



National Association of Insurance and Financial Advisors

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May 7, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Via Electronic Mail: rule-comments@sec.gov

**Re: Proposed Rule: Prohibition on the Use of Brokerage
Commissions to Finance Distribution; File No. S7 09-04**

Dear Mr. Katz:

This letter will present the comments of the National Association of Insurance and Financial Advisors (“NAIFA”) with respect to the Proposed Rule: Prohibition on the Use of Brokerage Commissions to Finance Distribution (File No. S7 09-04) (the “Proposed Rule”).

NAIFA is a national federation of over 700 state and local associations, whose members live and work in every congressional and state legislative district. The 65,000 members of these associations are bound by NAIFA’s Code of Ethics and are full time professionals in insurance and related financial services. Founded in 1890, NAIFA is the nation’s oldest and largest trade association of insurance and financial services professionals. NAIFA’s mission is to improve the business environment, enhance the professional skills and promote the ethical conduct of agents and others engaged in insurance and related financial services who assist the public in achieving financial security and independence. Over half of all NAIFA members are licensed as registered representatives of broker-dealers and market and service mutual funds.

The Proposed Rule would amend rule 12b-1 (17 C.F.R. 270.12b-1) under the Investment Company Act of 1940 (15 U.S.C. 80a) (“Rule 12b-1”) to specifically prohibit mutual funds from using brokerage commissions to pay for the distribution of fund shares. The Proposed Rule is designed to end a practice known as “directed brokerage”, which the Securities and Exchange Commission (“SEC” or the “Commission”) and others have concluded is one of many practices plagued by conflicts of interest which are potentially harmful to mutual funds and their investors.

The Commission has requested comments on the Proposed Rule, as well as whether additional amendments to Rule 12b-1 are needed or whether the rule should be rescinded in its entirety.

Our comments will focus primarily on the Commission's general request for comments on Rule 12b-1 and will address the impact that further amendments to Rule 12b-1 would have on NAIFA members. Our comments will focus on the following three points:

- NAIFA supports the Commission's efforts to eliminate conflicts of interest and illegal or inappropriate practices to the extent they may be present in the mutual fund industry;
- The payment of fees under Rule 12b-1 to broker-dealers and their registered representatives constitutes legitimate and appropriate compensation for providing ongoing service to their mutual fund owning clients and the Rule should not be rescinded; and
- The payment of fees under Rule 12b-1 to registered representatives is an acceptable use of fund assets provided adequate disclosure is given.

1. NAIFA supports the Securities and Exchange Commission's efforts to eliminate conflicts of interest to the extent they may be present in the mutual fund industry through practices such as "directed brokerage."

As registered representatives, NAIFA members do not engage in brokerage activities. We do, however, have a strong interest in the protection of mutual fund investors from unfair dealing and a strong interest in the health and good name of the mutual fund industry in general. For those reasons, we support the Securities and Exchange Commission's efforts to eliminate conflicts of interest to the extent they may be present in the mutual fund industry. The Proposed Rule's prohibition of directed brokerage appears to be a reasonable effort to remove the potential conflicts of interest posed by this practice.

2. Rule 12b-1 provides legitimate, reasonable compensation to registered representatives for providing continuing service to their clients and should not be rescinded.

Most mutual fund investors use the services of a financial intermediary – a registered representative – to purchase funds. Registered representatives provide ongoing services and continuing advice to their clients regarding their investments. In return, the broker-dealer and its registered representative receive compensation as provided for under each individual fund's 12b-1 plan.

This ongoing compensation should not be confused with commissions paid for the sale of fund shares to an investor. Rule 12b-1 fees and sales commissions compensate registered representatives for different services. Compensation for the initial sale of the product is typically paid in the form of a "sales load," which comes "off the top" of the client's investment. Although funds have developed various options for the payment of sales loads since the advent of Rule 12b-1, registered representatives generally receive their commissions at or near the time of sale. In contrast, payments received by registered representatives under Rule 12b-1 do not

serve as compensation for the initial placement of the fund; rather 12b-1 fees compensate the financial advisor for the ongoing services provided to the investor by the financial advisor after the investor becomes a client.

In accordance with NASD rules, the amount of this compensation is relatively modest: on a \$10,000 investment, the annual 12b-1 fee that is paid on a mutual fund's Class A shares for providing ongoing service equals about \$25. The broker-dealer and the registered representative share this amount. Although the payments are small, they are an important source of income for registered representatives.

Some have questioned the propriety of funds that are closed to new investors continuing to pay 12b-1 fees. The continuing payment of 12b-1 fees in these circumstances, however, is consistent with the overall purpose behind these fees, as this purpose has evolved over time. Registered representatives provide ongoing services to mutual fund investors. These services are provided to investors in "closed" funds as well as funds that accept new investors. The elimination of 12b-1 fees for "closed" funds would prevent registered representatives from being fairly compensated for services provided to investors in such funds.

Rule 12b-1 fees paid to registered representatives are legitimate, earned compensation for providing valuable services which greatly benefit individual investors. In exchange for a small annual payment, investors have access to a financial services expert to answer their questions and address their concerns. Conversely, investors who purchase funds directly from a mutual fund company – who also may pay a 12b-1 or similar fee depending on the class of shares they purchase – are not provided the same level of personal support. Investors who purchase mutual fund shares in this manner typically must call an "800" phone number and speak to a different customer service person each time they need assistance.

The elimination of 12b-1 fees would have a detrimental effect on the earnings of registered representatives. Equally important, loss of such revenues could cause funds and their distribution channels to change their ways of doing business – eliminating classes of shares, reducing payment options, and withholding ongoing services that are currently provided. This would harm not only the funds, broker-dealers and registered representatives, but also investors, who would likely lose the advice and counsel of familiar financial services experts whom they have come to rely upon over the years.

3. **Compensating registered representatives for providing ongoing service to the clients is a legitimate use of fund assets, provided such compensation is adequately disclosed.**

The payment of fees to registered representatives for providing ongoing service to client accounts is a legitimate and appropriate use of fund assets. When such payments are adequately disclosed, as required by law, 12b-1 fees paid for providing ongoing services pose little danger of causing conflicts of interest. Under NASD Conduct Rule 2830, 12b-1 fees are limited to a maximum of 1% of a fund's average net assets per year, including a fee of up to 0.25% to financial intermediaries for providing services or maintaining shareholder accounts. It is this latter amount that provides the "12b-1 fees" that registered representatives receive for providing

ongoing service to their clients. This cap essentially eliminates the potential for conflicts of interest because registered representatives are likely to receive approximately the same percentages from all funds. Indeed, to the degree these fees provide a registered representative with any incentive at all, it would seem to be to place an investor with a fund that is likely to perform better in the long-term.

Paying for ongoing services out of the fund manager's fee, rather than from fund assets, poses serious concerns for registered representatives. Elimination of the 12b-1 framework and allowing fund managers to pay – or not to pay – for ongoing services could significantly impact registered representatives' economic well-being. Currently, as described above, payment of 12b-1 fees for ongoing services is fairly uniform. Our concern is that removing fund assets from the equation and leaving it up to fund managers to pay such fees out of their own pockets will lead to the reduction or elimination of compensation for ongoing services.

In addition, payment of fees directly by fund managers, rather than out of fund assets, could lead to the very conflicts of interest (or the appearance thereof) that the Commission is seeking to eliminate. In order to encourage registered representatives to sell their funds, fund managers could adjust the fees paid for providing ongoing services based on fund sales. This could entice registered representatives to recommend one fund over another based on nothing more than the amount of the service fee.

In both these scenarios, the investor loses. If fund managers eliminate or reduce payments for ongoing services to the extent that providing such services is not economical, registered representatives may stop providing these services and investors would lose the advice and counsel of financial services experts. If fund managers use payments of fees to induce fund sales, investors could end up investing in a fund that is not appropriate for their needs.

NAIFA believes that any concerns about the use of fund assets to pay for ongoing services provided by registered representatives could be alleviated through appropriate disclosure. Although 12b-1 fees are currently fully disclosed in standardized fee tables located at the front of every fund's prospectus, such disclosures could be revised or amended to be more understandable to the average investor. We note that in its Proposed Rule: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities (the "Disclosure Proposed Rule"), the SEC has proposed new requirements requiring additional disclosures to investors, including the estimated amount of 12b-1 fees to be paid in the year following purchase. Although we do not comment on the specific proposals set forth in the Disclosure Proposed Rule, NAIFA generally supports clearer, more robust disclosure as the best way to ensure that investors understand fully the fees and expenses charged in connection with mutual fund ownership. We believe that fully informed investors would not object to their financial advisors being paid legitimate, earned compensation for providing beneficial services to their clients.

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In sum, NAIFA supports the SEC's efforts to eliminate conflicts of interest to the extent they are present in the mutual fund industry. At the same time, we strongly support retention of

Rule 12b-1, which is critical to enable registered representatives to continue to receive fair compensation for the ongoing services they provide mutual fund investors. In order to ensure that mutual fund investors fully understand the amount and purpose of fund fees and expenses, we support improved disclosure aimed at the average investor.

Thank you for your consideration of our views. Please contact the undersigned if you have any questions regarding our comments.

Yours Truly,

/s/ Gary A. Sanders

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