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Proposed Changes to the Regulatory Framework for Mutual Fund Distribution Fees

By Jack W. Murphy and Megan C. Johnson

On July 21, 2010, the Securities and Exchange Commission (SEC) voted unanimously to propose a new rule and rule amendments (the Proposed Rules) that would replace Rule 12b-1 under the Investment Company Act of 1940 (the 1940 Act), changing the framework through which funds may use fund assets to pay for the costs of distribution.[1] The Proposed Rules would also provide relief from Section 22(d) of the 1940 Act, the retail price maintenance provision of the statute, which could have far-reaching consequences for mutual funds and investors. In the release proposing the Proposed Rules, the SEC stated that the proposals are designed to "protect individual investors from paying disproportionate amounts of sales charges in certain share classes, to promote investor understanding of fees, eliminate outdated requirements, provide a more appropriate role for fund directors, and allow greater competition among funds

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and intermediaries in setting sales loads and distribution fees generally."

During the public comment period, which ended on November 5, 2010, many industry participants submitted comments that, while generally supportive of the SEC's stated goals, raised a number of questions and concerns about various aspects of the Proposed Rules.[2] In particular, a number of commenters questioned the timing of the Proposed Rules, suggesting that the SEC should delay Rule 12b-1 reform until it has adopted certain other changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, including the harmonization of the standards of care for investment advisers and broker-dealers and point of sale disclosures.[3] This article summarizes key aspects of the Proposed Rules and identifies certain concerns that industry participants raised during the comment process. These concerns will require further consideration by the SEC as it decides on the next steps to be taken with respect to the Proposed Rules.

Rescission of Rule 12b-1

The SEC proposed to rescind Rule 12b-1 in its entirety because it believes that many of the "assumptions underlying [the rule] appear to no longer reflect current marketplace realities."[4] As discussed below, the proposal would replace Rule 12b-1 with a new Rule 12b-2 and amended Rule 6c-10, imposing a new regime governing mutual fund distribution. The Proposing Release provided an extensive discussion of the administrative history of Rule 12b-1, reflecting the SEC's current perspective on the original purpose of Rule 12b-1.

The Proposing Release suggested that Rule 12b-1 was intended only to be a short-lived fix for specific distribution problems that existed at the time the rule was adopted.[5] In a 1986 memorandum to the Staff, then-SEC Chief Counsel Thomas Lemke referred to the struggling state of the fund industry in the late 1970s, when Rule 12b-1 was formulated.[6] The 1986 Staff Memorandum, however, made this observation while citing other arguments in support of Rule 12b-1 that had been presented during public hearings for proposed Rule 12b-1, including:

- More fund sales would increase fund assets, thereby benefitting shareholders through economies of scale, providing opportunities for funds to employ a greater variety of management techniques, and facilitating the ability of funds to maintain a significant degree of portfolio diversification;

- Greater fund assets would permit funds to obtain better, lower cost portfolio execution services and attract useful research reports from Wall Street analysts;

- If funds eschewed a front-end sales load, a greater proportion of investors' money could be invested immediately; and

- Precluding the use of a variety of distribution channels with different fee structures made mutual funds less competitive when compared with other investment products.[7]

It also has been suggested that the SEC did not intend Rule 12b-1 to operate as a substitute for front-end sales loads.[8] However, Rule 12b-1 itself anticipates the use of 12b-1 fees to make payments to persons who sell fund shares[9] and, once the rule was adopted in 1980, 12b-1 fees rapidly became one of a range of options available to pay for the costs of distributing fund shares and provide for shareholder servicing. In fact, the adoption of Rule 12b-1 was the first in a series of innovations in mutual fund share distribution that revolutionized the manner by which fund shares are sold and helped usher in a period of unprecedented growth in the mutual fund industry. As early as 1982, the SEC granted exemptive relief permitting a mutual fund to pay for the distribution of shares through a combination of a contingent deferred sales load (CDSL) and a 12b-1 fee.[10] A few years later, the SEC began to issue exempting orders allowing funds to offer multiple share classes, ultimately adopting Rule 18f-3 in 1995.[11] In the Multiple Class Adopting Release, the SEC characterized multiple class funds as benefiting shareholders and fund sponsors: "These structures may increase investor choice, result in efficiencies in the distribution of fund shares, and allow fund sponsors to tailor products more closely to different investor markets." The Multiple Class Proposing Release highlighted that some funds "use different classes to offer investors a choice of methods for paying for the costs of selling fund shares."[12]

The practice of using 12b-1 fees as an alternative to the imposition of front-end loads also was acknowledged in a 1986 letter from then-Director of the Division of Investment Management, Kathryn McGrath, to Rep. John Dingell. That letter stated that, "[f]or many funds, Rule 12b-1 provides a means to finance the distribution of fund shares without imposing a front-end sales load on investors. Other funds use 12b-1 plans to supplement front-end loads."[13] The same view was expressed in the 1988 release proposing amendments to Rule 12b-1, which stated that, "[m]any of the distribution financing techniques that have been developed under Rule 12b1, including reimbursement plans, have been developed in an attempt by the mutual fund industry to offer investors a product that charges distribution costs over a period of several years instead of imposing a front-end sales load."[14]

Against this backdrop of innovation and regulatory authorizations, it is clear that the SEC and its Staff have been willing to allow Rule 12b-1 to be used to provide funds with the ability of finance distribution-related expenses in a creative manner that benefits investors. Rather than simply serving as a substitute for front-end loads, the industry's use of 12b-1 fees has allowed funds to offer investors a variety of ways of paying for distribution and other services.

This remains true today. Commenters supported the rescission of Rule 12b-1 because it would eliminate the need for funds to adopt and annually approve formal written plans in connection with asset-based distribution fees and would also eliminate certain board reporting requirements.[15] A number of commenters, however, questioned whether the replacement of Rule 12b-1 with the Proposed Rules would adversely affect the share class options currently available to investors.[16]

Placing Limits on Asset-Based Distribution Fees

Proposed Rule 12b-2: Marketing and Service Fees

Proposed Rule 12b-2 would permit funds to deduct a limited amount from fund assets to pay for distribution or other activities (the marketing and service fee). A fund would be allowed to impose a marketing and service fee in an amount up to the Financial Industry Regulatory Authority (FINRA)[17] limit on "service fees," which is currently 0.25 percent of net assets annually.[18] However, Proposed Rule 12b-2 would not confine the use of marketing and service fees to the types of services described in Rule 2830. Rather, funds would be able to use these fees to pay for any "distribution activity," which Proposed Rule 12b-2 defines to mean any activity that 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.[19]

Commenters on the Proposed Rules noted the discrepancy between the activities that must be paid for by the marketing and service fee, which is focused on promotional-type activities such as advertising and printing of sales literature, and the definition of "service fee" under Rule 2830, which focuses on personal services and account maintenance services.[20] Rule 2830 very clearly includes expenses of the kind contemplated by Proposed Rule 12b-2 within the definition of sales charges.[21] This discrepancy has the potential to confuse both directors when they consider the adoption of marketing and service fees, as well as the financial intermediaries who receive such payments.

Some commenters suggested that the SEC provide additional guidance about what activities would be considered distribution activities, in order to avoid the uncertainty that currently exists with respect to classifying which activities are "distribution" and which are not.[22] Others requested that the SEC provide more explicit guidance that administrative service fees, non-distribution service fees and/or other non-distribution payments to retirement plan recordkeepers and similar intermediaries would not fall within the scope of the marketing and service fee and that funds may continue to rely on FINRA guidance regarding administrative services.[23]

Ongoing Sales Charges

The Proposed Rules would also permit funds to deduct an asset-based fee for distribution in addition to the marketing and service fee. This fee would be labeled an "ongoing sales charge" and would be subject to certain restrictions.

Under the Proposed Rules, a fund would be able to deduct an ongoing sales charge from fund assets as long as the cumulative ongoing sales charges imposed on a purchase of fund shares would not exceed the maximum sales load that could be charged to the shareholder.[24] Proposed Rule 6c-10(b) would permit a fund to comply with this requirement by imposing an ongoing sales charge where the cumulative rate of the ongoing sales charge, when combined with the rate(s) of any front-end or deferred sales loads to be imposed on an investor's purchase of fund shares, would not exceed the rate of the highest front-end sales charge that the investor would have paid if investing in another class of shares of the same fund that does not have an ongoing sales charge (the reference load).[25] For example, if a fund offers Class A shares that have a 4.50 percent maximum front-end sales load, another class of shares that does not impose a front-end sales load could impose ongoing sales charges totaling as much as 4.50 percent (depending on whether a deferred sales load is also imposed on the investor).

The Proposed Rules provide for an automatic conversion mechanism to satisfy this requirement. Shares subject to an ongoing sales charge would be required to convert automatically to another class of shares that does not impose an ongoing sales charge, with the conversion taking place no later than the end of the month during which the rate of the cumulative ongoing sales charge paid by the investor exceeds the investor's maximum sales load rate.[26] Under the Proposed Rules, each purchase of fund shares would have a separate conversion period tied to the purchase date and applicable rates. Accordingly, the maximum length of the conversion period would be unaffected by increases or decreases in the value of the shares.

Commenters argued that the definition of ongoing sales charge is overly broad in that it assumes that any fee in excess of the marketing and service fee would be treated as the functional equivalent of a front-end sales load.[27] These commenters noted that certain classes or funds, such as those offered as investment options for retirement plans or money market funds that serve as brokerage "sweep" vehicles, currently charge a 12b-1 fee that is greater than 0.25 percent and that the excess fee is not the functional equivalent of a front-end sales load, but rather represents a fee for ongoing services provided to the retirement plan and its participants or to the shareholders of money market funds.[28]

Many commenters also challenged the assumptions made in the Proposing Release regarding the ability of funds to utilize existing conversion and share lot aging functionality to implement the automatic conversion features of the Proposed Rules.[29] Certain funds and financial intermediaries would face significant challenges in developing and implementing share lot aging and conversion functionality. For example, financial intermediaries that invest in funds on an omnibus basis where their positions are not fully networked may have to develop lot level accounting systems if any of those funds were to convert their 12b-1 fees to marketing and service fees and ongoing sales charges. Commenters raised similar concerns with respect to fund supermarkets, retirement plan recordkeepers and insurance company separate accounts.

Several commenters also suggested that the cost estimates for the implementation of conversion and share lot aging functionality in the Proposing Release significantly underestimate the potential economic burden on funds and intermediaries of implementing the Proposed Rules.[30] These commenters maintained that any benefits of converting current 12b-1 fees to ongoing sales charges would be limited and would be substantially outweighed by the attendant costs.

Reducing the Role of Fund Directors

The Proposed Rules would eliminate much of the current role of fund directors in the approval and monitoring of fund payments for distribution. The Proposed Rules would eliminate explicit responsibilities on boards of directors to approve (or approve the continuation of) asset-based sales charges, and would thereby lessen burdens on boards. The Proposing Release noted, however, that fund directors would continue to have fiduciary duties with respect to their oversight of the use of fund assets under both state law and Section 36(a) of the 1940 Act. The Proposing Release stated that the SEC "intends that the board (including the independent directors) would oversee the amount and use of these fees in the same manner that it oversees the use of fund assets to pay any other fund operating expenses…."[31] The SEC's proposed guidance provides that directors must decide, among other things, whether

> …the underwriter's compensation is fair and reasonable (considering the nature, scope and quality of the underwriting services rendered), and whether the sales loads (including the ongoing sales charge) are fair and reasonable in light of the usual and customary charges made by others for services of similar nature and quality.[32]

The proposed guidance indicated that in evaluating the "fairness and reasonableness" of the distribution 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."[33]

Many commenters acknowledged that the Proposed Rules would significantly reduce the burden on fund directors by eliminating written plans that require approval (and annual re-approval) by directors, and by eliminating quarterly board reporting currently required by Rule 12b-1, and supported those aspects of the Proposed Rules.[34] Many, however, questioned whether the SEC's proposed guidance would create a new standard under which directors would be required to evaluate both the underwriters' compensation and sales loads.[35]

One commenter suggested that the proposed guidance overstates the obligations of fund directors in making determinations with respect to the compensation of fund underwriters, including the amount of sales loads paid by investors.[36] Section 15 of the 1940 Act sets forth the standards for approving both investment advisory contracts and principal underwriting contracts—including the requirements with respect to board approval of these contracts. Section 15(c) requires the approval of only the terms of the contract and not the amounts that would be paid under the contract. In adopting Section 15(a), Congress specifically required that each investment advisory contract "precisely describe [] all compensation to be paid thereunder."[37] In contrast, Section 15(b) does *not* require that the compensation payable to an underwriter be described in the contract. Consequently, many principal underwriting agreements do not specify the amount of sales loads to be paid, anticipating that the load structure may be modified from time to time. Moreover, the standard suggested by the Proposing Release appears to be derived from the *Gartenberg* line of cases relating to board consideration of management compensation under Section 36(b) of the 1940 Act.[38] However, by its terms, Section 36(b) specifically does *not* apply to "sales loads for the acquisition of any security" issued by a fund, calling into question the applicability of this standard to underwriter compensation.[39]

The distinctions drawn in the 1940 Act between management compensation and underwriting compensation reflect an understanding that underwriter compensation (including sales loads) is essentially set by the distribution marketplace, subject to limitations imposed by other provisions of the 1940 Act and FINRA rules.[40] As amended in 1970, Section 22(b) of the 1940 Act authorized FINRA to place limitations on the compensation to be paid to member firms in connection with the primary offering of investment company securities, including limitations so that such compensation "shall not include an excessive sales load but shall allow for *reasonable compensation* for sales personnel, broker-dealers, and underwriters, and for *reasonable* sales loads to investors."[41] Consistent with this authority, sales charges (including asset-based sales charges, front-end sales loads and CDSLs) already are subject to limitations imposed by FINRA conduct rules that have been approved by the SEC, and presumably are "reasonable" as contemplated by Section 22(b) of the 1940 Act.[42]

As a number of commenters observed, the Proposing Release acknowledged that directors lack bargaining power to negotiate the level of fees paid to intermediaries pursuant to 12b-1 plans.[43] Yet by suggesting that boards are required to find sales loads and marketing and service fees to be fair and reasonable, the Proposing Release could be read as suggesting that boards should become involved in setting such amounts, which is inconsistent with market realities.

Finally, commenters pointed out that, in evaluating a fund's distribution arrangements, directors will continue to be bound by the fiduciary duties they owe to the fund under state law, making a separate "fair and reasonable" standard an unnecessary requirement that would provide little meaningful additional investor protection.[44]

Disclosure Changes: Registration Statements and Transaction Confirmations

Prospectuses and Statements of Additional Information

The SEC also proposed amendments to several disclosure requirements designed to improve investors' understanding of the distribution related charges they directly and indirectly incur from their fund investments.

Proposed amendments to the Form N-1A fee table requirements would remove references to "12b-1 fees" and would separate these fees into two components. The current heading "Distribution [and/or Service] (12b-1) Fees" would be replaced with the heading "Ongoing Sales Charge"[45] and a new subheading "Marketing and Service Fee" would be added under "Other Expenses." Form N-1A would also be revised to eliminate disclosure regarding 12b-1 plans and to add, among other things, disclosure with respect to the amount of marketing and service fees and ongoing sale charges and the purposes for which they are used, the nature and extent of the services provided in exchange for any asset-based distribution fee for services provided to fund investors, and the number of months (or years) until the shares would automatically convert to another class without the charge.

Most commenters supported changes to provide more transparency for investors regarding fees, although at least one noted that eliminating references to 12b-1 fees and plans may require significant changes to the internal reporting systems of financial intermediaries and to data feeds that are linked to fund and intermediary websites and other displays.[46] Several commenters pointed out that many agreements between funds and fund intermediaries include references to 12b-1 fees and plans and would need to be amended if the Proposed Rules are adopted and the fees are renamed.[47] Amending these agreements, which for some fund complexes number in the thousands, would require substantial contract administration and legal resources, and could take a significant amount of time.

Transaction Confirmations

The Proposed Rules would require broker-dealers to provide information about sales charges, including information about the amount of front-end sales charges, contingent deferred sales charges, ongoing sales charges and marketing and service fees, in confirmations for transactions in fund shares.[48] Under the proposals, confirmations would need to include, among other things, the aggregate amount of any ongoing sales charge that may be incurred over time, and the maximum number of months or years over which the investor will incur the ongoing sales charge.

Commenters raised concerns that confirmation disclosure would be duplicative of current prospectus disclosure and would offer little additional benefit to shareholders when weighed against the costs required to implement the proposed changes.[49] Many commenters suggested that investor-specific disclosure of this nature would be more useful for investors if provided at the point of sale, rather than in transaction confirmations. The ICI Letter suggested that requiring expanded transaction confirmation disclosure might have the unintended effect of incentivizing broker-dealers to sell non-fund products. Indeed, many commenters requested that the SEC consider postponing any changes to confirmation disclosure requirements until such time as the SEC considers point of sale disclosure requirements for all securities products so that any changes could be implemented simultaneously.[50]

Distribution Alternative: Account-Level Sales Charge

Section 22(d) of the 1940 Act prohibits a fund, its principal underwriter, and dealers from selling the fund's shares except at the current public offering price described in the fund's prospectus. Fund sales loads are part of the selling price of the shares,[51] with the result that all dealers must sell shares according to the sales charge structure disclosed in the prospectus. Thus, dealers are prohibited by Section 22(d) from establishing their own pricing schedules for mutual fund shares, as they can for transactions in exchange-traded funds[52] or other equity securities, largely precluding price competition among dealers with respect to sales load levels.[53]

In an attempt to introduce additional price competition into the mutual fund distribution marketplace, the Proposed Rules would exempt certain funds and dealers from the restrictions of Section 22(d), permitting funds to issue shares of a class at net asset value (NAV) and allowing dealers to set and collect their own sales charges to pay for distribution.[54] The amount of the sales charges imposed by dealers would not be governed by the 1940 Act, although those intermediaries registered with FINRA presumably would remain subject to existing limits on excessive compensation. In order to rely on the exemption from the restrictions of Section 22(d), a fund would not be permitted to impose an ongoing sales charge on that class (although it would be allowed to charge a marketing and service fee under Proposed Rule 12b-2). A fund would also be required to disclose in its Statement of Additional Information the intention to rely on the exemption.

Commenters questioned whether Proposed Rule 6c-10(c) would actually generate increased competition among broker-dealers.[55] Some commenters suggested that competition already exists in the marketplace, noting that funds offer a variety of classes with different fee structures that permit investors and/or their financial intermediaries to purchase the classes that best suit their financial circumstances. Moreover, many intermediaries have created wrap programs and similar products that offer load-waived share classes and institutional classes. Commenters also suggested that account level sales charge classes would also be likely to create operational challenges for funds, such as the possibility of so-called "orphan" accounts if a broker-dealer goes out of business or terminates its FINRA membership and the difficulty of disclosing a variety of fee schedules in confirmations.[56] The ICI Letter noted the wide range of views it has seen on this aspect of the Proposed Rules and requested that the SEC conduct further study of this area before proceeding with Proposed Rule 6c-10(c).

Compliance Date and Grandfathering Provisions

The Proposing Release stated that the date for complying with the Proposed Rules for new shares sold would be at least 18 months after the effective date of the final rule. Funds would be required to comply with the changes discussed above with respect to all shares issued after the compliance date. Commenters requested a longer compliance period in order to have sufficient time to address the operational and systems challenges likely to result from implementing the Proposing Rules.[57]

The SEC proposed that share classes issued prior to the compliance date that deduct fees pursuant to Rule 12b-1 would have a grandfathering period of five years, after which a fund would be required to convert or exchange the grandfathered shares into classes that do not deduct an ongoing sales charge. No new sales would be permitted in grandfathered share classes after the compliance date. Grandfathered shares could not be converted or exchanged into a class of shares with a marketing and service fee in excess of the annual rate of the 12b-1 fee paid in the last fiscal year prior to the conversion or exchange.

A fund's grandfathered classes could continue to charge 12b-1 fees at the same (or lower) rate as approved under the fund's 12b-1 plan. If the fund wanted to increase the rate of distribution fees, however, it would need to comply with the Proposed Rules. During the grandfathering period, fund and fund boards could eliminate the mandatory provisions of 12b-1 plans related to annual board approval, quarterly reports, and termination of the plans. Directors would continue to exercise responsibility over the fees charged to these classes in accordance with their general oversight responsibilities.

Commenters raised concerns about the inflexibility of the grandfathering provisions, especially in light of the variety of 12b-1 fees currently imposed by different share classes, including the appropriateness of a five year grandfathering period for classes or funds with low 12b-1 fees that, under the Proposed Rules, would be able to charge the asset-based distribution fees for significantly longer periods.[58]

Conclusion

If adopted, the Proposed Rules would require major changes to the manner in which mutual fund shares are sold. The comments from industry participants raise serious and wide-ranging concerns about various aspects of the Proposed Rules as well as the attendant costs and resources that would be necessary to implement the Proposed Rules. Regardless of whether Rule 12b-1 still serves its intended purposes, it has become tightly interwoven into the fabric of the mutual fund industry. It is essential that, before adopting the Proposed Rules, the SEC and its Staff carefully consider the concerns, questions and suggestions provided by the commenters in order to ensure that the final rules will achieve the goals of the SEC while minimizing the disruptions for mutual funds, their investors and financial intermediaries.

Notes

1. *Mutual Fund Distribution Fees; Confirmations*, Release No. IC-29367 (Jul. 21, 2010) (Proposing Release).

2. *See*, *e.g.*, letters to Elizabeth M. Murphy, Secretary, SEC, from Karrie McMillan, General Counsel, Investment Company Institute (Nov. 5, 2010) (ICI Letter); Carl B. Wilkerson, Vice President and Chief Counsel, Securities and Litigation, American Council of Life Insurers (Nov. 5, 2010) (ACLI Letter); Barbara Novick, Vice Chairman, BlackRock, Inc. (Nov. 5, 2010) (BlackRock Letter); Jonathan R. Baum, Chairman and CEO, The Dreyfus Corporation (Nov. 5, 2010) (Dreyfus Letter); John W. McGonigle, Executive Vice President and Chief Legal Officer, Federated Investors, Inc. (Nov. 5, 2010) (Federated Letter); Scott A. Goebel, Senior Vice President and General Counsel, FMR Co. (Nov. 5, 2010) (Fidelity Letter); Dorothy A. Berry, Chair, IDC Governing Council (Nov. 5, 2010) (IDC Letter); John M. Zerr, Managing Director and General Counsel, Invesco Distributors, Inc. (Nov. 5, 2010) (Invesco Letter); David B. Smith, Jr., Executive Vice President and General Counsel, Mutual Fund Directors Forum (Nov. 5, 2010) (MFDF Letter); Ari Gabinet, Executive Vice President and General Counsel—Asset Management, OppenheimerFunds, Inc. (Nov. 5, 2010) (OppenheimerFunds Letter); David J. Lekich, Vice President and Associate General Counsel, Charles Schwab & Co., Inc. (Nov. 5, 2010) (Schwab Letter); Kevin M. Carroll, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association (Nov. 5, 2010) (SIFMA Letter); Larry H. Goldbrum, General Counsel, The Spark Institute, Inc. (Nov. 2, 2010) (Spark Institute Letter); Dechert LLP (Nov. 5, 2010) (Dechert Letter). Comments received on the Proposed Rules are available at *http://www.sec.gov/comments/s7-15-10/s71510.shtml*.

3. *See*, *e.g.*, ICI Letter, ACLI Letter, Fidelity Letter, and OppenheimerFunds Letter.

4. Proposing Release, at text accompanying notes 147-148.

5. *See*, *e.g.*, Proposing Release, at notes 28-31 and accompanying text; and Christopher Cox, Chairman, SEC, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), available at *http://sec.gov/news/speech/2007/spch041207cc.htm* (Cox MFDF Address).

6. Memorandum for Staff Use in Responding to Public Inquiries Regarding Disclosure and Other Issues Raised by Certain Types of 12b-1 Plans, from Thomas Lemke, SEC Chief Counsel, to Mary Joan Hoene, SEC Associate Director (May 21, 1986) (pub. avail. Jun. 1986) (1986 Staff Memorandum).

7. *Id.* at 4. *See also* SEC Division of Investment Management, "Protecting Investors: A Half-Century of Investment Company Act Regulation" (May 1992) (Protecting Investors).

8. Cox MFDF Address.

9. Rule 12b-1(a)(2) includes "compensation to underwriters, dealers and sales personnel" as activities that would be included in those for which a fund would be deemed to be acting as a distributor of its shares.

10. *E.F. Hutton Investment Series, Inc.*, Release Nos. IC-12079 (Dec. 4, 1981) (Notice of Application) and IC-12135 (Jan. 4, 1982) (Order). The Hutton order was the first of nearly 300 exemptive orders permitting mutual funds to adopt what came to be known as a "spread load," consisting of an asset-based fee, charged in accordance with Rule 12b-1, in combination with a CDSL. The advent of spread load arrangements allowed mutual fund investors who rely on the advice and assistance of third party intermediaries to avoid paying front-end sales loads, allowing them to choose to pay for the services of these intermediaries over time. *See* "Report of the Working Group on Rule 12b-1," Submitted to the Investment Company Institute Board of Governors (May 2007), at 3.

11. *See Merrill Lynch California Municipal Bond Trust, et al,* Release Nos. IC-16503 (Jul. 28, 1988) (Notice of Application) and IC-16535 (Aug. 23, 1988) (Order). *Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares,* Release No. IC-20915 (Feb. 23, 1995) (Multiple Class Adopting Release). The Multiple Class Adopting Release noted that, prior to adopting Rule 18f-3, the SEC had issued approximately 200 exemptive orders permitting funds to offer multiple classes of shares. *See also Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares,* Release No. IC-19955 (Dec. 15, 1993), (Multiple Class Proposing Release).

12. The Multiple Class Proposing Release describes various types of classes, such as a class with "a front-end sales load and a low distribution fee (or no such fee)," a class with "a higher distribution fee and a contingent deferred sales load" and a class with a "relatively high distribution fee but no front-end load or contingent deferred sales load."

13. Response to Letter from Chairman Dingell Concerning Rule 12b-1 Under the Investment Company Act of 1940 from Kathryn B. McGrath, Director, SEC Division of Investment Management to John Shad, Chairman, SEC (Sept. 12, 1986) (1986 SEC No-Act. LEXIS 2866), at *10.

14. *Payments of Asset Based Sales Loads by Registered Open-End Management Investment Companies,* Release No. IC-11431 (June 13, 1988) (1988 Proposing Release).

15. *See*, *e.g.*, ICI Letter and Schwab Letter.

16. *See*, *e.g.*, ICI Letter, Dreyfus Letter, Fidelity Letter, and SIFMA Letter. In fact, commenters also observed that even the Proposing Release acknowledged that the Proposing Rules would "likely make R shares a less attractive investment option for retirement plans to offer." Proposing Release, at notes 394-395 and accompanying text.

17. References to FINRA in this article include the National Association of Securities Dealers (NASD), as appropriate.

18. *See* FINRA Conduct Rule 2830 (Rule 2830).

19. This definition is substantively equivalent to the current standard applied under Rule 12b-1. The Proposing Release also provided a non-exhaustive list of other costs that funds may use the proceeds of the marketing and service fee to pay for, including: the ongoing cost of participation on a distribution platform such as a fund supermarket; paying trail commissions to broker-dealers in recognition of the ongoing services they provide to fund investors; paying retirement plan administrators for the services they provide participants (and which relieve the fund from providing such services); and shareholder call centers. The Proposing Release noted that Rule 12b-1 does not restrict the use of fees payable under that rule to "distribution" expenses, and that Proposed Rule 12b-2 would not preclude funds from using the marketing and service fee to pay for mixed expenses. *See* Proposing Release, at n.153 (citing the 1988 Proposing Release). The Proposing Release also noted, however, that "to the extent 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," paying them outside the limits of Rule 12b-2.

20. *See*, *e.g.*, ICI Letter and Schwab Letter.

21. Rule 2830(b)(8) defines "sales charges" as "all charges or fees paid to finance sales or promotion expenses, including front-end, deferred and asset-based sales charges."

22. *See*, *e.g.*, ICI Letter, ACLI Letter, OppenheimerFunds Letter, and Schwab Letter.

23. *See*, *e.g.*, ICI Letter, OppenheimerFunds Letter, and Schwab Letter.

24. Proposed Rule 6c-10(b)(1).

25. The reference load would be the maximum front-end sales charge on another class of the fund that does not charge an ongoing sales charge and for which the investor qualifies according to the fund's registration statement. For funds that do not offer a class with a front-end sales charge (or whose front-end sales charge class has asset-based distribution fees in excess of 0.25%), the reference load would be the maximum sales charge permitted under Rule 2830(d)(2) for funds with both an asset-based sales charge and a service fee, which is currently 6.25% of the amount invested. Many commenters recommended that, in order to reduce some of the operational complexity inherent in implementing ongoing sales charges, the SEC should establish an industry-wide standard reference load that applies to all funds, whether it is the FINRA maximum of 6.25% or some other standard rate. *See*, *e.g.*, ICI Letter, OppenheimerFunds Letter, and Schwab Letter.

26. For example, if a fund's maximum sales load rate is 4.50%, the fund could impose an ongoing sales charge of 0.50% for up to nine years, 0.75% for up to six years, or 1.50% for up to three years before automatic conversion of an investor's shares is required.

27. *See*, *e.g.*, ICI Letter, Fidelity Letter, Invesco Letter, Spark Institute Letter, and Dechert Letter.

28. *See*, *e.g.*, ICI Letter, Dreyfus Letter, Federated Letter, Fidelity Letter, and Dechert Letter.

29. *See*, *e.g.*, ICI Letter, Dreyfus Letter, Federated Letter, Fidelity Letter, Schwab Letter, and Spark Institute Letter.

30. *See*, *e.g.*, Fidelity Letter, Dreyfus Letter, Federated Letter, OppenheimerFunds Letter, Schwab Letter, SIFMA Letter, and Spark Institute Letter.

31. Proposing Release, at n.157 and accompanying text.

32. *Id.*, at notes 213-214 and accompanying text.

33. *Id.*

34. *See*, *e.g.*, ICI Letter, Fidelity Letter, IDC Letter, and Dechert Letter.

35. *See*, *e.g.*, ICI Letter, MFDF Letter and Dechert Letter.

36. *See* Dechert Letter.

37. 15 U.S.C. § 80a-15(a).

38. Jones v. Harris Associates L.P., No. 08-586, 2010 WL 1189560 (U.S. Mar. 30, 2010); Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982).

39. 15 U.S.C. § 80a-36(b)(4). The Proposing Release does not address whether ongoing sales charges, which the SEC characterizes as a substitute for front-end sales loads, would be considered "sales loads," as that term is defined in Section 2(a)(35) of the 1940 Act (although current Rule 6c-10 specifically provides an exemption from that definition).

40. Since 1975, when the SEC approved the FINRA sales charge limitations adopted under then-recently amended Section 22(b) of the 1940 Act, FINRA has been the principal regulatory body with respect to sales load maximums and the SEC has not taken any steps to reduce that oversight. Many of the SEC's concerns expressed in the 1988 Proposing Release, including the level of fees paid by funds, were subsequently addressed by subjecting 12b-1 plan payments to FINRA sales load limits when FINRA amended the predecessor of Rule 2830 in 1992. *See Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies*, Release No. 34-30897 (Jul. 7, 1992). In connection with the 1970 amendments to the 1940 Act, which added language to Section 22(b) allowing FINRA to adopt rules prohibiting excessive mutual fund sales charges, Congress stated that it had "decided to rely on the existing self-regulatory machinery of the securities industry in order to protect public investors against unreasonable sales charges subject to appropriate [SEC] oversight." S. Rep. No. 91-184, at 8 (1969). The approval of the 1992 amendments to Rule 2830 by the SEC, combined with the SEC's failure to pursue further its 1988 proposals, appears to indicate acceptance by the SEC of the Rule 2830 limitations as an appropriate response to its concerns stated in the 1988 Proposing Release. *See* 1988 Proposing Release, at text accompanying n.105-123 (discussing the SEC's concerns with the use of Rule 12b-1 to charge more than could be charged under the NASD Rules); Protecting Investors, at 327 (stating that the FINRA sales load proposal was a "step in the direction of limiting fee levels").

41. 15 U.S.C. § 80a-22(b)(1) (emphasis added).

42. *See* Rule 2830.

43. Proposing Release, at n.139 and accompanying text.

44. *See*, *e.g.*, ICI Letter, Fidelity Letter, and Dechert Letter.

45. This line item would remain in the lower portion of the fee table relating to expenses that are paid indirectly by shareholders as a result of holding an investment in the fund, rather than being moved to the portion of the fee table reflecting expenses paid directly from a shareholder's investment.

46. *See* OppenheimerFunds Letter.

47. *See*, *e.g.*, Invesco Letter and Schwab Letter.

48. Currently, transaction confirmations need not include this information under a long-standing SEC Staff position. *See* Investment Company Institute, SEC No-Action Letter (pub. avail. Apr. 18, 1979) (granting no-action relief for broker-dealers that do not provide transaction-specific disclosure about mutual fund loads and related charges, so long as the customer receives a prospectus that discloses sales load information that would allow a customer to calculate the precise amount of those fees). The Proposing Release states that this no-action letter would be withdrawn if the proposals are adopted. The Schwab Letter argued against the withdrawal of this letter, stating a concern that the withdrawal "would be interpreted more broadly than intended and will call into question aspects of the mutual fund disclosure regime that have proven relatively effective in delivering information to investors without being overly repetitive or redundant."

49. *See*, *e.g.*, ICI Letter, BlackRock Letter, Fidelity Letter, and OppenheimerFunds Letter.

50. *See*, *e.g.*, ICI Letter, ACLI Letter, OppenheimerFunds Letter, and SIFMA Letter. SEC Staff members, speaking at the open meeting at which the Proposed Rules were considered, suggested that Staff recommendations regarding point of sale disclosure would be considered by the SEC in the near future.

51. *See* Section 2(a)(35) of the 1940 Act, which defines "sales load" by reference to the public offering price.

52. Exchange traded funds, while open-end investment companies, routinely request and are granted exemptive relief from Section 22(d).

53. *See* 1988 Proposing Release, at n.108.

54. In 2007, the SEC held a roundtable with industry participants regarding Rule 12b-1, at which several participants raised concerns with the externalized sales charge concept, including increased transition costs, significant disruptions to current distribution

systems, higher distribution costs for small investors, and adverse tax consequences. *See* Transcript of Roundtable on Rule 12b-1 (June 17, 2007), available at *http://sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf*. The Proposing Release suggested that, due in part to these concerns, the SEC is not proposing to require funds to implement account-level sales charge arrangements.

55. *See*, *e.g.*, BlackRock Letter, Invesco Letter, and OppenheimerFunds Letter.

56. *See*, *e.g.*, ACLI Letter and OppenheimerFunds Letter.

57. *See*, *e.g.*, Fidelity Letter, Schwab Letter, SIFMA Letter, and Spark Institute Letter.

58. *See*, *e.g.*, ICI Letter, ACLI Letter, and Dechert Letter.