(b) or the proposed rescission of rule 12b-1, should it nevertheless adopt proposed rule 6c-10(c)? Is any of the rationale that supports the Commission's adoption of rule 6c-10(c) diminished (or augmented) if the Commission does not adopt any of the other amendments it is today proposing?

J. Amendments to Improve Disclosure to Investors

We are proposing several amendments to our disclosure requirements to improve the transparency of sales loads and asset-based distribution fees. The amendments, which reflect the new approach we are proposing with respect to asset-based distribution fees, are designed to improve investors' understanding of the distribution related charges they would directly and indirectly incur as a result of investing in a fund.

1. Amendments to Form N-1A

Form N-1A is the registration form used by funds to register with the Commission under the Securities Act and the Investment Company Act. Item 3 of Form N-1A sets forth the requirements for the prospectus "fee table," which lists all fund expenses.[293] Rule 12b-1 fees

[293] We recently amended Form N-1A to require key information to appear in plain English in a standardized order in mutual fund prospectuses, including information about the fund's investment objectives and strategies, risks, costs, and performance. In the same release, we also amended rule 498 under the Securities Act to allow a fund to satisfy its prospectus delivery obligations under section 5(b)(2) of the Securities Act by providing the summary prospectus, if the full statutory prospectus is available on an Internet Web site. *See* Enhanced Disclosure and New Prospectus for Registered Open-End Management Investment Companies, Investment Company Act Release No. 28584 (Jan. 13, 2009) [74 FR 4546 (Jan. 26, 2009)] ("Summary Prospectus Adopting Release"). In the proposing release for the summary prospectus, we requested comment as to whether we should consider other revisions to the headings in the fee table to make them more understandable to investors, including eliminating the term 12b-1. *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Investment Company Act Release No. 28064 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)] ("Summary Prospectus Proposing Release"). However, in the Summary Prospectus Adopting Release, we concluded that it was more appropriate to consider these changes in the context of a full reconsideration of sales charges and rule 12b-1. *See* Summary Prospectus Adopting Release at text accompanying n.126.

currently are disclosed as a fund operating expense under the heading "Distribution [and/or Service] (12b-1) Fees."[294]

The reference in the current fee table to "12b-1 fees" is not, of course, consistent with the new regulatory approach we are proposing for asset-based distribution fees. Moreover, the current fee table may not present the fee most effectively. Many of our roundtable panelists, as well as a number of commenters on our summary prospectus rule, agreed that reference to an SEC rule number is not informative.[295]

To address these concerns, we are proposing to amend the fee table requirements to separate asset-based distribution fees into two component fees. Specifically, we propose to delete the current heading, and replace it with the heading "Ongoing Sales Charge," which would be the ongoing sales charge we are proposing today. This line item would continue to appear in the lower portion of the fee table which relates to the expenses that shareholders pay indirectly as a result of holding an investment in the fund, expressed as a percentage of net asset value.[296] We would also add a new subheading to the "Other Expenses" category called "Marketing and Service Fee."[297] Funds would include each of these line items in their fee tables only if they

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[294] *See* Item 3 of Form N-1A.

[295] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 106 (Bob Uek, MFS Funds). *See also* Comment Letter of The Honorable Donald Manzullo (Feb. 28, 2006) (File No. S7-28-07) ("In keeping with the idea of simplified disclosures, a preferential way to begin would be by re-naming the fees altogether, as the name '12b-1' is esoteric, at best.").

[296] The percentage of the maximum front-end and deferred sales loads would continue to be presented in the upper part of the fee table related to fees that are paid directly by shareholders upon entry to or exit from the fund.

[297] The fee table currently requires funds to disclose separately only two types of operating expenses – management fees (the fee paid to the investment adviser) and 12b-1 fees. The rest of a fund's operating expenses are included under the caption "other expenses." The instructions permit funds to subdivide this caption into no more than three sub-captions that identify the largest expense or expenses comprising "other expenses," but the fund must include a total of all "other expenses." *See* Instruction 3(c) to Item 3 of Form N-1A.

charge the relevant fee.[298]

The new heading and subheading correspond to our treatment of these charges under the new rule and rule amendments we are proposing today,[299] and are designed to more clearly describe the fees to investors.[300] In particular, the "Ongoing Sales Charge" heading should better convey to investors that this portion of the asset-based distribution fee operates as a substitute for a sales load. When this heading is used in a prospectus offering multiple classes with adjacent fee tables, investors may be more likely to understand the nature of the alternatives available to them. We view greater investor understanding of this fee as an important goal of this rulemaking, and expect that it would lead to more informed decisions by investors when selecting among funds and fund share classes.

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.[301] 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

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[298] Instruction 1(c) to Item 3 of Form N-1A.

[299] *See supra* Sections III.C and III.D of this Release.

[300] A recent opinion issued by the Second Circuit emphasizes the importance of accurate description and categorization of fund fees to investors. The court noted that the full and accurate description of both the amount and use of fees charged by a fund is an important part of the "total mix" of information in an investor's decision to purchase shares. *See Operating Local 649 v. Smith Barney Fund Management LLC*, 595 F.3d 86 (2d Cir. 2010) ("Few facts would likely constitute more important ingredients in investors' 'total mix' of information than the fact that, in violation of these disclosure requirements the expenses categorized as transfer agent fees were not transfer agent fees at all …. The importance of the accurate reporting of categories of fees in prospectuses is obvious: a "comparative" fee table is not useful to an investor if the information in the table is incomplete or otherwise misleading ….").

[301] *See* Item 3 of Form N-1A.

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 fit best as a subheading to the "other expenses" category. We believe that it is important for investors to know whether a fund charges a marketing and service fee, but do not believe it requires its own heading in the fee table.

We request comment on the proposed location for the marketing and service fee disclosure in the fee table.

- Does including the marketing and service fee in the "other expenses" category raise any concerns that it may obscure the fact that all or a portion of the marketing and service fee is or may be used for distribution purposes? If so, would it matter to most investors?
- We request comment on the two headings and the names that we have proposed for them.[302] Would they help investors better understand the nature of the fees? Are there better names we could use? Should we require the disclosure of additional categories of fees? Should we require that additional fee information be provided in the fee table? For example, should the fee table indicate fees paid initially, annually, and upon redemption? Should we also require that the conversion period for the

302 The Commission has long sought to find a descriptive term that both informs investors and accurately describes the fees deducted pursuant to a 12b-1 plan. In 1988, when we began requiring funds to disclose certain fee information in the form of a uniform fee table, fees deducted pursuant to a 12b-1 plan were simply listed as an annual operating expense called "12b-1 Fees." Consolidated Disclosure of Mutual Fund Expenses, Investment Company Act Release No. 16244 (Feb. 1, 1988) [53 FR 3192 (Feb. 4, 1988)]. This description of 12b-1 expenses was criticized as being uninformative, and in 1998 we made a number of amendments to Form N-1A, including renaming the "12b-1 Fee" heading as "Distribution [and/or Service] (12b-1) Fees." Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 23064, at text accompanying n.79 (Mar. 13 1998) [63 FR 13916 (Mar. 23, 1998)]. Similar to the approach we are proposing today, the hypothetical illustrative example that was a part of our summary prospectus proposal used separate headings (Distribution Fee and Service Fee) in the fee table. *See* Summary Prospectus Proposing Release, *supra* note 293.

ongoing sales charge be included in the fee table (or a footnote to the table), to provide investors with an immediate reference for how long the fee would be charged?

- We also request comment on our proposed use of the term "marketing and service fee." Is it too general a term to provide useful disclosure to investors? We are proposing this term instead of only the term "service fee" because funds could use the marketing and service fee for different activities than the "service fee" defined by the NASD, and because we are concerned that use of only the term "service fee" in some circumstances could mislead investors.[303] Should we permit funds that do not use the fees for distribution related purposes to use the term "service fee" in lieu of "marketing and service fee"? Would such an alternative diminish the comparability of fund fee tables and thus their usefulness to investors in comparing expenses among different funds? Would a different term, such as "sales and service fee" or "distribution and service fee" be more descriptive or informative to investors?[304]
- Finally, we request comment on fee table disclosure of asset-based distribution fees charged under existing 12b-1 plans, as permitted by proposed rule 12b-2(d).[305] Should Item 3 continue to require disclosure of "12b-1 fees" that are charged in the future?[306] Alternatively, should the 12b-1 fees be disclosed as marketing and service fees and ongoing sales charges, as appropriate? Should another term be used?

We also propose to amend Item 12(b) of Form N-1A, which currently requires funds that

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[303] *See supra* note 100 and accompanying text.

[304] *See supra* text following note 161.

[305] *See infra* Section III.N.3 (treatment of "grandfathered" shares).

[306] *See* Item 3 of Form N-1A (requiring disclosure of "Distribution [and/or Service] 12b-1 Fees").

have adopted 12b-1 plans to disclose information about the operation of the plan in the prospectus.[307] Because funds would no longer be required to have a "plan," we are proposing to eliminate this requirement. Instead, we would require funds to disclose whether they charge a marketing and service fee or an ongoing sales charge and, if they do, to disclose the rates of the fees and the purposes for which they are used.[308] In addition, if the fund deducts an asset-based distribution fee for services provided to fund investors, it would need to describe the nature and extent of the services provided.[309] We would also require a fund that imposes an ongoing sales charge to disclose the number of months (or years) when the shares will automatically convert (to another class without the charge) and after which the shareholder would cease paying the charge.[310]

We would also require a fund offering multiple classes of shares in a single prospectus (each with its own method of paying distribution expenses) to describe generally the circumstances under which an investment in one class may be more advantageous than another class.[311] We understand investors often face difficulties when deciding which share class they should purchase because the advantages and disadvantages of each class are not always clearly presented in the prospectus.[312] Although the differing fees and terms of each class currently are

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[307] This disclosure complements the information presented in tabular form in the fee table.

[308] Proposed Item 12(b) of Form N-1A.

[309] *Id.*

[310] For funds that choose the account-level sales charge alternative, existing regulatory provisions would generally require the delivery of similar information to investors in their confirmation statements. *See* rule 10b-10 under the Exchange Act [17 CFR 240.10b-10].

[311] Proposed Item 12(b)(2) to Form N-1A.

[312] FINRA has addressed, on numerous occasions, the responsibilities of its members in helping investors understand and evaluate the sales structures of different classes of funds. *See, e.g.,* Special Notice to Members 95-80 (Sept. 1995) (http://finra.complinet.com/finra/display/display_content.html?rbid=1189&element_id=1159003637).

readily available, the actual consequences of the decision to purchase a particular class (in terms of overall loads paid, appropriate holding periods, *etc.*) may not be readily apparent. We believe that requiring funds to provide a clear description of the situations in which one class may be more advantageous than another would reduce shareholder confusion and simplify the investment decision making process, and we understand that some funds currently provide this type of disclosure.

We request comment on these proposed amendments to Item 12(b).

- Would the disclosure be useful to investors in identifying the appropriate class to purchase? Should we provide more specific disclosure requirements? If so, what should they be? Would funds have difficulties in providing this information?

We are also proposing to amend Item 19(g) of Form N-1A, which currently requires a fund to describe in detail the material aspects of its 12b-1 plans and related agreements, in the Statement of Additional Information (SAI). Under our proposals, funds would no longer be required to have written "plans" that are approved by the board of directors, and thus much of this item would no longer serve any purpose. We therefore propose to eliminate paragraphs 2 through 6 of Item 19(g).[313] Because these items relate to the specific operation of a 12b-1 plan that would no longer be required under our proposal, we believe that they should be removed.

See also FINRA, *Understanding Mutual Fund Classes* (Jan. 14, 2003) (http://www.finra.org/Investors/protectyourself/InvestorAlerts/MutualFunds/p006022).

[313] Item 19(g)(2) requires a fund to disclose the relationship between the amounts paid to the distributor under a 12b-1 plan and the expenses it incurs. Item 19(g)(3) requires disclosure of any unreimbursed expenses incurred by the plan and carried over to future years. Item 19(g)(4) requires disclosure of any joint distribution activities with another fund and the method of allocating distribution costs (any joint arrangement between funds that implicates section 17(d) and rule 17d-1 would require the funds to apply for and obtain an exemption from the Commission prior to implementing the arrangement). Item 19(g)(5) requires disclosure of whether any interested person or director has a financial interest in the operation of the 12b-1 plan. Item 19(g)(6) requires disclosure of the anticipated benefits of the plan to the fund.

- We request comment as to whether we should retain any of these parts of Item 19(g).

We believe that some of the other information required to be disclosed under Item 19(g) may continue to be useful to investors and the Commission. In particular, Item 19(g)(1) which includes a list of the principal activities paid for under the plan and the dollar amounts spent on each activity over the last year as a material aspect of a 12b-1 plan, may help investors to more clearly understand how the asset-based distribution fees they pay are used. We propose to amend Item 19(g) to eliminate references to the 12b-1 plan, and instead require disclosure of the principal activities paid for through asset-based distribution fees (both ongoing sales charges and marketing and service fees). As proposed, the amendment would not require disclosure of dollar amounts.[314]

We request comment on the proposed amendments to Item 19(g).

- Specifically, we request comment whether we should retain the disclosures required by Item 19(g)(1) as it currently exists, including the dollar amounts spent on each activity. Our proposal would remove this disclosure because we believe that the information is unlikely to be important to investors. Should these disclosure requirements be eliminated or retained? Should we require funds to disclose the percentage of fees spent on each type of activity instead? Are there any other activities that are not disclosed in Item 19(g) that should be disclosed under our proposal?

Finally, we propose to: (i) amend Item 25 of Form N-1A to add a paragraph (d) requiring funds electing to rely on the exemption to section 22(d) of the Act provided by rule 6c-10(c) to

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[314] We do not believe that disclosure of the actual dollar amount spent on these activities would be useful to investors because that figure would depend primarily on the size of the fund, and not the services purchased.

state that the fund has made this election; and (ii) eliminate existing Item 28(m) of Form N-1A, which requires a registered fund to attach its rule 12b-1 plan and any related agreements as an exhibit to its registration statement. The exhibit would be unnecessary because proposed rule 12b-2 would not require a written plan, and funds that charge grandfathered fees would not be required to have a written plan.[315]

- We request comment on these proposed changes to Item 25 and Item 28(m) of Form N-1A.

2. Amendments to Schedule 14A

Our proposal would require funds to obtain shareholder approval before instituting or increasing the rate of marketing and service fees deducted from fund assets in existing share classes.[316] To obtain shareholder approval, funds generally have to solicit proxies from their shareholders, and those proxy solicitations must include sufficient information to allow shareholders to make an informed decision. Item 22(d) of Schedule 14A under the Exchange Act[317] requires funds to disclose information regarding any distribution plan adopted under rule 12b-1 and the fees paid under the plan when soliciting proxy votes for approval of any material

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[315] *See infra* Section III.N.3 for a discussion of grandfathering funds and share classes. We also are proposing additional conforming, technical changes to other items of Form N-1A, including: Instruction 3(b) to Item 3; Item 26(b)(4); and Item 27(d)(1) (and Instruction 2(a)(i) to Item 27(d)(1)). These changes are necessary to delete references to rule 12b-1 and rule 12b-1 plans and add references to rules 12b-2(b) and (d) and to 6c-10(b) as the operative rules regarding asset-based distribution fees.

[316] Generally, as allowed by rule 12b-1 (and as our proposal would allow), most funds institute a marketing and service fee or an ongoing sales charge before a fund is offered for sale to the public. *See* rule 12b-1(b)(1); Section III.F of this Release. If a fund wishes to institute a new marketing and service fee after a public offering, or increase those fees, the fund would be required to disclose in the proxy the information discussed in this section of the Release. As discussed in Section III.F, funds may not increase or impose an ongoing sales charge in a share class of a fund after any public offering of the fund's voting shares or the sale of such shares to persons who are not organizers of the fund.

[317] 17 CFR 240.14a-101.

change in that plan. This disclosure is designed to provide shareholders with relevant information regarding the distribution costs of the fund when they are voting on issues that impact their investment.[318] Our proposal would eliminate the need for a distribution plan as currently required by rule 12b-1, which would make much of the disclosure required in Item 22(d) of Schedule 14A no longer relevant. Therefore, we propose to amend Item 22(d) of Schedule 14A, as well as replace the term "distribution plan" used in Schedule 14A with the new defined term "Marketing and Service Fee."[319]

Although our proposal would not require a distribution plan, it would permit funds to continue to use fund assets for distribution related purposes. In addition, it would require fund shareholders to approve any institution of, or increase in the rate of, marketing and service fees charged by the fund.[320] In order for fund shareholders to make appropriate and informed decisions, we believe that shareholders would continue to find information regarding the rate of marketing and service fees, the purposes of the fees, the reasons for any proposed increase, and the identity of certain affiliated recipients relevant to their voting decisions. Thus, we propose to leave these disclosures, which are currently required under Item 22(d), substantially unchanged.[321]

Because our proposal would not require any special action by the board of directors in approving marketing and service fees, we do not believe that information regarding the board of directors' consideration of these fees would be relevant to the shareholder voting decision.

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[318] *See* Amendments to Proxy Rules for Registered Investment Companies, Investment Company Act Release No. 19957 (Dec. 16, 1993) [58 FR 67720 (Dec. 22, 1993)] at section II.F.

[319] Proposed Item 22(a)(iii) of Schedule 14A would define "Marketing and Service Fee" to mean "a fee deducted from Fund assets to finance distribution activities pursuant to rule 12b-2(b)."

[320] *See* proposed rule 12b-2(b)(2).

[321] *See* Item 22(d)(1)-(3) of Schedule 14A; proposed Item 22(d)(1), (2) of Schedule 14A.

Therefore, we propose to eliminate the disclosure requirements in Item 22(d) regarding director involvement in approving asset-based distribution fees.[322]

We also propose to eliminate the current requirement that funds disclose in Item 22(d) the aggregate dollar amount of distribution fees paid by the fund in the previous year. When we initially discussed such disclosure in 1979, we envisioned that the disclosure of aggregate dollar amounts could be useful for shareholders who were being asked to renew a 12b-1 plan.[323] This information may have been useful for shareholders who were evaluating whether the expenditure of dollar amounts was helpful to address certain problems or circumstances that the 12b-1 plan addressed. In light of our current proposal to eliminate 12b-1 plans, however, and the fact that the aggregate dollar amount of marketing and service fees primarily reflects the rate of the fee and the size of the fund (information that is readily available elsewhere), we believe this information is unlikely to affect a shareholder's decision to approve an increase in a marketing and service fee. Thus, we propose to eliminate the requirement to disclose information regarding asset-based distribution fees in Item 22(d).[324]

We request comment on our proposed changes to Schedule 14A.

- Should we require disclosure of any other aspects of marketing and service fees in the

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[322] *See* Item 22(d)(4) of Schedule 14A.

[323] *See* 1979 Proposing Release, *supra* note 33, at text accompanying n.37 ("If shareholders were being asked to vote on the renewal of a plan, it would appear appropriate to include as well the amount spent by the fund in the previous fiscal year, as a total dollar amount and as a percentage of average net assets during that period, and the benefits to the fund from such expenditures.").

[324] *See* Item 22(d)(2)(iii) of Schedule 14A. This information will continue to be available to investors in the financial statements that are included in annual and semi-annual shareholder reports. See Item 27 of Form N-1A (requiring the inclusion of financial statements required by Regulation S-X); 17 CFR 210.6-07 (Regulation S-X requirement that the statement of operations separately state management and service fees); proposed amendment to 17 CFR 210.6-07 (proposed requirement that Regulation S-X require the separate statement of "all fees deducted from fund assets to finance distribution activities" pursuant to rules 12b-2(b), (d) or 6c-10(b) under the Investment Company Act). In addition, directors will continue to review the amounts charged to funds in the course of their oversight of fund expenses.

proxy statement? Is information about the aggregate amount of marketing and service fees collected relevant and meaningful to investors? Should we include any requirement for disclosure of director involvement in the setting of marketing and service fees?

3. Request for Comment on Account Statement Alternative

The GAO previously suggested that the Commission consider requiring funds to disclose in account statements the actual dollar amount of fees and expenses that each shareholder directly or indirectly has paid as an investor in the fund.[325] Many commenters argued, however, that such an approach would be unduly costly and may not be helpful to shareholders.[326] We believe that our proposed amendments would improve transparency of distribution related expenses without requiring funds and intermediaries to incur the costs that these commenters have asserted are associated with account statement disclosures.[327]

- Is our assumption correct? Or should we pursue the recommendations made by the GAO and require account statement disclosure of the actual dollar amount of asset-based distribution fees? Would such account statement disclosure be helpful or useful to investors? Have technological advances permitted account statement disclosure to be provided to investors without undue costs?

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325 *See* GAO, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION, *supra* note 130. *See also* Roundtable Transcript, *supra* note 109, at 221 (Richard Phillips, K&L Gates) ("[I]f you had [disclosure of 12b-1 fees] in dollars and cents terms, if you had it in the account statements…I think you would get a mutual fund investing public that is more sensitive to the issue of sales charge. And, over the long run, it would have a competitive effect of a more informed investing public.").

326 *See*, *e.g.*, Comment Letter of the ICI (July 19, 2007); Comment Letter of W. Hardy Callcott (June 18, 2007). However, another commenter argued that account statement disclosure could provide useful information to shareholders. *See* Comment Letter of Access Data Corp. (July 19, 2007).

327 We note that we have addressed this issue in part by requiring that prospectuses include an example of the costs an investor would pay on a hypothetical $10,000 investment in the fund. *See* Item 3 of N-1A.

K. Proposed Conforming Amendments to Rule 11a-3

Section 11(a) of the Act requires exchanges between funds to be based on the relative net asset values of the shares to be exchanged.[328] Rule 11a-3 provides a conditional exemption permitting funds and fund underwriters to charge a sales load on shares acquired in certain exchanges between funds within the same fund group. Among other things, the rule limits the total combined sales load that may be charged on shares that have been subject to an exchange (*i.e.*, all sales loads incurred on both the exchanged and acquired shares) to the highest sales load rate applicable to those shares (exchanged or acquired) in the absence of an exchange.[329] This provision is designed to give shareholders credit for all sales loads paid in connection with a purchase of fund shares, regardless of whether the sales load was paid with respect to the exchanged or acquired shares.[330]

As discussed above, our proposed amendments to rule 6c-10 would treat traditional sales loads and the sales charge component of existing 12b-1 fees, (*i.e.*, the ongoing sales charge) similarly under the Act.[331] Accordingly, we propose two changes to rule 11a-3 that would conform that rule with our general approach.

1. Credit for Ongoing Sales Charges Paid

Paragraph (b)(4) of rule 11a-3 requires that funds, in determining any sales load due upon an exchange, give shareholders credit (*i.e.*, reduce the amount of sales load charged on the

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[328] Section 11(a) of the Act makes it unlawful for a fund or its principal underwriter to make an exchange offer to the fund's shareholders or to shareholders of another fund on any basis other than the relative net asset values of the shares to be exchanged, unless the terms of the offer are approved by the Commission or comply with Commission rules governing exchanges.

[329] Rule 11a-3(b)(4).

[330] Offers of Exchange Involving Open-End Investment Companies and Unit Investment Trusts, Investment Company Act Release No. 15494, at text following n.28 (Dec. 23, 1986) [51 FR 47260 (Dec. 31, 1986)].

[331] *See supra* note 141 and accompanying text.

purchase of new shares) for their previous payment of sales loads on the shares exchanged, but does not require funds to give shareholders credit for the payment of any rule 12b-1 fees. In order to ensure that shareholders are credited for all sales charges previously paid in connection with a purchase of fund shares, we propose to amend rule 11a-3(b)(4) to require funds to also give shareholders credit for the payment of ongoing sales charges.

We request comment on our proposed treatment of ongoing sales charges in rule 11a-3.

- Are there reasons not to treat a sales load and an ongoing sales charge in the same way when determining the amount of sales load due upon an exchange? Should we require funds to also give credit for any marketing and service fee paid under rule 12b-2 when calculating the sales load due upon an exchange? Should we require funds to also give credit for any 12b-1 fees previously paid on the exchanged shares? If so, should we limit the credit to fees paid in excess of 25 basis points (*i.e.*, the asset-based sales charge component of 12b-1 fees)? Would our proposed amendments to rule 11a-3 result in significant operational difficulties? Is there a simpler or less costly method of accomplishing the goal of ensuring that investors receive credit for ongoing sales charges during rule 11a-3 exchanges than the approach we are proposing?

2. Deferred Sales Loads upon Exchange

Rule 11a-3 prohibits funds from imposing a deferred sales load at the time of an exchange.[332] The provision was designed to remove the incentive for fund underwriters to induce shareholders to make exchanges in order to accelerate its collection of a deferred sales

[332] Rule 11a-3(b)(3).

load.[333] Under the rule, a fund may not treat an exchange as a redemption for purposes of assessing a deferred sales load, and thus may impose a deferred sales load only when the acquired shares are ultimately redeemed.[334] When the deferred load is imposed, the fund must determine the amount of the deferred load by "tacking" (*i.e.*, adding) the time the shareholder held shares of the exchanged fund to the time the shareholder held shares of the acquired fund.[335] However, in determining the amount of the deferred load, a fund may toll (*i.e.*, exclude) the time the acquired shares are held if a new sales load is not charged upon the exchange *and* credit is given to the investor for any 12b-1 fees paid with respect to the acquired shares.[336]

We propose to modify the "tolling" provision of rule 11a-3 to permit funds, in determining the amount of deferred sales load due upon ultimate redemption, to provide credit only for the sales charge component of any asset-based distribution fee, *i.e*., the ongoing sales charge. Because the marketing and service fee is not considered to be an alternative sales charge under our proposal, we would not require funds to give credit for such fees when determining the sales load payable upon an exchange. In addition, we propose to modify the rule to clarify that funds must provide credit for ongoing sales charges in terms of the cumulative *rate* of the ongoing sales charge previously paid rather than the *amount* of fees paid. As discussed

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[333] *See* Rule 11a-3 Adopting Release, *supra* note 186, at text following n.28.

[334] Rule 11a-3(b)(5).

[335] *Id.*

[336] Rule 11a-3(b)(5)(i). The rule provides an analogous provision for acquired shares that have a CDSL. Rule 11a-3(b)(5)(ii). The rule recognizes that CDSLs typically are reduced over time to reflect amounts paid by investors indirectly through a 12b-1 plan. We reasoned that "if a shareholder is making any payments for distributions through a 12b-1 plan, those payments should be reflected in a commensurate reduction of the CDSL owed, [but] … tolling would prevent a shareholder from receiving credit for the 12b-1 payments made while holding the acquired shares …." *See* Offers of Exchange Involving Registered Open-End Investment Companies and Unit Investment Trusts, Investment Company Act Release No. 16504, at text following n.35 (July 29, 1988) [53 FR 30299 (Aug. 11, 1988)] (revised proposal of rule 11a-3). Thus, rule 11a-3 permits tolling of the time the acquired shares are held only if "a credit is given to investors for any 12b-1 fees with respect to the acquired shares …." Rule 11a-3 Adopting Release, *supra* note 186, at text accompanying n.35.

previously, we understand that funds generally do not have the ability to track dollar amounts of 12b-1 fees that are attributable to individual shareholder accounts.[337] In addition, requiring that credit be given in terms of rates rather than dollar amounts would make rule 11a-3 consistent with the method of calculating maximum sales loads under rule 6c-10(b).[338]

- Should rule 11a-3 require funds to give shareholders credit for the payment of any marketing and service fee when relying on the tolling provisions? We request comment on any aspect of our proposed changes to rule 11a-3. Should rule 11a-3 operate in terms of dollar amounts instead of rates? Would it be difficult or costly for funds to comply with the new requirements? Is it difficult or costly for funds today to comply with the tolling provisions of rule 11a-3? Is our understanding correct that funds generally do not have the ability to track dollar amounts of 12b-1 fees? Would it be difficult or costly for funds to track these amounts?

L. Other Proposed Conforming Amendments

1. Rule 17a-8

Rule 17a-8 provides an exemption from section 17(a) of the Act to permit mergers of funds with certain of their affiliated persons, including other funds (affiliated funds), subject to certain conditions.[339] Among other requirements, the rule requires the board of the merging fund to have made certain determinations, the surviving fund to keep certain records, and the shareholders of the merging fund to approve of the merger.[340] The rule allows for affiliated funds to merge in the absence of a shareholder vote, if, among other conditions, the 12b-1 fees of

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[337] *See supra* note 170 and accompanying text.

[338] *See supra* Section III.D.1 of this Release.

[339] "Affiliated person" is defined in section 2(a)(3) of the Act.

[340] *See* rule 17a-8(a)(2), (a)(5), and (a)(3), respectively.

the surviving company are no greater than the 12b-1 fees of the merging company.[341] This condition prevents 12b-1 fees from being instituted or increased as a result of a merger on which the acquired fund's shareholders have not had an opportunity to vote.[342] We propose to preserve this protection by amending rule 17a-8 to replace references to rule 12b-1 with references to rule 12b-2(b) or (d) and rule 6c-10(b).[343]

- We request comment on this proposed revision. Should we continue to permit affiliated funds to merge in reliance on this provision in light of our new approach to asset-based distribution fees and the different role that fund directors would have in overseeing these fees under our proposal? Is there another approach we should take in amending rule 17a-8 to conform with our proposal?

2. Rule 17d-3

When the Commission adopted rule 12b-1 in 1980, it also adopted rule 17d-3 because a fund's payments for distribution under a rule 12b-1 plan may involve it in a "joint enterprise" with an affiliated person that otherwise would be prohibited by section 17(d) of the Act and rule 17d-1 unless an application regarding the joint arrangement was filed with the Commission and granted by order.[344] The rule grants an exemption for funds to enter into agreements with certain affiliated persons and the fund's principal underwriter in connection with the distribution of its

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341 Rule 17a-8(a)(3)(iv).

342 Investment Company Mergers, Investment Company Act Release No. 25666 (July 18, 2002) [67 FR 48512 (July 24, 2002)].

343 *See* proposed amendments to rule 17a-8(a)(3)(iv).

344 *See* 1980 Adopting Release, *supra* note 23, at section titled "Proposed Rule 17d-3" (rule 17d-3 was adopted in the same release as rule 12b-1). Section 17(d) of the Act and rule 17d-1, in general, prohibit an investment company from entering into a "joint enterprise or other joint arrangement or profit-sharing plan" (as defined in the rule) with any affiliated person or principal underwriter (or their affiliated persons) unless the Commission by order grants an exemption before the agreement goes into effect.

shares, provided that such an agreement is in compliance with rule 12b-1, among other requirements.[345]

We believe that under our proposed new rules, funds should continue to be afforded the exemption provided by rule 17d-3 with respect to distribution payments made to certain affiliated persons and the principal underwriter, so long as those payments are consistent with the conditions set forth in proposed rule 12b-2 and amended rule 6c-10.[346] We therefore propose to revise rule 17d-3(a) to replace the reference to 12b-1 with references to rule 12b-2(b), rule 12b-2(d) and rule 6c-10(b) in order to permit a fund to enter into an asset-based distribution fee arrangement with an affiliated underwriter.[347]

- We request comment on any aspect of this proposed revision. Would the revised role of directors in approving asset-based distribution fees under our proposal make this type of exemption less warranted? Is there another approach we should take in revising rule 17d-3 to conform with our proposal?

3. Rule 18f-3

Rule 18f-3 permits funds to offer multiple classes of fund shares. Section (f) of the rule permits funds to convert shares of one class to shares of another class after a specified period of time, provided that, among other things, the expenses (including 12b-1 fees) charged to the converted class are no higher than the expenses of the original share class. We believe that,

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345 The Commission stated that prior review and approval as required by rule 17d-1 would not be necessary if the safeguards of rule 12b-1 have already been applied to the arrangement. 1979 Proposing Release, *supra* note 33. The exemption does not extend to arrangements for the joint sharing of distribution costs by funds that are affiliates (or affiliates of affiliates) of each other (*e.g.*, mutual funds in the same fund complex). 1980 Adopting Release, *supra* note 23, at section titled "Proposed Rule 17d-3."

346 We note that fund boards would continue to review and scrutinize arrangements involving asset-based distribution fees and ongoing sales charges, as discussed above. *See supra* section III.D.4.

347 *See* proposed amendments to rule 17d-3(a).

under our proposed amendments, funds should continue to be able to convert shares under the same conditions. We believe that expenses attributable to proposed rule 12b-2 and proposed amendments to rule 6c-10 should be taken into account when making these conversions, much like rule 12b-1 expenses are today. We therefore propose that rule 18f-3(f)(ii) be amended to delete the reference to 12b-1 fees and replace it with references to fees under rule 12b-2(b), rule 12b-2(d) and rule 6c-10(b).[348]

- We request comment on any aspect of this revision. Is there another approach we should take in revising rule 18f-3 to conform with our proposal?

4. Forms N-3, N-4, and N-6

Form N-3 is the registration form used by insurance company separate accounts registered as management investment companies that offer variable annuity contracts. Instruction 2 to Item 7(a) requires separate accounts to disclose, among other things, the principal activities for which 12b-1 payments are made and the total amount spent under a 12b-1 plan in the most recent fiscal year, as a percentage of net assets. We believe that most of the information required to be disclosed by Instruction 2 to Item 7(a) would continue to be useful to investors and the Commission, and thus we propose to amend Instruction 2 to Item 7(a) to replace references to rule 12b-1 and 12b-1 plans with references to asset-based distribution expenses incurred under rule 12b-2(b), rule 12b-2(d) and rule 6c-10(b). The proposal would eliminate the requirement that registrants disclose the total amount spent in the most recent fiscal year (although this information would continue to be available in funds' financial statements), and would instead require registrants to provide a description of asset-based distribution fees. As discussed above, disclosure of the aggregate total of asset-based distribution fees may not be

[348] *See* proposed amendments to rule 18f-3(f)(ii).

helpful to investors because it primarily reflects the size of the fund and not the distribution activities that are paid for with these amounts.[349] The proposal would retain the requirement that registrants list the principal types of activities for which asset-based distribution fees are charged.

As discussed above, under our proposals funds would not be required to have written "plans" that are supervised and approved by the board of directors. We therefore propose to eliminate paragraphs (ii) and (iii) of Item 21(f) because these items relate to the specific operation of a 12b-1 plan that would no longer exist under our proposal.[350]

- We request comment whether we should retain any of these parts of Item 21(f).

We believe, however, that the information required to be disclosed in paragraph (i) of Item 21(f), which requires registrants to disclose the manner in which amounts paid by the registrant under a 12b-1 plan were spent, would continue to be useful to investors and the Commission. This information may be relevant to an investor making an investment decision because it discloses the types of services the fund (and its investors) may receive in exchange for these fees. We propose to amend Item 21(f) to eliminate references to the 12b-1 plan, and instead require disclosure of the principal activities paid for through asset-based distribution expenses incurred under rule 12b-2(b), rule 12b-2(d) and rule 6c-10(b). For the reasons discussed above, we also propose to amend Instruction 5 to Item 26(b)(ii)[351] to delete any references to 12b-1 plans.[352] However, registrants would be required to provide the same information with respect to expenses and reimbursements accrued pursuant to rule 12b-2(b), rule

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[349] *See supra* note 323 and accompanying text.

[350] Item 21(f)(ii) requires a registrant to disclose whether any interested person or director has a financial interest in the operation of the 12b-1 plan. Item 21(f)(iii) requires disclosure of the anticipated benefits of the plan to the fund.

[351] Instruction 5 to Item 26(b)(ii) explains how registrants should include expenses related to 12b-1 fees in the calculation of their performance data.

[352] *See* proposed amendments to Instruction 5 to Item 26(b)(ii).

12b-2(d) and rule 6c-10(b).

- We request comment on any aspect of these proposed revisions to Form N-3.

We are also proposing to amend the fee tables in Forms N-4 and N-6, the registration forms used by insurance company separate accounts registered as unit investment trusts that offer variable annuity contracts and variable life insurance contracts, respectively. We propose to replace existing references to "distribution [and/or service] (12b-1) fees" with a new defined term, "asset-based distribution fees." We also propose to add new instructions that would define the term "asset-based distribution fee" as "all asset-based distribution fees paid under rule 12b-2(b), rule 12b-2(d), and rule 6c-10(b)."

- We request comment on these proposed revisions to Forms N-4 and N-6.

5. Form N-SAR

We are proposing to amend the instructions to Form N-SAR, the reporting form that is used by mutual funds for filing annual and semi-annual reports with the Commission.[353] Form N-SAR currently requires funds to answer a series of five questions about their 12b-1 plans in a yes/no or fill-in-the-blank format, which provides the Commission information regarding the use and amount of 12b-1 fees. The first of these questions asks a fund to state whether it has adopted a rule 12b-1 plan, and if the answer is "no," the fund need not answer the next four questions.[354] Because under our new approach funds would no longer be required to have 12b-1 plans, funds would answer "no" to the first question, and would not be required to respond to the remaining four questions. Under the proposed amended instructions, funds with share classes subject to a grandfathered 12b-1 plan (as discussed in Section N.3 below) would respond "yes" to the first

[353] Mutual funds that have effective registrations statements for their shares under the Securities Act are required to file annual and semi-annual reports with the Commission on Form N-SAR under section 30(b) of the Act and rule 30b1-1.

[354] Item 40 of Form N-SAR.

question, and provide the information required in the remaining questions. Funds that do not have grandfathered 12b-1 plans would answer "no" to the first question, and would not be required to respond to the remaining four questions.

Although the operation of grandfathered 12b-1 fees would differ in certain ways from current 12b-1 fees if the proposal is adopted (primarily because there would no longer be board approval of a 12b-1 plan), those differences should not affect the disclosures required under Form N-SAR, and this information could continue to be useful to the Commission and investors.

- We request comment on our proposed changes to Form N-SAR. Should we delete the Form N-SAR questions related to 12b-1 plans entirely and not require funds with grandfathered share classes to answer the questions? Or should we amend the questions so that they apply not only to funds with a 12b-1 plan, but also to any fund with asset-based distribution fees pursuant to our proposed new rule 12b-2 and amended rule 6c-10? Is there a continuing need for the information to be disclosed in the questions related to 12b-1 plans in Form N-SAR if our proposal is adopted?

6. Regulation S-X

Mutual funds must include in their registration statements and shareholder reports the financial statements required by Regulation S-X.[355] As part of this requirement, mutual funds file a statement of operations listing their income and expenses.[356] Under the expense category, funds currently must state separately all amounts paid in accordance with a plan adopted under

[355] Item 27 of Form N-1A. Article 6 of Regulation S-X contains special rules applicable to the financial statements of registered investment companies. 17 CFR 210.6-01 *et seq.*

[356] Rule 6-07 of Regulation S-X contains the requirements for an investment company's statement of operations. 17 CFR 210.6-07. The statement of operations reports changes in a fund's net assets resulting from the amount of net investment income, net realized gains and losses on investments, and net unrealized appreciation or depreciation of investments.

rule 12b-1.[357] We propose to delete the reference to rule 12b-1 and replace it with a requirement that funds list separately, in two line items in the statement of operations, the portion of this expense that represents marketing and service fees under proposed rule 12b-2(b), and the portion of this expense that represents ongoing sales charges under proposed amendments to rule 6c-10(b) or other fees under rule 12b-2(d).[358] Multiple-class funds would be permitted to disclose the marketing and service fees and ongoing sales charges incurred by each class either in the statement of operations or in a note to the financial statements, so that investors in each class would have an understanding of the expenses paid by their particular distribution arrangement. This change is designed to provide investors with information about marketing and service fees and ongoing sales charges in a fund's financial statements and is consistent with the proposed changes to the prospectus fee table.[359] In addition, funds that receive reimbursements relating to distribution would continue to report these reimbursements as a negative amount and deduct them from current 6c-10(b), 12b-2(b) or (d) expenses in the statement of operations.

- We request comment on the proposed amendments. Would listing ongoing sales charges in the statement of operations help investors understand that they are paying a sales charge as part of their investment in the fund? Should this information be presented in the statement of operations separately for each class of the fund? Is a note to the financial statement the appropriate place to provide this information? If not, where should we require disclosure of class-specific information? Should we also require that the conversion period for the ongoing sales charge be included in

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[357] 17 CFR 210.6-07.2(f).

[358] Shares subject to grandfathering under proposed rule 12b-2(d) would continue to list asset-based fees as a single line item, as under current practices.

[359] *See supra* Section III.J of this Release.

shareholder reports to provide investors with a regular reminder and reference for how long the fee would be charged?

M. Potential Impact of Proposed Rule Changes

Our rule proposals are designed to resolve many of the difficulties that investors, as well as fund directors, managers, underwriters, and intermediaries, have experienced with rule 12b-1 and 12b-1 fees over the years. We also recognize that, if adopted, our proposals would affect how some fund groups and their distributors conduct business. The benefits and potential impacts of the proposed rule changes on various market participants, which we summarize below, are also discussed further in the Cost-Benefit Analysis contained in Section V of this Release.

1. Fund Investors

Our proposals are designed to make it easier for fund investors to understand fund expenses. As a result, investors would be better able to select the fund or fund class that offers the combination of costs and services that is most advantageous for them. In addition, our proposals would provide for equivalent limitations on sales charges for shareholders who invest in a fund through a class of shares that charges front-end sales loads and those who choose to invest in a class of shares that bears an ongoing sales charge. We believe the proposals would yield investors two benefits. First, they would protect investors from the imposition of excessive sales loads, in furtherance of the goals of section 22(b) of the Act,[360] by limiting the cumulative amount of sales charges that an investor could bear directly or indirectly.[361] Second, they would promote a fairer allocation of distribution costs among investors who invest through different share classes by limiting the extent to which one class of shares (*e.g.*, class C shares) may bear

[360] *See supra* note 20.

[361] *See infra* Section III.N.3 (discussing grandfathered share classes).

these costs. In addition, the proposed rule amendments may lead to lower distribution costs if greater retail price competition develops.

Some investors wrote to us urging the elimination of rule 12b-1 as a way of reducing the cost of owning mutual funds.[362] Although one consequence of the proposed rule amendments may be to reduce distribution costs, the elimination of asset-based sales charges would not eliminate the need to compensate fund intermediaries for fund distribution and for the other services they provide. Investors who do not want to pay 12b-1 fees have available to them a range of funds that do not charge these fees, although investors in these funds may pay distribution costs through other means. In recent years, expenses of funds as a group have begun to decline as more investors have sought funds with lower expenses, and as index funds and exchange-traded funds have become more popular with investors.[363] We believe that more transparent disclosure of fund expenses may help investors to better evaluate different fund options. This transparency also may lead to greater competition among funds and ultimately downward pressure on fund costs.

2. Fund Intermediaries and Distributors

We received comments from a large number of financial planners, broker-dealer representatives, and brokerage firm managers who expressed concern that the "trail commissions" or "service fees" they receive from the proceeds of 12b-1 fees might be cut off as a result of this rulemaking, and they could no longer provide ongoing services to their

[362] *See, e.g.*, Comment Letter of Melvyn H. Mark (June 17, 2007); Comment Letter of Jack Thomas (June 19, 2007); Comment Letter of Weiwan Ng (June 19, 2007).

[363] *See, e.g.*, Fee Trends Report, *supra* note 22 (discussing the decline in expense ratios during the past 20 years, but noting that the expense ratios of stock funds and bond funds increased in 2009).

customers.[364] These proposals should address these concerns.[365] Approximately 80 percent of fund assets that are subject to 12b-1 fees are charged 12b-1 fees of 25 basis points or less. They therefore would not be subject to the portion of our rule proposals related to ongoing sales charges.[366]

Intermediaries that may be affected by our proposed rules are primarily broker-dealers that currently receive payments from the sale of classes of fund shares that pay 12b-1 fees that exceed 25 basis points (*e.g.,* class C shares). Under our rule proposals, funds could continue to pay broker-dealers 12b-1 fees at previously approved levels for grandfathered shares.[367] For shares issued after the compliance date, fund underwriters would likely reduce the stream of payments when the shares convert to a class that pays no more than 25 basis points of asset-based distribution expenses (*e.g.,* class A shares) or else find a different source of revenue to fund the payments. The amount of time before conversion would depend on the amount of sales load charged on the class A shares, *i.e.*, the reference load, and the rate of the ongoing sales charge (the amount of asset-based distribution fees that exceeds 25 basis points). Thus, for example, if a fund offers class A shares with a 5.25 percent front-end load and class C shares with an ongoing sales charge of 75 basis points, then the class C shares would have to convert no later than seven years from the time of purchase.[368] This consequence flows from the premise

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[364] *See, e.g.,* Comment Letter of Jill Shannon (Aug. 6, 2007); Comment Letter of Bernard Smit (Oct. 9, 2007); Comment Letter of Eric Connors (June 19, 2007)). *See also* Comment Letter Type A and Comment Letter Type B.

[365] *But see supra* notes 100 and 168 of this Release.

[366] According to industry statistics derived from Lipper's LANA Database analyzed by our staff, funds that charge 12b-1 fees have aggregate assets of $4.86 trillion, which we assume is the source of payments for trail commissions or services fees (or a combination) to intermediaries. 12b-1 fees of 25 basis points or less are charged on approximately 82 percent of these assets ($4.0 trillion).

[367] *See infra* Section III.N of this Release.

[368] We calculated the length of the conversion period by dividing the rate of the front-end load (5.25%) by the rate of the ongoing sales charge (0.75%).

(discussed above) that amounts paid by funds in excess of the marketing and service fee are charged as an alternative to sales loads, and thus are properly limited by the NASD sales load caps.

Some commenters and roundtable participants described “level load” classes of shares as providing for an alternative to front-end or spread-load arrangements, and thus acknowledged them as a form of sales load designed to support distribution of fund shares.[369] Others, however, have asserted that the 12b-1 fees associated with level load funds (often 100 basis points) pay for valuable ongoing investment advice provided by the intermediary, and are an alternative to mutual fund wrap fee programs, which often charge a 100 basis point (or greater) wrap fee.[370] The use of fund assets to finance personal advisory services (rather than support fund distribution), however, raises issues regarding whether those advisory services provided by an intermediary to a customer years after the sale ought to be payable from fund assets. Such expenditures arguably do not relate to the operation of the fund or to the distribution of its shares.

- We request comment on these matters. Are asset-based distribution fees associated with level load share classes an efficient means to pay for ongoing investment advice?

With respect to level load share class arrangements, roundtable panelists and commenters raised questions regarding the applicability of the Investment Advisers Act of 1940 (“Advisers

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369 *See, e.g.*, Roundtable Transcript, *supra* note 109, at 198-99 (Richard Phillips, K&L Gates) (“I think you have got to separate the 25 basis point service fee from the 75 basis point sales compensation fee, or broker’s compensation fee …. The 75 basis point substitute for the front-end load … is pure sales compensation.”).

370 *See, e.g.*, Comment Letter of Gregory A. Keil (June 1, 2007) (“The current ‘Class C’ share is really the next step toward a more ‘advice driven’ model … removing a ‘transaction cost’ from the equation – and applying an “always-on” Advisory Fee to a DISCRETIONARY investment vehicle – the mutual fund ….”); Comment Letter of Daryl Nitkowski (July 19, 2007) (“In fact, I believe the typical 1% fee charged on class C shares represents the best option for clients who want continuing advice, but do not want to have a fee based account.”).

Act")[371] to intermediaries that receive those ongoing fees.[372]

- We request comment on these matters, and whether the conversion provisions of our proposed rules would appropriately address them by requiring a nexus between the sale of a share of a mutual fund and the amount of ongoing sales charges an intermediary's customer pays through the fund.

Finally, we note that our proposed relaxation of restrictions on retail price competition could provide fund intermediaries with greater control over the pricing of fund shares sold to their customers by permitting intermediaries to establish their own sales loads specifically tailored for their customers. This may result in greater competition among intermediaries and in particular may impact smaller broker-dealers that lack the distribution capacity and negotiating ability of larger broker-dealers. However, some smaller broker-dealers may use this alternative to create new pricing structures that permit them to better compete with larger broker-dealers.

- We request comment on the likely effects on competition that may result from our proposal, including the effects with regard to smaller broker-dealers.

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[371] 15 U.S.C. 80b.

[372] Intermediaries that are broker-dealers are excluded from the definition of investment adviser under the Advisers Act with respect to advice they provide that is "solely incidental to the conduct of [their] business as a broker or dealer" and for which they receive "no special compensation." Section 202(a)(11)(C) of the Advisers Act [15 USC 80b-2(a)(11)(C)]. Some commenters asserted that broker-dealers receiving 12b-1 fees are ineligible for this exclusion. *See, e.g.*, Comment Letter of Ron A. Rhoades (June 18, 2007) ("It is clear from various comments recently submitted by broker-dealer firm registered representatives, as well as … industry representatives and the ICI, that 12b-1 fees are being utilized as 'special compensation' for advice which is ongoing … and which clearly cannot be considered incidental to the mutual fund sales transaction …. I would submit that the payment of 12b-1 fees for such purposes violates the Investment Advisers Act, when such fees are paid in connection with brokerage (not investment advisory) accounts."); Comment Letter of Harold Evensky (June 26, 2007). *See also* Roundtable Transcript, *supra* note 109, at 203 (Barbara Roper) ("The other thing I would just like to point out, having listened to today's discussion, this advice we're getting doesn't sound remotely like anything I would call solely incidental to product sales. And these fees sound a lot like special compensation for advice."). *See also* Beagan Wilcox Volz, *Class Action Firm Mounts Legal Attack on 12b-1 Fees*, IGNITES (Apr. 9, 2010) (discussing recent lawsuits alleging that broker-dealers may not properly receive 12b-1 fees without registration as investment advisers).

3. Fund Managers and Principal Underwriters

Our proposals would largely preserve existing distribution arrangements, and should provide fund managers, directors, etc., with greater legal certainty regarding many distribution financing practices that have developed over the years.[373] In this regard, our proposals would respond to the many calls we have received from mutual fund managers and others to revise rule 12b-1 in a way that recognizes that 12b-1 fees are today a substitute for sales loads, and to eliminate the procedural requirements of the rule that they view as outdated.[374]

Today's proposals are designed to address the criticism of funds and fund managers expressed by investors, the academic community, and the financial press who argue that rule 12b-1 fees may not collectively benefit fund shareholders because they do not produce economies of scale and, in fact, operate to increase fund expense ratios.[375] We anticipate that the proposed rules, if adopted, would shift the focus from whether fund expenses are increased by a 12b-1 fee to whether the sales charges imposed by a particular fund are appropriate in light of the services provided by the intermediary. This is the issue we believe investors should be exploring before they decide to invest in a fund and pay sales charges.

4. Small Fund Groups

Some fund and broker-dealer industry participants expressed concern about the possible

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[373] One of the uncertainties involves whether fund boards can appropriately approve continuation of 12b-1 fees for funds that are no longer selling shares. *See* Standard & Poor's, *Closed Funds and 12b-1 Fees* (Aug. 2008) (http://www2.standardandpoors.com/spf/pdf/index/concept_12B1-Fess&ClosedFunds.pdf) (the existence of 12b-1 fees in funds closed to new investments may seem "counter-intuitive," but may be appropriate when viewed as a substitute for a sales load).

[374] *See supra* Section II.E.

[375] *See, e.g.*, Haslem, *supra* note 108; William Dukes et al., *Mutual Fund Mortality, 12b-1 Fees, and the Net Expense Ratio*, 29 J. FIN. RES. 235 (2006); Charles Trzcinka & Robert Zweig, *An Economic Analysis of the Cost and Benefits of SEC Rule 12b-1*, MONOGRAPH SERIES IN FINANCE AND ECONOMICS 67 (Leonard N. Stern School of Business, NYU) (1990). *See also* William P. Dukes & James B. Wilcox, *The Difference Between Application and Interpretation of the Law as It Applies to SEC Rule 12b-1 Under the Investment Company Act of 1940*, 27 NEW ENG. L. REV. 9 (1992).

effects of changes to rule 12b-1 on smaller fund groups. Several asserted that use of fund assets to pay for distribution has played an important role in permitting smaller fund groups to compete with larger fund groups for the attention of intermediaries by permitting them to access a wide array of distribution networks.[376] Of particular importance to small funds is their continued ability to use fund assets to pay for participation in fund supermarkets,[377] which are an important means by which investors find smaller fund groups.[378] A number of studies of the role of brokers and fund supermarkets in selling shares of mutual funds offered by smaller fund groups appear to support these assertions.[379]

In developing our proposals, we have considered their potential effect on smaller fund groups. A representative of a smaller fund group participated in our roundtable discussion, and our staff met with representatives from other small fund groups to listen to their concerns and explore ways in which we might address them.

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[376] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 67-68 (Mellody Hobson, Ariel Capital Management). *See also* Comment Letter of Thornburg Investment Management (July 19, 2007) ("[L]arge brokerage firms have increasingly become more open to using funds managed by independent advisors, rather than relying entirely on in-house managed products" because of compensation from 12b-1 fees); Comment Letter of the Securities Industry and Financial Markets Association (July 19, 2007) ("[A]vailability of 12b-1 fees makes smaller funds more attractive to larger intermediaries, and correspondingly smaller intermediaries, that do not enjoy the same economies of scale as larger ones, are able to support and offer a broader choice of funds for their clients"); Comment Letter of the ICI (July 19, 2007) ("[T]he ability of small funds to assess asset-based distribution fees has enabled these funds to remain competitive by allowing them to gain access to a wider array of distribution channels . . . .").

[377] *See supra* note 96.

[378] *See* Comment Letter of Charles Schwab & Co., Inc. (July 16, 2007) ("Repeal of rule 12b-1 would undoubtedly restrict a fund's ability to rely on supermarkets and their superior infrastructure, and, in particular, we believe it would have a disproportionate impact on smaller and new funds that lack the resources outside of fund assets to pay for shareholder servicing.").

[379] Conrad S. Ciccotello et al., *Supermarket Distribution and Brand Recognition of Open-End Mutual Funds*, 16 FIN. SERVS. REV. 309 (Winter 2007) (http://findarticles.com/p/articles/mi_qa3743/is_200701/ai_n25499878) (fund families that are focused and smaller in size are more likely to rely on fund supermarkets for distribution); Xinge Zhao, *The Role of Brokers and Financial Advisors Behind Investments Into Load Funds* (August 2003) (http://ssrn.com/abstract=438700) (brokers and financial advisors are more likely than self-directed investors to allocate investment dollars to smaller funds).

We believe that our proposal reflects consideration of the concerns small fund groups shared with us, and would preserve their ability to compete with larger fund groups. Based on an analysis of data collected from the Lipper LANA Database by our staff, we estimated that approximately 108 "small fund groups," offered 189 classes of fund shares to the public.[380] Our analysis found that of these classes, 166 (88 percent) either charged no 12b-1 fee or charged a 12b-1 fee of 25 basis points or less.[381] The remaining 23 classes (12 percent), under our proposal, would be required to comply with the limits on ongoing sales charges, reduce their distribution expenditures, or otherwise change their distribution arrangements. Alternatively, as discussed above, where non-distribution related expenses are now paid under 12b-1 plans, many funds may be able to allocate that portion of their existing 12b-1 fees to administrative expenses, and thus ensure that their asset-based distribution expenses fall within the limits of the 25 basis points marketing and service fee.[382]

Only 11 of the small fund groups (6 percent) offered class C shares, and fund assets attributable to these classes amounted to only $60 million of assets (0.2 percent of small fund group assets). Based on this data, we do not believe that our proposals would require many small funds to restructure their fund classes.[383]

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[380] We are using, for purposes of our estimates, the definition of "small business" or "small entity" that we use for purposes of the Regulatory Flexibility Act [5 U.S.C. 601, *et seq*.]. Rule 0-10 under the Act defines a "small entity" for purposes of the Act as a group of related management companies (funds) that has net assets of $50 million or less as of the end of its most recent fiscal year.

[381] 111 classes (59 percent) do not have a 12b-1 plan in effect.

[382] *See supra* Section III.C of this Release. *See also* Roundtable Transcript, *supra* note 109, at 89 (Mellody Hobson, Ariel Capital Management) (explaining that Ariel funds may treat 15 basis points of a 40 basis point fund supermarket fee as a sub-transfer agent fee.).

[383] Our staff also evaluated the potential impact of our proposal on somewhat larger fund groups – those with less than $250 million of assets under management – and obtained similar results. This group consisted of 191 fund groups that offered 497 share classes. Of these classes, 397 (79.9 percent) carried no 12b-1 fee or a fee of 25 basis points or less. Only 22 of the 191 fund groups offered class

- We request comment on the impact of our proposals on small fund groups. In particular, we request comment on the competitive impact of our rule proposals on smaller fund groups. Is this data correct? Should our rules treat small fund groups differently than larger fund groups?

5. *Retirement Plans*

Many investors invest in mutual funds through tax-advantaged retirement plans, such as 401(k) plans.[384] Some of these funds use fund assets to compensate plan administrators for services provided to plans and plan participants, including recordkeeping, sub-accounting, transaction processing, account maintenance services, and participant education.[385] Many of these payments essentially reimburse plan administrators for costs they incurred to provide services (such as shareholder recordkeeping) that typically funds would have to bear as operational expenses for direct accounts.[386] Other payments, in whole or in part, may be distribution related, and thus many funds today make them to plan administrators and financial intermediaries pursuant to a rule 12b-1 plan.[387] Different funds take different approaches to

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C shares (11.5 percent), with total assets of approximately $400 million (3.5 percent of the assets of these fund groups). *See also* Section V.B of this Release.

384 According to data compiled by the ICI, 36 percent of long-term mutual fund assets were held in tax-advantaged retirement plans as of the end of 2009. *See* 2010 ICI FACT BOOK, *supra* note 6, at 112.

385 *See* Comment Letter of The Spark Institute, Inc. (July 17, 2007).

386 *See* Roundtable Transcript, *supra* note 109, at 79 (Charles P. Nelson, Great-West Retirement Services).

387 *See* Deloitte Consulting LLP, Inside the Structure of Defined Contribution / 401(k) Plan Fees: A Study Assessing the Mechanics of What Drives the 'All-In' Fee (Spring 2009 – updated June 2009) (conducted by Deloitte Consulting LLP for the ICI) (http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf) (noting portions of the distribution fee may be used to compensate financial intermediaries and service providers for services provided to the plan and its participants and to offset recordkeeping and administration costs). To the extent that plan administrators receive these fees as compensation for the sale of fund shares, broker-dealer registration may be required unless an exemption is available. *See supra* note 168. As discussed

paying these expenses. Some funds may specifically identify operational costs and pay them outside of rule 12b-1.[388] Other funds might, for convenience, use 12b-1 fees to pay all of these expenses to avoid the need to determine exactly which of the expenses contribute to fund distribution.[389]

According to the Investment Company Institute, retirement plan assets are typically invested in low cost funds.[390] Approximately 80 percent of 401(k) plan assets are held in mutual fund share classes that pay no 12b-1 fees or 12b-1 fees of 25 basis points or less.[391] If our proposals are adopted, we would therefore expect that funds could continue to make the payments from the proceeds of the marketing and service fee.

Some funds with higher 12b-1 fees may identify a portion of those expenditures as not distribution related and treat them accordingly, and may thus be able to reduce their distribution related payments so that they do not exceed the limits of the marketing and service fee. As a result, these funds would not be subject to the ongoing sales charge limits discussed above. Other funds, however, may be required by our rule proposals to treat a portion of their 12b-1 fee as an ongoing sales charge and provide for a conversion period. We understand that many plan administrators currently do not track and age shares both because plan beneficiaries do not pay

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previously, broker-dealer registration would be required if a plan administrator received the proceeds of an "ongoing sales charge" under the proposal.

388 *See* THOMAS P. LEMKE & GERALD T. LINS, MUTUAL FUNDS SALES PRACTICES § 5:1 (Aug. 2009) (noting that third-party services in retirement plans may be paid by employer subsidies, direct charges to employees, or fees included in mutual fund expenses, such as rule 12b-1 fees and service fees).

389 *See* Paul G. Haaga, Jr. & Michele Y. Yang, Practicing Law Institute, *Distribution of Mutual Fund Shares: Rule 12b-1*, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES (June 1998) (indicating that rule 12b-1 fees may cover things that are not purely "sales" or "distribution" and pointing out that many fund groups subsidize the cost of 401(k) recordkeeping).

390 *See* ICI, *The Economics of Providing 401(k) Plans: Services, Fees and Expenses, 2008* (Aug. 2009) (http://www.ici.org/pdf/fm-v18n6.pdf).

391 *See id.* at 9.

taxes on capital gains realized on sales of shares in retirement plans and because many (or most) plans do not offer share classes that impose CDSLs.[392] Plan administrators would have to either develop this capability, which most other intermediaries have, or offer only classes of shares that do not impose an ongoing sales charge, *i.e.*, classes of shares that carry an asset-based distribution fee of only 25 basis points or less.[393]

A small number of funds today issue a class of shares created especially for retirement plans, often called "R shares." R type shares typically carry a 12b-1 fee of 50 to 100 basis points that generates sufficient revenue to pay for a substantial amount of plan expenses. The Commission staff estimates that less than two percent of plan assets are invested in R shares.[394] Treating amounts deducted in excess of 25 basis points as an ongoing sales charge and eventually converting these shares may not be a viable option for retirement plans with R share classes because plan expenses are ongoing. Thus, our proposal would likely make R shares a less attractive investment option for plans to offer.

We request comment on the potential consequences of our rule proposals on R shares, and whether investors would be harmed.[395] We also note that public policy, as embodied in the

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392 *See* Comment Letter of Charles P. Nelson (June 19, 2007) ("B and C shares usually aren't used by group retirement plan platforms due to the back-end loads that are assessed, which cause recordkeeping problems at the participant level."). Some retirement plans do, however, invest in share classes that require the tracking of share lots. *See* The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, *supra* note 390 at Appendix (the ICI estimates that approximately one percent of 401(k) assets invested in mutual funds are invested in class B shares). We also understand that in light of rule 22c-2, some plan administrators now track the holding periods of fund shares to ensure that redemption fees are properly assessed.

393 This issue is also raised in the context of insurance company separate accounts, as discussed in Section III.H of this Release, *supra*. We discuss the potential costs of implementing a conversion feature in Section V of this Release, *infra*.

394 The staff's estimate is based in part on information obtained from Lipper's LANA Database.

395 We believe that our proposal will complement disclosure initiatives proposed by the Department of Labor ("DOL"), which were designed to ensure that retirement plan participants and beneficiaries could make informed investment decisions about their retirement savings. Fiduciary Requirements

securities laws we administer and the laws administered by other agencies, favors transparency of expenses.[396]

- Do R share classes subsidize significant plan expenses or obscure plan costs by bundling them with mutual fund costs? Are R shares most attractive to plan sponsors that either are unable or choose not to bear plan expenses as an employee benefit? Does this tend to obscure that plan participants are paying the costs themselves through their investments? Do payments to plan administrators from the proceeds of 12b-1 fees on R shares pay for services that may not be exclusively attributable to the funds in which those assets are invested? If so, then are fund assets potentially being used to pay for services to non-fund investors (*i.e.,* not for exclusive benefit of fund investors)?[397]

N. Transition

If we adopt the rule and amendments we are proposing today, we expect to provide for a transition period in order to minimize disruption and costs to funds, fund shareholders, and those who participate in the distribution of fund shares.

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for Disclosure in Participant-Directed Individual Account Plans, 73 FR 43014 (July 23, 2008). The proposed DOL regulation would require, among other things, enhanced disclosure of the fees and expenses of certain retirement plans and their investment options. *Id.*

[396] *See, e.g.*, Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001, *et seq*.); U.S. Dept. of Labor, Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure (Dec. 7, 2007) [72 FR 70988, 70995 (Dec. 13, 2007)]. *See also* U.S. Dept. of Labor, Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure (July 6, 2010) [75 FR 41600 (July 16, 2010] (interim final rule).

[397] We understand that representatives from the fund industry have asserted that because the *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 purpose 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.

1. Effective Date

We would expect to provide for an effective date within 60 days of issuing a release adopting the proposed amendments, which would permit (but not require) funds to take advantage of the new rules quickly.

- We request comment on the effective date.

2. Compliance Period

We would anticipate providing a compliance period of at least 18 months after the effective date in the adopting release for funds to come into compliance with rule 12b-2, amended rule 6c-10, and the other amendments, for new shares sold. Although we want to provide fund shareholders with the benefits we believe will be afforded by the rule amendments as soon as possible, we are sensitive to the operational consequences of the changes we are proposing, and the potential complexities of altering existing fund distribution arrangements. We believe a period of 18 months should be sufficient for funds and fund managers to make the necessary changes to their operating systems, distribution and other agreements, and registration statements.

- We request comment on the length of the compliance period, particularly in light of the "grandfathering" provisions we describe below.

3. Grandfathering

a. <u>Grandfathered Classes and Shares</u>

Five-year grandfathering period. Under our proposal, funds would be required to comply with the changes discussed above with respect to all shares issued after the compliance date of the new rules. We would provide a five-year grandfathering period after the compliance date for share classes issued prior to the compliance date, and that deduct fees pursuant to rule

12b-1 as it exists today, after which those shares would be required to be converted or exchanged into a class that does not deduct an ongoing sales charge.[398] New sales would not be permitted in grandfathered share classes after the compliance date of the new rules.[399]

We are proposing this five-year grandfathering period so that investors, including those in classes currently subject to rule 12b-1 plans, would benefit from the protections provided by the proposed new rules. The grandfathering period is also designed to avoid unnecessarily disrupting existing distribution arrangements under which fund underwriters may have advanced commissions to pay dealers who have sold fund shares, and who may depend upon cash flow from existing rule 12b-1 fees. The five-year grandfathering period would provide time for funds and dealers to revisit and revise existing arrangements to reflect the approach to asset-based distribution fees we are proposing today. This period could allow the existing 12b-1 classes to wind down in an orderly manner. The five-year period is designed to allow sufficient time for funds and their boards to institute any necessary conversion or exchange procedures, and prepare to transition all remaining assets out of grandfathered 12b-1 classes.

We request comment on the proposed grandfathering period for the transition of existing shares into shares that comply with any new rules we adopt.

- Does this approach make sense in light of the compelling need for the regulatory changes we have discussed in this Release? Should we not provide a grandfathering period and instead require compliance immediately? Should we provide a shorter or longer period than five years (*e.g.*, one, three, eight, or ten years)? Instead of a five-

[398] Proposed rule 12b-2(d).

[399] Dividends or other distributions on the old shares, however, could be reinvested in the same share class as the shares on which the dividend or distribution was declared. These investments are not considered "sales" of securities for purpose of the Securities Act and this grandfathering provision. *See* Interpretation of the Division of Corporation Finance Relating to Dividend Reinvestment and Similar Plans, Securities Act Release No. 5515 (July 22, 1974), 4 SEC Docket 623 (Aug. 6, 1974).

year grandfathering period, should we permit the grandfathering of 12b-1 share classes to continue indefinitely?

- Should the proposed grandfathering period apply only to certain types of classes, such as “level load” share classes, and not apply to other classes, permitting them to convert on their own schedules? What benefits might result from such an approach? Should the proposed grandfathering period apply only to classes that charge a certain level of 12b-1 fees (*e.g.,* 12b-1 fees greater than 50 or 75 basis points)?

Alternative transition approaches. We also request comment on alternative approaches to carrying out the transition of existing share classes into classes that comply with any new rules we adopt.

- Should we adopt a “sunset” provision requiring that, by a certain date in the future, all share classes that do not conform to the new rules must be converted or exchanged into share classes that do conform to the new rule? Should we require, in connection with this approach, that shares in an existing fund class that are charged 12b-1 fees at a certain rate per annum be converted or exchanged into shares of a class that are charged a total of marketing and service fees and ongoing sales charges at the same or lower rate per annum? For example, under this approach, shares in an existing class that are currently charged a 12b-1 fee of 100 basis points would have to be converted or exchanged into a class that charges a marketing and service fee of no more than 25 basis points, and an ongoing sales charge of no more than 75 basis points for a limited time period. Should such an approach also take into account the existence of contingent deferred sales loads in existing classes or classes into which shareholders may be converted or exchanged?

- In addition, if we were to adopt this approach, when should we require that all fund shares be converted or exchanged into shares that comply with the new rules? By the compliance date of the rules (*i.e.*, 18 months), or within a shorter period (*e.g.*, six months or one year) or longer period (*e.g.*, two, three, five or seven years) of time? Should we exclude from the sunset provision any shares (such as certain B shares) that by their terms already convert automatically into shares with no ongoing sales charge?
- We request comment whether certain share classes would encounter special difficulty in complying with the proposed five-year transition period. For example, R share classes (which often charge a 50 basis point asset-based distribution fee for an indefinite period) may not be designed to convert to another class, and are often structured to pay certain costs that might otherwise be paid by the plan provider or the plan participants. If these classes are required to transition into a class that does not charge an ongoing sales charge after five years, this may result in a situation in which fees used to pay for these services may no longer be available. However, as discussed previously, this situation could also arise after the conversion period of an ongoing sales charge R share class under our proposal.[400] Does the proposed grandfathering period pose any special issues for certain share classes? If so what type of issues, and how should we deal with them? Should we exempt any funds or share classes from the requirement to eventually end existing 12b-1 share classes? Should we provide different grandfathering periods for different funds or classes? If so, how should we identify and define those funds or classes?

[400] *See supra* Section III.M.5.

- Should we take another approach to dealing with the problem of old 12b-1 share classes other than grandfathering or a sunset provision, and if so what should that approach require? Should we instead require funds to make special exchange offers to shareholders of old classes?

Funds could comply with the new rules by adding a conversion feature to newly issued shares. These funds would disclose in their prospectuses that shares issued before a specified date (the compliance date or earlier) will not convert on the same schedule as new shares would convert.

- Would this approach confuse shareholders? If so, should we require that shares offered under the new rules be issued in a separate class from grandfathered shares?

b. Operation of Grandfathered Classes

During the grandfathering period, under proposed rule 12b-2(d), funds could continue to charge 12b-1 fees on grandfathered share classes at the same (or lower) rate as was approved in the fund's 12b-1 plan.[401] A fund that wants to increase the rate of distribution fees, as a result, would have to comply with the proposed new rules. Because the level of fees charged on old share classes could not be increased, we do not believe any investor protection purpose would be served by requiring these funds to continue to have a formal 12b-1 plan, if we adopt these proposed rules. Thus, directors could eliminate mandatory provisions of 12b-1 plans that require board annual approval, quarterly reports, and allow for board or shareholder termination of plans.[402] Directors would continue to exercise responsibility over the 12b-1 plans in accordance with their general oversight responsibilities. In addition, pursuant to their broad authority, directors could terminate the plan at any time.

[401] Proposed rule 12b-2(d)(2).

[402] Proposed rule 12b-2(d)(1).

After the expiration of the proposed grandfathering period, grandfathered shares would be required to be converted or exchanged into a class of shares that does not charge an ongoing sales charge. We are concerned that permitting the deduction of an ongoing sales charge on grandfathered fund shares could continue to result in shareholders overpaying for distribution. In addition, it may lead to operational and administrative difficulties in identifying the asset-based distribution fees that the shareholders may have already paid and providing proper credit for these fees. Not permitting the deduction of ongoing sales charges on grandfathered shares that have been exchanged or converted is likely to reduce investor confusion and provides equal treatment to investors.

Because under both rule 12b-1 and our proposal a shareholder vote is required to materially increase the rate of a 12b-1 fee, we would also require that the marketing and service fee of the class that the grandfathered shares are exchanged or converted into not be higher than the 12b-1 fee charged on the shares in the last fiscal year. This is designed to ensure that shareholders are not transitioned into a class that charges higher asset-based distribution fees than they agreed to when they originally bought the fund.

We request comment on any aspect of the proposed grandfathering provision.

- Should we require that directors continue to have specific, annual approval duties pursuant to existing rule 12b-1 until those fees are no longer collected? Should the rule provide further flexibility in addition to what we propose? We request comment on how grandfathered 12b-1 fees should be presented in the prospectus fee table. Should classes with grandfathered 12b-1 fees be required to separate and label their distribution fees just as they would under our proposed amendment to the fee table (*i.e.,* by assigning the first 25 basis points charged as a marketing and service fee and the remainder as an ongoing sales charge)? Is there another label for grandfathered 12b-1 fees that would be descriptive without a reference to "12b-1"?

- Instead of providing requirements regarding which class grandfathered shares would need to be transitioned into after the expiration of the grandfathering period, should we instead leave the decision to the discretion of the board? If so, should we provide any guidance to the board, and what should that guidance provide? For example, should we require that the board take into account the length of time that the grandfathered shares have already paid 12b-1 fees, the rate of the ongoing sales charge that might be charged, the technical capabilities of the fund and its service providers, or other factors?

4. Shareholder Voting

For funds that decide to convert current 12b-1 share classes to conform with the proposed rules, proposed rule 12b-2 would prohibit a fund from instituting a marketing and service fee unless the fee has been approved by a vote of at least a majority of outstanding voting securities.[403] A shareholder vote would not be required if the fund: (i) currently deducts from fund assets annual 12b-1 fees of 25 basis points or less, and does not increase the rate of the fee; or (ii) reduces the amount of the 12b-1 fees it currently deducts to an annual rate of 25 basis points or less, and renames the 12b-1 fee a "marketing and service fee." We understand that approximately two-thirds of fund classes either do not deduct a 12b-1 fee, or deduct a 12b-1 fee of 25 basis points or less annually. The proposed rule also would not require funds that currently impose a 12b-1 fee to obtain shareholder approval if the combined ongoing sales charge and marketing and service fee would not exceed amounts that could be deducted under a 12b-1 plan

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[403] *See* proposed rule 12b-2(b)(3).

in effect at the time the proposed amendments, if adopted, become effective. In those instances, funds only would be required to separate the 12b-1 fee into a marketing and service fee and an ongoing sales charge, and treat each fee in conformity with the new rule and rule amendments.

We believe that, in the circumstances described above, a shareholder vote would serve no useful purpose because shareholders have already implicitly approved the fee, and a shareholder vote would thus impose unnecessary costs on funds and their shareholders.

- We request comment on whether a shareholder vote would serve any purpose in either of these situations.

IV. PAPERWORK REDUCTION ACT

Certain provisions of our proposal would result in new or altered "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[404] The Commission is therefore submitting proposed rule 12b-2 and proposed amendments to rule 6c-10 and Form N-SAR under the Act; proposed amendments to Forms N-1A and N-3 under the Act and the Securities Act; and proposed amendments to Schedule 14A and rule 10b-10 under the Exchange Act to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. Responses to the collection of information requirements of our proposals would not be kept confidential.

The proposed amendments to rule 6c-10 would result in a new collection of information requirement within the meaning of the PRA. The title for the collection of information requirement is "Rule 6c-10 under the Investment Company Act of 1940, 'Exemptions for Certain Open-End Management Investment Companies to Impose Deferred Sales Loads and Other Sales Charges.'" If adopted, this collection would not be mandatory, but would be required in order

[404] 44 U.S.C. 3501-3520.

for a fund to deduct asset-based distribution fees in excess of the proposed limits in rule 12b-2.

Proposed rule 12b-2 would result in a new collection of information requirement within the meaning of the PRA. The title for the collection of information requirement is "Rule 12b-2 under the Investment Company Act of 1940, 'Investment Company Distribution Fees.'" If adopted, this collection would not be mandatory, but would be required in order for funds to deduct certain asset-based distribution fees. In addition, our proposal would rescind rule 12b-1 and its associated collection of information requirement. We are submitting to OMB the proposed rescission of rule 12b-1's collection of information requirement.

The Commission is also proposing amendments to existing collection of information requirements titled "Form N-1A under the Investment Company Act of 1940 and Securities Act of 1933, 'Registration Statement of Open-End Management Companies.'" Compliance with the disclosure requirements of Form N–1A is mandatory. The Commission is also proposing amendments to existing collection of information requirements titled "Form N-3 under the Investment Company Act of 1940 and Securities Act of 1933, 'Registration Statement of Separate Accounts Registered as Management Investment Companies.'" Compliance with the disclosure requirements of Form N-3 is mandatory. The Commission is also proposing amendments to existing collection of information requirements titled "Form N-SAR under the Investment Company Act of 1940, 'Semi-Annual Report for Registered Investment Companies.'" Compliance with the disclosure requirements of Form N-SAR is mandatory. The Commission is further proposing amendments to existing collection of information requirements titled "Regulation 14A under the Securities Exchange Act of 1934 and the Investment Company Act of 1940, 'Commission Rules 14a-1 through 14a-16 and Schedule 14A.'" Compliance with the disclosure requirements of Regulation 14A is mandatory. The Commission is also proposing amendments to existing collection of information requirements titled "Rule 10b-10." Compliance with the disclosure requirements of rule 10b-10 is mandatory.

Finally, the Commission is also proposing a number of technical and conforming amendments that would not amend the existing collection of information burdens for rules 11a-3, 17a-8, 17d-3, and 18f-3 under the Investment Company Act, and Forms N-4 and N-6, and Regulation S-X under the Securities Act and the Investment Company Act. These technical and conforming amendments would not constitute new or altered collections of information because they would not alter the legal requirements of these rules and forms.[405] We estimate that the approved burdens for these rules and forms would not change if our proposal is adopted.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. OMB has not yet assigned control numbers to the new collections for proposed rule 12b-2 and amended rule 6c-10. The approved collection of information associated with Form N-1A, which would be revised by the proposed amendments, displays control number 3235-0307. The approved collection of information associated with Form N-SAR, which would be revised by the proposed amendments, displays control number 3235-0330. The approved collection of information associated with Form N-3, which would be revised by the proposed amendments, displays control number 3235-0316. The approved collection of information associated with Schedule 14A, which would be revised by the proposed amendments, displays control number 3235-0059.

[405] As discussed in the cost-benefit analysis in Section V of this Release, *infra*, we have estimated that complying with these amended rules and forms would take the same amount of time and cost the same amount of money as complying with the existing rules and forms, with the exception of rule 11a-3. The additional costs that the staff has estimated that funds may incur as a result of our proposed amendments to rule 11a-3 are not related to collections of information in the rule (certain disclosure, recordkeeping, and notice requirements), but are instead a result of system changes that funds may undertake. As a result, we do not expect that these proposed technical and conforming rule and form amendments would change existing approved collection of information burdens for any of these rules and forms.

The approved collection of information associated with rule 10b-10, which would be revised by the proposed amendments, displays control number 3235-0444.

A. Rule 6c-10

Proposed rule 6c-10(c) would give funds and their underwriters the option of offering classes of shares that could be sold by dealers subject to competition in establishing sales charge rates. A fund could rely on this provision if it discloses its election on Form N-1A. This disclosure would be a collection of information within the meaning of the PRA. The collection of information for rule 6c-10(c), however, is incorporated into the total collection of information burden for our amendments to Form N-1A, discussed below. As a result, the collection of information burden for proposed rule 6c-10(c) is not a separate collection of information within the meaning of the PRA.

B. Rescission of Rule 12b-1

We are proposing to rescind rule 12b-1. If adopted, the rescission would eliminate the current collection of information requirement for rule 12b-1 in its entirety. Therefore, there would no longer be a collection of information burden for rule 12b-1.

C. Rule 12b-2

Proposed rule 12b-2(b) would permit funds to deduct a "marketing and service fee" from fund assets that is limited to the maximum rate permitted by NASD Conduct Rule 2830 for "service fees." In order to institute or increase the rate of a marketing and service fee after the initial public sale of class shares, proposed rule 12b-2(b)(3) would require a fund to obtain approval from a majority of the class's shareholders. As under proposed rule 6c-10(b)(3), funds would obtain shareholder approval by soliciting proxies from shareholders, which would be a collection of information under the PRA on Schedule 14A under the Exchange Act. As noted above, Schedule 14A has an approved collection of information which our proposed amendments would change. As a result, the collection of information burden for proposed rule 12b-2(b)(3) is not a separate collection of information, but is incorporated into the estimated paperwork burden for Schedule 14A.

Proposed rule 12b-2(c) would maintain the restrictions in current rule 12b-1(h) that prohibit funds from using brokerage commissions to finance distribution. Among other things, proposed rule 12b-2(c) would maintain the requirement that a fund (and its board of directors) approve policies and procedures designed to prevent: (i) the persons responsible for selecting brokers and dealers to effect the fund's portfolio securities transactions from taking into account the brokers' and dealers' promotion or sale of shares issued by the fund or any other registered investment company; and (ii) the fund, or any investment adviser or principal underwriter of the fund, from entering into any agreement or other understanding under which the fund directs portfolio securities transactions to a broker or dealer to pay for the distribution of fund shares. The requirement to adopt these policies and procedures would be a collection of information under the PRA, and would be mandatory in order to direct brokerage transactions to a broker or dealer that distributes fund shares. The Commission has determined that these collections of information would continue to be necessary to protect against the inappropriate use of fund assets to finance distribution, and would continue to be used by the Commission and its examination staff to monitor these activities.

As discussed in the most recent PRA update to rule 12b-1, we understand that funds (if they intend to pay brokerage commissions to brokers and dealers who distribute their shares) generally adopt these policies and procedures when the fund is created, and incur any burden associated with this collection of information at that time. We assume that all funds that are currently operating have already adopted these policies and procedures (if relevant), and therefore only new funds that begin to operate in the future will incur this burden. As previously estimated in the most recent update to the rule 12b-1 PRA, the staff estimates that approximately 300 new funds would begin operations annually that would comply with proposed rule 12b-2(c) and adopt these policies and procedures. Based on information received during conversations with fund representatives, the staff estimates that adopting these policies and procedures would take a total of approximately 1 hour of the board of directors' time as a whole, at an internal time cost equivalent rate of $4500 per hour.[406] The staff further estimates that preparing these policies and procedures for adoption would take approximately 3 hours of internal fund counsel time, at an internal time cost equivalent rate of $316 per hour.[407] Finally, the staff estimates that it would cost funds approximately $800 in outside counsel time (2 hours multiplied by an estimated $400 per hour for outside counsel time)[408] to adopt these policies and procedures.

Therefore, the collection of information related to adopting directed brokerage policies and procedures pursuant to proposed rule 12b-2(c) would require a total annual burden of 300 hours of director time (at a total internal time cost equivalent of $1,350,000),[409] 900 hours of

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406 The staff has estimated the average cost of board of director time as $4500 per hour for the board as a whole, based on information received from funds, intermediaries, and their counsel.

407 The staff estimates that the internal time cost equivalent for time spent by internal counsel is $316 per hour. This estimate, as well as all other internal time cost estimates made in this analysis (unless otherwise noted) is derived from SIFMA's *Management & Professional Earnings in the Securities Industry 2009*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead or from SIFMA's *Office Salaries in the Securities Industry 2009*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

408 The staff has estimated the average cost of outside counsel as $400 per hour based on information received from funds, intermediaries, and their counsel.

409 This estimate is based on the following calculations: (1 hour of directors time × 300 newly formed funds = 300 hours); (300 hours × $4500 per hour = $1,350,000).

inside counsel time (at a total internal time cost equivalent of $284,400),[410] and $240,000 in outside counsel expenses.[411] The total annual number of respondents would be 300, the total number of responses would also be 300, and the annual burden per respondent would be 4 hours and $800 in costs.

- We request comment on these estimates and assumptions. If commenters believe these estimates and assumptions are not accurate, we request they provide specific data that would allow us to make a more accurate estimate.

D. Form N-1A

Form N-1A is the form that funds use to register with the Commission under the Investment Company Act and to offer their shares under the Securities Act.[412] As discussed previously, the proposed amendments would require funds that file Form N-1A to: (i) eliminate the line item currently titled "Distribution and/or Service (12b-1) Fee" and include two new line items (as relevant) titled "Marketing and Service Fee" and "Ongoing Sales Charge;" (ii) revise prospectus narrative disclosure on asset-based distribution fees; and (iii) revise the SAI disclosure regarding asset-based distribution fees. The Commission believes that these changes in the collection of information should better enable fund investors to understand the purpose and use of the asset-based distribution fees that they may pay. These changes will be used to better monitor and oversee the use of asset-based distribution fees by funds, and assist investors in obtaining information about the use of fund assets. Preparing Form N-1A is a collection of

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[410] This estimate is based on the following calculation: (3 hours of inside counsel time × 300 newly formed funds = 900 hours); (900 hours × $316 per hour = $284,400).

[411] This estimate is based on the following calculation: ($800 cost of outside counsel time × 300 newly formed funds = $240,000).

[412] There are two types of Form N-1A filings: (i) initial filings; and (ii) annual post-effective amendments. Funds usually incur significantly more time and incur greater costs when first registering a fund under their initial N-1A filings than when filing their annual post-effective updates. Therefore, we separately estimate the burden for each type of filing.

information under the PRA and is mandatory.

1. New Defined Term

The proposed amendments would add the defined term "Asset-Based Distribution Fee" to the general instructions of Form N-1A.[413] This term would be used in other parts of our proposed amendments to the form. The additional definition would not affect the form's collection of information requirements and therefore would not change current paperwork burden estimates.

2. Revised Fee Table

The proposed amendments would require funds, in the fee table of Form N-1A, to replace the current line item titled "Distribution and/or Service (12b-1) Fees" with two line items titled "Marketing and Service Fee" and "Ongoing Sales Charge," as relevant. Only funds that charge asset-based distribution fees would be affected by these proposed amendments. Funds would be able to refer to the same information about asset-based distribution fees that they use to complete the 12b-1 line item currently in the fee table. All information necessary to disclose these fees in the fee table would be readily available, and the staff estimates that funds would not require any additional resources to disclose the fees on two lines, instead of one. Therefore, the staff estimates that funds would not incur any additional hourly burdens or costs to complete the fee table as we propose to amend it. As a result, the staff estimates that the proposed amendments to the fee table would not change the collection of information currently approved by OMB to complete the fee table in Form N-1A, either initially or when submitting a post-effective amendment.

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[413] The proposal would define an "Asset-Based Distribution Fee" as "a fee deducted from Fund assets to finance distribution activities pursuant to rule 12b-2(b) ("Marketing and Service Fee"), rule 12b-2(d), or rule 6c-10(b) ("Ongoing Sales Charge")." Proposed General Instructions to Form N-1A.

- We request comment on these assumptions. If commenters believe these assumptions are not accurate, we request they provide specific data that would allow us to make a more accurate estimate.

3. Prospectus Revisions

The proposal would amend Item 12(b) of Form N-1A, which currently requires funds that have adopted 12b-1 plans to disclose information about the operation of the plan in the prospectus. The proposal would eliminate this requirement, and instead require funds to disclose whether they charge a marketing and service fee or an ongoing sales charge, and if they do, to disclose the rate of the fees and the purposes for which they are used. A fund that imposes an ongoing sales charge would be required to disclose the number of months (or years) before the shares would automatically convert to another class without an ongoing sales charge. In addition, we would require a fund offering multiple classes of shares in a single prospectus (each with its own method of paying distribution expenses) to describe generally the circumstances under which an investment in one class may be more advantageous than an investment in another class.

Based on information received during conversations with fund representatives, the staff estimates that funds filing initial Form N-1A registrations would expend approximately the same amount of time and costs to provide the narrative prospectus disclosure on asset-based distribution fees under our proposal as they expend under the current disclosure requirements.

The proposed amendments would also require funds that deduct asset-based distribution fees to revise their narrative prospectus disclosure in post-effective amendments. The staff further estimates that the funds would need to incur a one-time cost and time expenditure to revise and update existing narrative prospectus disclosure to comply with the proposal. After this one-time revision and update is complete, the staff estimates that ongoing costs and time expenditures would remain the same as current estimates because we expect the revised disclosures to be of similar length and complexity as the previous disclosure. The staff expects that the revised narrative prospectus disclosure would be similar in length to the current narrative, and thus would not change the number of pages in the prospectus or change printing costs of the prospectus.[414] The staff estimates that funds would use outside legal resources to prepare this one-time amendment to reflect the proposed new framework. The staff expects that all funds in a fund family would engage in this one-time update at the same time, and therefore the costs for revising a series prospectus would be shared among all funds in the family, thereby reducing the cost for each post-effective update filer. Based on an analysis of data received on Form N-SAR and information received from fund representatives, the staff estimates that there are approximately 379 fund families that may be affected by this proposed change. The staff further estimates that, on average, each of these fund families would incur approximately $2000 in one-time costs (for outside legal counsel drafting and review) and expend 10 hours in internal personnel time (at an internal time cost equivalent rate of $316 per hour) to revise item 12(b) of Form N-1A to comply with the proposed changes. The staff therefore estimates that funds will incur a one-time burden of 3710 hours (at an internal cost equivalent of $1,197,640) and $758,000 in outside costs associated with this proposed revision to Item 12(b) of Form N-1A.[415] The staff estimates that the proposed amendments would not change the *ongoing* currently approved collection of information for Item 12(b) of Form N-1A.

- We request comment on these estimates and assumptions. If commenters believe

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[414] Based on conversations with fund representatives, the staff understands that, in general, unless the page count of a prospectus is changed by at least 4 pages, the printing costs would remain the same.

[415] These estimates are based on the following calculations: (379 x 10 hours = 3790 hours); (3790 hours x $316 per hour = $1,197,640); (379 x $2000 = $758,000).

these estimates and assumptions are not accurate, we request they provide specific data that would allow us to make a more accurate estimate.

4. Statement of Additional Information

The proposal would amend a number of items contained in the SAI portion of Form N-1A. Item 19(g) currently requires funds to describe in detail the material aspects of their 12b-1 plans, and related agreements, in the SAI. Under the proposal, 12b-1 plans would no longer be required, and grandfathered funds would no longer be required to have written “plans” that are supervised and approved by the board of directors; therefore, the proposal would eliminate paragraphs 2 through 6 of Item 19(g).[416] However, Item 19(g)(1) (which requires disclosure of the material aspects of a 12b-1 plan, including a list of the principal activities paid for under the plan and the dollar amounts spent on each activity over the last year), may help investors to better understand how the fund uses asset-based distribution fees, and the proposal would retain it in substance. The proposal would amend Item 19(g)(1) to eliminate references to a 12b-1 plan, and instead require disclosure of the principal activities paid for through asset-based distribution fees (both ongoing sales charges and marketing and service fees).

The proposal would add new paragraph (d) to Item 25, which would require funds that have elected to externalize the sales charge pursuant to proposed rule 6c-10(c) to disclose this election on Form N-1A. This disclosure is designed to inform interested investors of the fund’s election. The proposal would also make technical conforming changes to Instruction 3(b) to Item 3; Instruction 5 to Item 26(b)(4); and Item 27(d)(1) (and Instruction 2(a)(i) to Item 27(d)(1)) to replace references to 12b-1 fees and plans with references to the appropriate types of asset-based distribution fee under the proposal. Finally, the proposal would eliminate existing

[416] *See supra* note 313 and accompanying text.

Item 28(m) of Form N-1A, which requires a fund to attach its rule 12b-1 plan and any related agreements as an exhibit to its registration statement. The exhibit would be unnecessary because proposed rule 12b-2 does not require a written plan.

The staff estimates that the proposed amendments to the SAI would result in overall time and cost savings for funds. Funds would incur savings because of the reduced time required and lower costs to prepare disclosure materials for Item 19(g).[417] The staff further estimates that responding to proposed paragraph (d) of Item 27 would entail little additional time and no costs, as it would only require a fund to make a single affirmative statement (if applicable) that the fund has taken the election. The staff estimates that the other proposed technical and conforming amendments to the SAI would not result in changes in the hourly burdens or cost because they would not change the legal or disclosure obligations of funds.

Therefore, based on conversations with fund representatives, the staff estimates that the proposed amendments to the SAI would result in a *net* time savings of approximately 10 hours for each fund's initial filing and of 1 hour for each post-effective amendment (all of which time would be spent by fund counsel at a time cost equivalent rate of $316 per hour). Based on a review of information filed with the Commission on Form N-SAR, the staff estimates that there are approximately 300 funds with a 12b-1 plan that newly file each year and 7367 funds that have adopted a 12b-1 plan that file post-effective amendments. The staff further estimates that the amendments would reduce costs incurred for outside counsel associated with completing the SAI, by $500 for each initial filing and $150 for each post-effective amendment. Therefore, the

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[417] Generally, most SAIs are not printed in advance, but are instead printed on demand when requested. The staff estimates that the proposal would not result in a change in printing costs because the staff does not expect that the number of pages of the SAI would be reduced as a result of the proposal, and if there were any reduction; any savings would be minimal due to the few occasions on which the SAI is printed.

staff estimates that all funds submitting their initial SAI filing would experience a reduction of 3000 hours (at an internal cost equivalent of $948,000) and a cost savings of $150,000.[418] The staff also estimates that all funds filing post-effective amendments will experience a reduction of 7367 hours (at an internal cost equivalent of $2,327,972) and cost savings of $1,105,050.[419]

5. Change in Burden

In the most recent Paperwork Reduction Act submission for Form N-1A, the staff estimated that for each fund portfolio or series, the initial filing burden is approximately 830.47 hours at a cost of $20,300, and the post-effective amendment burden is approximately 111 hours at a cost of $8894. This hourly burden includes time spent by in-house counsel, back office personnel, compliance professionals, and others in preparing the form. The costs include that of outside counsel to prepare and review these filings.

As discussed above, in total the staff estimates that our proposed amendments to Form N-1A would result in net time savings of approximately 10 hours for each fund's initial filing (for a new total estimate of 820.47 hours) and of 1 hour for each post-effective amendment (for a new total estimate of 110 hours).[420] The staff further estimates that the proposed amendments would reduce costs spent on outside counsel associated with completing Form N-1A, by $500 for each initial filing (for a new total estimate of $19,800) and $150 for each post-effective amendment (for a new total estimate of $8744). The staff also estimates that the proposed amendments would require each fund family with any funds that would file a post-effective

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418 These estimates are based on the following calculations: (300 x 10 hours = 3000 hours); (3000 hours x $316 per hour = $948,000); (300 x $500 = $150,000).

419 These estimates are based on the following calculations: (7367 x 1 hours = 7367 hours); (7367 hours x $316 per hour = $2,327,972); (7367 x $150 = $1,105,050).

420 This is based on the estimates made previously in this section that there would be no burden change as a result of our proposed amendments to the prospectus portion of N-1A and that the proposed changes to the SAI portion would result in the savings indicated.

amendment to incur approximately $2000 in one-time costs and expend 10 hours in internal personnel time.

The staff assumes that only funds that charge asset-based distribution fees would be affected by our proposed amendments to Form N-1A and would realize these reduced burdens and cost savings. The staff estimates that, each year, there are approximately 7367 funds with 12b-1 plans that file post-effective amendments, and would therefore be affected by our proposed amendments. The staff estimates that an additional 300 funds with asset-based distribution fees would file an initial Form N-1A each year after our proposed amendments would go into effect. Based on these estimates, the staff estimates that funds would save a total of 3000 hours and $150,000 when submitting initial Form N-1A filings each year.[421] In addition, the staff anticipates that funds would save approximately 7367 hours, and $1,105,050 annually when preparing post-effective updates to Form N-1A.[422]

Finally, as discussed above, the staff further estimates that all fund families that file post-effective amendments and have adopted 12b-1 plans would incur a one-time burden of 3790 hours (at an internal cost equivalent of $1,197,640) and $758,000 in outside costs when preparing post-effective amendments to comply with the proposed amendments for the first time.[423]

- We request comment on any of these estimates or assumptions.

E. Form N-SAR

Form N-SAR is the form that registered investment companies use to make periodic

[421] This is based on the following calculations: (300 new filers × 10 hours savings = 3000 hours in total savings); (300 new filers × $500 savings = $150,000 total savings).

[422] This estimate is based on the following calculations: (7367 amendments × 1 hour savings = 7367 hours in total savings); (7367 amendments × $150 savings = $1,105,050 total savings).

[423] These estimates are based on the following calculations: (379 x 10 hours = 3790 hours); (3790 hours x $316 per hour = $1,197,640); (379 x $2000 = $758,000).

reports to the Commission. Completing Form N-SAR is a collection of information under the PRA and is mandatory. Our proposed amendments would add an instruction to Form N-SAR to disregard, for funds that no longer have 12b-1 plans, four questions (Items 41-44) that relate to the operation of rule 12b-1 plans (because they would be irrelevant in light of our proposed new framework for asset-based distribution fees). However, funds that maintain grandfathered fund classes would continue to respond to these items.

The total annual hour paperwork burden estimate for Form N-SAR is 107,213 hours. The current approved total number of respondents is 4142**,** and the total annual number of responses is 7461.[424] The staff estimates that there are approximately 1292 management investment companies that respond to Items 40-44 of Form N-SAR.

The staff estimates that our proposed amendments would reduce the time it takes funds that do not have grandfathered share classes to complete Form N-SAR by 0.25 hours, and that there would be no change for funds that maintain grandfathered share classes. The staff estimates that, if these amendments are adopted, in the first three years after adoption, approximately 20% of these 1292 management investment companies (or 258) will no longer maintain grandfathered share classes and experience the estimated savings, while the remaining 80% (or 1034) will continue to have grandfathered share classes and respond to these items. Because Form N-SAR is completed twice a year, the staff estimates that each filer that no longer responds to these items would save approximately 0.5 hour annually (at an internal time cost equivalent rate of $316 per hour). The staff therefore estimates that our proposed amendments to Form N-SAR would result in an aggregate incremental time savings of approximately 129 hours

[424] The staff estimates the number of filers and filings based on the actual number of EDGAR filings and on other Commission records.

(with a total internal time equivalent cost savings of $40,764)[425] annually compared to the current approved hour burden.

- We request comment on these estimates and assumptions.

F. Schedule 14A

Funds must comply with the requirements of Schedule 14A when they solicit proxies from their shareholders. Our proposal would amend the required disclosures under Schedule 14A when a fund seeks approvals from its shareholders to institute or increase the rate of a marketing and service fee after shares have been offered to the public. The proposed amendments would remove items regarding asset-based distribution fees that would be superfluous in light of our proposed rescission of rule 12b-1 and new rule and rule amendments on asset-based distribution fees, and would amend certain other items.

Based on conversations with fund representatives and the most recent PRA update to Schedule 14A, the staff estimates that 75% of the burden of preparing Schedule 14A filings is undertaken by the fund internally and that 25% of the burden is undertaken by outside counsel retained by the fund at an average cost of $400 per hour.[426] The staff estimates that 3 funds would solicit proxies each year for the purposes of seeking approval to implement or increase a fee as required under proposed rules 6c-10(b)(3) and 12b-2(b)(3) (the same number that the staff has estimated would solicit proxies under rule 12b-1) because the staff believes the proposed amendments are unlikely to affect the number of funds that seek proxy approval from their shareholders. For each of these 3 funds, the staff estimates that our proposed amendments to Schedule 14A would create an incremental reduction in burden of 3 hours of fund personnel time

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[425] This estimate is based on the following calculation: (258 × 0.5 hours = 129 hours); (129 hours × $316 per hour = $40,764).

[426] This cost estimate is based on consultations with several registrants and law firms and other persons who regularly assist registrants in preparing and filing proxies with the Commission.

(at an internal time cost equivalent rate of $316 per hour) and reduced costs of $400 for the services of outside counsel, as a result of the proposed amended disclosures relating to marketing and service fees on Schedule 14A. The staff therefore estimates that these amendments would reduce the total annual paperwork burden of Schedule 14A by approximately 9 hours of fund personnel time (3 funds x 3 hours) at an internal time cost equivalent of $2844,[427] and by approximately $1200 (3 funds x $400) for the services of outside counsel.

In our most recent PRA submission for Regulation 14A (which includes Schedule 14A), the staff estimated that there are a total of 7300 respondents who use Schedule 14A, each of whom responds once a year, for a total of 7300 responses annually. The staff estimates that this number of respondents would remain the same under the proposed amendments because the staff does not expect our proposed amendments to affect the number of funds that seek approval from their shareholders to institute or increase marketing and service fees. The current approved aggregate time burden for these respondents is 669,026 hours and the cost burden is $78,822,387. The staff estimates that the proposed amendments would reduce this time burden by a total of 9 hours (3 hours times the 3 respondents affected by our proposed amendments) for a new total of 669,017 hours, and would reduce the cost burden by a total of $1200, for a new aggregate total of $78,821,187. This would represent an average per respondent time burden of 92 hours, and a cost burden of $10,797.[428]

- We request comment on these estimates and assumptions. If commenters believe these estimates and assumptions are not accurate, we request they provide specific data that would allow us to make a more accurate estimate.

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[427] This estimate is based on the following calculation: (9 hours × $316 per hour = $2844).

[428] This is based on the following calculations: (669,017 hours ÷ 7300 respondents = 92 hours); ($78,821,187 ÷ 7300 respondents = $10,797).

G. Form N-3

Form N-3 is the registration form used by insurance company separate accounts registered as management investment companies that offer variable annuity contracts.[429] The proposed amendments would require separate accounts that file Form N-3 to: (i) revise prospectus narrative disclosure on asset-based distribution fees; and (ii) revise the SAI disclosure regarding asset-based distribution fees. Preparing Form N-3 is a collection of information under the PRA and is mandatory.

The proposal would amend Instruction 2 to Item 7(a) of Form N-3, which currently requires registrants to list the principal types of activities for which 12b-1 payments are made and the total amount spent in the most recent fiscal year, as a percentage of net assets (or, if the plan has not been in effect for a full fiscal year, a description of the payments). The proposal would eliminate the requirement that registrants disclose the total amount spent in the most recent fiscal year, and instead require registrants to provide a description of asset-based distribution fees, as defined in the new proposed rule. The proposal would retain the requirement that registrants list the principal types of activities for which asset-based distribution fees are deducted.

As discussed above, funds would no longer be required to have written plans that are supervised and approved by the board of directors under our proposed rule amendments. Therefore, the proposal would eliminate paragraphs (ii) and (iii) of Item 21(f), which relate to the

[429] There are two types of Form N-3 filings: (i) initial filings; and (ii) annual post-effective amendments. Funds usually incur significantly more time and incur greater costs when first registering a fund under their initial N-3 filings than when filing their annual post-effective updates. Therefore, the staff separately estimates the burden for each type of filing.

specific operation of a 12b-1 plan.[430] Paragraph (i) of Item 21(f) requires registrants to disclose the manner in which amounts paid by the registrant under a 12b-1 plan were spent. We believe that the information required to be disclosed in paragraph (i) of Item 21(f) would continue to be useful to investors and the Commission. Therefore, we are proposing to amend Item 21(f) to require disclosure of the principal activities paid for through asset-based distribution expenses incurred under rule 12b-2(b) and (d) and rule 6c-10(b), deleting references to 12b-1 plans. For the reasons discussed above, we are also proposing to amend Instruction 5 to Item 26(b)(ii) to delete any references to 12b-1 plans. However, registrants would be required to provide the same information with respect to expenses and reimbursements accrued pursuant to rule 12b-2(b), rule 12b-2(d), and rule 6c-10(b).

The current approved aggregate time burden to comply with the collection of information requirements in Form N-3 is 13,024 hours. The current approved aggregate cost burden is $601,400.

Only registrants that charge asset-based distribution fees would be affected by our proposed amendments to Form N-3. Based upon a review of filings with the Commission, the staff estimates that 1 registrant that currently files on Form N-3 charges asset-based distribution fees, and would file a post effective amendment. Based upon conversations with fund representatives, the staff estimates that it would cost this registrant approximately $2000 in one-time costs (for outside legal counsel drafting and review) and require an expenditure of 10 hours in internal personnel time (at an internal time cost equivalent rate of $316 per hour) to revise its prospectus to comply with the proposed amendments. The staff further estimates, based on those

[430] Item 21(f)(ii) requires a registrant to disclose whether any interested person or director has a financial interest in the operation of the 12b-1 plan. Item 21(f)(iii) requires disclosure of the anticipated benefits of the plan to the fund.

conversations, that the proposed amendments to Item 21 and Instruction 5 of Item 26 would result in time savings when completing a post-effective amendment of a Form N-3 filing. The staff estimates that this registrant would save approximately 1 hour (at an internal time cost equivalent of $316 per hour) annually as a result of the proposed amendments.

The staff further estimates that no new registrants that file on Form N-3 are likely to charge asset-based distribution fees under proposed rule 12b-2 and the proposed amendments to rule 6c-10. Accordingly, the staff estimates that there will be no other changes in burden hours or costs for Form N-3 as a result of the proposed rule and rule amendments.

- We request comment on these estimates and assumptions.

H. Rule 10b-10

Rule 10b-10 requires broker-dealers to convey basic trade information to customers regarding their securities transactions. The proposed amendments would revise rule 10b-10 by requiring disclosure of additional information related to sales charges in connection with transactions involving mutual funds, requiring disclosure of certain additional information in connection with callable debt securities, and removing certain outdated transitional provisions from the rule. This collection of information would be mandatory. The information would be used by broker-dealer customers to evaluate the terms of their own securities transactions. In addition, the information contained in the confirmations may be used by the Commission, self-regulatory organizations, and other securities regulatory authorities in the course of examinations, investigations, and enforcement proceedings. No governmental agency regularly would receive any of this information.[431]

[431] Exchange Act Rule 17a-4(b)(1), 17 CFR 240.17a-4(b)(1), requires broker-dealers to preserve confirmations for three years, the first two years in an accessible place.

The proposed amendments to rule 10b-10, in part, would require transaction confirmations to disclose additional information about sales charges associated with purchases and redemptions of mutual fund shares. The purpose of these changes is to help make the confirmation a more complete record of the transaction, help mutual fund investors more fully understand the sales charges they pay, and assist investors in verifying whether they paid the correct sales charge as set forth in the prospectus. The proposed amendments to rule 10b-10 also would require confirmation disclosure of certain additional information about callable debt securities. The purpose of these proposed amendments is to provide investors with information necessary to evaluate their transactions involving callable debt securities, by helping to alert investors to misunderstandings, avoid confusion, promote the timely resolution of problems, and better enable investors to evaluate potential future transactions.[432]

The rule would apply to the approximately 5035 broker-dealers registered with the Commission. The Commission staff understands, however, that under the current industry practice confirmations are customarily generated and sent by clearing broker-dealers ("clearing firms") subject to agreements ("clearing agreements") with introducing broker-dealers ("introducing firms"). Under this industry practice, the Commission staff understands that clearing firms would bear most of the costs associated with updating back-office operations to accommodate the proposed changes to rule 10b-10.[433]

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[432] The proposal also would delete certain expired transitional provisions of rule 10b-10 related to securities futures products; there would be no burden associated with this deletion.

[433] For purposes of this analysis, the staff assumes that all registered broker-dealers effect transactions in mutual fund shares. To the extent that some broker-dealers may not effect transactions in mutual fund shares, the paperwork burdens and costs may be overstated. Furthermore, for the purposes of this analysis, broker-dealers that have not entered into clearing agreements with introducing firms yet generate and send confirmations, are included as clearing firms in the staff's estimates.

Based on filings with the Commission, the staff estimates that of the 5035 broker-dealers registered with the Commission, approximately 530 are clearing firms. The Commission staff understands that approximately 30% of clearing firms, or 160 firms, have developed their own proprietary systems for generating and inputting the information necessary to generate and deliver a confirmation. The staff further understands that the other approximately 70% of clearing firms, or 370 firms,[434] license platforms from third-party service providers (or vendors) that, among other things, generate the data necessary to produce and send confirmations.[435]

Based on the industry's current practices, the staff understands that the 160 clearing firms with proprietary systems would have a one-time burden associated with reprogramming software and otherwise updating back-office systems and platforms to enable confirmation delivery systems to generate the information required under the proposed amendments.[436] The Commission staff further estimates, based on discussions with industry representatives, that this one-time programming burden for clearing firms with proprietary back-office systems would amount to, on average, approximately 4500 hours per clearing firm, for a total of 720,000 burden hours.[437]

With respect to clearing firms that license vendor platforms ("clearing firm licensees"), the staff estimates that these vendors will incur costs similar to those incurred by clearing firms with proprietary systems to reprogram and update their platform. Thus, staff estimates that the

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[434] The staff's understanding is that these firms are usually small and medium-sized clearing firms, but may also include some larger firms as well.

[435] The staff's understanding is that there are three primary vendors that license platforms used by clearing firms to generate and send confirmations. In addition to licensing platforms, many clearing firms may also use vendors to separately print and mail confirmations to investors.

[436] The staff notes that these estimates are based on the assumption that ongoing sales charges and marketing and service fees commonly will not change over time for any particular mutual fund. The staff also assumes that the information necessary to comply with the proposed changes to rule 10b-10 will be readily available to clearing firms from various third-party service providers.

[437] 160 clearing firms with proprietary systems x 4500 burden hours = 720,000 burden hours.

burden to vendors would be approximately 4500 burden hours per vendor, resulting in one-time costs to these vendors of approximately $3.4 million dollars.[438] Based on discussions with industry representatives, the staff also understands that clearing firm licensees would still incur approximately 800 burden hours per firm to adopt the changes to a vendor's platform and determine that the output satisfies the requirements of the proposed amendments to the rule. The staff estimates that the total burden for clearing firm licensees would be approximately 296,000 total hours.[439] When we sum the labor hours borne by clearing firms with proprietary systems with those borne by clearing firm licensees, we estimate that that the total one-time hour burden as a whole for entities registered with the Commission will be 1,016,000 burden hours.[440]

The Commission staff understands that once completed, this reprogramming and systems updating should permit clearing firms to have automated access to the additional information that would be disclosed in confirmations. Accordingly, the staff does not believe that there will be a material increase in the ongoing costs associated with producing and sending confirmations once the initial one-time reprogramming costs are completed.

I. Request for Comments

We request comment on whether the estimates provided in this PRA are accurate. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections

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438 3 vendors x 4500 burden hours x $251 dollars per hour = $3,388,500. The staff estimates per hour costs to be $251.

439 370 clearing firm licensees x 800 burden hours = 296,000 total burden hours.

440 (160 clearing firms with proprietary systems x 4500 burden hours) + (370 clearing firm licensees x 800 burden hours) = 1,016,000 total burden hours.

of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-15-10. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-15-10, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549-0213.

V. COST-BENEFIT ANALYSIS

A. Background

The Commission is sensitive to the costs and benefits imposed by its rules. We recognize that if adopted, the proposed new rule and rule amendments would result in costs for some funds and other marketplace participants.[441] We have identified certain costs and benefits of the proposed rule and rule amendments and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on our estimates of the costs and benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this analysis, and request that commenters provide data that may be relevant to these cost estimates. In addition, we seek estimates and views regarding these costs and benefits for funds and their intermediaries, including small entities, and for investors, as well as any other costs or benefits that may result from the adoption of the proposed rule and rule and form amendments.

The proposal is designed to protect individual investors from paying disproportionate amounts of sales charges in certain share classes, promote investor understanding of fees, eliminate outdated requirements, provide a more appropriate role for fund directors, and introduce greater competition among funds in setting sales loads and distribution fees generally. As discussed in greater detail above, we are proposing to: (i) rescind rule 12b-1 under the Act; (ii) adopt new rule 12b-2 under the Act, which would permit funds to deduct a marketing and service fee at a rate no greater than the maximum rate permitted as a service fee under the NASD sales charge rule (currently 25 basis points) annually; (iii) adopt amendments to rule 6c-10, which would permit funds to deduct asset-based sales charges in excess of the marketing and service fee in the form of an "ongoing sales charge" (up to certain limits); (iv) as an alternative to the ongoing sales charge, provide an elective alternative that would allow funds to sell their shares through intermediaries subject to competition in establishing sales charge rates; (v) amend

[441] Although we discuss many of these costs in terms of the fund, the preparation of these reports is most likely done by employees of the fund's adviser, because most funds do not have any employees of their own.

Form N-1A and N-3 under the Securities Act and the Investment Company Act, and Schedule 14A under the Exchange Act to reflect the proposed rule and rule amendments, (vi) make conforming amendments to rule 11a-3 under the Investment Company Act; and (vii) make technical amendments to rules 17a-8, 17d-3, and 18f-3, and Forms N-SAR, N-4 and N-6 under the Investment Company Act, and rule 6-07 of Regulation S-X under the Securities Act.

In general, for each aspect of the proposal, we have attempted to estimate the potential costs and benefits in dollars for each entity that may be affected. Some of the expected costs and benefits from our proposals cannot be measured in dollars, but are effects nonetheless, such as the benefits of improved investor understanding of distribution charges and the costs and benefits of greater equity in the cumulative amount of sales charges paid by individual investors. When actual dollar costs and benefits would likely result (such as from the elimination of certain disclosure requirements that would be eliminated under the proposal, such as descriptions of 12b-1 plans) we have estimated the relevant costs and savings.[442]

In this analysis, Commission staff has estimated the percentage of funds or other parties that are likely to change their operations in response to our proposal. These and other estimates and assumptions are based on interviews with representatives of funds, their intermediaries, investor advocates, and the experience of Commission staff. In addition, in preparing this cost-benefit analysis, Commission staff reviewed fund prospectuses, periodic reports made to the Commission pursuant to Form N-SAR and other fund filings, and a commercial database of information on funds.[443] Throughout this analysis, unless otherwise stated, the estimates are

[442] We have discussed many of the benefits of this proposal previously in this Release, and therefore, we will focus more on the proposal's costs in this section, and will refer back to previous discussions of our proposal's anticipated benefits when appropriate.

[443] The Commission staff's review is based in part on information obtained from Lipper's LANA Database.

based on these interviews, reviews, and examinations.

B. Impact of the Proposal

We have designed our proposal to minimize the cost impact on funds, intermediaries, and service providers while maximizing the investor protection and other benefits. As further discussed below, the staff anticipates that funds representing approximately 93% of all assets under management will incur minor or no expenses in complying with our proposal. This section contains some basic estimates about the size of the fund marketplace and its use of 12b-1 fees, and a general outline of what we believe our proposal's impact will be on certain market segments. Much of the information described in this section is included in two tables at the end of this section. The information is based on an analysis of data received on Form N-SAR and other filings and a review of a Lipper database.

The staff estimates that as of the end of 2009, there were approximately 9427 funds (consisting of 8611 traditional mutual funds and 816 ETFs) sponsored by 682 investment advisers.[444] Approximately 7367 of these funds have adopted a 12b-1 plan for one or more of their share classes.[445] Assets managed by all funds, as of the end of 2009, totaled approximately $12.2 trillion.[446]

The number of sponsors is roughly equivalent to the number of "fund families," which

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[444] Like mutual funds, most ETFs are registered open-end management investment companies (a small number of ETFs are UITs). However, ETFs are counted separately from mutual funds in ICI statistics. The number of funds above reflects each separate series of a fund (many funds consist of more than one series or portfolio). Costs incurred in complying with the proposal may often be incurred at the fund "complex" or "family" level, and not at the series or class level, and, when appropriate, the staff has based its estimates on the number of sponsors or families affected rather than the number of series or classes.

[445] A fund may have a 12b-1 plan, but not charge 12b-1 fees on one or more particular share classes of the fund.

[446] This figure is based on staff examination of industry data, and includes traditional mutual funds, funds of funds, ETFs, and funds underlying insurance company separate accounts.

are groups of funds that share the same investment adviser or principal underwriter and hold themselves out to investors as related companies. Therefore, on average, each fund family has approximately 14 funds.[447] Of the 682 fund families, the staff estimates that approximately 379 (or 56%) have at least one fund in the family that currently has a 12b-1 plan. These fund families may be affected in some way by our proposal. The staff estimates that 172 of these 379 fund families (or 45%) only have funds that charge no more than 25 basis points in 12b-1 fees, and the remaining 207 (or 55%) have at least *one* fund that charges 12b-1 fees in excess of 25 basis points. The 207 fund families that have at least one fund that charges 12b-1 fees in excess of 25 basis points average 37 funds per fund family, a significantly higher average number of funds per family than the typical fund family.[448] As discussed previously, and in more detail below, we anticipate that funds that charge 25 basis points or less in 12b-1 fees would incur minimal costs under our proposal, while those that charge more than 25 basis points may be more significantly affected by our proposal.

The staff estimates that, as of the end of 2009, there were approximately 26,788 fund share classes. On average, the staff estimates that each mutual fund has approximately 3 share classes.[449] However, some funds only have one share class (including many no-load funds),

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447 This is based on the following calculation: (9427 funds ÷ 682 advisers = 14 funds per adviser). This number can and does vary widely, with some advisers managing only a single fund, and others managing hundreds of funds.

448 The 207 advisers that advise at least one fund with a 12b-1 fee in excess of 25 bps advise a total of 7660 funds, for an average of 37 funds per family.

449 This is based on the following calculation: (26,788 classes ÷ 8611 funds = 3 classes per fund). The staff excludes ETFs from this calculation because most ETFs offer only one class of shares, and therefore have reduced both the total fund and class number by the number of ETFs in this calculation. An ETF that is offered as a share class in a fund would be included in this estimate of average share classes per fund.

while others may have ten or more classes to support a variety of distribution arrangements.[450] Generally, funds that charge 12b-1 fees tend to have more share classes, because they offer multiple methods of paying for distribution (*e.g.*, at the time of purchase, at the time of redemption, or over time through the 12b-1 fee charged on fund assets) for investors with different needs and goals.[451] Thus, for purposes of estimating costs per fund in this analysis, the staff will assume that a typical fund that charges 12b-1 fees would have 4 classes: an A, B, and C share class, as well as an institutional or retirement share class.[452]

Of the 26,788 existing fund share classes, 12,646 (or 47% of all classes) do not charge a 12b-1 fee. These classes hold approximately $7.3 trillion in assets.[453] The remaining 14,142 classes (or 53% of all classes) that do charge a 12b-1 fee hold approximately $4.9 trillion in assets. The staff believes that 47% of fund classes (those that do not charge 12b-1 fees) are unlikely to incur any costs as a result of our rule proposal.[454] Thus, the staff believes that funds managing approximately $7.3 trillion in assets, representing 60% of all assets under management, would not have to change their operations or disclosures as a result of our

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450 *See, e.g.*, Prospectus for The Growth Fund of America (Nov 1, 2009) (http://www.americanfunds.com/pdf/mfgepr-905_gfap.pdf).

451 Not all funds that charge 12b-1 fees offer multiple retail classes. For example, the Legg Mason Funds only offer a single retail class of shares for their funds, a C share equivalent that charges 12b-1 fees without a front-end load. *See, e.g.*, Prospectus for Legg Mason American Leading Companies Value Trust (Aug 1, 2009), (http://prospectus-express.newriver.com/get_template.asp?clientid=legg&fundid=52465Q101&level=4&doctype=pros).

452 *See supra* note 84. We do not expect that institutional classes would be affected by our proposal because funds do not typically charges 12b-1 fees on these classes.

453 This figure is based on a staff examination of industry data and includes mutual funds, funds of funds, ETFs, and funds underlying insurance company separate accounts.

454 If our proposal is adopted, we do not expect that fund classes that do not currently charge 12b-1 fees would begin charging asset-based distribution fees, because the fund would have already established a distribution structure and in light of the necessity of obtaining shareholder approval to institute such a fee.

proposal.[455]

A total of 6482 share classes (or 46% of classes that charge 12b-1 fees) charge a 12b-1 fee of 25 basis points or less. As discussed further below, although our proposal would affect these classes, we anticipate that the funds with these classes are likely to incur minimal costs associated with complying with our proposal. As a result, the staff anticipates that of all 26,788 fund share classes, 19,128 (which hold $11.3 trillion in assets, representing approximately 93% of all assets under management) would incur only minor, if any, costs if our rule proposals are adopted.[456]

Approximately 7660 (or 54%) of the share classes that have 12b-1 fees charge 12b-1 fees of greater than 25 basis points. All of these classes would be affected in some way by our rule proposals. These share classes hold approximately $855 billion in assets, or 17% of the assets managed by classes that charge 12b-1 fees, and 7% of all assets under management.

- We request comment on these estimates.

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[455] This figure is based on the following calculation: ($7.3 trillion (assets not subject to a 12b-1 fee) ÷ $12.2 trillion (total assets under management) = 60% of assets under management not subject to a 12b-1 fee).

[456] As discussed further below, we recognize that the cost impact of our proposal would not be distributed evenly across all funds, but rather that certain funds and fund families are likely to bear a greater share of the expenses that may result due to the nature of their distribution and operational models.

Table 1: 12b-1 Fees – Class Data

	Fund Classes	% of Total Classes
Classes without 12b-1 Fees	12,646	47%
Classes with 12b-1 Fees	14,142	53%
• **12b-1 Fees < or = 25 BPs**	6482	24%
• **12b-1 Fees > 25BPs**	7660	29%
Totals	26,788	100%

Table 2: 12b-1 Fees – Asset Data

	Assets (in billions)	% of All Fund Assets
Classes without 12b-1 Fees	$7289	60%
Classes with 12b-1 Fees	$4861	40%
• **12b-1 Fees < or = 25 BPs**	$4006	33%
• **12b-1 Fees > 25BPs**	$855	7%
Totals	$12,150	100%

C. Marketing and Service Fee

Proposed rule 12b-2 would allow funds to deduct from fund assets a marketing and service fee of up to the maximum rate of the service fee permitted under NASD Conduct Rule 2830 (currently 0.25% or 25 basis points of net fund assets annually).[457] The proposed 25 basis point marketing and service fee could be used for any legitimate distribution related activity including, but not limited to, the continuing shareholder account services encompassed by the

457 Proposed rule 12b-2(b); NASD Conduct Rule 2830(d)(5).

NASD service fee.

1. Benefits

We anticipate that proposed rule 12b-2 would benefit investors by permitting funds to continue to pay for: (i) follow-up services provided to investors by brokers and other intermediaries after the sale has been made; and (ii) a fund's participation in distribution channels that offer investors a convenient way of buying shares, such as fund supermarkets[458] and retirement plans.[459]

We anticipate that our proposal would also benefit funds and their directors, and ultimately fund shareholders, by eliminating the procedural requirements of rule 12b-1. Under proposed rule 12b-2, boards of directors of funds that deduct a marketing and service fee would not be required to adopt a 12b-1 plan or annually approve it. As a result, funds and their advisers would no longer incur many of the costs of creating a 12b-1 plan, preparing quarterly and fiscal year reports of plan expenditures, or preparing materials that support the specific findings that fund boards are required to make annually in order to approve a 12b-1 plan, as discussed in more detail in Section I of this analysis.

As discussed above, fund boards would have discretion to use fund assets to finance distribution activities within the limits of the rule and their fiduciary obligations to the fund and fund shareholders. Therefore, we anticipate that funds would still incur some costs stemming from director review of arrangements paid for through the marketing and service fee. Our understanding is that, in general, funds pay their directors on an annual or per meeting basis, and

[458] *See supra* Section III.C.

[459] Because these payments represent an integral part of many funds' distribution strategies, we believe that significantly restricting the ability of funds to continue to pay for these ongoing services through fund assets would likely disrupt existing distribution systems, impose significant costs on funds and intermediaries, and may have other unintended consequences that could adversely affect funds and fund shareholders.

we do not expect that the directors will reduce the frequency of their meetings as a result of the proposed marketing and service fee. Based on this assumption, we estimate that funds that currently charge a 12b-1 fee of 25 basis points or less will likely *not* realize significant cost savings as a benefit deriving from our proposal. However, the directors of funds that impose a marketing and service fee under proposed rule 12b-2 might spend less time on reviews and plan approvals, and instead be able to focus more of their time on other pressing concerns related to the fund's operations.[460]

2. Costs

We anticipate that funds that currently charge a 12b-1 fee of 25 basis points or less would not change the amount that they currently charge under proposed rule 12b-2. The proposed maximum amount of the marketing and service fee would be the same as the current NASD limit on service fees, and would also be the same as the current NASD limit on the amount of asset-based distribution fees that may be charged by funds describing themselves as "no-load." Thus, we expect that funds that currently use 12b-1 fees for these purposes would continue to charge the same level of fees. Because under the proposal, funds that currently charge 12b-1 fees of 25 basis points or less could charge marketing and service fees of the same or smaller amount without holding a shareholder vote, we expect that funds that currently charge 12b-1 fees of 25 basis points or less would incur only the costs of updating their disclosure documents as a result of our proposed rulemaking.[461]

As discussed above, we do not anticipate that funds that currently charge 25 basis points or less in 12b-1 fees would have to implement any significant systems changes or incur other

[460] We discuss the cost savings that might result from the proposed rescission of rule 12b-1 and its attendant director duties in Section V.I of this Release, *infra*.

[461] We estimate the costs of such disclosure changes in Section V.G of this Release, *infra.*

additional operational costs in order to impose a marketing and service fee under proposed rule 12b-2 because there should be no significant impact on operational expenses due to a transition from a 12b-1 fee of that level to a marketing and service fee. Nevertheless, directors and legal counsel to these funds and their advisers may require some time and training to review and understand the permissible uses and limits of marketing and service fees, compared to current practices. Commission staff estimates that for each fund family with one or more funds that charge a 12b-1 fee of 25 basis points or less, inside fund counsel would spend[462] approximately 20 hours[463] to review and understand the proposal and the board of directors would spend approximately 3 hours[464] to review and understand their responsibilities under the proposal. Because inside counsel and directors are typically not paid on an hourly basis, and the staff does not expect that funds would hire additional personnel or increase the frequency of meetings as a result of this proposal, the staff does not anticipate that this process would have any specific dollar costs for funds or advisers. However, we recognize that this represents time that directors and counsel would otherwise have spent on other fund business.

Based on these estimates, other than the costs of revising their disclosure documents

[462] Throughout this analysis we will estimate the cost of the time spent by internal personnel in complying with the proposal, because the time spent represents time that would otherwise be available for other activities of the fund (or relevant entity). Although these costs may be an economic cost of the proposal, it would not result in new monetary costs for funds, and would not result in the hiring of more staff by advisers or funds.

[463] The staff estimates that the internal time cost equivalent for time spent by internal counsel is $316 per hour, for a total cost per fund family of $6320 (20 hours x 316 per hour =$6230). This estimate of $316 per hour, as well as all other internal time cost estimates made in this analysis (unless otherwise noted) is derived from SIFMA's *Management & Professional Earnings in the Securities Industry 2009*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead or from SIFMA's *Office Salaries in the Securities Industry 2009*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

[464] The staff estimates that the internal time cost equivalent for time spent by the boards of directors as a whole is $4500 per hour, for a total cost per fund family of $13,500 (3 hours x $4500 per hour = $13,500). The staff has estimated the average cost of board of director time as $4500 per hour for the board as a whole, based on information received from funds, intermediaries, and their counsel.

which we analyze later in the section on the disclosure amendments, the staff expects that the 6482 fund classes that currently charge 12b-1 fees of 25 basis points or less would incur no new costs in complying with proposed rule 12b-2. The assets under management of these classes represent approximately 82% of the total assets under management that are currently subject to 12b-1 fees.

We request comment on these estimates and assumptions regarding the costs of compliance with our proposal for funds that currently charge 12b-1 fees of 25 basis points or less.

- Is the staff correct in estimating that, other than costs to amend disclosure documents, these funds would incur no new dollar costs in complying with this part of our proposal? Is the estimate regarding time spent by inside counsel and directors reasonable? Would funds hire additional personnel, or otherwise incur additional or different costs or benefits than what we have estimated here?

D. Ongoing Sales Charge: Funds

The proposed amendments to rule 6c-10 would permit funds to deduct asset-based distribution fees in excess of the marketing and service fee in the form of an ongoing sales charge.[465] Proposed rule 6c-10(b) would limit ongoing sales charges to an amount that does not exceed the amount of the highest front-end load that the investor would have paid if he or she had invested in another class of shares in the same fund. Funds could also comply with the proposed rule amendments by deducting the ongoing sales charge only until the cumulative rates imposed on each share purchase matches the maximum front-end load, or in some

[465] For a complete discussion of the proposed ongoing sales charge, *see* Section III.D, *supra*. All funds that charge an ongoing sales charge would also incur the costs of implementing a marketing and service fee pursuant to proposed rule 12b-2 as well, as discussed in Section C above.

circumstances, the maximum sales charge limit set forth in NASD Conduct Rule 2830(d)(2)(A) (currently 6.25% of the amount invested). In effect, the proposal would treat asset-based distribution fees in excess of the marketing and service fee as a type of deferred sales load.

1. Benefits

We believe that the ongoing sales charge proposal would create a number of benefits, many of which are discussed above.[466] The proposed amendment would limit the cumulative ongoing sales charges that may be imposed on a purchase of fund shares to a set "reference load" (generally the highest front-end load charged on the fund's class A shares). As a result, investors would have the benefit of knowing, at the time of their purchase, either the maximum amount that they would pay for distribution, or the maximum length of time ongoing sales charges would be deducted. As a result, long-term shareholders would be protected from paying disproportionate amounts of sales charges in certain share classes, as is currently possible under rule 12b-1.[467] Finally, the ongoing sales charge would also be clearly identified and described in the fund prospectus and fee table, which should increase transparency and improve investor understanding of fees.

We believe that the ongoing sales charge proposal would also result in benefits for funds and fund directors. Under our proposal, funds would not have to adopt a "plan" in order to impose an ongoing sales charge, and fund directors would not be required to undertake time-consuming formal reviews and approvals of 12b-1 plans. Instead, funds and their boards would consider ongoing sales charges as integral parts of a fund's sales load structure and would review them under the same procedures under which boards currently review and approve the

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[466] *See supra* Section III.M.

[467] *See, e.g.*, Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007).

fund's underwriting contract. Boards could benefit from this to the extent it permits them to focus more on the fund's distribution system as a whole.

As a result of our proposal, funds may eventually incur lower compliance costs in tracking the sales charge limits established by NASD Conduct Rule 2830. As discussed previously, NASD Conduct Rule 2830(d)(2) imposes a complex, fund-level cap on the aggregate amount of sales charges, including asset-based sales charges, that may be imposed by funds sold by broker-dealer members. The investor-level cap on ongoing sales charges created by our proposal would provide an alternative means of ensuring that the NASD sales charge rule's maximum sales charge limits are not circumvented through the use of asset-based sales charges. If our proposal is adopted, FINRA may consider amending (or interpreting), this provision to eliminate the need for funds to track aggregate sales charges at the fund level.[468]

If FINRA were to amend (or interpret) this provision of Rule 2830, it could reduce compliance costs for these funds.[469] The staff estimates that funds currently spend $2000 in costs and 5 hours of internal staff time tracking these caps annually for each class that charges a 12b-1 fee in excess of 25 basis points. The costs are for computer and software resources, outside accountants, and other compliance costs. The 5 hours of internal time spent by these funds include 4 hours of time spent by accountants (at a cost of $153 per hour) and 1 hour spent by an assistant compliance director (at a cost of $326 per hour), for a total internal time cost equivalent of $938 per fund class.[470] As discussed above, approximately 7660 classes charge a 12b-1 fee in excess of 25 basis points, and we estimate that approximately 50% of these (or 3830

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[468] *See* note 74 *supra (*discussing how rule 2830 provides a "minimum standard," and does not prevent a fund from developing a better method of tracking the loads paid by shareholders and ensuring that they do not overpay).

[469] Funds that continue to have shares in classes with grandfathered 12b-1 fees pursuant to proposed rule 12b-2(d) would continue to incur these costs, however, during the grandfathering period.

[470] This estimate is based on the following calculations: ($153 x 4 hours = $612; $612 + $326 =$938).

classes) may no longer need to incur these expenses. Therefore, the staff estimates a potential total annual cost savings of $7,660,000 and a time savings of 19,150 hours (representing an internal time cost equivalent of $3,592,540)[471] for this portion of the proposal for all funds.

- We request comment on these estimates and assumptions.

We considered several alternative methods of achieving the goals of this rulemaking, including potentially requiring individual shareholder level accounting of asset-based distribution fees, and prohibiting the deduction of asset-based distribution fees entirely. Although these alternatives might result in some of the benefits of the ongoing sales charge proposal, we expect they would come at a significant cost. Our proposal for an ongoing sales charge instead is designed to provide many of these benefits to investors, without significantly disrupting current distribution models or requiring most funds and intermediaries to develop costly new operating systems.

2. Costs

If adopted, the limitations on ongoing sales charges contained in proposed rule 6c-10(b) would require funds that currently charge 12b-1 fees in excess of 25 basis points to amend their share classes and/or alter their operations in one of several ways. First, some funds may choose to amend their share classes so that they conform to the new requirements (*e.g.*, by reducing their fees to a level that would not implicate the ongoing sales charge limitations). Second, other funds might restructure their expenses and separate non-distribution related expenses from their asset-based distribution fees in order to keep total fees from exceeding 25 basis points. Third, some funds might keep their present share classes, but issue new shares that comply with the proposed rule amendments after a certain date (*i.e.*, “old” and “new” shares would be mixed in

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[471] This is based on the following calculation: ($938 × 3830 classes = $3,592,540 time savings value; 5 hours × 3830 classes = 19,150; $2,000 × 3830 classes = $7,660,000 cost savings).

the same class). Fourth, other funds might create new share classes on or before the compliance date that meet the proposal's requirements. The chosen method of complying with the new requirements would likely be driven by the fund's business model and the cost-effectiveness of each option given the fund's particular circumstances. In general, the staff assumes that either funds or their advisers or other service providers would bear the costs of implementing these changes.[472] The costs of each of these potential compliance options are discussed below.

a. Fee Reductions

Funds with classes that currently charge 12b-1 fees of more than 25 basis points might determine that it would be cost effective to reduce their asset-based distribution fees to the 25 basis point cap of the marketing and service fee. Funds could accomplish this by either reducing their distribution expenses or shifting a portion of the costs to their adviser or another party. These funds could continue offering their existing share classes without having to provide for a conversion period under proposed rule 6c-10(b).

We anticipate that, out of the funds that charge a 12b-1 fee of more than 25 basis points, only those funds that charge up to 30 basis points would likely reduce their asset-based distribution fee to 25 basis points or less. We expect that funds that charge more than 30 basis points would be unlikely to find the reduction to 25 basis points or less to be the most cost effective means of complying with our proposal, and therefore would be unlikely to pursue this alternative. Commission staff estimates that there are approximately 471 fund classes that

[472] Fund families are organized in many ways, with some having affiliated transfer agents, underwriters and other service providers, and others contracting these services out to unaffiliated third parties. The staff understands that some contracts obligate the fund to reimburse the transfer agent for system costs related to regulatory changes, while other contracts require the transfer agent to bear these expenses. Because of the variability in these contract terms, throughout this analysis, when the staff estimates costs, the staff generally assumes that the estimated costs would be borne directly by the affiliated service providers and the fund family, or indirectly through increased expenses charged by unaffiliated service providers. Except in the case of retirement plan record keepers, who may face unique issues in responding to this proposal, the staff does not break these costs out separately.

charge 12b-1 fees of more than 25 up to and including 30 basis points (representing $143 billion in assets), and that 40% of these classes (188) may reduce their fees to 25 basis points or less in response to our proposal. The average class that charges 12b-1 fees in this range has approximately $304 million in assets. If a class with $304 million in assets that charged 30 basis points reduced its 12b-1 fees to 25 basis points, investors in that class would see their 12b-1 fees reduced by approximately $152,000 annually. If all of the classes that chose to reduce their fees charged the full 30 basis points, the maximum fee reduction would be approximately $28,576,000 a year.[473]

These reductions in fees could be viewed as a cost to these funds or their advisers. Nonetheless, investors in the funds would experience a corresponding and offsetting dollar-for-dollar benefit due to lower expenses. In any event, a fund likely would only elect this alternative if it determined that the reduction would be cost effective. We request comment as to the likelihood that funds would respond to our proposal with fee reductions.

- Are we correct in assuming that only funds that charge between 25 and 30 basis points are likely to reduce their fees? How many funds would choose this option? What kind of costs would they or their affiliates bear to reduce their current 12b-1 fee, if any?

b. Fee Restructuring

Many funds currently pay for expenses that are not distribution related with 12b-1 fees (such as administrative, sub-transfer agency, or other fees). As a result, we expect that some funds with classes that impose 12b-1 fees of more than 25 basis points, up to and including 50 basis points (*e.g.*, some A and R share classes), might instead be able to treat the amount greater

[473] This estimate is based on the following calculation: ($152,000 x 188 classes = $28,576,000).

than 25 basis points as a fund operating expense. These funds would have to carefully examine their 12b-1 fees and identify which, if any, expenses could be properly classified as non-distribution expenses. If non-distribution expenses paid through 12b-1 plans are significant enough, these funds might be able to reduce their asset-based distribution fees to the 25 basis point cap and avoid being subject to the ongoing sales charge limits and conversion periods in proposed rule 6c-10(b).

The staff estimates that there are approximately 2168 fund classes that charge 12b-1 fees of more than 25 up to and including 50 basis points. The staff previously estimated that approximately 188 of these classes may respond by reducing their fees, leaving a total of 1980 classes that fall into this category. Of those classes, the staff estimates that approximately 50% (or 990 classes) may be able, and find it cost effective, to re-characterize a portion of their current 12b-1 fee.

We expect that funds that choose this course of action would incur the costs of: (i) conducting an internal review of the fees and expenses charged by the affected share classes; (ii) amending fund prospectuses and disclosure documents to reflect the fee re-structuring (as discussed in greater detail below); and (iii) modifying operational and accounting systems to reflect the restructured fees. The staff estimates that it would take approximately 20 hours of inside counsel time (at an internal time cost equivalent of $316 per hour), and 1 hour of time for each board as a whole (at an internal time cost equivalent of $4500 per hour), for a total internal time cost equivalent of $10,820 to complete these tasks for each class.[474] The staff estimates that funds may incur an additional $5,000 in outside counsel expenses associated with the internal

[474] This is based on the following calculations: ($316 × 20 = $6320); ($6320 + $4500 = $10,820).

review and disclosure changes.[475]

Therefore, we estimate that it would cost the 990 fund classes that might perform this internal review and re-assessment of expenses approximately $4,950,000 in outside expenses and $10,711,800 in internal time cost equivalent to comply with our proposal.[476] We assume that the other 990 fund classes that charge between 25 and 50 basis points in 12b-1 fees, but do not re-assess these fees or otherwise reduce their fees to 25 basis points or less, would impose an ongoing sales charge in compliance with proposed rule 6c-10(b). Their costs are discussed below.

We request comment on these estimates and assumptions.

- Is the staff's estimate of $5,000 per fund class for outside counsel expenses, 20 hours of inside counsel time, and 1 hour of board time reasonable for the internal review and disclosure amendment process? If not, what would be a better estimate? Are there other costs that might be associated with such a review?

c. <u>Ongoing Sales Charge: Conversion and Modified Share Classes</u>

Under our proposed amendments to rule 6c-10, funds with asset-based distribution fees in excess of 25 basis points (*i.e.* with ongoing sales charges) that issue new shares after the compliance date, must have, or create, a share class that does *not* impose an ongoing sales charge (such as a typical class A) into which shares with the ongoing sales charge would convert after a set period of time (a "target class").[477] We anticipate that there would be two primary sets of costs that these fund families may incur related to our proposed amendments to rule 6c-10: (i)

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475 Any operational and accounting system costs would be likely made at the fund family level, and are included in the staff's estimated costs for fund families complying with the ongoing sales charge proposal, as discussed below.

476 This estimate is based on the following calculations: ($5000 per class × 990 classes = $4,950,000 total expenses); ($10,820 per class × 990 classes = $10,711,800 total internal time cost equivalent).

477 *See supra* Section III.D for a further discussion of the operation of the proposed rule.

updating or creating a conversion system, and (ii) amending or creating new share classes. Both sets of costs would include expenses related to building or enhancing systems and back office technology and operations.

(i) Conversion System

As a preliminary matter, the staff estimates that approximately 90% (or 186) of the 207 fund families[478] that may be affected by our proposed amendments to rule 6c-10 have at least one fund with a class of B shares and, as a result, have a conversion system in place that they could use to convert shares with ongoing sales charges. The staff estimates that it may cost a fund family $100,000 in one time initial costs, and $50,000 annually, to modify an existing B share conversion system to manage the conversions of funds with ongoing sales charges. These costs would include: (i) computer hardware needed to store an increased volume of transaction activity; (ii) computer software to expand and update the systems' ability to track share lots and convert the shares based on the new aging schedules; and (iii) expanding back office and accounting operations and hiring and training additional back office personnel.

The other 10% or 21 fund families that do not have conversion systems may incur additional costs to create a conversion system, or contract for one through an external service provider. The staff estimates that it would cost a fund family (or its affiliated transfer agent) approximately $250,000 in initial costs and $100,000 in annual costs to purchase or create a conversion system, integrate existing computers, software, and networks, train personnel, and update records. The staff estimates it would cost approximately the same amount to outsource

[478] As we have discussed previously, a number of funds may avoid these costs by reducing their asset-based distribution fees or by re-characterizing expenses. Although some funds in a family may be able to avoid such costs, it may be that only a few funds in the family could do so, and therefore the fund family as a whole would still incur these costs of complying with this part of our proposal. The staff has therefore chosen to be conservative and include all fund families that might be affected by the ongoing sales charge proposal in the cost estimates below.

this type of system to an outside vendor. Because a fund family's class structure generally is intimately tied to its conversion system, as discussed below, we expect that the decision to amend or create new share classes would be made in coordination with any changes to the conversion system.

(ii) Operational Changes and Modified Share Classes

Next, we describe four potential routes that we believe fund families could use to come into compliance with our proposed amendments to rule 6c-10. In addition, we describe the staff's estimates of the number of fund families that may use each route and the potential costs. These routes include: (1) retaining existing share class structures and conversion systems; (2) updating the fund family's existing conversion system and amending the class structure; (3) updating the fund family's existing conversion system, amending the class structure, and creating new share classes; and (4) creating/purchasing a new conversion system, amending the class structure, and creating new share classes. Because these routes are general paths to compliance with our proposed amendments to rule 6c-10, we expect that the experience of each fund family would likely vary significantly from the average costs outlined below. In addition, some fund families may need to "mix and match" parts of these outlined routes to meet the particular needs of each fund within the fund family. However, we would expect that affected fund families would generally comply with the proposed amendments in one of the ways described above.

Funds would also have a variety of choices in managing shares with 12b-1 fees that have been grandfathered pursuant to proposed rule 12b-2(d). Some fund families may choose to retain grandfathered 12b-1 share classes for the period allowed, and *amend* those classes so that future share purchases comply with the proposed amendment to rule 6c-10 (essentially mixing shares with differing conversion dates in the same class), and then converting or exchanging the grandfathered shares into the amended classes after five years. Other fund families may decide not to grandfather 12b-1 shares and instead amend their existing classes to fully comply with the proposed amendments to rule 6c-10 for both new and existing shareholders (effectively applying the requirements of the proposal to existing shares and not taking advantage of the grandfathering provisions of proposed rule 12b-2(d)). Finally, some funds may choose to manage grandfathered shares by leaving those assets in existing classes for the period allowed, and *creating* new share classes for all future share purchases, and then converting or exchanging the grandfathered shares into the new classes after five years. In any event, we anticipate that fund families would choose the method that is most cost-effective and is in the best interest of the fund family and its shareholders. The method of managing share classes with grandfathered 12b-1 fees selected by the fund family is likely to influence the route that the fund family would select in complying with our proposed amendments to rule 6c-10(b), and we have included the costs of managing share classes with grandfathered fees in the staff's estimates below.[479]

Route 1: Retain Existing Share Class Structure and Conversion Systems

A fund family that sells funds with an existing class structure that already generally complies with our proposed amendments to rule 6c-10 might only need to make minor changes to its operations in response to our proposal. A fund family that does not sell C shares, sells B shares that convert at a time that is consistent with proposed rule 6c-10(b), and has a target class for converted shares (*i.e.*, a class that deducts 25 basis points or less in asset-based distribution

[479] Funds that amend or update existing share classes as a result of our proposal would provide notification to their existing shareholders. If the proposal is adopted, we anticipate providing a transition period of at least 18 months, which should allow most funds to provide this notification in their next regularly scheduled prospectus update, or in an annual or semi-annual report. In some cases, due to timing constraints, a fund may determine that it needs to "sticker" its registration statement and inform its shareholders of the share class changes in a separate and unscheduled communication. These funds would incur additional costs.

fees), would be included in this category.[480] The costs and time expended by such a fund family to comply with the proposed amendments to rule 6c-10 would include: reviewing the requirements of the rule (if adopted); updating fund prospectuses, SAIs, and shareholder reports to reflect the changed terminology and function of the two new types of asset-based distribution fees; reviewing and making any necessary updates to compliance policies and procedures; hiring outside counsel to perform these reviews and updates; and providing training to relevant internal personnel (*i.e.*, staff from the fund, adviser, or underwriter).

The staff estimates that approximately 15% (or 28) of the 186 fund families that may be affected would be able to comply with the proposal by making these minor changes to their operations. The staff estimates that fund families that would make these operational changes would incur approximately \$20,000 in one-time costs, and 100 hours of time expended by internal personnel to implement these changes for the entire fund family. The staff estimates that the 100 hours spent by internal personnel would break down as follows: 50 hours spent by accountants and other back office personnel at \$153 per hour; 30 hours spent by programmers and other IT personnel at \$190 per hour; 18 hours spent by internal counsel at \$316 per hour; and 2 hours spent by the board of directors at \$4500 per hour, for a total internal time cost equivalent of \$28,038.[481] The staff therefore estimates that the total costs for all affected fund families that use this route would be \$560,000 in one-time costs and 2800 hours of internal personnel time

[480] Such a fund would be unlikely to incur any costs relating to managing shares with grandfathered 12b-1 fees because its existing class structure would already be in compliance with our proposed amendments and, thus, it would not need to maintain separate classes for shares with grandfathered 12b-1 fees.

[481] These figures are based on the following calculations: (50 hours × \$153 = \$7650); (30 hours × \$190 = \$5700); (18 hours × \$316 = \$5688); (2 hours × \$4500 = \$9000); (\$7650 + \$5700 + \$5688 + \$9000 = \$28,038 total internal time cost equivalent).

expended at a total internal time cost equivalent of $785,064.[482]

- We request comment on these estimates and assumptions.

Route 2: Update Conversion System and Make Amendments to Class Structure

Alternatively, funds might need to make amendments to their existing share classes to comply with our proposal.[483] These funds may need to change the conversion period of their class B shares, institute a conversion period for class C shares, or make other changes to their class structure. However, the staff assumes that fund families that choose this route would not need to create new share classes, because they would already have a target class for conversions that meets the requirements of proposed rule 6c-10(b) (*e.g.*, an existing share class with 12b-1 fees of 25 basis points or less). The staff expects that these fund families would not choose to create new share classes for purchases made after the compliance date of the proposal (if adopted), but would instead amend their existing classes.[484] These fund families would also have to update their conversion systems, at a previously estimated one-time cost of $100,000 and $50,000 annually. The staff estimates that approximately 50% (or 93) of the 186 fund families that may be affected would need to amend their existing share classes as a result of our proposal. The staff estimates that, on average, each fund that amends its share classes would need to amend an average of two share classes. The staff estimates that it would typically cost

[482] These figures are based on the following calculations: ($20,000 costs × 28 fund families = $560,000); (100 hours × 28 fund families = 2800); ($28,038 × 28 fund families = $785,064).

[483] Pursuant to rule 18f-3, fund share classes are required to be organized according to a written plan that is approved by the fund's directors, and thus this plan must be amended when changes are made to a share class.

[484] Instead, they would either amend existing classes to mix grandfathered 12b-1 fee shares with new purchases with differing conversion dates, or would not grandfather existing 12b-1 fees. In either case, these funds would amend existing share classes, but would not create new ones. The costs for funds that choose to create new share classes as a means of managing share classes with grandfathered 12b-1 fees or in response to our proposed amendments to rule 6c-10 are described in our discussion of route 3, below.

approximately $10,000 and 25 hours of internal personnel time to amend a share class to meet the requirements of our proposed amendments to rule 6c-10.

However, the staff expects that most fund families would amend all of the relevant share classes at the same time as part of a coordinated plan for compliance with the proposed rules, and therefore should be able to achieve significant economies of scale. Much of the work involved in amending one share class is similar to that involved in amending other classes, and if all amendments are undertaken at the same time, significant efficiencies and elimination of duplicative effort should result. The staff therefore estimates that a fund family with 35 funds (the average for fund families that have at least one fund with 12b-1 fees in excess of 25 basis points) would incur a total of $100,000 in outside expenses and 250 hours of internal personnel time expended. The time would represent approximately 140 hours spent by accountants and other back office personnel at a rate of $153 per hour, 100 hours spent by inside counsel at a rate of $316 per hour, and 10 hours spent by the board of directors as a whole, at a rate of $4500 per hour, for a total internal time cost equivalent of $98,020.[485]

These costs and time expenditures would include internal staffing and outside counsel review to establish the amended terms of the class, creating and/or amending relevant disclosure documents, amending the written plan setting forth the terms of the funds' class structure, holding a director vote on the class plan if necessary, any training expenses, costs related to amending distribution or underwriting agreements, and any costs related to altering the terms of the class on the fund or its transfer agent's systems, the costs of exchanging or converting remaining grandfathered shares into appropriate share classes after the expiration of the grandfathering period, as well as the costs of updating the fund family's operations discussed

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485 These figures are based on the following calculations: ($153 × 140 hours = $21,420); ($316 × 100 hours = $31,600); ($4500 × 10 hours = $45,000); ($21,420 + $31,600 + $45,000 = $98,020).

above.[486] The staff assumes that the costs of maintaining these amended share classes would be the same as the cost of maintaining current share classes, and therefore the staff estimates that funds that choose this option would incur no additional ongoing annual cost burden.

Therefore, the staff estimates that each fund family would incur $100,000 in costs and 250 hours in internal personnel time (at an internal time cost equivalent of $98,020) to amend their share classes, and an additional $100,000 in one-time costs and $50,000 in annual costs to update their conversion systems, for a total one-time cost of $200,000, annual costs of $50,000, and 250 hours of time expended for each of these fund families to comply with the ongoing sales charge portion of our proposal. Based on these estimates, the staff further estimates that all 93 potentially affected fund families that may choose this option would incur a total of $18,600,000 in one-time costs, $4,650,000 annually, and 23,250 hours in one-time internal personnel time expended at an internal time cost equivalent of $9,115,860.[487]

- We request comment on these estimates and assumptions.

Route 3: Update Conversion System, Make Significant Changes to Class Structure, and Create New Share Classes

Other fund families may need to create new share classes to comply with our proposed amendments to rule 6c-10. These fund families might need to create new share classes either because they do not have an appropriate target class for conversions (for example, if their class A shares deduct more than 25 basis points in asset-based distribution fees), or if they chose to maintain grandfathered 12b-1 assets in existing share classes and create new share classes for all

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486 The costs of amending the fund family's operations, as discussed above under route 1, is included in this estimate.

487 These figures are based on the following calculations: ($200,000 one-time costs × 93 fund families = $18,600,000); ($50,000 annually × 93 fund families = $4,650,000); (250 hours × 93 fund families = 23,250 hours); ($98,020 × 93 fund families = $9,115,860).

future share purchases after the compliance date of the rule (if adopted).[488] In addition to creating new share classes, these fund families would also likely need to amend their existing share classes. These fund families would also need to update their conversion systems, at a previously estimated one-time cost of $100,000, and $50,000 annually.[489]

The staff estimates that the remaining 35% (or 65) of 186 potentially affected fund families with conversion systems would create new share classes in response to our proposed amendments to rule 6c-10. The staff estimates that it would cost each fund approximately $100,000 and 100 hours of internal personnel time to create a new share class.[490] These expenses would include internal staffing and outside counsel involvement to establish the terms of the new class, create and/or amend relevant disclosure documents, amend the written plan setting forth the terms of the funds' class structure, hold a director vote if necessary, any training expenses, the costs of amending distribution and underwriting agreements, the costs of exchanging or converting remaining grandfathered shares into appropriate share classes after the expiration of the grandfathering period, any costs related to implementing the new class on the fund's or transfer agent's systems, and any costs related to updating the fund's operations discussed above. The staff's estimate assumes that the costs of maintaining these new share

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[488] For example, a fund might have a class A that deducts 35 basis points in asset-based distribution fees, class B shares that convert at a date later than the proposal would require, and class C shares that do not convert. This fund might need to create a new class A that deducts 25 basis points or less as a target class for conversions, and if the fund chose to maintain grandfathered assets in the existing A and C shares classes, might also create a new class A and C that meets the terms of the proposal. In addition, the fund may choose to amend the conversion requirements of the class B shares to comply with the requirements of the proposal for both new and existing shareholders ("mixing" conversion dates in the same class). This fund would be creating three new share classes and amending one other class.

[489] *See supra* Section V.D.2.c.(i).

[490] As discussed below, funds that choose this option would likely achieve significant cost savings and economies of scale by creating all new classes simultaneously. To be conservative, however, Commission staff has also estimated the costs of creating each class individually.

classes would be the same as the costs of maintaining current share classes, and the staff estimates that funds that choose this option would incur no additional ongoing annual cost burden related to the class structure changes. The staff estimates that, on average, each fund that creates new share classes would need to create two new share classes and amend one additional share class (at the same cost as amending share classes discussed above).

However, as discussed previously, the staff expects that most fund families would make all necessary changes to their distribution structure as part of a coordinated plan for compliance with the proposed rules, and therefore should be able to achieve significant economies of scale and costs savings over the costs of amending or creating a single share class. For example, often, a number of funds in a family share a single prospectus, which could be amended at a single time, and the class structure could be amended with a single director vote. In light of these expected economies of scale, the staff estimates that a typical fund family would incur $800,000 in costs and 500 hours in internal personnel time to create new share classes, and $50,000 in costs and 100 hours in internal personnel time expended to amend existing share classes, for a total of $850,000 in outside costs and 600 hours of internal personnel time expended. The internal personnel time expended would include approximately 200 hours spent by programmers and other back office IT staff at a rate of $190 per hour, 200 hours spent by accountants at a rate of $153 per hour, 190 hours spent by inside counsel at a rate of $316 per hour, and 10 hours spent by the board of directors as a whole at $4500 per hour, for a total internal time cost equivalent of $173,640.[491] Including $100,000 in one-time costs and $50,000 in annual costs to update their conversion systems, the total cost for each fund family would be $950,000 in one-

[491] These figures are based on the following calculations: ($190 × 200 hours = $38,000); ($153 × 200 hours = $30,600); ($316 × 190 hours = $60,040); ($4500 × 10 hours = $45,000); ($38,000 + $30,600 + $60,040 + $45,000 = $173,640).

time costs, $50,000 in annual costs and 600 hours expended.

Based on these staff estimates, the 65 potentially affected fund families would incur a total of $61,750,000 in one-time costs, $3,250,000 in annual costs, and 39,000 hours in one-time internal personnel time expended (at an internal time cost equivalent of $11,286,600) to comply with our proposal.[492]

- We request comment on these estimates and assumptions.

Route 4: Purchase New Conversion System, Make Significant Changes to Class Structure, and Create New Share Classes

Finally, if our proposed amendments to rule 6c-10 are adopted, some funds would have to purchase or create a conversion system. As previously discussed, the staff estimates that 10% or 21 fund families that may be affected by our proposed amendments to rule 6c-10 currently do not have a conversion system, either because they only sell a single class of shares, or if they sell multiple classes of shares, none of their share classes has a conversion feature. The staff has previously estimated that that it would cost approximately $250,000 in initial costs and $100,000 in annual costs to purchase or create a conversion system.

In addition to purchasing a new conversion system, these fund families would also need to create a new target class for converted shares and amend existing share classes to meet the requirements of our proposed amendments to rule 6c-10. For example, if a fund sold only class C shares that deducted asset-based distribution fees in excess of 25 basis points, the fund would need to create a new target class for converted shares. In addition, if the fund chose to maintain grandfathered 12b-1 assets in the existing class, the fund may need to create a second class of

[492] These figures are based on the following calculations: ($950,000 one-time costs × 65 fund families = $61,750,000); ($50,000 annually × 65 fund families = $3,250,000); (600 hours × 65 fund families = 39,000 hours); ($173,640 × 65 fund families = $11,286,600).

shares for future purchases. On the other hand, if the fund chose to dispense with grandfathering 12b-1 fees, it might amend the existing C class so that it complied with our proposed amendments to rule 6c-10 for both existing and new shareholders.

The staff has previously estimated that it may cost each fund approximately $100,000 and 100 hours of internal personnel time to create a new share class and $10,000 and 25 hours to amend a share class. The staff assumes that each affected fund that does not currently convert shares would have to create two new share classes and amend one additional share class to meet the requirements of the proposed amendments to rule 6c-10.

However, as discussed previously, the staff expects that most fund families would make all necessary changes to their distribution structure as part of a coordinated plan for compliance with the proposed rules, and therefore should be able to achieve significant economies of scale and costs savings over the costs of amending or creating a single share class. In light of these expected economies of scale, the staff estimates that each fund family would incur $800,000 in costs and 500 hours in internal personnel time to create new share classes, and $50,000 in costs and 100 hours in internal personnel time expended to amend existing share classes, for a total of $850,000 in outside costs and 600 hours of internal personnel time expended. The internal personnel time expended would include approximately 200 hours spent by programmers and other back office IT staff at a rate of $190 per hour, 200 hours spent by accountants at a rate of $153 per hour, 190 hours spent by inside counsel at a rate of $316 per hour, and 10 hours spent by the board of directors as a whole at $4500 per hour, for a total internal time cost equivalent of $173,640.[493] Including $250,000 in one-time costs and $100,000 in annual costs to purchase or

493 These figures are based on the following calculations: ($190 × 200 hours = $38,000); ($153 × 200 hours = $30,600); ($316 × 190 hours = $60,040); ($4500 × 10 hours = $45,000); ($38,000 + $30,600 + $60,040 + $45,000 = $173,640).

build a conversion system, the total cost for each fund family would be $1,100,000 in one-time costs, $100,000 in annual costs and 600 hours expended.

Based on these staff estimates, the 21 potentially affected fund families would incur a total of $23,100,000 in one-time costs, $2,100,000 in annual costs, and 12,600 hours in one-time internal personnel time expended (at an internal time cost equivalent of $3,646,440) to comply with our proposal.[494]

- We request comment on these estimates and assumptions.

E. Ongoing Sales Charge: Investors

Investors currently appear to have difficulty understanding 12b-1 fees and the activities and services for which they are used.[495] Our proposal would differentiate between the two constituent parts of current 12b-1 fees (asset-based sales charges and service fees). It would allow funds to use a limited amount of assets as a marketing and service fee, and deduct any excess amounts over the marketing and service fee as an ongoing sales charge. The renamed fees would appear separately in an amended fee table in the prospectus under the headings "marketing and service fees" and "ongoing sales charge."

By more clearly identifying the two types of asset-based distribution fees, we expect that the proposal would make it easier for investors to understand when they are paying a sales charge. In addition, these proposed changes to the fee table and the revised narrative disclosure in the prospectus should also help investors better understand the services they are paying for through the marketing and service fee and the ongoing sales charge. This improved understanding should help investors more easily compare sales charges in alternative share

[494] These figures are based on the following calculations: ($1,100,000 one-time costs × 21 fund families = $23,100,000); ($100,000 annually × 21 fund families = $2,100,000); (600 hours × 21 fund families = 12,600 hours); ($173,640 × 21 fund families = $3,646,440).

[495] *See supra* Section II.E.

classes and competing funds and, therefore, choose the sales charge option that best meets their investment needs. We anticipate that this would lead investors to choose lower priced offerings of funds or share classes that offer comparable services, which should lead to greater price competition among funds and lower sales charges.

Investors empowered with this information may invest differently. Although we cannot predict investor behavior, we assume that if offered lower prices for the same services, or provided with better information regarding the distribution services received, many investors would choose to move their investments to, or make new investments in, a fund or share class with lower asset-based distribution fees or loads. Conversely, investors may decide to avoid funds that charge high asset-based distribution fees if they believe that they would not get, or want, commensurate levels of service. We expect that investors who choose to shift invested assets would only move assets that are not subject to a CDSL, or on which they had not already paid a front-end load. Thus, we do not anticipate that investors would shift assets invested in class A or B shares if our proposal were adopted. In addition, our proposal would require that assets held for long periods of time in level load classes (for example, class C shares) eventually convert to classes that do not deduct an ongoing sales charge, which would result in a net movement of assets out of these level load classes into lower cost classes.

Commission staff estimates that approximately $686 billion in total net assets currently are invested in level load share classes, and that approximately $3.4 billion in 12b-1 fees are deducted from these assets fees annually, for an average 12b-1 fee as a percentage of total net assets in these classes of 50 basis points.[496] The staff further estimates that if our proposed rule

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[496] We recognize that some portion of the 50 basis points may represent service fees and that an investor who shifts their assets from a level load fund class may still select a fund class that charges a service fee or a reduced ongoing sales charge. However, for purposes of this analysis, the result of the staff's

and disclosure amendments are adopted, improved investor understanding of distribution related charges would result in an aggregate total of between five and ten percent of assets currently invested in level load classes (for example, C shares) moving to share classes (within the same fund or in a different fund) that do not deduct an asset-based distribution fee. If *five percent* of the $686 billion in assets in these classes (or $34 billion) were moved to share classes without asset-based distribution fees, at an annual 12b-1 fee rate of 50 basis points, investors would save approximately $170 million annually.[497] If *ten percent* of the $686 billion in assets in these classes (or $68 billion) were moved to share classes without asset-based distribution fees, investors would save approximately $340 million annually.[498] Over a ten-year period, this would represent a potential savings of between $1.7 billion and $3.4 billion to investors in asset-based distribution fees that they would otherwise have paid, but would avoid because of better informed decision making.

If our proposal is adopted, we would provide a grandfathering provision for current 12b-1 share classes for a five-year period. However, at the end of that five-year period, all shares that are currently subject to a 12b-1 plan would need to be converted or exchanged into a class that does not deduct an ongoing sales charge and with a marketing and service fee that is no higher than the 12b-1 fee in effect in the previous fiscal year. This expiration of the grandfathering period would effectively time limit level load share classes as they exist today. All assets that remain in level load share classes after the expiration of the grandfathering period would need to be converted to a class that does not deduct an ongoing sales charge; effectively a class that

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estimates represent the total cumulative effect of all asset movement from level load funds to no-load or lower load funds.

497 This estimate is based on the following calculation: ($34,000,000,000 × 0.005 = $170,000,000).

498 This estimate is based on the following calculation: ($68,000,000,000 × 0.005 = $340,000,000).

charges 25 basis points or less in asset-based distribution fees. This conversion or exchange would benefit investors who remained in these level load classes at the end of the grandfathering period to the extent that the asset-based distribution fees on the share class they are converted into is lower than the current 12b-1 fee.

The staff estimated above that the average 12b-1 fee on level load share classes is 50 basis points. Because no ongoing sales charge could be charged on the converted or exchanged shares and the highest marketing and service fee allowed under the proposal is 25 basis points, the staff estimates that investors who remain in the grandfathered 12b-1 share class would save 25 basis points a year after the expiration of the grandfathering period. However, as discussed above, the staff estimates that some investors may move their existing level load assets to lower load classes as a result of this proposal, and further reductions in the assets of existing level load share classes may occur through redemptions or reduced investment. The staff estimates that at the expiration of the grandfathering period in five years, approximately 50% of the $686 billion (or $343 billion) in existing level load share class assets will remain. Upon the conversion or exchange of these assets into share classes that do not deduct an ongoing sales charge, the staff estimates that investors in these classes will save 25 basis points a year (the asset-based distribution fees charged in excess of the amount permitted as a marketing and service fee), or a total of $857,500,000 annually.[499]

In addition, if our proposal is adopted, we estimate that net new investments in level load fund classes would decline as investors choose share classes with no or lower sales charges, whether in the form of an asset-based distribution fee, front-end load or CDSL, and as a result of requirements in the proposal to eventually convert shares that charge an ongoing sales charge

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[499] This estimate is based on the following calculation: ($343,000,000,000 × 0.0025 = $857,500,000).

into a class that does not deduct such a fee at a set time. The staff estimates net new investments in level load fund classes may decline between ten and twenty percent as a result of our proposal (with a commensurate increase in net new investments in no or low load funds). Based on a review of Lipper's LANA Database and data filed with the Commission, the staff estimates that approximately $52 billion in net new cash flowed to level load classes in 2009, with those level load classes charging an average asset-based distribution fee of approximately 50 basis points. Assuming that there would be similar net cash flow to these classes in future years, if *ten percent* of the net new cash flow to level load classes (or $5.2 billion) is invested in classes that do not charge asset-based distribution fees, Commission staff estimates that investors would save approximately $26 million annually.[500] If *twenty percent* of the net new cash flow to these classes (or $10.4 billion) is instead invested in classes that do not charge asset-based distribution fees, Commission staff estimates that investors would save approximately $52 million annually.[501] Over a ten-year period, this represents potential savings of between $260 million and $520 million for investors who might be better served in other classes with a more appropriate level of service for their needs or wants.

As discussed above, we expect that one result of our proposal would be a net shift by investors to lower load share classes. As part of this net shift, we would expect that some investors might determine that they need or want continuing high levels of service, and may choose to move their assets out of level load share classes and into fee-based or wrap fee accounts, which may have higher expenses than the level load share classes the investor had

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[500] This estimate is based on the following calculation: ($5,200,000,000 × .005 = $26,000,000).

[501] This estimate is based on the following calculation: ($10,400,000,000 × .005 = $52,000,000).

previously owned.[502] These investors may pay higher expenses as a result of this choice, but would presumably also receive higher levels of service, and the ability to trade between funds in different fund families without paying additional loads. The proposal would provide investors with better information regarding the asset-based distribution fees they pay, which should enhance the ability of investors to select the type of account or method of paying distribution fees that is best for them, even if some investors choose to invest through more costly methods as a result.

There is some question as to whether a reduction in asset-based distribution fees paid by investors would be purely a benefit of the proposal resulting from markets that are more efficient and investors making better-informed investment choices, or whether it would represent a transfer of assets from investment managers or broker-dealers to investors. The goals of this rulemaking include providing better and more transparent information to investors regarding the asset-based distribution fees they pay, enabling investors to more efficiently allocate their investments and meet their investment goals, and promoting competitive markets. In light of these goals, we believe that any reduction in asset-based distribution fees paid by investors that is due to better-informed investment decisions made as a result of this proposal should be counted as a benefit.

- Do commenters agree that the estimated reductions in sales charges investors would pay are a benefit of this proposal? We further request comment on the estimates and assumptions we have made in this section regarding the benefits of our proposal to

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[502] Other investors, however, would move their assets into lower cost funds, as discussed previously. Level-load share classes typically deduct 100 basis points or less in asset-based distribution fees annually. Fee-based or wrap accounts often charge higher fees (between 100 and 200 basis points annually) but the broker-dealers that offer wrap accounts also provide additional services and transaction options for their clients.

> investors and the likelihood that a certain portion would invest in funds with lower sales charges. In particular, we request comment on the quantitative estimates the staff has made and request that commenters provide any quantitative data they may have on the likely behavior of investors in response to our proposals.

Currently, funds with class C shares typically do not charge a CDSL after the first year, which allows the potential for some short-term shareholders in C share classes to redeem soon after purchase and pay less asset-based distribution fees compared to longer -term shareholders in the same share class. Essentially, the longer-term C class shareholders subsidize some of the distribution expenses of the shorter-term shareholders. Funds typically structure their C shares in this manner to attract investors who may not want to be committed to a long-term investment in a fund, and who may pay significantly more or less in distribution costs depending on how long they remain invested in the fund. Funds also take the risk that the distribution expenses associated with short-term investments in C shares will not be balanced out by long-term C class shareholders who may pay significantly more in asset-based distribution fees than if they had instead invested in some other class.

Proposed new rule 12b-2 and amended rule 6c-10 would have the effect of limiting the total asset-based distribution fees that long-term shareholders would pay, and may thereby alter the economic incentives involved in structuring a C share class without a CDSL. If the proposal is adopted, some funds may reconsider the economics of C share classes, and could restructure those classes, perhaps imposing a CDSL similar to B share classes. If this occurs, this could effectively eliminate the opportunity for some short-term C class shareholders to avoid paying a portion of the distribution expenses associated with their investment. However, it would also effectively eliminate the potential for some longer-term shareholders in C classes to subsidize those costs by paying significantly more in asset-based distribution fees over time. One of the goals of this rulemaking is to help ensure more equity between shareholders in the payment of fund distribution expenses. However, we acknowledge that achieving this more equitable treatment between shareholders may come at a cost to certain short-term shareholders whose distribution expenses would no longer be subsidized by long-term C class shareholders.

We request comment on the likelihood of funds restructuring their C share classes as discussed above, and any potential impact such a restructuring might have on both long- and short-term investors in those classes.

- In particular, we request comment on any quantitative estimates of the amount of additional asset-based distribution fees that short-term investors may pay and the amount of such fees that long-term shareholders may save as a result of this proposal.

F. Ongoing Sales Charge: Intermediaries

Broker-dealers and other intermediaries may also be affected by the proposed limitations on ongoing sales charges. Currently, FINRA rules do not limit the total amount of asset-based sales charges that an individual fund investor may pay. NASD Conduct Rule 2830 limits the aggregate amount of these fees and other sales loads that a fund may pay to its distributor, to a percentage of the amount of gross new sales of fund shares. Because most funds continually sell new shares (and thus have new sales), we understand that most funds do not reach this limit. As a result, broker-dealers generally may receive asset-based sales charges on an investment in fund shares for as long as the investor holds the shares (or, in the case of B shares, until the shares convert). The conversion requirements of our ongoing sales charge proposal would limit the amount of asset-based distribution fees that an individual investor would pay to an amount that is tied to the front-end load of the fund, or the NASD sales charge limits.

Our proposed amendments to rule 6c-10 may have the effect of reducing the total compensation that intermediaries receive from the sale of certain types of shares (such as B, C, or R shares). However, as discussed previously, any reduction in compensation would be experienced as reduced costs for investors because distribution charges that are not deducted from fund assets would be retained by shareholders.

The amount of any reduction in intermediary compensation that might result is speculative.[503] For example, many class B shares currently convert on a schedule that generally meets, or come close to meeting, the requirements we propose today. Therefore, we anticipate that complying with the proposal's requirements with respect to class B shares would result in, at most, a minor reduction in compensation to broker-dealers. Class C shares (which are generally described in fund prospectuses as being suitable for short-term investments) do not convert, but if they are sold as short-term investments, we believe they generally would not be held long-term. Based on average holding periods for funds generally, we expect that only a limited portion of outstanding class C shares would be held long enough for any asset-based distribution fees on class C shares to exceed the proposed ongoing sales charge limit.[504]

Funds with class R shares or similar classes (which typically are sold in tax-advantaged accounts and are intended as long-term investments) may charge 12b-1 fees in amounts exceeding 25 basis points that would become subject to the limitations on ongoing sales charges. These share classes often use 12b-1 fees to pay for associated recordkeeping and shareholder

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[503] The staff has estimated some potential effects of our rulemaking on investor behavior (and consequent reduction in intermediary compensation) in Section V.E of this Release, *supra*.

[504] Comprehensive data on the typical retention period for C shares is not available, but the typical fund shareholder only holds fund shares for approximately 3-4 years. Based on a front-end load equal to 6%, a C share investor could pay an ongoing sales charge of 75 basis points for approximately 8 years before reaching the ongoing sales charge limits we propose today. This holding period would be more than double the typical holding period for all fund shares, and particularly long for C shares, which funds disclose as appropriate for short-term holding periods.

services, as well as for distribution expenses. As we have discussed above, some funds may be in a position to identify those non-distribution expenses and re-characterize them as administrative fees, thereby avoiding the need to impose an ongoing sales charge without reducing distribution payments to intermediaries. To the extent that any portion of 12b-1 fees currently charged on class R shares must be considered to be an ongoing sales charge, any estimate reduction in compensation resulting from our proposal would be speculative, because as discussed above, we anticipate that the lost revenue may be recovered through other sources.[505]

If intermediaries experience a significant reduction in distribution compensation, would they be likely to renegotiate revenue sharing agreements and recover some or all of the lost compensation through these sources? Would intermediaries be likely to receive less compensation based on the ongoing sales charge limits of our proposal? How much less? Would they make up any or all of any such loss through revenue sharing agreements? Do commenters believe that this reduction in compensation should be treated as a cost of the proposal, considering that any reduction would come with a corresponding increase in the assets held by investors?

Intermediaries such as broker-dealers, banks, and insurance companies may also incur costs in connection with our proposals.[506] For example, these intermediaries may need to enter into new or amended distribution agreements with the funds that they sell, enhance their recordkeeping systems, update sales literature, and provide additional training to their sales representatives regarding the new regulatory framework for mutual fund asset-based distribution

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[505] As discussed above, broker-dealers often receive payments from fund advisers known as "revenue sharing," which supplements the compensation they receive for distributing fund shares. *See supra* note 65.

[506] The costs for retirement plan record keepers are discussed below, and the costs for transfer agents are included in the previously discussed costs for mutual funds above.

fees and the suitability of different share classes for their clients. The staff estimates that there are approximately 4770 of these types of intermediaries, and that approximately 40% of these intermediaries (or 1908) receive 12b-1 fees, and therefore would be affected by our proposal.[507] The staff estimates that, on average, each affected intermediary would expend $50,000 in costs and 100 hours of internal personnel time in response to our proposals.[508] This internal time would include approximately 75 hours spent by professionals such as compliance personnel at a rate of $210[509] per hour and 25 hours spent by inside counsel at a rate of $316 per hour, at a total internal time cost equivalent of $23,650.[510] Therefore, the staff estimates that all intermediaries may incur approximately $95,400,000 in one-time costs and 190,800 hours (at an internal time cost equivalent of $45,124,200 as a result of the proposed new rule and rule amendments).[511]

In addition, our proposal may require intermediaries such as retirement plan administrators or other omnibus account record keepers to begin tracking share lots and managing share conversions. This change may require these intermediaries to invest in new systems or enhance their current record-keeping and back office systems. If a retirement plan

[507] This number consists of the following: 2203 broker-dealers classified as specialists in fund shares, 167 insurance companies sponsoring registered separate accounts organized as unit investment trusts, approximately 2400 banks that sell funds or variable annuities (the number of banks is likely over inclusive because it may include a number of banks that do not sell registered variable annuities or funds, or banks that do their business through a registered broker-dealer on the same premises). This number may be over or under inclusive, because the actual number of intermediaries that would be affected would vary based on the intermediary's business model and whether the intermediary sells funds that deduct 12b-1 fees.

[508] We recognize that this average will likely vary significantly, with large intermediaries incurring many times this cost estimate and small intermediaries likely incurring far less.

[509] The staff has based the hourly cost estimates for time spent by intermediaries in this section on SIFMA's *Management & Professional Earnings in the Securities Industry 2009*, *supra* note 407, because the staff believes the hourly costs are comparable.

[510] These figures are based on the following calculations: ($210 × 75 hours = $15,750); ($316 × 25 hours = $7900); ($15,750 + $7900 = $23,650).

[511] These estimates are based on the following calculations: (1908 intermediaries × $50,000 = $95,400,000 in costs); (1908 intermediaries × 100 hours = 190,800 hours expended); (1908 intermediaries × $23,650 = $45,124,200).

offers fund classes that deduct an ongoing sales charge, the proposal would require such shares purchased by plan participants to eventually be converted to a class that does not deduct an ongoing sales charge. This conversion requirement would create costs for retirement plan record-keepers because we understand that currently, most record-keepers do not maintain individual participant share histories. Record-keepers for plans that offer shares classes with an ongoing sales charge would need to begin tracking the date of purchase of each share lot for each participant, and tie that share history to the appropriate conversion date. In addition, plans currently usually only have a single class of shares for each fund offered within the plan. If our proposal is adopted, however, if the single class that is offered within the plan deducts an ongoing sales charge, a second class of shares for each fund (*i.e.* a target class for converted shares) would have to be added to the record-keeper's systems, effectively adding more complexity and costs to their operations. For example, as a result of this increase in the number of shares classes, record-keepers might need to increase the size of their participant statements, spend more time answering participant questions, process more trades, and manage operational complexities related to multiple share classes (such as allocating withdrawals between share classes for participant loans and rebalancings, identifying the correct conversion date for reinvested dividends, and other issues).

Only record-keepers that provide services to retirement plans that offer fund share classes with 12b-1 fees in excess of 25 basis points would be affected by our proposal.[512] The staff estimates that there are approximately 2025 intermediaries that provide record-keeping for retirement plans, and that approximately 25% (or 506) of those record-keepers provide services

[512] Record-keepers for plans that only offer funds with 12b-1 fees of 25 basis points or less would be generally unaffected by our proposal, because they would not need to change their systems to manage the ongoing sales charge and its related multiple share classes and conversions.

to plans that offer fund share classes with 12b-1 fees in excess of 25 basis points.[513] The staff estimates that approximately 35% (or 177) of the 506 affected record-keepers would choose to upgrade their systems to manage ongoing sales charges, while the other 65% (or 329) would choose to do business only with plans that offer funds without an ongoing sales charge, and thus avoid the costs discussed below.[514] The staff estimates that it would cost a record-keeper approximately $1,000,000 in one-time costs and $1,500,000 annually to manage ongoing sales charges for the plans they service.[515] These expenses would include, but not be limited to, expenses related to enhancing computer software to begin tracking and aging share histories and multiple share classes, additional computer hardware and storage costs for the increased volume of information related to participant positions, larger participant statements (and higher mailing costs), increased time spent providing service to participants, and costs related to managing the operational complexities discussed above. Therefore, the staff estimates that intermediaries that provide record-keeping services to retirement plans may incur a total one-time cost of

[513] This includes 225 bank, mutual fund, and insurance record-keepers, and an additional 1800 third party administrators that provide some record-keeping for the plans they administer. The number of participant accounts serviced by these record-keepers varies widely, with some servicing more than ten million accounts, and others only providing service to a few hundred or thousand accounts. The costs we provide here are estimates for the average record-keeper, and we acknowledge that the larger firms will likely incur significantly higher costs, while the smaller firms may incur far less.

[514] These funds might include funds that have re-assessed the asset-based distribution fees they charge and restructured their fees to identify non-distribution services that could be paid separately from the asset-based distribution fee limits of our proposal, in the manner discussed in Section V.D.2.b of this Release, *supra*.

[515] The staff assumes that record-keepers would continue to receive approximately the same amount of compensation for the services they provide. Record-keepers currently often receive some or all of their compensation from 12b-1 fees deducted from participant funds. The staff expects that much of the compensation that is currently paid to record-keepers through a 12b-1 fee in excess of the marketing and service fee (which would be an ongoing sales charge that would eventually end and no longer be able to pay for record-keeping services) may be re-assessed and paid as an ordinary fund expense, and not be subject to the limits on asset-based distribution fees contained within our proposal.

$177,000,000 and an annual cost of $265,500,000 in complying with our proposal.[516]

As discussed previously, under our proposed rulemaking, ongoing sales charges would qualify as transaction based compensation, and intermediaries who receive the ongoing sales charge may need to register as broker-dealers under section 15 of the Exchange Act unless they can avail themselves of an exception or exemption from registration.[517] The proposed rulemaking could potentially lead to some intermediaries who are currently receiving 12b-1 fees but that are not registered as broker-dealers under section 15 of the Exchange Act to either no longer receive asset-based distribution fees or to register as broker-dealers. However, we understand that virtually all advisers and other intermediaries that currently receive 12b-1 fees in excess of 25 basis points (thus qualifying as an ongoing sales charge) already associate themselves with registered broker-dealers, either by registering themselves, or by becoming an independent contractor registered representative of an registered broker-dealer. Therefore, we do not anticipate that, if our proposal is adopted, any intermediaries who are currently receiving 12b-1 fees would newly register as broker-dealers, and thus incur the costs associated with registration.

We request comment on all of the estimates and assumptions made in this section.

- Is our understanding correct? Would the proposed rulemaking in fact require any intermediaries who are currently receiving 12b-1 fees to register as a broker-dealer? In particular, we request comment on what types of intermediaries, if any would be affected, and if they are affected, how many would be required to register or no longer receive ongoing sales charges. If intermediaries are required to register, what

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516 These estimates are based on the following calculations: (177 record-keepers × $1,000,000 one-time costs = $177,000,000 in one-time costs); (177 record-keepers × $1,500,000 in annual costs = $265,500,000 in annual costs).

517 *See supra* note 168.

kind of costs would they incur? We currently estimate that any new entities registering as broker-dealers would incur a time burden of 2.75 hours to complete Form BD.[518] Are there other costs that would be implicated by broker-dealer registration? Would other burdens be incurred and, if so, what are those burdens? What one-time and on-going costs, if any, would be incurred? We request comment on the estimates and assumptions we have made in this section.

G. Disclosure

The proposal would make the following changes to the disclosure requirements:

- Amend Form N-1A to replace the current line item for 12b-1 fees in the fee table and statement of operations with two new line items ("Marketing and Service Fee" and "Ongoing Sales Charge") and revise most of the current disclosure in the prospectus and SAI related to the discussion of 12b-1 plans (which would no longer exist) and the dollar amounts spent under the plans for different distribution activities;

- Eliminate the periodic reporting requirement related to 12b-1 plans in Form N-SAR, the annual and semi-annual reporting form used by mutual funds;

- Amend the statement of operations for fund income and expenses in Regulation S-X to conform to our proposal;

- Amend Forms N-3, N-4, and N-6 to conform to our proposed changes; and

- Provide better proxy disclosures for shareholder votes on asset-based distribution fees.

These proposed disclosure changes would provide a number of benefits, including providing more descriptive disclosure of the use and amount of asset-based distribution fees deducted by funds in prospectuses and SAIs, providing greater transparency of these fees to investors, removing requirements that would become outdated, and conforming disclosure

[518] Form BD is the application form used by entities to apply to the Commission for registration as a broker-dealer. *See* Proposed Collection; Comment Request (Apr. 20, 2010) [75 FR 22638 (Apr. 29, 2010)] (providing estimates of and seeking comments on compliance burden of Form BD).

requirements to our proposal. We have discussed these benefits in detail previously in this Release in Sections III.I and III.M above. These benefits include providing clearer disclosure of the amount and use of asset-based distribution fees, eliminating potentially confusing or unnecessary disclosure, and providing better descriptions of the fees. The amendments would provide investors access to more relevant and transparent information that could help guide their investment making decision when considering whether to invest in a fund that deducts asset-based distribution fees. As discussed below, the staff estimates that there would be no additional ongoing costs as a result of these disclosure changes, and in fact, those ongoing costs may decrease.

1. Revised Fee Table, Prospectus, and SAI Disclosure

The proposal would require funds to eliminate the current line item titled "Distribution and/or Service (12b-1) Fees" and add, as necessary, two items for the fees permitted under the proposal – "Marketing and Service Fee" and "Ongoing Sales Charge." Funds that do not currently charge asset-based distribution fees would not be affected by these proposed amendments. The staff estimates that funds that charge asset-based distribution fees would be able to complete the revised fee table in the same amount of time, and for the same cost because the revised fee table only includes data that is readily available when the fund regularly updates the fee table, and does not include any new information. The revised fee table would not be significantly longer, and would instead simply include a new line item, which is a breakdown of an existing line item, that was already known when the fee was instituted.[519] Therefore, the staff estimates that the proposed new line items in the fee table would not increase costs or the amount

[519] There are two types of Form N-1A filings; (i) initial filings, and (ii) annual post-effective amendments. Funds usually incur significantly more time and incur greater costs when first registering a fund under their initial N-1A filings than when filing their annual post-effective updates. Therefore, the staff separately estimates the burden for each type of filing.

of time required to complete Form N-1A, either initially or when submitting a post-effective amendment.

The proposal would also significantly revise the disclosure required for funds with 12b-1 fees in the prospectus narrative and in the SAI. These proposed amendments would eliminate many disclosures that would become outdated or irrelevant based on our proposed rule changes, including some of the most detailed disclosures of the dollar amount the fund spends on each distribution activity. However, some of the other disclosure requirements regarding asset-based distribution fees currently in Form N-1A would be retained in the same or similar form.[520] Thus, we anticipate that the proposed amendments would reduce the amount of time needed to provide disclosure on asset-based distribution fees on an ongoing basis, although some one-time costs may be incurred to initially revise and update the prospectus to conform its description regarding asset-based distribution fees to the proposed new framework.

In our most recent Paperwork Reduction Act submission for Form N-1A, the staff estimated that for each fund portfolio or series, the initial filing burden is approximately 830.47 hours at a cost of $20,300, and the post-effective amendment burden is approximately 111 hours at a cost of $8894. This includes time spent by inside counsel, back office personnel, compliance professionals, and others in filling out the form. The costs include that of outside counsel to prepare and review these filings. We assume that only funds that charge asset-based distribution fees would be affected by our proposed amendments to Form N-1A. The staff estimates that, each year, there are approximately 7367 funds with 12b-1 plans that file post-effective amendments.

The staff estimates that our proposed amendments would result in time savings of

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[520] *See* Section III.J, *supra*.

approximately 10 hours for each portfolio's initial filing (for a new total estimate of 820.47 hours) and of 1 hour for each post-effective amendment (for a new total estimate of 110 hours). The staff further estimates that the amendments would reduce costs spent on outside counsel, and other costs associated with completing Form N-1A, by $500 for each initial filing (for a new total estimate of $19,800) and $150 for each post-effective amendment (for a new total estimate of $8744). In addition, the staff estimates that each fund would incur a total one-time cost of $2000 and a one-time time expenditure of 10 hours of attorney time at a rate of $316 per hour to initially revise their post effective amendments to Form N-1A to meet the requirements of the proposed amendments for the first time.

The staff estimates that, in each year following the effective date of the proposed amendments, 300 additional funds with asset-based distribution fees would file an *initial* Form N-1A. Based on these estimates, the staff estimates that funds would save a total of 3000 hours (at an internal time cost equivalent of $948,000)[521] and $150,000 when submitting initial Form N-1A filings each year.[522] In addition, the staff anticipates that funds would save approximately 7367 hours (at an internal time cost equivalent of $2,327,972)[523], and $1,050,050 annually when preparing post-effective updates to Form N-1A.[524] Finally, the staff estimates that all funds with asset-based distribution fees would incur a total one-time expenditure of 73,670 hours (at an internal time cost equivalent of $23,279,720) and a cost of $14,734,000 when preparing post-

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521 This estimate is based on the following calculation: (300 new filers × 10 hours savings = 3000 hours in total savings); (3000 hours × $316 per hour = $948,000).

522 This estimate is based on the following calculations: (300 new filers × $500 savings = $150,000 total savings).

523 This estimate is based on the following calculation: (7367 amendments × 1 hour savings = 7367 hours in total savings); (7367 hours × $316 per hour = $2,327,972).

524 This estimate is based on the following calculations: (7367 amendments × $150 savings = $1,105,050 total savings).

effective amendments to comply with the proposed amendments for the first time.[525]

- We request comment on these estimates and assumptions.

2. N-SAR Periodic Reporting

Our proposal would amend the instructions to Form N-SAR, which currently requires funds to respond to a series of questions regarding their 12b-1 plans. Form N-SAR is the form that registered investment companies use to make periodic reports to the Commission. Our proposed amendments would add an instruction to Form N-SAR to disregard, for funds that no longer have 12b-1 plans, four questions (Items 41-44) that relate to the operation of rule 12b-1 plans (because they would be irrelevant in light of our proposed new framework for asset-based distribution fees). However, funds that maintain grandfathered fund classes would continue to respond to these items.

The staff estimates that there are approximately 1292 management investment companies that respond to Items 41-44 of Form N-SAR. The staff estimates that our proposed amendments would reduce the time it takes funds that do not have grandfathered share classes to complete Form N-SAR by 0.25 hours, and that there would be no change for funds that maintain grandfathered share classes. The staff estimates that, if these amendments are adopted, in the first three years after adoption, approximately 20% of these 1292 management investment companies (or 258) would no longer maintain grandfathered share classes and would then experience the estimated savings, while the remaining 80% (or 1034) would continue to have grandfathered share classes and respond to these items. Because Form N-SAR is completed twice a year, the staff estimates that each respondent would save approximately 0.5 hour

[525] This estimate is based on the following calculations: (7367 amendments × 10 hours expended = 73,670 hours); (73,670 hours x 316 per hour = $23,279,720); (7367 amendments × $2000 costs = $14,734,000 total one-time costs).

annually (at an internal time cost equivalent rate of $316 per hour). The staff therefore estimates that our proposed amendments to Form N-SAR would result in total incremental time savings of approximately 129 hours (with a total internal time equivalent cost savings of $40,764)[526] annually.

- We request comment on these estimates and assumptions.

3. Regulation S-X

As discussed in Section III.L of this Release, we are proposing changes to rule 6-07 of Regulation S-X, which requires funds to file a statement of operations listing income and expenses, and state separately all amounts paid in accordance with a 12b-1 plan. Our proposal would conform the disclosure requirement to the terms of our proposed new rule and rule amendments regarding asset-based distribution fees, by requiring that funds state separately amounts charged for marketing and service fees and ongoing sales charges.

Our understanding is that funds already have information on asset-based distribution fees available in order to prepare the statement of operations as we have proposed. Funds analyze this information as a matter of course for ordinary business and tax reasons, and therefore our proposed changes to Regulation S-X would not require the preparation of new information. Accordingly, the staff estimates that our proposed changes to Regulation S-X would not change the amount of time or the costs required for funds to prepare their statements of operations under the regulation.

- We request comment on these estimates and assumptions.

4. Form N-3, N-4, and N-6

The proposal would revise the currently required disclosure for 12b-1 plans in the

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[526] This estimate is based on the following calculation: (258 × 0.5 hours = 129 hours); (129 hours × $316 per hour = $40,764).

prospectus narrative and in the SAI of Form N-3. These proposed amendments would eliminate disclosures that would become outdated or irrelevant based on our proposed rule changes, including some of the most detailed disclosures of the exact dollar amount the registrant spends on each distribution activity. However, much of the general disclosures regarding asset-based distribution fees currently in Form N-3 would be retained in the same or similar form.[527]

In our most recent Paperwork Reduction Act submission for Form N-3, the staff estimated that for each portfolio, the initial filing burden is approximately 922.7 hours at a cost of $20,300, and the post-effective amendment burden is approximately 154.7 hours at a cost of $7650. This hourly burden includes time spent by in-house counsel, back office personnel, compliance professionals, and others in preparing the form. The costs include that of outside counsel to prepare and review these filings.

The staff assumes that only registrants that charge asset-based distribution fees would be affected by our proposed amendments to Form N-3. Based upon a review of filings with the Commission, the staff estimates that 1 registrant that currently files on Form N-3 charges asset-based distribution fees, and would file a post effective amendment. The staff estimates that it would cost this registrant approximately $2000 in one-time costs (for outside legal counsel drafting and review) and require an expenditure of 10 hours in internal personnel time (at an internal time cost equivalent rate of $316 per hour) to revise its prospectus to comply with the proposed amendments. The staff further estimates that the proposed amendments to Item 21 and instruction 5 of Item 26 would result in time savings when completing a post-effective amendment of Form N-3. The staff estimates that this registrant would save approximately 1 hour (at an internal time cost equivalent of $316 per hour) annually as a result of the proposed

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[527] *See supra* Section III.L.

amendments.

The staff further estimates that no new registrants that file on Form N-3 are likely to charge asset-based distribution fees under proposed rule 12b-2 and the proposed amendments to rule 6c-10. Accordingly, the staff estimates that there will be no other changes in burden hours or costs as a result of the proposed rule and rule amendments.

- We request comment on any of these estimates or assumptions.

Our proposal would also amend Forms N-4 and N-6 to conform them to the new rule and rule amendments that we are proposing today.[528] The proposed form amendments would replace references to rule 12b-1 with references to proposed rules 6c-10(b), 12b-2(b) or 12b-12(d), as appropriate. We expect this would benefit investors because it would more accurately describe these fees.

The staff estimates that the proposed amendments to these forms would not change current estimates of the amount of time or costs associated with completing the forms because they are primarily technical and only conform the disclosure to the proposal. Therefore, we estimate no costs will result from these proposed Form N-4 and N-6 changes.

- We request comment on these estimates and assumptions.

5. *Streamlined Proxy Procedure*

Our proposal would eliminate a number of disclosures in Schedule 14A (the form for proxy statements) that would become irrelevant in light of the proposed rule and rule amendments.[529] We anticipate that the proposed amendments would result in cost savings to

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[528] Form N-3 is used by separate accounts offering variable annuity contracts that are registered as management investment companies. Form N-4 is used by separate accounts offering variable annuity contracts and are registered as unit investment trusts. Form N-6 is used by separate accounts offering variable life insurance contracts and are registered as unit investment trusts.

[529] *See* proposed Item 22 of Schedule 14A.

funds that prepare such proxies when obtaining shareholder consent to increase or implement marketing and service fees.

Funds that rely on proposed rule 12b-2(d) would not be permitted to institute new 12b-1 plans or increase the rate of a 12b-1 fee under an existing plan after the rule's compliance date, and therefore they would no longer solicit proxies in relation to their 12b-1 plans. Proposed rule 12b-2(b) would require a shareholder vote and attendant proxy solicitation when a fund institutes or increases a marketing and service fee in existing share classes.[530]

Commission staff estimates that approximately 3 funds would solicit proxies each year for the purposes of implementing or increasing a fee under proposed rule 12b-2(b) (the same number that we have previously estimated would solicit proxies under rule 12b-1). Funds typically hire outside legal counsel and proxy solicitation firms to prepare, print, and mail these proxies. For each of these 3 funds, the staff estimates that our proposed amendments to Schedule 14A would result in an incremental burden reduction of 3 hours of internal personnel time (at an internal time cost equivalent rate of $316 per hour) and reduced costs of $400 for the services of outside professionals. The staff therefore estimates that these amendments will reduce the total annual costs of soliciting proxies and completing Schedule 14A by approximately 9 hours of internal personnel time (3 funds x 3 hours) at a internal time cost equivalent of $2844[531] and approximately $1200 (3 funds x $400) for the services of outside professionals.

H. Account-level Sales Charge Alternative

Proposed rule 6c-10(c) would provide funds the option of offering a class of fund shares that could be sold by dealers with sales charges set at negotiated rates. The sales charge could

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[530] As discussed in Section III.N.4 of this Release, *supra*, we would not require a shareholder vote if a 12b-1 fee is relabeled a marketing and service fee, provided the fee is 25 basis points or less and is not increased.

[531] This estimate is based on the following calculation: (9 hours × $316 per hour = $2844).

vary in amount, or time of payment, and could better reflect services provided by the broker. We assume that a limited number of funds would choose to rely on this exemption immediately, and that reliance on the exemption may increase over time as funds and dealers better understand the costs and benefits associated with a different business model.

1. Benefits

Some of the benefits that may derive from this exemption include enhanced competition in fund distribution, greater transparency of distribution charges for fund investors, and reduced conflicts for broker-dealers selling funds with different compensation structures.[532] Other benefits include less complicated distribution structures and reduced training required for registered representatives of broker-dealers. This part of the proposal could also prompt new innovative fund distribution systems and allow the development of new business models. We discuss the many other potential benefits of this proposal in detail in Sections III.I and III.M above.

2. Costs

Proposed rule 6c-10(c) is elective, and thus only funds or dealers that choose to rely on it would incur the costs of complying with its conditions. Proposed rule 6c-10(c) requires a fund that chooses to rely on the exemption to meet the following two conditions: (i) the fund must not deduct an ongoing sales charge pursuant to proposed rule 6c-10(b); and (ii) the fund must disclose that it has elected to rely on the exemption in its registration statement. The first condition (prohibiting funds from deducting an ongoing sales charge) should not impose any costs on funds. We expect that any fund that relies on proposed rule 6c-10(c) would do so as

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[532] We have not received any applications for an exemption from section 22(d) that are similar to our proposal, so we assume the proposal would not result in cost savings related to reduced preparation and processing of exemptive applications.

part of the creation of a new fund or fund class, and that therefore no funds with ongoing sales charges would incur costs in eliminating these charges.

We estimate that funds may incur some minor costs in complying with the second condition, the requirement to disclose the election to rely on proposed rule 6c-10(c) in their registration statement. The staff estimates that to make the required disclosure on the registration statement it would require one hour of time spent by outside counsel, charged at the rate of $400 per hour. Once the disclosure has been initially made on the registration statement, the staff estimates that there would be no further costs or time to update or revise the election, and therefore there would be no annual costs. Thus, the staff estimates that the cost of complying with the conditions in relying on rule 6c-10(c) would be a one-time initial cost of $400 per fund. The staff estimates that between 10 and 100 new funds might rely on proposed 6c-10(c) for the first time each year, and therefore estimate that the total costs for all funds to comply with the proposed exemption would be between $4000 and $40,000[533] in one-time costs (to newly formed funds) each year.

We anticipate that funds that rely on proposed rule 6c-10(c) would do so as part of a decision to provide competitive alternatives to other distribution models, and that any other costs not imposed by the conditions of the rule to establish the structure would be justified by the anticipated benefits accruing to the fund. Other such costs to establish the new distribution structure might include setting up new classes of the fund, negotiating new distribution agreements with broker-dealers, and educating investors and financial representatives about the

[533] This estimate is based on the following calculations: (10 funds × $400 = $4000; 100 funds × $400 = $40,000).

new fee structure.[534] The decision to rely on the proposed rule would be driven by business factors, and the potential for new markets and customers. Funds and broker-dealers that do not choose to rely on this exemption would not bear any costs related to the proposed rule.[535]

We request comment on the discussion of the costs and benefits of our proposed rule 6c-10(c).

- Are there any costs that this exemption would impose on funds or others? What other benefits might it provide? What should we assume about the compensation structure that brokers would design? How many funds are likely to take advantage of this exemption, and what kind of factors would drive this choice? What kind of costs would these funds incur? Are our estimates of the cost of complying with the conditions of the exemptions reasonable?

As discussed previously, our experience with unfixing commission rates leads us to expect that when sales loads are subject to market pressure, sales loads will go down for all investors. However, we acknowledge the potential that some investors (perhaps due to a lack of bargaining power) may pay higher sales loads under proposed rule 6c-10(c) than they might have under the fixed sales load regime of section 22(d). We request comment as to whether investors are likely to pay lower (or higher) sales loads if they purchase fund shares from a fund taking advantage of the proposed exemption.

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[534] Based on discussions with one fund, that fund suggested that these and similar efforts could include one-time costs of $550,000 and ongoing costs of $250,000 annually per fund family.

[535] Broker-dealers could face certain difficulties related to “investor portability” or account transfers for investors in classes that rely on the proposed rule. Broker-dealers may encounter recordkeeping or other issues when an investor account that holds fund shares in such a class is transferred to a broker-dealer that only sells shares of the fund with asset-based distribution fees. Broker-dealers currently face this issue when transferring investor accounts today (if, for example, the transferred account includes shares of a fund that the new broker-dealer does not sell), although it may be exacerbated by the different fee structure the exemption offers.

- Are investors likely to experience any other costs or benefits as a consequence of the proposed exemption? If the exemption is widely relied upon, what might be the effect on distribution arrangements, and on distributors that do not rely on the rule?

I. Director Responsibilities

Board of directors' responsibilities would change under the proposal because we would not require directors to adopt and annually renew a 12b-1 plan or make any special findings.[536] The proposal would not impose other procedural requirements currently in rule 12b-1, including the requirements for quarterly review. Although the proposal would eliminate director specific oversight requirements, directors would still have a fiduciary obligation to consider whether the asset-based distribution fees are in the best interest of the fund and fund shareholders.

1. Benefits

We expect that the proposed reduction in formal requirements regarding the approval of asset-based distribution fees would result in significant cost and time savings for funds and their investors. The staff has estimated in our most recent Paperwork Reduction Act analysis for rule 12b-1 that, for each fund family that has at least one fund with a 12b-1 plan, it takes approximately 425 hours for the fund's directors, counsel, accountants, and other staff to maintain the plan, prepare and evaluate quarterly reports, make the necessary findings, and hold director votes, at an internal time cost of $99,811 per fund family. The staff estimates that there are approximately 379 fund families with at least one fund that charges 12b-1 fees. Therefore, the staff estimates that for all fund families with a 12b-1 plan, funds expend a total of 161,075

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[536] Our proposed rescission of rule 12b-1 would also eliminate the recordkeeping requirements in rule 12b-1(f) to maintain copies of the plan, reports or any other agreements related to the plan. Although our proposal would not impose recordkeeping requirements, we do not anticipate that funds would realize any cost savings as a result of this amendment, because they would continue to maintain records regarding their asset-based distribution fees to prepare their financial statements.

hours at an internal time cost of $37,828,369.[537]

The staff estimates that our proposal would reduce this burden by approximately 75% (proportionately for all fund employees) for an annual hour reduction for each fund family of 319 hours, and a $74,858 reduction in internal costs.[538] If our proposal is adopted, we estimate that funds, their employees (or the employees of the adviser), and directors would only need to spend 106 hours instead of 425 hours annually on asset-based distribution fee matters pursuant to rules 12b-2 and 6c-10, at an internal cost of $24,953 instead of $99,811.[539] Therefore, the staff estimates that our proposed amendments to director responsibilities and the proposed removal of rule 12b-1 would reduce this total time from a total of 161,075 hours per year at an internal cost of $37,828,369, to 40,269 hours at an annual cost of $9,457,092[540] resulting in an annual savings of 120,806 hours and $28,371,277 dollars.[541]

- We request comment on these estimates and assumptions.

2. Costs

Other than the time expenditures we have outlined previously in this analysis, we do not expect that there will be any costs associated with our proposed removal of rule 12b-1 and clarification of director responsibilities in our proposal. As discussed above, we anticipate that the proposed changes would simplify the requirements for imposing asset-based distribution fees

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537 These estimates are based on the following calculations: (425 hours x 379 fund families = 161,075 hours; $99,811 x 379 fund families = $37,828,369).

538 This estimate applies to both funds that deduct asset-based distribution fees under proposed rules 12b-2(b) and 6c-10, and to funds that deduct grandfathered 12b-1 fees pursuant to proposed rule 12b-2(d).

539 These estimates are based on the following calculations: (425 hours x 25% = 106 hours; $99,811 x 25% = $24,953).

540 These estimates are based on the following calculations: (161,075 hours x 25% = 40,269 hours; $37,828,369 x 25% = $9,457,092).

541 These estimates are based on the following calculations: (161,075 hours x 75% = 120,806 hours; $37,828,369 x 25% = $28,371,277).

compared to the current requirements of rule 12b-1. Costs that a fund might incur in connection with revising disclosures regarding asset-based distribution fees are discussed above.[542]

- We request comment on these estimates and assumptions.

J. 11a-3 Amendments

We are also proposing to amend rule 11a-3 (which governs sales loads on offers of exchange within a fund family) to bring it into conformity with the proposed treatment of ongoing sales charges we describe in this Release. The proposed amendments would require funds to give shareholders "credit" against the rate of any sales load owed for ongoing sales charges paid by investors who exchange fund shares within a fund group.[543]

1. Benefits

We anticipate that the proposed amendments to rule 11a-3 would provide a number of benefits. Some of the principal benefits include more equitable treatment of investors who pay sales charges, whether with the initial investment, or over time, and greater transparency in sales charges paid.

2. Costs

Based on conversations with industry representatives, the staff understands that most funds that currently rely on the exemptive relief provided by rule 11a-3 have systems that can credit ongoing sales charges in the way the proposed amendments would require. In order to process credits for CDSLs (and other purposes), funds (or their transfer agents) use a bucketing system that allows them to track the history of fund shares. The staff understands that these existing systems can track the length of time shares subject to an ongoing sales charges have been held, determine the charges that have been paid, and credit those charges against any load

[542] *See supra* Section V.G of this Release.

[543] A more detailed description of these amendments is included in Section III.K of this Release, *supra*.

imposed on the new shares acquired in an exchange. The staff understands that most funds generally limit exchanges to shares of the same class in other funds within the fund group. As a result, when transferred, the ongoing sales charge and conversion date of both the exchanged and acquired shares would generally be the same, if the maximum sales load remains the same. In those circumstances, no action would be required on the part of the fund or its transfer agent. Alternatively, the conversion date may need to be changed (if, for example, the maximum sales loads of the two funds are different). We expect that most funds should be able to comply with our proposed 11a-3 amendments with little difficulty.

Funds may still need to update their systems for share exchanges and enhance their capacity to include shares with ongoing sales charges. The staff therefore estimates that a typical fund family with funds that deduct ongoing sales charges (or the fund's transfer agent) would incur $25,000 in one-time costs to update its systems to comply with our proposed amendments. For purposes of this analysis, the staff assumes that all 196 fund families that may be affected by our ongoing sales charge proposal would incur this cost, for a total cost of $4,900,000.[544]

- We request comment on these estimates and assumptions.

K. Other Technical Amendments

Our proposal would make a number of technical amendments to Investment Company Act rules and forms, removing current references to rule 12b-1 and adding references to the appropriate proposed rule.[545] We do not expect these changes to materially affect funds, intermediaries, or others, because they are technical changes that should not affect fund

[544] This estimate is based on the following calculation: (196 fund families × $25,000 = $4,900,000).

[545] These proposed technical amendments would affect rules 17a-8, 17d-3, 18f-3, and Regulation S-X under the Act. For a complete discussion of the changes, *see* Section III.L of this Release, *supra*.

operations. Therefore, we do not believe that there would be any costs associated with these amendments. We request comment on this assumption.

- Would there be any costs associated with making the technical changes described in Section III.L above?

L. Rule 10b-10

The proposed amendments to Exchange Act rule 10b-10 would provide broker-dealer customers with additional information related to mutual fund costs and callable securities.

1. Benefits

The improved disclosure related to mutual fund costs could be expected to help make the confirmation a more complete record of the transaction and help mutual fund investors more fully understand the sales charges they incur. Those improved disclosures could be expected to promote decision making by investors that more appropriately takes those costs into account. Those improved disclosures also could be expected to assist investors in verifying whether they paid the correct sales charge set forth in the prospectus. The improved disclosure related to callable debt securities could be expected to help alert investors to misunderstandings, avoid confusion, promote the timely resolution of problems, and better enable investors to evaluate potential future transactions.

2. Costs

These proposed amendments to rule 10b-10 would require brokers-dealers to include additional information in confirmations that are currently sent to investors. The costs of adding this new information into confirmation disclosures would largely be expected to be one-time programming-related costs, borne primarily by clearing firms and third-party service providers, which are included in the estimates of the Paperwork Reduction Act burden. For purposes of the

Paperwork Reduction Act, the Commission staff has estimated that the one-time burden to clearing firms with proprietary systems to reprogram software and otherwise update their systems to enable them to generate confirmations meeting the requirements of the proposed amendments would be approximately 720,000 hours.[546] The staff estimates that this one-time burden would equal total internal costs of approximately \$180.7 million dollars,[547] or \$1.1 million per vendor.[548] The staff also estimates that vendor licensors of platforms would incur costs equivalent to those incurred by clearing firms with proprietary systems, resulting in one-time burden of 13,500 hours and costs of approximately \$3.4 million dollars,[549] or \$1.1 million per vendor.[550] In addition, the staff understands that clearing firm licensees would incur an additional 800 burden hours each, or 296,000 total, for a total cost of approximately \$74.3 million,[551] or \$200,800 per clearing firm licensee.[552]

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546 4500 burden hours x 160 clearing firms with proprietary systems = 720,000 burden hours. *See* note 437 *supra* and accompanying text.

547 720,000 hours x \$251 dollars per hour = \$180,720,000. These figures are based on an estimated hourly wage rate of \$251. The estimated wage figure is based on published compensation for compliance attorneys (\$291) and the average costs of a senior computer programmer (\$285) and a computer programmer analyst (\$190) ((\$190 + \$285) ÷ 2 = \$238). *See* Securities Industry and Financial Markets Association, *Management and Professional Earnings in the Securities Industry* (Sept. 2009). The staff estimates that programmers would utilize 75% of the burden hours to implement system changes while attorneys would utilize 25% of the burden hours to review the output, yielding a weighted wage rate of \$251 dollars per hour ((\$291 x .25) + (\$238 x .75)) = \$251).

548 4500 burden hours x \$251 dollars per hour = \$1,129,500.

549 3 vendors x 4500 burden hours x \$251 dollars per hour = \$3,388,500. For purposes of this analysis, the staff assumes that vendors would incur the same per hour costs and burden hours incurred by clearing firms with proprietary systems. *See* note 438 *supra*.

550 4500 burden hours per vendor x \$251 dollars per hour = \$1,129,500.

551 370 clearing firm licensees x 800 burden hours x \$251 dollars per hour = \$74,296,000. For purposes of this analysis, the staff also assumes that vendors or other third-parties would perform the work needed to adapt each of these clearing firms' systems to the changes made to its vendor's platform. The staff further assumes the hourly costs to clearing firms to outsource these additional burdens to third-parties would be equivalent to the hourly costs incurred by vendors and by clearing firms with proprietary systems. This hourly cost is estimated at approximately \$251 per hour. *See* note 438 *supra*.

552 800 burden hours per clearing firm licensee x \$251 per hour = \$200,800.

When we include the costs borne by vendors and clearing firm licensees, we estimate that that the total one-time burden as a whole would be approximately $258.4 million dollars.[553]

- We request comment on these estimates and assumptions.

M. Total Costs and Benefits

As discussed above, we have designed our proposal to minimize the cost impact on funds, intermediaries, and service providers while maximizing the investor protection and other benefits. The staff anticipates that funds representing approximately 93% of all assets under management will incur minor or no expenses in complying with our proposal.[554]

The staff estimates that the total one-time costs of compliance with our proposed amendments would be $400,994,000 in outside expenses and $362,348,000 in internal time cost equivalents. The staff further estimates the total annual costs of compliance would be $304,076,000. The staff also estimates that the total annual benefits of compliance with our proposed amendments would be between $1,062,361,000 to $1,258,361,000 in cost savings and $31,963,000 in internal time cost equivalents. This does not reflect our full expectation of the costs and benefits of the proposed amendments because many of the expected costs and benefits are qualitative in nature.

- We request comment on these estimates.

N. Request for Comment

We request comments on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of, or suggested alternatives to, the proposed amendments.

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553 ((3 vendors x 4500 burden hours) + (370 clearing firm licensees x 800 burden hours) + (160 clearing firms with proprietary systems x 4500 burden hours)) x $251 per hour = $258,404,500. As discussed above, the staff believes that all parties would incur costs of $251 per hour.

554 *See supra* Section V.B of this Release.

Commenters are requested to provide empirical data and other factual support for their views to the extent possible. In particular, we request comment on the quantitative estimates made within this section and any other costs or benefits that were not discussed here that might result from the amendments. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs and benefits.

VI. INITIAL REGULATORY FLEXIBILITY ANALYSIS

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with 5 U.S.C. 603. It relates to the Commission's proposed removal of rule 12b-1, new rule 12b-2, and amendments to rules 6c-10, 10b-10, 11a-3, 17a-8, 17d-3, and 18f-3, and amendments to Forms N-1A, N-3, N-4, N-6, N-SAR and Regulation S-X and Schedule 14A, under the Securities Act, the Securities Exchange Act, and the Investment Company Act.

A. Reasons for, and Objectives of, the Proposed Actions

As more fully described in Sections I, II, and III of this Release, we are proposing a new rule and rule and form amendments designed to address funds' use of asset-based distribution fees, to amend our current regulations to reflect current economic realities and the role of directors regarding these charges, and to enhance transparency and equity of these fees for investors. Rule 12b-1, the current rule that governs the use of asset-based distribution fees, relies on fund directors to oversee the level and use of these fees. Asset-based distribution fees have evolved into a substitute for front-end loads, and have also enabled the development of new models of fund distribution that could not have been anticipated when the rule was adopted. Small funds, in particular, often rely on asset-based distribution fees as a means of gaining access to distribution channels that would not otherwise be available to them.[555]

The proposal is also designed to improve investor understanding of these fees and their purposes, as well as to enhance equity in the amount of distribution costs all fund shareholders pay, regardless of the method of payment. Currently, investors may not understand that asset-based distribution fees are the equivalent of sales loads, and some investors may believe that they have avoided a sales load entirely by purchasing a share class that charges an asset-based distribution fee. In addition, under current distribution practices, certain long-term shareholders that pay asset-based distribution fees may subsidize the distribution expenses of other shareholders in the fund. As a result, some fund shareholders may pay a disproportionate amount of the fund's distribution expenses.

Our proposed new rule, and rule and form amendments, would significantly revise our current regulations regarding asset-based distribution fees by eliminating the specific requirements for the board of directors. The proposal would recognize that funds bear ongoing expenses that, although they are distribution related, may benefit the fund and fund shareholders, and would replace the specific formal requirements for the board with other regulatory protections. In particular, the proposal would recognize that asset-based distribution fees may be used as a substitute for a sales load, and would regulate them in a similar manner. We expect that this would give directors more time to focus on other important fund matters. In order to provide greater equity among shareholders who bear distribution fees, the proposal would limit the amount of asset-based distribution fees that may be charged to each investor. Funds would be required to convert shares that have an ongoing sales charge to a class that does not impose an

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[555] *See, e.g.*, Roundtable Transcript, *supra* note 109, at 67-68 (statement of Mellody Hobson, Ariel Capital Management, LLC), and discussion of the impact of the proposal on small funds, Section III.M, *supra*.

ongoing sales charge no later than when the cumulative charges equal the amount of the highest front-end load that the investor would have paid had the investor invested in another class of shares in the same fund, or after a set conversion period based on the rate of the front-end load and the rate of the ongoing sales charge imposed.

In addition, the proposal would allow funds that deduct a marketing and service fee pursuant to rule 12b-2 to sell their shares at other than the public offering price as disclosed in their prospectus. This would enable funds to offer new choices to investors in paying for the costs of distribution; enhance competition in pricing between broker-dealers in the sale of fund shares; and present new business opportunities to funds that choose to use this exemption. We believe small funds may be the funds that are more likely to so experiment and use this exemption to expand their market opportunities.

Finally, the proposal would also make a number of changes to current disclosure requirements designed to enhance investor understanding of these fees. In particular, the proposal would require the prospectus fee table to state separately (i) the amount of asset-based distribution fees that pays for services received by shareholders in the fund and for other general distribution purposes (the marketing and service fee), and (ii) the amount of asset-based distribution fees that are a substitute for a sales load (the ongoing sales charge). This disclosure is designed to allow fund shareholders to understand better the purpose of these fees, and the amounts they are paying. The proposal would also make a number of conforming changes to other rules and forms that are intended to update current references to rule 12b-1 to reflect the regulations we are proposing today, as well as eliminating or updating requirements that would become irrelevant if our proposal were adopted. The proposal further would make changes to rule 10b-10 to improve disclosure on broker-dealer confirmations of costs related to mutual funds and to make other improvements.

B. Legal Basis

The Commission is proposing amendments to Schedule 14A under the authority set forth in sections 3(b), 10, 13, 14, 15, 23(a), and 36 of the Exchange Act [15 U.S.C. 78c(b), 78j, 78m, 78n, 78*o*, 78w(a), and 78mm], and sections 20(a), 30(a), and 38(a) of the Investment Company Act [15 U.S.C. 80a-20(a), 80a-29(a), and 80a-37(a)]. The Commission is proposing amendments to rule 6-07 of Regulation S-X under the authority set forth in section 7 of the Securities Act [15 U.S.C. 77g] and sections 8 and 38(a) of the Investment Company Act [15 U.S.C. 80a-8, 80a-37(a)].

The Commission is proposing to remove rule 12b-1 under the authority set forth in sections 12(b) and 38(a) of the Investment Company Act [15 U.S.C. 80a-12(b) and 80a-37(a)]. The Commission is proposing new rule 12b-2 under the authority set forth in sections 12(b) and 38(a) of the Investment Company Act [15 U.S.C. 80a-12(b) and 80a-37(a)]. The Commission is proposing amendments to rule 6c-10 under the authority set forth in sections 6(c), 12(b), 22(d)(iii), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-12(b), 80a-22(d)(iii) and 80a-37(a)]. The Commission is proposing amendments to rules 11a-3, 17a-8, 17d-3, and 18f-3 under the authority set forth in sections 6(c), 11(a), 17(d), 18(i), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-11(a), 80a-17(d), 80a-18(i) and 80a-37(a)].

The Commission is proposing amendments to Form N-SAR under the authority set forth in sections 10(b), 13, 15(d), 23(a), and 36 of the Securities Exchange Act [15 U.S.C. 78j(b), 78m, 78o(d), 78w(a), and 78mm], and sections 8, 13(c), 24(a), 30, and 38 of the Investment Company Act [15 U.S.C. 80a-8, 80a-13(c), 80a-24(a), 80a-29, and 80a-37]. The Commission is proposing amendments to registration Forms N-1A, N-3, N-4, and N-6, under the authority set forth in sections 6, 7(a), 10, and 19(a) of the Securities Act [15 U.S.C. 77f, 77g(a), 77j, 77s(a)], and sections 8(b), 24(a), and 30 of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-24(a), and 80a-29]. The Commission is proposing amendments to Exchange Act rule 10b-10 pursuant to the authority conferred by the Exchange Act, including sections 10, 17, 23(a), and 36(a)(1) [15 U.S.C. 78j, 78q, 78w(a), and 78mm(a)(1)].

C. Small Entities Subject to the Rule

For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year. Based on a review of filings submitted to the Commission, approximately 108 investment companies registered on Form N-1A meet this definition. These funds have approximately 189 classes. Commission staff estimates that 40 of these investment companies have at least one class that charges 12b-1 fees, with approximately 78 classes that deduct 12b-1 fees. Of those 78 classes, 23 charge 12b-1 fees in excess of 25 basis points, while the remaining 55 classes charge 12b-1 fees of less than 25 basis points.

For purposes of the Regulatory Flexibility Act, a broker-dealer is a small business if it had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to rule 17a-5(d) of the Exchange Act or, if not required to file such statements, a broker-dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter) and if it is not an affiliate of an entity that is not a small business.[556] The Commission staff estimates that approximately 862 broker-dealers meet this definition.[557] Of these, however, only 17 clearing firms can be classified as small entities that would likely incur the costs of adopting the proposed amendments to rule 10b-10.[558]

D. Reporting, Recordkeeping, and Other Compliance Requirements

Our proposal would amend the reporting, recordkeeping, and other compliance requirements for all funds (including small entities) that comply with rule 12b-1, or would comply with proposed rule 12b-2, proposed amendments to rules 6c-10, 11a-3, 17a-8, 17d-3, and 18f-3, or that would respond to amended Forms N-1A, N-3, N-4, N-6, N-SAR, Schedule 14A and Regulation S-X.[559] We have estimated the costs of these amendments for all marketplace participants previously in the cost-benefit analysis in Section V. above. No new classes of skills would be required to comply with our proposed new rule, or rule and form amendments.

1. Rule 6c-10

The proposed amendments to rule 6c-10(b) would allow a fund to deduct asset-based distribution fees from fund assets in excess of asset-based fees permitted under proposed rule 12b-2 (an "ongoing sales charge"), provided shares sold subject to such an ongoing sales charge convert to another class of shares without an ongoing sales charge when the shareholder has paid

[556] 17 CFR 240.0–10.

[557] This estimate is based on information provided in FOCUS Reports filed with the Commission in 2009.

[558] As discussed above, although there are approximately 5035 broker-dealers registered with the Commission to whom the rule would apply, the staff believes that the costs of implementing the proposed changes to rule 10b-10 would be primarily borne by clearing firms Also as discussed above, the staff estimates that there are approximately 530 clearing firms. Based on FOCUS Reports filed with the Commission in 2009, the staff believes that of these 530 clearing firms, approximately 17 come within the definition of a small entity.

[559] For a complete discussion of the specifics of the new rule and rule and form amendments, *see* Section III, *supra*.

cumulative charges or rates of fees that are equivalent to what he or she would have paid for shares subject to a front-end sales load. Rule 6c-10(c) would allow funds to sell shares at a price other than described in the prospectus. This provision is an exemption, and thus would not create any new recordkeeping, reporting, or compliance requirements for small entities unless they chose to rely on the exemption.

The proposed amendments would not impose any new reporting obligations on small entities. However, small entities that charge an ongoing sales charge would be required to keep certain new records regarding the length of time that a shareholder holds shares and would be required to comply with the new requirement for conversion of those shares. Commission staff has estimated the costs of these requirements for all funds (including small entities) in the cost-benefit analysis in Section V above. We do not anticipate that small funds would face unique or special burdens when complying with the proposed amendments to rule 6c-10.

2. Removal of Rule 12b-1

We are proposing to remove rule 12b-1. As discussed above, Commission staff has estimated that the proposed removal would reduce costs significantly for affected funds, including the 40 small funds that the Commission staff estimates have at least one class that currently charges 12b-1 fees. The proposal would eliminate existing recordkeeping, reporting, and compliance requirements, and would not create any new ones.

3. Rule 12b-2

The proposal would include new rule 12b-2, which would permit funds to deduct a "marketing and service fee" from fund assets, limited to the amount established in the NASD sales charge rule for "service fees." Any assets a fund deducts in excess of the marketing and service fee would be regulated under rule 6c-10 as an ongoing sales charge. The proposal would also permit funds to continue to charge 12b-1 fees on shares sold prior to the compliance date of the rule and rule amendments, if they are adopted, and would continue to regulate the use of fund assets to pay for brokerage as under rule 12b-1(h) (by including a similar provision in proposed rule 12b-2). We have previously estimated that almost all funds (including small funds) that currently charge 25 basis points or less in asset-based distribution fees under rule 12b-1 would incur no additional reporting, recordkeeping, or compliance requirements under proposed rule 12b-2.

4. Rule 11a-3

As previously discussed, our proposal would amend rule 11a-3 to ensure that funds give credit for ongoing sales charges when an investor exchanges fund shares within a fund family. The proposed amendments would expand current recordkeeping responsibilities for funds that charge an ongoing sales charge, including small funds. Commission staff has estimated the costs of these changes for all funds in the cost-benefit analysis in Section V above. The staff estimates that 40 funds qualify as small entities for purposes of the Regulatory Flexibility Act, and that they would incur the same costs of compliance ($25,000, as estimated in section V.K above) to comply with the proposed amendments to rule 11a-3 as larger funds, because these funds use similar computer systems and/or transfer agents to track share exchanges. Although the volume of rule 11a-3 share exchanges may be less for small funds, with comparably lower costs of expanding the systems to handle exchanges as compared to larger funds, the staff estimates that any expenses incurred in upgrading these systems to meet the compliance requirements of our proposal would be comparable, due to a lack of bargaining power and economies of scale for the smaller funds. Therefore, the Commission staff estimates that each small fund family that charges 12b-1 fees high enough to qualify as ongoing sales charges, would incur $25,000 in expenses related to the proposed amendments to the reporting, recordkeeping, and compliance requirements of rule 11a-3.

5. Rules 17a-8, 17d-3, and 18f-3

Our proposal would make technical conforming changes to these rules as discussed in Section III.L above. Commission staff estimates that the proposed changes would create no change in the reporting, recordkeeping, or compliance requirements for funds (including small funds).

6. Form N-1A

Form N-1A is the form that open-end mutual funds use to register with the Commission. The proposed amendments would require funds that file Form N-1A to: (i) eliminate the line item currently titled "Distribution and/or service (12b-1) fee" and include two line items, (if relevant) titled "Marketing and Service Fee" and "Ongoing Sales Charge"; (ii) revise and streamline prospectus narrative disclosure on asset-based distribution fees; and (iii) revise and streamline SAI disclosure regarding asset-based distribution fees. The staff estimates that the proposed changes would reduce costs for all funds, including small entities, by reducing the amount of time and costs funds incur in preparing the forms, and would not impose new reporting or recordkeeping requirements.

7. Form N-3, Form N-4, and Form N-6

The proposed amendments to Forms N-3, N-4, and N-6 would conform disclosures in these forms to our proposals.[560] The proposed amendments would replace references to rule 12b-1 with references to proposed rules 6c-10(b) or 12b-2(b) and (d). Form N-3 is the

[560] Form N-3 is used by separate accounts offering variable annuity contracts and registered as management investment companies. Form N-4 is used by separate accounts offering variable annuity contracts and registered as unit investment trusts. Form N-6 is used by separate accounts offering variable life insurance contracts and registered as unit investment trusts.

registration form used by insurance company separate accounts registered as management investment companies that offer variable annuity contracts. The proposed amendments to Form N-3 would: (i) revise and streamline prospectus narrative disclosure on asset-based distribution fees; and (ii) revise and streamline Statement of Additional Information disclosure regarding asset-based distribution fees. The proposed changes would not impose new reporting or recordkeeping requirements for Form N-3.

The proposed changes to Forms N-4 and N-6 are technical and designed to update references to 12b-1 plans to the new terminology used in our proposal. These proposed changes would not change the reporting or recordkeeping requirements of these forms. In the cost-benefit analysis above, we explained that we do not anticipate that these amendments would result in new costs or burdens associated with preparing the forms. We do not believe that these amendments will impose any new recordkeeping, reporting, or compliance requirements.

8. Form N-SAR

Our proposal would amend the instructions to Form N-SAR, which currently requires funds to respond to a series of questions regarding their 12b-1 plans. Form N-SAR is the form that registered investment companies use to make periodic reports to the Commission. Our proposed amendments would add an instruction to Form N-SAR to disregard, for funds that no longer have 12b-1 plans, four questions (Items 41-44) that relate to the operation of rule 12b-1 plans (because they would be irrelevant in light of our proposed new framework for asset-based distribution fees). However, funds that maintain grandfathered fund classes would continue to respond to these items. The proposal would impose no new recordkeeping, reporting, or compliance requirements, and would instead reduce these burdens for respondents that do not have grandfathered 12b-1 plans.

9. Schedule 14A

Funds comply with the requirements of Schedule 14A when they solicit proxies from their shareholders. Our proposal would amend the required disclosures under section 14A when a fund institutes or materially increases a marketing and service fee after shares have been offered to the public. The proposed amendments would streamline proxy disclosures, removing items that would be superfluous if our proposed new rules and rule amendments on marketing and service fees were adopted. As discussed above, we have previously estimated that our changes to Schedule 14A would not create any new reporting, recordkeeping, or compliance burdens for funds that solicit proxies, and would instead reduce the existing burden.

10. Regulation S-X

Regulation S-X requires funds to file a statement of operations listing their income and expenses, and to state separately all amounts paid in accordance with a plan adopted under rule 12b-1. Our proposal would conform this requirement to the terms of our proposed new rules and rule amendments regarding asset-based distribution fees. The proposed amendments to regulation S-X would require that funds state asset-based distribution fees paid, and state separately amounts paid pursuant to our proposed rules on marketing and service fees and ongoing sales charges. Our understanding is that funds, as a matter of good business practice, already keep the information on asset-based distribution fees in the proper form, because that information is used to prepare information on 12b-1 fees, and is a component of the overall statement of expenses. The staff estimates that our proposed changes to regulation S-X would not change the amount of time or the costs required for funds (including small funds) to prepare their statements of operations. Therefore, we do not expect that these amendments will impose any new recordkeeping, reporting, or compliance requirements.

11. Rule 10b-10

Exchange Act rule 10b-10 requires broker-dealers to provide transaction confirmations to customers. The proposed amendments to this rule would require disclosure of additional information related to sales charges in connection with transactions involving mutual funds, and certain additional information in connection with callable debt securities. The proposed amendments would expand current recordkeeping responsibilities for broker-dealers, including small broker-dealers. As discussed above, the Commission staff estimates that the one-time burden for clearing firms with proprietary systems associated with these proposed amendments would equal total internal costs of approximately $180.7 million dollars[561] or approximately $1.1 million per clearing firm with a proprietary system.[562] Also as discussed above, as a general matter, medium-sized and smaller clearing firms, and also some larger ones, use platforms licensed from vendors to generate the data necessary to send confirmations. As discussed above, the staff understands that there are three primary vendors that license the majority of platforms to clearing firms that do not have proprietary systems. In addition, clearing firms may also use vendors to send physical confirmations to investors. Therefore, these vendors would have to reprogram their software and update these platforms to generate the data that would allow their clients to comply with these proposed amendments to rule 10b-10. Based on discussions with industry representatives, the staff is of the view that the cost and burdens to vendors to update the platforms that they license to clearing firms would be equivalent to the costs and burdens that would be incurred by clearing firms who would have to reprogram and update their proprietary

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[561] (4500 burden hours x 160 clearing firms with proprietary systems) x $251 dollars per hour = $180,720,000.

[562] 4500 hours x $251 dollars per hour = $1,129,500. *See* note 548 *supra.*

systems, resulting in a cost to these vendors of approximately $3.4 million dollars[563] or $1.1 million per vendor.[564] In addition, the staff understands that clearing firm licensees of these platforms would still incur a one-time cost of approximately $74.3 million dollars[565] or $200,800[566] per clearing firm licensee, to adopt the changes made to vendor platforms and to determine whether the output satisfies the requirements of the proposed amendments.

As discussed above, of the approximately 530 clearing firms that would incur upgrade costs, 17 of those are small entities. The staff believes that these small entity clearing firms would likely license their platforms from vendors. Accordingly, the staff estimates that these firms would incur costs of approximately $200,800 each to adapt to the changes in vendor platforms, or approximately $3.4 million total.[567] These figures are already included in the total burden costs that clearing firms, and in particular, clearing firm licensees, would incur to implement the proposed amendments to rule 10b-10.

In addition, as discussed above,[568] the staff believes that clearing firms will bear most of the costs associated with updating back-office operations to accommodate the proposed changes to rule 10b-10. Accordingly, the staff does not believe that small introducing firms will incur these costs.

12. Request for Comment

- The Commission solicits comment on these estimates and the anticipated effect the

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563 (3 vendors x 4500 burden hours) x $251 dollars per hour = $3,388,500. *See* note 549 *supra.*

564 4500 hours x $251 dollars per hour = $1,129,500. *See* note 550 *supra.*

565 (800 burden hours x 370 clearing firms that use vendor licensed platforms) x $251 per hour = $74,296,000. *See* note 551 *supra.*

566 800 hours x $251 dollars per hour = $200,800. *See* note 552 *supra.*

567 (800 burden hours x 17 small entity clearing firms) x $251 per hour = $3,413,600.

568 *See* Section IV.H *supra*.

proposed amendments would have on small entities subject to the proposed rule and rule and form amendments.

E. Duplicative, Overlapping, or Conflicting Federal Rules

We have not identified any federal rules that duplicate, overlap, or conflict with the proposed rule or rule or form amendments.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small issuers. In connection with the proposed amendments, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed amendments for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the proposed amendments, or any part thereof, for small entities.

Investors in small funds face the same issues as investors in larger funds when paying asset-based distribution fees. Small funds use asset-based distribution fees as a means of growing their funds and accessing alternate distribution channels, and our rule proposal is designed to allow funds to continue to use asset-based distribution fees for these purposes. We have endeavored through the proposed amendments to minimize the regulatory burden on all funds, including small entities, while meeting our regulatory objectives. We have tried to design our proposal so that small entities would not be disadvantaged, and we anticipate that the potential impact of the proposed rule and amendments on small entities would not be significant.

Small entities should experience the same benefits from the proposal as other funds. We have endeavored to clarify, consolidate, and simplify disclosure for all funds, which should be beneficial for all funds, including those that are small entities. Moreover, with respect to the proposed revisions to the broker-dealer confirmation requirements of rule 10b-10, we also believe that special compliance or reporting requirements for small broker-dealers would not be appropriate or consistent with investor protection, because distinguishing such requirements based on the size of the broker-dealer may be accompanied by disparate treatment of investors and could lead to investor confusion.

For these reasons, we have not proposed alternatives to the proposed rule and rule and form amendments.

G. Request for Comments

We encourage the submission of comments with respect to any aspect of the IRFA.

- We particularly request comments on the number of, and the likely impact on, small entities that would be subject to the proposed rule, and rule and form amendments. Commenters are asked to describe the nature of any impact and provide empirical data supporting its extent. These comments will be considered in connection with any adoption of the proposed rule and amendments, and reflected in a Final Regulatory Flexibility Analysis.

Comments should be submitted in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Comments also may be submitted electronically to the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-15-10, and this file number should be included on the subject line if e-mail is used.[569] Comment letters will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549-1520, on official business days between the hours of 10:00 am and 3:00 pm. Electronically submitted comment letters also will be posted on the Commission's Internet Web site (http://www.sec.gov).

VII. CONSIDERATION OF BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 23(a)(2) of the Exchange Act requires the Commission, in adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[570] Section 2(b) of the Securities Act and section 3(f) of the Exchange Act require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[571] Further, section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[572] As discussed below, we expect that the proposed rule, and rule and form amendments, may promote efficiency, competition, and capital formation.

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[569] Comments on the IRFA will be placed in the same public file that contains comments on the proposed rule and amendments.

[570] 15 U.S.C. 78w(a)(2).

[571] 15 U.S.C. 77b(b); 15 U.S.C. 78c(f).

[572] 15 U.S.C. 80a-2(c).

A. Removal of Rule 12b-1

Our proposal would remove rule 12b-1, and in so doing, would eliminate the explicit requirements in the rule for board approval and annual review of asset-based distribution fees and written 12b-1 plans. By eliminating these formal requirements in rule 12b-1, our proposal is designed to modify the regulations governing these fees to reflect current economic realities. As discussed in Section V above, funds may realize significant time and expense savings when managing asset-based distribution fees under our proposal, compared to the current requirements of rule 12b-1. Thus, we expect that the proposed removal of rule 12b-1 would enhance the efficiency of funds in managing and overseeing the operation and use of asset-based distribution fees.

Many funds use asset-based distribution fees to pay for distribution costs in a cost-effective manner that allows them to compete with other investment products. We expect that, in combination with the rest of our proposal, our proposed removal of rule 12b-1, if adopted, would not prevent funds from continuing to access the competitive benefits of paying for distribution through asset-based fees. Small funds often use asset-based distribution fees as a means of building their funds and participating in distribution channels that they might not otherwise be able to access. We have designed our proposals to allow funds to continue to grow through these means. In addition, our proposal would allow funds that currently charge 12b-1 fees to continue to deduct these fees on outstanding shares without significant disruption. Therefore, we do not anticipate that our proposal to remove rule 12b-1 would affect capital formation or competition.

B. Rule 12b-2

We are proposing to adopt rule 12b-2 (in combination with the rest of our proposal) to replace rule 12b-1. Proposed rule 12b-2 would allow funds to deduct a "marketing and service fee" from fund assets, up to the amount permitted for service fees under NASD Conduct Rule 2830. The proposed amendments would consider any asset-based distribution fee that exceeds this amount to be an "ongoing sales charge" that would be separately regulated under our proposed amendments to rule 6c-10, as discussed below. Proposed rule 12b-2 would not require a "plan" or impose other special board requirements to deduct a marketing and service fee. As discussed above, we expect that the marketing and service fee under proposed rule 12b-2 would allow funds to continue to experience the competitive and capital formation benefits resulting from a 25 basis point asset-based distribution fee. The limited conditions associated with the proposed rule should allow funds to impose these fees in a more efficient way. Because all funds would be able to rely on the proposed rule, and because we do not expect that the rule would affect the ability of funds to create distribution structures that fit their competitive model, we do not believe that the proposed rulemaking would impact competition significantly. We also do not anticipate that the proposed rule would significantly encourage or discourage assets being invested in the capital markets, or in particular funds, and thus do not expect that there would be a significant impact on capital formation.

C. Amended Rule 6c-10

Proposed rule 6c-10(b) would treat asset-based distribution fees deducted in excess of the marketing and service fee as "ongoing sales charges." The proposal would require that funds convert shares subject to an ongoing sales charge to a share class without the fee after the investor has paid cumulative amounts or rates of ongoing sales charges that equal the fund's front-end load.

We expect that the ongoing sales charge may allow investors to better understand the costs of distribution they pay, and would reduce the potential for some long-time investors to subsidize the distribution costs of other investors in the same fund. Our proposal therefore may allow investors who are better informed to allocate their investments more efficiently. The proposed amendments should also reduce fund intermediary conflicts of interest when advising investors regarding fund classes that provide different levels of intermediary compensation based on the period or method for payment of distribution fees. This might allow fund intermediaries to spend less time managing these conflicts and instead allocate their resources more efficiently towards providing better services to investors and increasing competition among intermediaries. Because all funds would be able to rely on the proposed rule, and because we do not expect that the rule would affect the ability of funds to create distribution structures that fit their competitive model, we do not believe that the proposed rulemaking would impact competition significantly. We also do not anticipate that the proposed rule would significantly encourage or discourage assets being invested in the capital markets, or in particular funds, and thus do not expect that there would be a significant impact on capital formation.

In addition, the proposed amendments to rule 6c-10(c) would permit funds to sell their shares at a price other than a current public offering price as described in the prospectus, which is otherwise required by section 22(d). Section 22(d) imposes a significant restriction on competition and the efficient setting of sales loads for mutual fund distribution, because it effectively requires dealers to sell fund shares at the same sales load, regardless of the services provided or the actual cost of distribution. Currently, all investors in a particular fund class pay the same costs for distribution when purchasing shares through a fund intermediary, regardless of the quality or type of services provided by the intermediary. Our proposal would allow funds to make available a class of shares that “unbundles” the costs of distribution from the fund’s operating expenses. This is designed to give funds and intermediaries new avenues for competition, by permitting funds and intermediaries to break out the costs of distribution from other services they provide, and letting investors choose different levels of service based on their needs, considering among other things, cost and quality of the services offered.

Under our proposal, investors would be able to seek out intermediaries that provide a high level of service, provide simple execution of fund trades, or provide services that fall somewhere in the middle. Sales charges would be transparent and could be imposed or deducted in a manner and at any time selected by the investor. We expect that this would enhance efficiency of capital allocation as well as competition among fund intermediaries by allowing investors to shop for the pricing structure that best suits the investor's needs and the marketing choices of the fund or intermediary.[573]

Funds that take advantage of the exemption would be able to effectively externalize the distribution of their shares, an approach that may encourage small funds and new entrants to the market that are eager to attract dealers that wish to sell shares based on their own fee schedules. It may also permit these funds to compete better by reducing their expense ratios (because it would eliminate, at least with respect to the particular class, ongoing sales charges), while still charging low or no front-end sales loads. In addition, innovative distribution models may encourage additional investors to invest in the capital markets, enhancing capital formation.

An externalized approach could simplify the operations of intermediaries, allowing them to process transactions more efficiently based on a single, uniform fee structure. In some cases,

[573] Some roundtable commenters agreed that the externalization of asset-based distribution fees could improve competition among mutual funds. *See* Comment Letter of Bridgeway Funds, Inc. and Bridgeway Capital Management, Inc. (July 19, 2007) ("Mutualization of [12b-1] fees … distorts fundamental, free-market economics and restricts valuable competition in the intermediary channel.").

it could also simplify fund operations and fund prospectuses by eliminating the need to offer multiple classes of shares, further reducing fund expenses, enhancing the efficiency of distribution, and reducing investor confusion. This type of structure may also help traditional mutual funds better compete with other investments, such as exchange-traded funds (ETFs), which have externalized distribution costs and have been growing in popularity.[574]

The proposed exemption is designed to foster price competition among fund intermediaries that charge for the sale of mutual funds, and enhance the efficiency of fund operations and investor choice. Therefore, as discussed above, we expect that the proposed rule amendments are likely to enhance efficiency, competition, and capital formation in the fund marketplace.

D. Disclosure Amendments

Our proposal would amend Forms N-1A, N-SAR, N-3, N-4, and N-6 and Regulation S-X, to conform them to our proposed treatment of asset-based distribution fees.[575] The proposed amendments would improve disclosure by separately identifying the "marketing and service fee" and "ongoing sales charge" as individual line items in the fee table and income statement. The proposed amendments would also streamline current disclosure regarding asset-based distribution fees by replacing disclosure made irrelevant by our proposal with more narrowly focused and precise information regarding asset-based distribution fees. The proposed disclosure amendments would also replace references to 12b-1 fees in these forms with references to the appropriate rule in our proposal.

These proposed changes may allow investors to more efficiently obtain and manage

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[574] In 2009, ETF assets grew 46 percent (from $531 billion to $777 billion) while traditional equity and bond mutual fund assets grew 16 percent (from $9.6 trillion to $11.1 trillion). *See* 2010 ICI Fact Book, *supra* note 6, at 9 and 41.

[575] *See supra* Section III.

information about their investments, as well as reduce the time and cost burdens funds bear in preparing this information. These proposed amendments may lead to increased efficiency by enhancing the ability of investors to more specifically identify the costs of distribution they pay when investing in funds. This information should promote more efficient allocation of investments by investors among funds because they may compare and choose funds based on their costs of distribution and the services provided for these fees more easily. To the extent that these create efficiencies, this may result in new investors investing in funds (or existing investors adding additional capital), and could enhance capital formation, and the efficiency of investors selecting among funds. Because these disclosure amendments would apply to all funds, we do not expect that they would have an impact on competition in the fund marketplace.

E. Rule 11a-3 and Technical Amendments

Our proposal would also make amendments to rule 11a-3 (which governs the payment of sales loads when making share exchanges within a fund family) to conform to our proposed treatment of asset-based distribution fees as sales loads. The proposed amendments would require funds to credit ongoing sales charges an investor has paid against any other load owed when the investor exchanges shares within a fund family. We do not anticipate that these amendments would affect capital formation or competition, nor would they reduce the efficiency of these exchanges because they apply to all funds and should not encourage or discourage investors to invest in the capital markets. We expect that the proposed amendments may reassure investors that they would not pay excessive distribution costs when making exchanges within a fund family, regardless of whether they chose to pay the costs of distribution front-end, over time, or upon redemption.

Our proposal would also make technical conforming amendments to rules 17a-8, 17d-3, and 18f-3, to replace references to rule 12b-1 with references to the appropriate rule regulating asset-based distribution fees in our proposal. We do not expect that these changes would affect the operation of funds, or the behavior of investors, fund intermediaries, or service providers. Therefore, we do not anticipate that these proposed amendments would impact competition, efficiency, or capital formation.

F. Rule 10b-10 Amendments

Our proposal further would amend rule 10b-10 to provide broker-dealer customers with improved information in transaction confirmations about mutual fund sales charges and about information regarding callable securities. These proposed amendments may lead to increased efficiency and competitiveness by enhancing the ability of investors to more specifically understand information related to their transactions in these securities, which not only would allow them to correct any associated errors, but also would help inform their future purchases of securities of this type and promote investment into securities that bear lower distribution-related costs.

G. Request for Comment

- We request comment on whether the proposed rule and rule and form amendments, if adopted, would promote efficiency, competition, and capital formation. We also request comment on any anti-competitive effects of the proposed amendments. Commenters are requested to provide empirical data and other factual support for their views, if possible.

VIII. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”), a rule is “major” if it results or is likely to result in:

- an annual effect on the economy of $100 million or more;
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effects on competition, investment, or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review.

- We request comment on the potential impact of the proposed rules and rule amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

IX. STATUTORY AUTHORITY

The Commission is proposing amendments to rule 6-07 of Regulation S-X under the authority set forth in section 7 of the Securities Act [15 U.S.C. 77g] and sections 8 and 38(a) of the Investment Company Act [15 U.S.C. 80a-8 and 80a-37(a)]. The Commission is proposing amendments to Schedule 14A under the authority set forth in sections 3(b), 10, 13, 14, 15, 23(a), and 36 of the Securities Exchange Act [15 U.S.C. 78c(b), 78j, 78m, 78n, 78o, 78w(a), and 78mm], and sections 20(a), 30(a), and 38(a) of the Investment Company Act [15 U.S.C. 80a-20(a), 80a-29(a), and 80a-37(a)].

The Commission is proposing to rescind rule 12b-1 under the authority set forth in sections 12(b) and 38(a) of the Investment Company Act [15 U.S.C. 80a-12(b) and 80a-37(a)]. The Commission is proposing new rule 12b-2 under the authority set forth in sections 12(b) and 38(a) of the Investment Company Act [15 U.S.C. 80a-12(b) and 80a-37(a)]. The Commission is proposing amendments to rule 6c-10 under the authority set forth in sections 6(c), 12(b), 22(d)(iii), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-12(b), 80a-22(d)(iii), and 80a-37(a)]. The Commission is proposing amendments to rules 11a-3, 17a-8, 17d-3, and 18f-3 under the authority set forth in sections 6(c), 11(a), 17(d), 18(i), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-11(a), 80a-17(d), 80a-18(i), and 80a-37(a)]. The Commission is proposing amendments to Exchange Act rule 10b-10 pursuant to the authority conferred by the Exchange Act, including Sections 10, 17, 23(a), and 36(a)(1) [15 U.S.C. 78j, 78q, 78w(a), and 78mm(a)(1)].

The Commission is proposing amendments to registration Forms N-1A, N-3, N-4, and N-6 under the authority set forth in sections 6, 7(a), 10, and 19(a) of the Securities Act [15 U.S.C. 77f, 77g(a), 77j, and 77s(a)], and sections 8(b), 24(a), and 30 of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-24(a), and 80a-29]. The Commission is proposing amendments to Form N-SAR pursuant to authority set forth in sections 10(b), 13, 15(d), 23(a), and 36 of the Securities Exchange Act [15 U.S.C. 78j(b), 78m, 78o(d), 78w(a), and 78mm], and sections 8, 13(c), 24(a), 30, and 38 of the Investment Company Act [15 U.S.C. 80a-8, 80a-13(c), 80a-24(a), 80a-29, and 80a-37].

List of Subjects

17 CFR Part 210

Accounting, Reporting, and recordkeeping requirements, Securities.

17 CFR Parts 239, 240, and 249

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

TEXT OF PROPOSED RULES AND FORM AMENDMENTS

For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 210 – FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77nn(25), 77nn(26), 78(c), 78j-1, 78*l*, 78m, 78n, 78o(d), 78q, 78u-5, 78w, 78*ll*, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

2. The Part 210 heading is revised as set forth above.

3. Section 210.6-07 is amended by revising paragraph 2(f) to read as follows:

§ 210.6-07 Statements of operations.

*** * * * ***

2. *Expenses.* * * *

(f) State separately all fees deducted from fund assets to finance distribution activities pursuant to §§ 270.12b-2(b), (d) or 270.6c-10(b) of this chapter. Reimbursement to the fund of expenses deducted from fund assets pursuant to §§ 270.12b-2(b), (d) and 270.6c-10(b) shall be shown as a negative amount and deducted from current §§ 270.12b-2(b), (d) and 270.6c-10(b) expenses. If §§ 270.12b-2(b) and 270.6c-10(b) expense reimbursements exceed current §§ 270.12b-2(b) and 270.6c-10(b) expenses, such excess shall be used in the calculation of total expenses under this caption.

* * * * *

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

4. The authority citation for Part 239 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78*l*, 78m, 78n, 78o(d), 78u-5, 78w(a), 78*ll*, 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

5. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

6. Section 240.10b-10 is amended by:

a. Revising paragraph (a)(6)(i);

b. Revising paragraph (a)(9)(ii) by removing the period at the end of the paragraph and inserting "; and"

c. Adding paragraphs (a)(10) and (a)(11);

d. Revising paragraph (b)(2);

e. Adding paragraph (d)(10);

f. In paragraph (e) by removing “, *Provided* that:” at the end of the introductory text and adding in its place “; *provided* that the broker or dealer that effects any transaction for a customer in security futures products in a futures account gives or sends to the customer no later than the next business day after execution of any futures securities product transaction, written notification disclosing:”

g. Removing the introductory text of paragraph (e)(1) and redesignating paragraphs (e)(1)(i), (ii), (iii) and (iv) as paragraphs (e)(1), (2), (3), and (4); and

h. Removing paragraph (e)(2).

The revisions and additions read as follows.

§ 240.10b-10 Confirmation of transactions.

* * * * *

(a) * * *

(6) * * *

(i) The yield at which the transaction was effected, including the percentage amount and its characterization (e.g., current yield, yield to maturity, or yield to call) and if effected at yield to call, the type of call, the call date and, if different, the first date upon which the security may be called, and call price; and

* * * * *

(10) In the case of a purchase of a mutual fund security:

(i) The amount of any sales charge that the customer incurred at the time of purchase, expressed in dollars and as a percentage of the public offering price, the net dollar amount invested in the security**,** and the amount of any applicable breakpoint or similar threshold used to calculate the sales charge;

(ii) The maximum amount of any deferred sales charge that the customer may incur in connection with the subsequent redemption or sale of the securities purchased, expressed as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable;

(iii) If the customer will incur any ongoing sales charge (as defined in § 270.6c-10) or any marketing and service fee (as defined in § 270.12b-2) after the time of purchase:

(A) The annual amount of the charge or fee, expressed as a percentage of net asset value; the aggregate amount of the ongoing sales charge that may be incurred over time, expressed as a percentage of net asset value; and the maximum number of months or years that the customer will incur ongoing sales charge; and

(B) The following statement (which may be revised to reflect the particular charge or fee at issue): "In addition to ongoing sales charges and marketing and service fees, you will also incur additional fees and expenses in connection with owning this mutual fund, as set forth in the fee table in the mutual fund prospectus; these typically will include management fees and other expenses. Such fees and expenses are generally paid from the assets of the mutual fund in which you are investing. Therefore, these costs are indirectly paid by you."; and

(11) In the case of a redemption or sale of a mutual fund security, the amount of any deferred sales charge that the customer has paid in connection with the redemption or sale, expressed in dollars and as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable.

* * * * *

(b) * * *

(2) Such broker or dealer gives or sends to such customer within five business days after the end of each quarterly period, for transactions involving investment company and periodic plans, and after the end of each monthly period, for other transactions described in paragraph (b)(1) of this section, a written statement disclosing each purchase or redemption, effected for or with, and each dividend or distribution credited to or reinvested for, the account of such customer during the month; the date of such transaction; the identity, number, and price of any securities purchased or redeemed by such customer in each such transaction; the total number of shares of such securities in such customer's account; any remuneration received or to be received by the broker or dealer in connection therewith; any ongoing sales charges or marketing and service fees incurred in connection with the purchase or redemption of a mutual fund security; and that any other information required by paragraph (a) of this section will be furnished upon written request: *Provided*, *however*, that the written statement may be delivered to some other person designated by the customer for distribution to the customer; and

* * * * *

(d) * * *

(10) *Mutual fund security* means any security issued by an open-end company, as defined by section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-5(a)(1)), that is registered or required to register under section 8 of that Act, including any series of such company.

* * * * *

7. Schedule 14A (referenced in § 240.14a-101) is amended by revising paragraphs (a)(1)(iii) and (d) in Item 22 to read as follows:

§ 240.14a-101 Schedule 14A Information required in a proxy statement.

*   *   *   *   *

Item 22. Information required in investment company proxy statement.

(a) General.

(1) Definitions. * * *

(iii) *Marketing and Service Fee*. The term "Marketing and Service Fee" shall mean a fee deducted from Fund assets to finance distribution activities pursuant to rule 12b-2(b) (§ 270.12b-2(b)).

*   *   *   *   *

(d) *Marketing and Service Fees.* If action is to be taken to institute a Marketing and Service Fee or increase the rate of an existing Marketing and Service Fee, include the following information in the proxy statement:

(1) A description of the nature of the action to be taken and the reasons therefore, the rate of the Marketing and Service Fee as it is proposed to be deducted and the purposes for which such fee may be used, and, if the action to be taken is an increase in the rate of an existing Marketing and Service Fee, the reasons for the increase.

(2) If the Fund currently deducts a Marketing and Service Fee:

(i) Provide the date that the Marketing and Service Fee was first instituted and the date of the last increase, if any;

(ii) Disclose the rate of the Marketing and Service Fee and the purposes for which such fee may be used; and

(iii) Disclose the name of, and the amount of any Marketing and Service Fee paid by the Fund during its most recent fiscal year to, any person who is an affiliated person of the Fund, its investment adviser, principal underwriter, or Administrator, an affiliated person of such person, or a person that during the most recent fiscal year received 10% or more of the aggregate amount of Marketing and Service Fees paid by the Fund.

*   *   *   *   *

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

8. The authority citation for Part 249 continues to read, in part, as follows:

Authority: 15 U.S.C. 78a *et seq.* and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

*   *   *   *   *

PART 270 – RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

9. The general authority citation for Part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a-1 *et seq*., 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

10. The authority citation for § 270.6c-10 is revised to read as follows:

*   *   *   *   *

Section 270.6c-10 is also issued under 15 U.S.C. 80a-6(c), 15 U.S.C. 80a-12(b), 15 U.S.C. 80a-22(d) and 80a-37(a).

*   *   *   *   *

11. The authority citation for § 270.12b-2 is added to read as follows:

Authority: * * *

* * * * *

Section 270.12b-2 is also issued under 15 U.S.C. 80a-6(c), 15 U.S.C. 80a-12(b), and 80a-37(a).

* * * * *

12. The authority citation for § 270.17a-8 continues to read as follows:

Authority: * * *

* * * * *

Section 270.17a-8 is also issued under 15 U.S.C. 80a-6(c) and 80a-37(a).

* * * * *

13. Section 270.6c-10 is revised to read as follows:

§ 270.6c-10 Exemptions for certain open-end management investment companies to impose deferred sales loads and other sales charges.

(a) *Deferred Sales Load*.

(1) *Exemption.* Notwithstanding sections 2(a)(32), 2(a)(35), and 22(d) of the Act [15 U.S.C. 80a-2(a)(32), 80a-2(a)(35), and 80a-22(d), respectively] and § 270.22c-1, a fund, other than a registered separate account, and any exempted person may impose a deferred sales load on fund shares, if:

(i) The amount of the deferred sales load does not exceed a specified percentage of the net asset value or the offering price at the time of purchase; and

(ii) The terms of the deferred sales load are covered by the provisions of Rule 2830 of the Conduct Rules of the NASD; and

(iii) The same deferred sales load is imposed on all shareholders, except that a fund may offer scheduled variations in or elimination of a deferred sales load to a particular class of shareholders or transactions if the fund has satisfied the conditions in § 270.22d-1.

(2) *Load Reductions.* Nothing in this paragraph (a) prevents a fund from offering to existing shareholders a new scheduled variation that would waive or reduce the amount of a deferred sales load not yet paid.

(b) *Fund-Level Sales Charge*.

(1) *Exemption.* Notwithstanding § 270.12b-2(b)(1), a fund may deduct an ongoing sales charge from fund assets if the cumulative ongoing sales charges imposed on a purchase of fund shares do not exceed the shareholder's maximum sales load, provided that:

(i) A fund may satisfy the requirements of this paragraph (b) if shares subject to an ongoing sales charge convert (without any shareholder action and in accordance with § 270.18f-3(f)(2)) to a fund share class without an ongoing sales charge, on or before the end of the conversion period;

(ii) Shares acquired by reinvestment of dividends or other distributions may be invested in a fund share class with an ongoing sales charge only if the reinvested shares convert to a share class without an ongoing sales charge no later than when the shares on which the dividend or distribution was declared convert;

(iii) A fund may offer scheduled variations in the conversion period to a particular class of shareholders or transactions if the fund has satisfied the conditions in § 270.22d-1; and

(iv) The fund does not acquire shares of another fund that, with respect to the class of shares acquired, deducts an ongoing sales charge.

(2) *Sales Charge Reductions*. Nothing in this paragraph (b) prevents a fund from

offering to existing shareholders a new scheduled variation that would reduce the conversion period.

(3) *Changes to Ongoing Sales Charge*. No fund may:

(i) Institute or increase the rate of an ongoing sales charge applied to a fund share class or series after any public offering of the fund's voting shares or the sale of such shares to persons who are not organizers of the fund; or

(ii) Increase the amount of time after which a share class will automatically convert to a class of shares that does not have an ongoing sales charge, if it would increase the cumulative amount of ongoing sales charges imposed.

(c) *Account-Level Sales Charge*. Notwithstanding section 22(d) of the Act [15 U.S.C. 80a-22(d)], any fund class and any exempted person may offer or sell fund shares at a price other than the current public offering price described in the prospectus, if:

(1) The class does not impose an ongoing sales charge pursuant to § 270.6c-10(b), although it may impose a marketing and service fee pursuant to § 270.12b-2(b); and

(2) The fund discloses in its registration statement that it has elected to rely on this paragraph (c) for an exemption from section 22(d) of the Act [15 U.S.C. 80a-22(d)].

(d) *Definitions.* For purposes of this section:

(1) *Acquired security* has the same meaning as in § 270.11a-3(a)(1).

(2) *Conversion period* is the period beginning on the day that shares are purchased and ending on the last day of the calendar month during which the cumulative ongoing sales charge rates exceed the shareholder's maximum sales load rate. The maximum number of months in a conversion period is determined by dividing the shareholder's maximum sales load rate by the ongoing sales charge rate and multiplying the result by 12.

(3) *Deferred sales load* means any amount properly chargeable to sales or promotional expenses that is paid directly by a shareholder to a fund after purchase but before or upon redemption.

(4) *Distribution activity* means any "Distribution activity," as defined in § 270.12b-2(e)(2).

(5) *Exchanged security* has the same meaning as in § 270.11a-3(a)(4).

(6) *Exempted person* means any principal underwriter of, dealer in, and any other person authorized to effect transactions in, shares of a fund.

(7) *Fund* means a registered open-end management investment company, and includes a separate series of a fund.

(8) *Group of investment companies* has the same meaning as in § 270.11a-3(a)(5).

(9) *Maximum sales load* means the maximum sales load rate multiplied by the total dollar amount paid.

(10) *Maximum sales load rate* means the reference load minus the sum of the rates of:

(i) Any sales load (including a deferred sales load) incurred in connection with the purchase of fund shares; and

(ii) Any sales loads or ongoing sales charges previously paid with respect to an exchanged security within the same group of investment companies.

(11) *Ongoing sales charge* means any charges or fees deducted from fund assets to finance distribution activity in excess of the maximum rate permitted under § 270.12b-2(b). In the case of a fund ("the acquiring fund") that acquires shares of another fund (the "acquired fund"), ongoing sales charge means any charges or fees deducted from fund assets to finance distribution activity in excess of the acquiring fund's marketing and service fee (as defined in

§ 270.12b-2(e)(3)), without regard to any acquired fund’s marketing and service fee.

(12) *Ongoing sales charge rate* is the annual ongoing sales charge, expressed as a percentage of net asset value.

(13) *Organizers of a fund* means any affiliated person of the fund, any affiliated person of such person, any promoter of the fund, and any affiliated person of such promoter.

(14) *Reference load* means:

(i) The highest sales load rate that the shareholder would have paid if, at the time of the purchase of fund shares, the shareholder had purchased a class offered by the fund that does not have an ongoing sales charge and for which the shareholder qualifies according to the fund’s registration statement;

(ii) In the case of shares exchanged within the same group of investment companies, the highest applicable sales load rate of the acquired security or the exchanged security; or

(iii) If no reference load can be determined under paragraphs (d)(14)(i) or (d)(14)(ii) of this section, the reference load is the maximum sales charge rate permitted a fund that deducts an asset-based sales charge and a service fee under Rule 2830(d)(2)(A) of the Conduct Rules of the NASD.

(15) *Sales load rate* is the sales load expressed as a percentage of the fund share offering price.

14. Section 270.11a-3 is amended by revising paragraphs (b)(4) and (b)(5)(i)(A) and (b)(5)(ii)(A) to read as follows:

§ 270.11a-3 Offers of exchange by open-end investment companies other than separate accounts.

* * * * *

(b) * * *

(4) Any sales load charged with respect to the acquired security is a percentage that is no greater than the excess, if any, of the rate of the sales load applicable to that security in the absence of an exchange over the sum of the rates of all sales loads and ongoing sales charges (as permitted under § 270.6c-10(b)), previously paid on the exchanged security, *Provided that*:

(i) The percentage rate of any sales load charged when the acquired security is redeemed, that is solely the result of a deferred sales load imposed on the exchanged security, may be no greater than the excess, if any, of the applicable rate of such sales load, calculated in accordance with paragraph (b)(5) of this section, over the sum of the rates of all ongoing sales charges and sales loads previously paid on the acquired security, and

(ii) In no event may the sum of the rates of all ongoing sales charges and sales loads imposed prior to and at the time the acquired security is redeemed, including any ongoing sales charges and sales load paid or to be paid with respect to the exchanged security, exceed the maximum sales load rate, calculated in accordance with paragraph (b)(5) of this section, that would be applicable in the absence of an exchange to the security (exchanged or acquired) with the highest such rate;

(5) * * *

(i) * * *

(A) reduced by the sum of the rates of all ongoing sales charges collected on the acquired security pursuant to §270.6c-10(b), and

* * * * *

(ii) * * *

(A) the deferred sales load is reduced by the sum of the rates of all ongoing sales charges previously collected on the exchanged security pursuant to § 270.6c-10(b), and

*   *   *   *   *

15. Section 270.12b-1 is removed.

16. Section 270.12b-2 is added to read as follows:

§ 270.12b-2 Investment company distribution fees.

(a) *Preliminary Matters*.

(1) Except as provided in this section, it is unlawful for any fund (other than a fund complying with the provisions of section 10(d) of the Act [15 U.S.C. 80a-10(d)]) to act as a distributor of securities of which it is the issuer, except through an underwriter.

(2) For purposes of this section, a fund will be deemed to be acting as a distributor of securities of which it is the issuer, other than through an underwriter, if it directly or indirectly uses fund assets to finance any distribution activity.

(b) *Marketing and Service Fee.* A fund may use fund assets to finance distribution activity, provided that, with regard to any class of the fund:

(1) All charges and fees deducted from fund assets to finance distribution activity do not exceed the maximum rate of the service fee allowed under Rule 2830 of the NASD Conduct Rules, except as permitted by § 270.6c-10(b);

(2) If a fund (the “acquiring fund”) acquires shares of another fund (the “acquired fund”), the combined rate of the marketing and service fees of the acquiring fund and any acquired fund to finance distribution activities does not exceed the maximum rate permitted in paragraph (b)(1) of this section.

(3) The marketing and service fee (or any increase in the rate of such a fee) has been approved by a vote of at least a majority of the fund’s outstanding voting securities if the fee is instituted or increased after any public offering of the fund’s voting securities or the sale of such securities to persons who are not affiliated persons of the company, affiliated persons of such persons, promoters of the fund, or affiliated persons of such promoters.

(c) *Directed Brokerage*. Notwithstanding any other provision of this section, a fund may not:

(1) Compensate a broker or dealer for any promotion or sale of shares issued by that fund by directing to the broker or dealer:

(i) The fund's portfolio securities transactions; or

(ii) Any remuneration, including but not limited to any commission, mark-up, mark-down, or other fee (or portion thereof) received or to be received from the fund's portfolio transactions effected through any other broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer); and

(2) Direct its portfolio securities transactions to a broker or dealer that promotes or sells shares issued by the fund, unless the fund (or its investment adviser):

(i) Is in compliance with the provisions of paragraph (c)(1) of this section with respect to that broker or dealer; and

(ii) Has implemented, and the fund's board of directors (including a majority of directors who are not interested persons of the fund) has approved, policies and procedures reasonably designed to prevent:

(A) The persons responsible for selecting brokers and dealers to effect the fund's portfolio securities transactions from taking into account the brokers' and dealers' promotion or sale of shares issued by the fund or any other registered investment company; and

(B) The fund, and any investment adviser and principal underwriter of the fund, from entering into any agreement (whether oral or written) or other understanding under which the fund directs, or is expected to direct, portfolio securities transactions, or any remuneration described in paragraph (c)(1)(ii) of this section, to a broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer) in consideration for the promotion or sale of shares issued by the fund or any other registered investment company.

(d) *Grandfathered Rule 12b-1 Fees.* Until [date 5 years after compliance date of the rule], notwithstanding any other provision in this section, a fund may act as a distributor of securities sold prior to [the compliance date of rule 12b-2] subject to a rule 12b-1 plan approved under § 270.12b-1 (2010 version) as in effect prior to [the compliance date of rule 12b-2], *provided that*:

(1) The fund's board of directors may vote to eliminate the provisions in the fund's rule 12b-1 plan that were required by paragraphs (b)(3)(i) (annual approval), (b)(3)(ii) (quarterly reports) and (b)(3)(iii) (termination) of § 270.12b-1 (2010 version);

(2) With regard to any class of the fund, the fund does not increase the annual rate of the fee paid under its rule 12b-1 plan in the most recent fiscal year, and

(3) As of [date 5 years after compliance date of the rule] all securities subject to paragraph (d) of this section must be exchanged or converted into securities of a class that does not deduct an ongoing sales charge as defined in § 270.6c-10(d)(11) and that does not charge a marketing and service fee in excess of the annual rate of the fee paid under its rule 12b-1 plan in the most recent fiscal year.

(e) *Definitions.* For purposes of this section:

(1) *Fund* means a registered open-end management investment company, and includes a separate series of the fund.

(2) *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.

(3) *Marketing and Service Fee* means any charges or fees deducted from fund assets under paragraph (b)(1) of this section.

* * * * *

17. Section 270.17a-8 is amended by revising paragraph (a)(3)(iv) to read as follows:

§ 270.17a-8 Mergers of affiliated companies.

(a) * * *

(3) * * *

(iv) Any distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the surviving company pursuant to provisions of § 270.12b-2(b) or (d) or § 270.6c-10(b), are no greater than the distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the merging company.

18. Section 270.17d-3 is amended by revising paragraph (a) to read as follows:

§ 270.17d-3 Exemption relating to certain joint enterprises or arrangements concerning payment for distribution of shares of a registered open-end management investment company.

*	*	*	*	*

(a) Such agreement is made in compliance with the provisions of § 270.12b-2(b) or (d) or § 270.6c-10(b); and

*	*	*	*	*

19. Section 270.18f-3 is amended by revising paragraph (f)(2)(ii) to read as follows:

§ 270.18f-3 Multiple class companies.

*	*	*	*	*

(f) *	*	*

(2) *	*	*

(ii) The expenses, including distribution payments authorized under § 270.12b-2(b) or (d) or § 270.6c-10(b), for the target class are not higher than the expenses, including distribution payments authorized under § 270.12b-2(b) or (d) or § 270.6c-10(b), for the purchase class; and

*	*	*	*	*

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

20. The authority citation for Part 274 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78*l*, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

*	*	*	*	*

21. Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by:

a. Adding the definition “asset-based distribution fee” in alphabetical order to

General Instructions A;

b. Revising the "Annual Fund Operating Expenses" fee table and Instruction 3(b) to Item 3;

c. Revising paragraph b and removing the Instruction to paragraph b of Item 12;

d. Revising paragraph g and adding an Instruction to paragraph g of Item 19;

e. Adding paragraph d to item 25;

f. Revising Instruction 5 to paragraph (b)(4) of Item 26;

g. In the expense example in paragraph (d)(1) of Item 27, removing the reference to "distribution [and/or service](12b-1) fees" and adding in its place "asset-based distribution fees";

h. In Instruction 2(a)(i) following paragraph (d)(1) to Item 27, removing the reference to "Distribution [and/or service](12b-1) fees" and adding in its place "asset-based distribution fees"; and

i. Removing and reserving paragraph (m) of Item 28.

The revisions read as follows:

Note: The text of Form N-1A does not, and this amendment will not, appear in the Code of Federal Regulations.

Form N-1A

* * * * *

General Instructions

A. Definitions

* * * * *

"Asset-Based Distribution Fee" means a fee deducted from Fund assets to finance distribution activities pursuant to rule 12b-2(b) (17 CFR § 270.12b-2(b)) ("Marketing and

Service Fee”), rule 12b-2(d) (17 CFR § 270.12b-2(d)), and/or rule 6c-10(b) (17 CFR § 270.6c-10(b)) (“Ongoing Sales Charge”).

*   *   *   *   *

Item 3. Risk/Return Summary: Fee Table

*   *   *   *   *

Annual Fund Operating Expenses (expenses that you pay each year as a percentage of the value of your investment)

Management Fees		____%
Ongoing Sales Charge		____%
Other Expenses		____%
Marketing and Service Fee	____%	
		____%
		____%
Total Annual Fund Operating Expenses		____%

*   *   *   *   *

Instructions.

*   *   *   *   *

3.   Annual Fund Operating Expenses

*   *   *   *   *

(b) “Ongoing Sales Charge” includes all expenses incurred during the most recent fiscal year pursuant to rule 6c-10(b) (17 CFR § 270.6c-10(b)). “Marketing and Service Fee” includes all expenses incurred during the most recent fiscal year pursuant to rule 12b-2(b) (17 CFR § 270.12b-2(b)).

*   *   *   *   *

Item 12. Distribution Arrangements

*   *   *   *   *

(b) *Asset-Based Distribution Fees.* If the Fund deducts an Asset-Based Distribution Fee, state separately the rate of Ongoing Sales Charges, Marketing and Service Fees, or fees charged pursuant to rule 12b-2(d) (17 CFR § 270.12b-2(d)), as applicable, and state each one's purpose and general terms, and provide disclosure to the following effect:

(1) The Fund deducts a fee for the sale and distribution of its shares and, if applicable, for services provided to fund investors. If the Fund deducts a fee for such services, describe the nature and extent of services provided to fund investors.

(2) For Multiple Class Funds that offer more than one Class in the prospectus, discuss the general circumstances under which an investment in a Class that deducts an Asset-Based Distribution Fee may be more or less advantageous than an investment in a Class that either does not deduct an Asset-Based Distribution Fee or a Class that deducts a different Asset-Based Distribution Fee. Include the effect of different holding periods and investment amounts in this description.

(3) For Funds that deduct an Ongoing Sales Charge, the number of months/years that an investor's shares would be subject to the charge before automatically converting to a Class without such a deduction.

*   *   *   *   *

Item 19. Investment Advisory and Other Services

* * * * *

(g) *Asset-Based Distribution Fees.* If the Fund deducts an Asset-Based Distribution Fee, provide a description of the fee(s) and how they are used, including a list of the principal types of activities for which payments are or will be made (*e.g.*, advertising; printing and mailing of prospectuses to other than current shareholders; compensation to underwriters, compensation to broker-dealers, shareholder servicing fees, *etc*.).

Instruction. If a Fund offers a Class that deducts both an Ongoing Sales Charge and a Marketing and Service Fee, separate the list of activities according to type of fee.

* * * * *

Item 25. Underwriters

* * * * *

(d) If the fund has elected to rely on rule 6c-10(c) (17 CFR § 270.6c-10(c)) to permit the fund or its underwriter to distribute shares at a price other than a current public offering price described in the prospectus, state that the fund has made this election.

* * * * *

Item 26. Calculation of Performance Data

* * * * *

(b) * * *

(4) * * *

Instructions.

* * * * *

5. Include expenses accrued due to any Asset-Based Distribution Fees owed in the expenses accrued for the period. Reimbursement accrued may reduce the accrued expenses, but only to the extent the reimbursement does not exceed expenses accrued for the period.

* * * * *

Item 28. Exhibits

* * * * *

(m) *Reserved.*

* * * * *

22. Form N-3 (referenced in §§ 239.17a and 274.11b) is amended by:

a. Revising Instruction 2 to Item 7(a);

b. Revising paragraph (f) and the Instruction to paragraph (f) of Item 21;

c. Revising Instruction 5 to Item 26(b)(ii).

The revisions read as follows:

Note: the text of Form N-3 does not, and this amendment will not, appear in the Code of Federal Regulations.

Form N-3

* * * * *

Item 7. Deductions and Expenses

(a) * * *

Instructions:

* * * * *

2. If proceeds from explicit sales loads will not cover the expected costs of distributing the contracts, identify from what source the shortfall, if any, will be paid. If any shortfall is to be made up from assets from the Insurance Company's general account, disclose, if applicable, that any amounts paid by the Insurance Company may consist, among other things, of proceeds derived from mortality and expense risk charges deducted from the account. If Registrant directly or indirectly pays any asset-based distribution expenses under rule 12b-2(b) (17 CFR § 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), or rule 6c-10(b) (17 CFR § 270.6c-10(b)), provide a description of the expenses and list the principal types of activities for which payments are made.

*   *   *   *   *

Item 21. Investment Advisory and Other Services

*   *   *   *   *

(f) If the Registrant deducts any asset-based distribution fees under rule 12b-2(b) (§ 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), or rule 6c-10(b) (17 CFR § 270.6c-10(b)), provide a description of the fee(s) and how they are used, including a list of the principal types of activities for which payments are or will be made (*e.g.*, advertising; printing and mailing of prospectuses to other than current shareholders; compensation to underwriters, compensation to broker-dealers, shareholder servicing fees, *etc.*).

Instruction. If a Registrant deducts both an ongoing sales charge and a marketing and service fee, separate the list of activities according to type of fee.

*   *   *   *   *

Item 26. Calculation of Performance Data

*   *   *   *   *

(b) *   *   *

(ii) *   *   *

*   *   *   *   *

Instructions.

*   *   *   *   *

5. Include all asset-based distribution expenses accrued under rule 12b-2(b) (17 CFR § 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), and rule 6c-10(b) (17 CFR § 270.6c-10(b)) among the expenses accrued for the period. Reimbursement of expenses deducted from fund assets pursuant to rule12b-2(b) (17 CFR § 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), and rule 6c-10(b) (17 CFR § 270.6c-10(b)) may reduce the accrued expenses, but only to the extent the reimbursement does not exceed expenses accrued for the period.

*   *   *   *   *

23. Form N-4 (referenced in §§ 239.17b and 274.11c) is amended by:

a. In the "Total Annual [Portfolio Company] Operating Expenses" table in Item 3(a), removing the reference to "distribution [and/or service](12b-1) fees" and adding in its place "asset-based distribution fees."

b. In Instruction 16 to Item 3 adding a definition of "asset-based distribution fees."

The addition reads as follows:

Note: the text of Form N-4 does not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-4

*   *   *   *   *

Item 3. Synopsis

*   *   *   *   *

16. "Management Fees" include investment advisory fees (including any component thereof based on the performance of the portfolio company), any other management fees payable by the portfolio company to the investment adviser or its affiliates, and administrative fees payable to the investment adviser or its affiliates not included as "Other Expenses." "Asset-based distribution fee" includes all asset-based distribution expenses paid under rule 12b-2(b) (17 CFR § 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), and rule 6c-10(b) (17 CFR § 270.6c-10(b)).

*   *   *   *   *

24. Form N-6 (referenced in §§ 239.17c and 274.11d) is amended by:

a. In the "Total Annual [Portfolio Company] Operating Expenses" table in Item 3, removing the reference to "distribution [and/or service](12b-1) fees" and adding in its place "asset-based distribution fees."

b. Adding paragraph (g) to Instruction 4 of Item 3.

The addition reads as follows:

Note: the text of Form N-6 do not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-6

*   *   *   *   *

Item 3. Risk/Benefit Summary: Fee Table

*   *   *   *   *

Instructions.

*   *   *   *   *

(4)   *   *   *

(g) "Asset-based distribution fee" includes all asset-based distribution expenses paid under rule 12b-2(b) (17 CFR § 270.12b-2(b)), rule 12b-2(d) (17 CFR § 270.12b-2(d)), and rule 6c-10(b) (17 CFR § 270.6c-10(b)).

*   *   *   *   *

25. Form N-SAR (referenced in §§ 249.330 and 274.101) is amended by:

a. Revising Item 40 in Instructions to Specific Items;

b. Removing Items 41-44 in Instructions to Specific Items; and

c. Removing the last sentence in the Instruction to Sub-Item 72DD2 in Instructions to Specific Items.

The revision reads as follows:

Note: the text of Form N-6 do not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-SAR

*   *   *   *   *

Instructions to Specific Items

*   *   *   *   *

Item 40: Plans Adopted Pursuant to Former Rule 12b-1

Rule 12b-1 under the Act (17 CFR § 270.12b-1), has been rescinded. Registrants that have grandfathered 12b-1 share classes pursuant to rule 12b-2(d) (17 CFR § 270.12b-2(d)), should answer this question “Yes.” Registrants that do not have grandfathered 12b-1 share classes pursuant to rule 12b-2(d) under the Act should answer this question “No.”

By the Commission.

Elizabeth M. Murphy
Secretary

Dated: July 21, 2010