

# STROOCK

November 5, 2010

*Submitted electronically*

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

Re: Mutual Fund Distribution Fees; Confirmations – Rel. No. IC-29367 (July 21, 2010),  
File No. S7-15-10

Dear Ms. Murphy:

We respectfully submit this comment letter regarding the above-referenced release (the "Proposing Release") proposing a new rule and rule amendments that would replace Rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act").

Stroock & Stroock & Lavan LLP represents over 700 registered funds (or their independent board members), with more than \$1 trillion in assets under management (approximately 9% of U.S. investment company assets). This letter reflects only the views of our firm and does not necessarily reflect the views of any of our clients.

We are limiting our comments on the Proposing Release to concerns about the status of shareholder services plans, or similar arrangements, not established pursuant to Rule 12b-1 under the 1940 Act:<sup>1</sup>

- We believe clarification is needed that the views of the Securities and Exchange Commission (the "Commission") regarding what constitutes shareholder services and distribution services have not changed from those expressed in the Commission's release proposing Rule 18f-3 under the 1940 Act.<sup>2</sup>
- Alternatively, if the Commission's views have changed, we urge the Commission to explicitly allow funds with an existing Shareholder Services Plan to "convert" these plans or arrangements to a marketing and service fee under Rule 12b-2 without a shareholder vote.

## **History of Shareholder Services Plans**

**Exemptive Orders.** Before the adoption of Rule 18f-3 under the 1940 Act in 1995, the Commission issued approximately 200 exemptive orders ("Orders") generally permitting the subject funds to establish

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<sup>1</sup> Such plans or arrangements are referred to herein as "Shareholder Services Plans."

<sup>2</sup> Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds, Rel. No. IC-19955 (Dec. 15, 1993) (the "18f-3 Release"). Rule 18f-3 permits registered open-end management investment companies (referred to herein as "funds") to issue more than one class of voting stock.

a multiple class distribution system to issue and sell separate classes of shares representing interests in the same investment portfolio, which classes were to be identical except for limited features such as the allocation of certain expenses.<sup>3</sup> These arrangements, as described in the Notices of Application for Exemption under the Investment Company Act of 1940 relating to the Orders ("Notices"), generally consisted of a structure that could offer investors the option of purchasing shares offered in conjunction with a distribution plan adopted pursuant to Rule 12b-1 under the 1940 Act,<sup>4</sup> with a Shareholder Services Plan, with neither type of plan, or with combinations of these or similar arrangements. Consistent with descriptions in the various Notices, services provided under a Shareholder Services Plan were generally similar to those later described as "shareholder services" in the 18f-3 Release (discussed below). Conditions of the Orders, as stated in the Notices, typically provided that Shareholder Services Plans would be adopted and operated in accordance with the procedures set forth in Rule 12b-1-1(b) through (f) as if the payments made thereunder were subject to Rule 12b-1, except for the shareholder voting rights specified in Rule 12b-1.

Rule 18f-3. Consistent with the typical multiple class distribution system as described in the Notices, Rule 18f-3 provides, in relevant part, that each class of a fund that issues more than one class of stock "shall have a different arrangement for shareholder services or the distribution of securities or both."<sup>5</sup> The 18f-3 Release provided examples of "shareholder services" and "distribution services":

*Shareholder services* may include establishing and maintaining customer accounts and records, providing periodic account statements, arranging for bank wires, processing dividend payments, forwarding fund communications (such as proxies, shareholder reports and dividend, distribution, and tax notices), answering routine customer inquiries, and assisting with changes in dividend options. *Distribution services* may include advertising and marketing, sales support services, and preparing, printing, and mailing sales literature, prospectuses, and other reports to prospective investors.<sup>6</sup>

The 18f-3 Release clearly contemplates two distinct concepts of shareholder services and distribution services. In light of the history of the Notices and Orders, which Rule 18f-3 was adopted to replace, these concepts generally have been interpreted in practice as (1) shareholder services that may be paid for outside of a Rule 12b-1 Plan and (2) distribution services that, if paid by the fund, must be paid for pursuant to a Rule 12b-1 Plan. Otherwise, there would seemingly be no purpose to referring to shareholder services and distribution services as separate concepts and providing in the 18f-3 Release separate lists of examples of each.

We believe that references in the Proposing Release to the history of multiple class arrangements are not consistent with the 18f-3 Release and the actual language of Rule 18f-3. The Proposing Release states that "multiple class arrangements were designed to give investors a choice of ways to pay for sales

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<sup>3</sup> See, e.g., Franklin Gold Fund, et al., Rel. No. IC-20868 (Jan. 30, 1995 (notice)) and Rel. No. 20923 (Feb. 27, 1995 (order)); Nuveen Municipal Bond Fund, Inc., et al., Rel. No. IC-20439 (Aug. 3, 1994 (notice)) and Rel. No. 20504 (Aug. 30, 1994 (order)); John Hancock Asset Allocation Fund, et al., Rel. No. IC-19701 (Sept. 10, 1993 (notice)) and Rel. No. IC-19764 (Oct. 6, 1993 (order)); Financial Square Trust, et al., Rel. No. IC-18282 (Aug. 20, 1991 (notice)) and Rel. No. IC-18319 (Sept. 17, 1991 (order)); and CoreFunds, Inc., Rel. No. IC-18259 (Aug. 2, 1991 (notice)) and Rel. No. IC-18298 (Aug. 28, 1991 (order)).

<sup>4</sup> A plan adopted pursuant to Rule 12b-1 is referred to herein as a "Rule 12b-1 Plan."

<sup>5</sup> Rule 18f-3(a)(1)(i) (emphasis added).

<sup>6</sup> 18f-3 Release, at n.9 (emphasis added).

charges. 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."<sup>7</sup> However, discussion in the 18f-3 Release regarding class differences is broader than sales charge differences and includes references to multiple class funds that "target different investor markets, offering each a separate class with an arrangement for shareholder services or a distribution plan that is tailored to that market," noting that, for financial institutions that invest on behalf of their customers, "[m]ultiple classes allow funds to design classes with fees and services that complement those of the institutions."<sup>8</sup> In addition, the quoted statement from the Proposing Release refers to "distribution and shareholder services"<sup>9</sup> as a single concept, which also is a departure from discussion in the 18f-3 Release and the language in Rule 18f-3.

Funds' Adoption of Shareholder Services Plans. A number of funds have adopted Shareholder Services Plans, or otherwise bear payments for shareholder services, outside of a Rule 12b-1 Plan,<sup>10</sup> in reliance on the concepts in the Notices and Orders and/or Rule 18f-3. These plans or other arrangements provide for payments by the subject funds for services that generally consist of some or all of those listed as shareholder services in the 18f-3 Release.<sup>11</sup> Consistent with the concepts in the Notices and Orders, many Shareholder Services Plans contain operating provisions similar to those required to be included in a Rule 12b-1 Plan, except for the shareholder voting rights specified in Rule 12b-1. These Shareholder Services Plans or similar arrangements typically are described in funds' registration statements filed with the Commission.

### **Shareholder Services as Discussed in the Proposing Release**

While the definition of "distribution activity" in proposed Rule 12b-2 is the same as the description in Rule 12b-1 of activity required to be financed only pursuant to Rule 12b-1,<sup>12</sup> in light of the statements in the Proposing Release discussed below, we are concerned that the Proposing Release could be read as an expansion in the views of the Commission, as commonly understood and applied prior to issuance of the Proposing Release, of what should be considered "distribution" (and thus must be financed pursuant to proposed Rule 12b-2) and that this is broader than the understanding of distribution services or activities subjected to Rule 12b-1.

We are concerned that the Proposing Release seems to discuss payments for shareholder services in a manner that could be interpreted as different from how Shareholder Services Plans and similar arrangements currently operate. This creates confusion about whether and what type of shareholder services could be paid for by a fund outside of proposed Rule 12b-2. The Proposing Release seems to us to suggest in several places (discussed below) that shareholder services would be paid for primarily pursuant to Rule 12b-2 because they constitute a "distribution activity." Such a view would be contrary to the nearly 20 year history of Shareholder Services Plans, as discussed above.<sup>13</sup> While we recognize that,

<sup>7</sup> Proposing Release, at 23 (emphasis added).

<sup>8</sup> 18f-3 Release, at text accompanying n.9.

<sup>9</sup> *Id.*

<sup>10</sup> The 18f-3 Release refers to shareholder services "plans" that are not subject to Rule 12b-1 (18f-3 Release, at text accompany n. 41), even though Rule 18f-3 has no requirement for a written Shareholder Services Plan, which is a concept from the Notices and Orders.

<sup>11</sup> *Supra* note 6 and accompanying text.

<sup>12</sup> Rule 12b-1(a)(1).

<sup>13</sup> *Supra* p. 2.

as is currently the case for Rule 12b-1 Plans,<sup>14</sup> shareholder services may be paid for pursuant to Rule 12b-2,<sup>15</sup> we are concerned that language in the Proposing Release could be interpreted as stating that, other than the limited services discussed in the Proposing Release as permissible to be paid outside of Rule 12b-2, they must be paid pursuant to Rule 12b-2.

Below are examples of the types of statements in the Proposing Release that give rise to our request that the Commission clarify its position, following which is discussion related to the examples.

- (1) The approach taken in the Proposing Release is introduced by reference to Conduct Rule 2830 of the National Association of Securities Dealers, Inc. (the "NASD," now the Financial Industry Regulatory Authority ("FINRA")) as differentiating "between the two constituent parts of current 12b-1 fees (asset-based sales charges and service fees)."<sup>16</sup> The Proposing Release states that under proposed new Rule 12b-2 funds could continue to use a limited amount of fund assets to pay for distribution-related expenses and that the maximum amount of this "marketing and service fee" would be tied to the service fee limit imposed by Conduct Rule 2830 of the NASD.<sup>17</sup> The Proposing Release also requests comment on whether the Commission should "limit the marketing and service fee to expenses incurred for 'shareholder services' as defined in Conduct Rule 2830."<sup>18</sup>
- (2) The Proposing Release further states that "[t]he 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 [Conduct Rule 2830] service fee."<sup>19</sup>
- (3) The Proposing Release also states that funds may use the marketing and service fee to pay for "trail commissions to broker-dealers in recognition of the ongoing services they provide to fund investors."<sup>20</sup>

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<sup>14</sup> See Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Rel. No. IC-16431 (June 21, 1988) (the "1988 12b-1 Release"), n.126.

<sup>15</sup> Proposing Release, at 41.

<sup>16</sup> *Id.* at 38.

<sup>17</sup> *Id.* "Service fees" are defined in Conduct Rule 2830(b)(9) as "payments by an investment company for personal service and/or the maintenance of shareholder accounts." NASD Notice to Members No. 93-12 (Feb. 1993) ("NTM 93-12") states, in the answer to question 17, that service fees are "essentially intended to compensate [FINRA] members for shareholder liaison services they provide, such as, responding to customer inquiries and providing information on their investments." The Proposing Release states that personal service and/or the maintenance of shareholder accounts under Conduct Rule 2830 "could include responding to customer inquiries, providing information on investments, and reviewing customer holdings on a regular basis." (Proposing Release, at n.100).

<sup>18</sup> Proposing Release, at 44. We note, however, that the term "shareholder services" is not defined in Conduct Rule 2830. The Proposing Release also uses the term "shareholder service fees" interchangeably with "service fees" as defined in Conduct Rule 2830 in another section of the Proposing Release (see (5) below), which we do not believe is appropriate and causes additional confusion.

<sup>19</sup> Proposing Release, at 170-71.

<sup>20</sup> *Id.* at 43.

- (4) The Proposing Release does note that Conduct Rule 2830 does not address whether service fees are required to be included in plans pursuant to Rule 12b-1, but goes on to state that:

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.<sup>21</sup>

- (5) The Proposing Release states that:

[m]any funds use [fees paid pursuant to a Rule 12b-1 Plan] to compensate intermediaries for providing customers with follow-up information and account maintenance services pursuant to [Conduct Rule 2830]. In such cases, 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,<sup>22</sup>

noting that "[f]unds 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."<sup>23</sup>

- (6) Form N-1A, as proposed to be revised with the adoption of Rule 12b-2, includes as an example of marketing and service fees "shareholder servicing fees."<sup>24</sup>

We are concerned that the characterization of the service fee in Conduct Rule 2830 as a "constituent part[] of current 12b-1 fees"<sup>25</sup> (see (1) above) could imply that the Commission believes that service fees must be paid pursuant to a Rule 12b-1 Plan, which is not necessarily consistent with how service fees currently are applied by funds. We are not aware that the Commission or its staff previously has publicly stated a position that service fees are for "distribution related activity" or that such fees must be paid pursuant to a Rule 12b-1 Plan. In fact, the 18f-3 Release noted that the scope of shareholder services may differ from that of a service fee in Conduct Rule 2830,<sup>26</sup> which seemed to relate service fees in Conduct Rule 2830 more closely to shareholder services fees rather than making them part of distribution services fees.<sup>27</sup>

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<sup>21</sup> *Id.* at n.100.

<sup>22</sup> *Id.* at 45.

<sup>23</sup> *Id.*

<sup>24</sup> Item 19(g), as proposed to be amended.

<sup>25</sup> *Supra* note 16.

<sup>26</sup> 18f-3 Release, at n.9.

<sup>27</sup> *See also*, Registration Form Used by Open-End Management Investment Companies, Rel. No. IC-22528 (Feb. 27, 1997) ("When service fees [pursuant to Conduct Rule 2830] are paid outside of a rule 12b-1 plan, the fund would be required to disclose the amount and purpose of the fee ..." (text following n.202)); and Investment

The Proposing Release does provide a citation to a portion of the Commission's website that states:

Some 12b-1 plans also authorize and include "shareholder service fees," which are fees paid to persons to respond to investor inquiries and provide investors with information about their investments. A fund may pay shareholder service fees without adopting a 12b-1 plan. ... FINRA imposes an annual .25% cap on shareholder service fees (regardless of whether these fees are authorized as part of a 12b-1 plan).<sup>28</sup>

Not only does this statement clearly contemplate payment of shareholder services fees outside of a Rule 12b-1 Plan for services such as responding to investor inquiries and providing investors with information about their investments, but it *relates the service fee in Conduct Rule 2830 to shareholder services fees and indicates that such fees may be paid outside of a Rule 12b-1 Plan.*

The Proposing Release cites no authority or source for the stated understanding regarding inclusion of service fees within Rule 12b-1 Plans (see (4) and (5) above) and, in fact, this is not a universal practice among funds with Shareholder Services Plans. We are concerned that the Proposing Release appears to us to put forth a new theory that any payments to intermediaries whose clients purchase fund shares could be an inducement to sell fund shares and therefore are distribution related.<sup>29</sup> We also question the Proposing Release's use of the term "trail commissions" in the context of service fees (see (3) and (4) above). This terminology could imply that payments for legitimate, non-distribution services are instead distribution-related "commissions." The NASD clearly sought, in 1993, to discontinue use of this term in connection with service fees:

The term "service fees," intended to describe payments that compensate members for providing personal service and maintenance of shareholder accounts, is being substituted for the previously used term "trail commission." The NASD believes the term "service fees" more accurately describes the intent of the payments and *intends that the term "trail commission" not be used in the future to describe such payments.*<sup>30</sup>

The Proposing Release also asserts, without further explanation, that intermediaries would provide services for which service fees are paid in the ordinary course of business regardless of whether they receive compensation from funds (see (4) and (5) above). We are unclear as to the basis for the

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Company Institute (Aug. 22, 1994) (includes form of letter sent to certain funds discussing the NASD's limit on "[R]ule 12b-1 fees *or* service fees" exceeding the NASD's 0.25% limit on a "no-load" fund's Rule 12b-1 Plan fees or service fees—indicating two distinct concepts of Rule 12b-1 Plan fees and service fees as defined in Conduct Rule 2830).

<sup>28</sup> Mutual Fund Fees and Expenses (2007) (<http://www.sec.gov/answers/mffees.htm>).

<sup>29</sup> Cf. 1988 12b-1 Release, at n.126 ("to the extent a fund is paying for legitimate non-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") and Letter from Douglas Scheidt, Associate Director and Chief Counsel of the Division of Investment Management of the Commission, to the Investment Company Institute (Oct. 30, 1998) (discusses payment of fund "supermarket" fees pursuant to Rule 12b-1 Plans, for distribution services and separately out of fund assets for non-distribution services) (the "Supermarket Letter").

<sup>30</sup> NTM 93-12, at n.6 (emphasis added).

Commission's assertion. In the absence of agreements with funds or their agents to provide shareholder services, many intermediaries may not otherwise be obligated to provide such services.<sup>31</sup>

Types of Shareholder Services Discussed in the Proposing Release. While the Proposing Release does provide some examples of shareholder services that could be paid outside of Rule 12b-2, these examples are much more limited than the shareholder services discussed in the 18f-3 Release<sup>32</sup> and include only "administrative functions (e.g., producing account statements and recording transactions)"<sup>33</sup> and sub-transfer agency fees.<sup>34</sup> Conversely, the Proposing Release refers to payments for shareholder call centers as for "traditional distribution activities,"<sup>35</sup> whereas the 18f-3 Release included "responding to routine customer inquiries" in the list of shareholder services activities.<sup>36</sup> If a call center is for "shareholders" (meaning they already own shares), we do not understand how payments can be assumed to be only for distribution activities and therefor payable only pursuant to proposed Rule 12b-2. In our experience, funds may consider shareholder services to include expenses of call centers or other means to respond to shareholder inquiries so long as these interactions do not involve purchases of new shares, responding to requests for purchase applications or other activities that may be considered to relate primarily to the sale of fund shares.

We urge the Commission to clarify, in any release adopting rules or rule amendments similar to those proposed in the Proposing Release, that the Commission's views on what constitutes shareholder services and distribution services have not changed from those expressed in the Rule 18f-3 Release and that such shareholder services may be financed outside of proposed Rule 12b-2 (or any similar rule or rule amendment).

### **Alternative Treatment of Shareholder Services Plans**

Alternatively, if the Commission has adopted a more expansive view of the meaning of "distribution activity" than is currently understood as coming within Rule 12b-1, such that the Commission believes that many shareholder services activities may only be paid pursuant to Rule 12b-2 (or a similar rule or rule amendment), we urge the Commission to explicitly allow funds with an existing Shareholder Services Plan or similar arrangement to "convert" these plans or arrangements, in connection with the compliance date of such new rules or rule amendments, to a marketing and service fee under Rule 12b-2 without a shareholder vote. These funds may have operated such arrangements for many years, having instituted fees pursuant to Shareholder Services Plans or other arrangements in accordance with then-current Commission positions. Shareholders of these funds purchased fund shares with such fees already in place as of the compliance date—no new fee is being imposed without a shareholder vote. To require these funds and their shareholders to incur what could be substantial expenses to obtain shareholder

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<sup>31</sup> Although some intermediary clients may pay ongoing fees for services directly to the intermediary, this is not the case for many intermediary platforms.

<sup>32</sup> *Supra* note 6 and accompanying text.

<sup>33</sup> Proposing Release, at n.104. *Cf.* Supermarket Letter at n.3 (administrative services are stated to include sub-accounting; *shareholder account set up and maintenance*; *shareholder assistance*; transaction processing and settlement; preparation and distribution of account statements and transaction confirmations; payment of fund distributions; and distribution of prospectuses).

<sup>34</sup> *Id.* at n.153 and n.382 and accompanying text.

<sup>35</sup> *Id.* at 43.

<sup>36</sup> *Supra* note 6 and accompanying text.

approval for an existing fee merely because of changes in Commission rules and/or interpretations would not seem to us to be in the best interests of the funds or their shareholders.

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If you have any questions about our comments or would like any additional information, please contact any of the investment management partners at the respective phone number listed below.

Sincerely,

/s/ Stroock & Stroock & Lavan LLP  
Stroock & Stroock & Lavan LLP

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