

Fund Democracy
Consumer Federation of America

November 5, 2010

FILED ELECTRONICALLY

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

RE: File No. S7-15-10

Dear Ms. Murphy:

We are writing on behalf of Fund Democracy and the Consumer Federation of America to comment on the SEC's proposal regarding 12b-1 fees and issues related to the regulation of mutual fund distribution compensation. We enthusiastically support this proposal and applaud the Commission for its balanced, forward-thinking analysis. If adopted, the proposed rules will promote competition, enhance price transparency and reduce conflicts of interests in ways that will strengthen the regulatory structure in which mutual funds have flourished during the three decades since Rule 12b-1 was adopted.

In Part I of this comment letter, we discuss the SEC's proposal. We strongly support the repeal of Rule 12b-1 and agree that replacing it with a new rule that would limit account level, asset-based distribution fees is an appropriate accommodation to current business practices. We also support the ongoing sales load as a means of allowing investors to pay sales loads on an installment basis. The SEC's proposal to require disclosure of fund distribution compensation in the confirmation is a good first step toward increased price transparency, but it can be improved in significant ways, such as by requiring the dollar disclosure not just of front-end loads, but of other forms of sales compensation as well. The proposed Section 22(d) exemption sets the stage for increased competition, lower prices and reduced conflicts of interest.

In Part II, of this letter, we address other issues that need to be addressed in the context of the regulation of mutual fund distribution. The current proposals leave significant, related issues unaddressed. This is no reason to delay finalizing the proposals, but it is reason for the Commission to act promptly to rationalize the regulation of revenue sharing with the overall regulatory scheme for distribution compensation. The Commission should also consider whether, in light of the new Section 22(d) exemption, broker-dealers can, consistent with their legal obligations, continue to collect differential fees for the same level of services.

PART I: SEC PROPOSAL

A. Rule 12b-1 Repeal / Rule 12b-2 Proposal

We strongly support the repeal of Rule 12b-1 and its replacement with new Rule 12b-2. Fees charged under Rule 12b-1 are misleading to investors and inadequately disclosed, and in some cases are excessive. Although the smaller fee permitted under Rule 12b-2 would perpetuate these transparency problems, we believe that it currently is a reasonable accommodation of competing policy concerns.

The characterization of 12b-1 fees as distribution-related is inherently misleading to investors. Although labeled as “distribution fees,” 12b-1 fees can be used for wide variety of non-distribution purposes. These fees are also misleading to the extent that they *do* reflect distribution services, because a fund that does not charge a 12b-1 fee may be paying as much asset-based distribution compensation as a fund that does charge a 12b-1 fee. For example, a fund with no distribution expenses may be paying 0.25 percent in revenue sharing to broker-dealers while another fund may make the same payment through a prospectus-disclosed 0.25 percent 12b-1 fee. The fee table in the prospectus implies that the first fund pays no distribution fees, while in fact its distribution fees are just as high as those charged by the second fund.

Rule 12b-1 fees are also opaque. Although 12b-1 fees appear in the prospectus fee table, many investors use broker-dealers precisely in order to leave the evaluation of particular funds to a professional adviser. In this context, the prospectus is not an effective means of directing the investor’s attention to that information because the investor may be less inclined to review the prospectus. A 2006 CFA survey of mutual fund investors’ purchase practices found, for example, that well under half (44 percent) of those who had purchased most of their funds through an investment professional considered the fund prospectus as even somewhat influential in their purchase decision.¹ In addition, the 12b-1 fee shows only the amount that the fund deducts from the investor’s account. It bears no necessary relationship to the amount paid to the investor’s broker.

Additionally, 12b-1 fees can be collected in perpetuity, which means that they can result in investors’ paying much higher sales compensation than would have been permissible under other classes of shares.² In one example provided by the Commission, an investor would pay a \$500 front-end sales load as opposed to

¹ See Roper, Barbara and Brobeck, Stephen, *Mutual Fund Purchase Practices: An Analysis of Survey Results*, Consumer Federation of America (June 2006).

² See Proposing Release at 21.

\$2,292 under a comparable 12b-1 fee arrangement.³ The NASD limits on sales compensation were designed to limit the collection of 12b-1 fees on a fund-wide basis, not to ensure that individual investors' payments do not exceed a specified amount. An investor who would pay a 3.00 percent front-end load, for example, could pay substantially higher distribution compensation in a class of shares that imposes a 1.00 percent 12b-1 fee. While there may be circumstances that would warrant purchasing the 12b-1 fee shares, the reason for recommending them may reflect a broker-dealer's self-interest rather than the best interest of investors.

The complete repeal of Rule 12b-1 would resolve these problems. However, the SEC's proposal is, in effect, merely to reduce the amount of 12b-1 fees, rather than eliminate them. Proposed Rule 12b-2 would permit a fund to charge a 12b-1 fee of up to 0.25 percent. The permissible uses of that fee will leave the same degree of uncertainty that currently exists for 12b-1 fees. Rule 12b-2 fees would continue to be opaque and could therefore easily operate as an alternative for revenue sharing payments. And they could cause investors to pay higher distribution compensation than would be payable under other classes of shares.

Nonetheless, we agree that a 0.25 percent 12b-2 fee is a reasonable accommodation to current practices and procedures. Without some form of exemptive rule, Section 12(b) would prohibit funds from charging any fees for distribution, and the concept of "distribution" is often difficult to separate from administrative services and fund marketing.⁴ A small 12b-2 fee provides a reasonable safe harbor within which to permit fees that Section 12(b) was not intended to regulate while constraining fees that Section 12(b) was intended to prohibit. As discussed further below, however, we believe that the Commission should continue to monitor the way in which fund services are structured in order to determine the point at which all distribution compensation may be separately identified as such.

It is not clear to us why the specific limit on 12b-2 fees should be linked to the applicable limit under the NASD Rule 2830. As the Commission has noted, 12b-1 fees are (and ultimately 12b-2 fees will be) used for a variety of expenses other than compensation that is subject to Section 12 or to FINRA's regulatory authority under Section 22(b). Tying the 12b-2 fee limit to FINRA rulemaking under Section 22(b)

³ See *Mutual Fund Distribution Fees; Confirmations*, Investment Company Act Rel. No. 29367, at 50 – 51 (July 21, 2010) ("Proposing Release"). This is the result not only of the fee being collected for an extended period, but also of the fee being collected on what is likely to be a rising baseline. It appears that the Commission incorporated the time-value discount on the amount paid in 12b-1 fees into the fund's assumed five percent annual return. The Commission should clarify its assumptions regarding the relative time value of each payment.

⁴ See Proposing Release at 46 ("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.")

might work under current NASD Rule 2830, but it is not clear that this would always be the case. It is likely, for example, that FINRA will re-evaluate its sales load limits in light of this rulemaking. In doing so, it should not be constrained to formulations that fit the independent purpose served by Rule 12b-2's 0.25 percent limit.

We take a different view of the SEC's delegating regulatory authority to FINRA as to the use of the term "no-load." This issue is closely analogous to the issue of fund names, which falls squarely within the SEC's jurisdiction. We raise this issue because we disagree with the view that the term "no-load" should be used to describe funds that charge up to a 0.25 percent fee to cover distribution expenses in addition to an undetermined amount through revenue sharing payments. These funds are charging the functional equivalent of a load; they are not "no-load" funds. The SEC's argument that small 12b-1 fees are used to "finance advertising and other sales promotion activities," in contrast with the uses of large 12b-1 fees, FESL and CDSLs, is inaccurate.⁵ Under this proposal, the entirety of a 0.25 percent 12b-1 fee can be used to compensate a broker, and this can be supplemented by substantial revenue sharing payments. As a result, a "no-load" fund could actually spend far more in broker-dealer compensation than a "load" fund with a 0.30 percent 12b-1 fee. In such cases, the "no-load" moniker is inherently misleading.

B. The Ongoing Sales Charge

We support the substitution of an ongoing, installment load for a substantial part of existing 12b-1 fees. The Commission has proposed to permit funds to impose a fund-level sales charge that does not exceed the maximum sales load set by the fund. The fund industry has long argued that 12b-1 fees should be viewed not as a temporary means of maintaining a fund's asset level, as their purpose was originally conceived, but primarily as a substitute or complement for front-end and back-end sales loads. Both front-end and back-end sales loads are fixed amounts, however, whereas 12b-1 fees can be collected in perpetuity. An investor can pay more in 12b-1 fees than the highest sales load that could have been paid in another share class.⁶ To the extent that 12b-1 fees are intended to permit the collection of a load on an installment basis, then it is self-evident that they should not be collected after the point at which the maximum front-end and back-end sales loads would have been fully paid (or upon reaching a separate limit for ongoing sales loads, if established by FINRA). To the extent that 12b-1 fees are not substitutes for loads, the perpetual, 0.25 percent fee under new rule 12b-2 will provide a continuing incoming stream.

Some may argue that 12b-1 fees actually provide a substitute for externalized fees paid under an advisory program. For example, Class C shares with a 1.00 percent 12b-1 fee could be viewed as a substitute for a mutual fund wrap fee

⁵ See *id.* at n.160.

⁶ See *id.* at 50.

program that imposed a 1.00 percent advisory fee. In theory, this alternative would no longer be available to shareholders that held fund shares for longer than the six-year period that a 1.00 percent ongoing sales charge could be imposed consistent with the current 6.25 percent FINRA limit. We are not aware, however, of any evidence that a material number of shareholders hold Class C shares for a longer period than six years. The potential problem probably is not a material one. In 2006, only approximately 350 out of 6,835 long-term funds offered Class C shares.⁷

Even assuming that some Class C shares may be held for more than six years, there is no reason why asset-based fees for subsequent years cannot be collected on an externalized basis. Many financial services professionals, including those employed by firms that sell Class C shares, charge externalized advisory fees. The purportedly “costly systems changes” that externalized fees require are already in place for such professionals and readily available for others. They presumably have determined that this fee arrangement is appropriate for their customers, does not result in onerous tax effects, and is consistent with their legal duties.

In any case, the adverse tax consequences that the industry claim would result from externalizing fees assume that the fees would be paid through the redemption of fund shares. This assumption defies reason, as competent financial planners that charge external fees typically manage their clients’ assets to avoid such adverse tax consequences. For example, many manage clients’ cash assets to provide a sufficient source for quarterly fee payments. While there may be additional costs associated with externalized fees, again assuming that a material amount of Class C assets would need to convert to an externalized format, the industry’s analysis does not begin to provide the information necessary to evaluate this issue.

Finally, it is not clear why the industry views this issue as arising from the structure of an ongoing sales charge. The proposed ongoing sales charge does not establish a maximum sales load; NASD Rule 2830 is the source of that restriction. FINRA undoubtedly will reconsider the sales load limits in connection with the new rules. It appears to us that FINRA could establish a higher maximum sales load that was designed to accommodate bona fide, long-term advisory relationships if, in fact, there is a material number of such relationships would run up against the current 6.25 percent limit.

For example, a new rule could be based on the difference between investors who do not receive the ongoing advisory services that would justify a perpetual 1.00

⁷ See Letter from ICI to SEC at Appendix I (July 19, 2007) at <http://www.ici.org/pdf/21378.pdf>. According to the ICI, this is the number of funds that satisfy the following criteria: “Front load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fees > 0.25 percent. Primarily includes Class C shares; excludes institutional share classes.” Virtually all of these shares carried a 1.00 percent 12b-1 fee.

percent sales charge and investors who do.⁸ We would likely have no objection to higher a perpetual sales charge that was contingent on the existence of a *fiduciary* advisory relationship with the investor. The problem with the current structure is that, in order to accommodate such advisory relationships, it permits excessive sales loads to be collected from non-advisory customers that can substantially exceed purported sales load “limits” under NASD Rule 2830. Broker-dealers would continue to have an incentive to sell Class C shares because they offer greater long-term compensation, an incentive that may have increased with the general abandonment of similarly conflict-creating Class B shares. If the industry is to argue that Class C shares are a substitute for a wrap fee arrangement, then it should be willing to have Class C share relationships subject to the same fiduciary limits that apply to wrap fees.

C. Confirmation Disclosure of Distribution Compensation

The Commission has proposed to require that the Rule 10b-10 transaction confirmation generally include the amount of any front-end and back-end sales load, ongoing sales load and 12b-2 fees. We agree with the proposition that the confirmation should do what it has always claimed to do: disclose all “remuneration received or to be received by the broker from [the] customer in connection with the transaction.” Currently, it does not come close. It does not show front-end or back-end loads or 12b-1 fees. It does not show revenue sharing payments, which are not even disclosed in the prospectus. As such, it promotes a profoundly misleading impression of the structure and amount of mutual fund distribution compensation.

The nondisclosure of this information is based on the SEC’s longstanding view that it is provided in the prospectus. As the Commission now recognizes, this position reflects a misguided faith in the power of prospectus disclosure to inform investors about the fees that they pay and the conflicts of interest that may affect their brokers’ recommendations. Investors use intermediaries to help them make investment decisions, including providing and analyzing the kind of information that appears in the fund prospectus. While it is always advisable for investors to review a fund’s prospectus before investing, it makes no sense to expect all investors to do so, especially when they may view information provided by their broker as a substitute for prospectus disclosure.⁹ Investors may be inclined not to review a prospectus precisely because they have retained a broker to evaluate the

⁸ This statement should not be taken as a blanket endorsement of such a move, which we would have to consider on its merits were it to be proposed, but as an illustration that alternatives exist for dealing with the issue should that be deemed necessary.

⁹ The CFA mutual fund survey found, for example, that nearly three in ten (28 percent) of investors who purchased their funds through an investment professional relied totally on that professional’s recommendations without doing any additional research. Another 36 percent said they relied heavily on that recommendation but reviewed some additional written materials.

prospectus for them. In this case, reliance on prospectus disclosure fundamentally misunderstands the nature of the brokerage relationship.

The prospectus is also inadequate because it is not well designed to inform investors about the compensation that their brokers actually receive. The 12b-1 fee exemplifies this problem. As the Commission notes, 12b-1 fees may substantially comprise fees for non-distribution services (*e.g.*, transfer agency). The amount of the 12b-1 fee that appears in the fund prospectus therefore does not provide meaningful information about actual distribution expenses, much less about the amount of distribution expenses that end up in the broker-dealer's pocket. Although the proposed 12b-2 fee does not entirely solve this problem, we agree, as discussed *supra*, that it is, at this point in the evolution of compensation regulation, a reasonable accommodation to the array of conflicting public policy objectives that fee disclosure must navigate.

We appreciate the SEC's acknowledgment that the confirmation is inherently deficient as a means of informing investors about their brokers' conflicts of interest. The confirmation is delivered after the investment decision is made, which may occur long after the investor has decided to enter into a relationship with the broker. Investors should be apprised of the cost of brokers' services before they enter into that relationship, not after the broker has executed the first transaction on a customer's behalf. While this larger issue is addressed, which we strongly encourage, there is no reason to delay reforms that will make the confirmation a more useful document and distribution compensation more transparent to investors. Improved pre-engagement, pre-sale and post-sale disclosures are complementary, not conflicting goals that need not be pursued in lock-step.

Dollar Disclosure. The Commission has proposed to require that the confirmation include the: (1) amount of any front-end sales load paid as a percentage *and as a dollar amount*, and (2) the amount of any back-end sales load, ongoing sales load or 12b-2 fee *only as a percentage*. We agree with the Commission that disclosure of fees as a dollar amount is an effective way to fully apprise investors of the costs of their brokers' services. We disagree, however, that dollar disclosure should be limited to front-end sales loads.

The disclosure of back-end sales loads, ongoing sales loads and 12b-2 fees only as a percentage will provide inadequate information and be potentially misleading to investors. There is no structural difference between a front-end load on the one hand and a back-end or ongoing sales load on the other hand that would warrant inconsistent disclosure of the amount to be paid. With respect to a front-end sales load and an ongoing sales load, the precise dollar amount of the total load that will be paid is known at the time of the purchase. With respect to a back-end sales load that is based on the purchase price, the precise dollar amount of the maximum load that will be paid is known at the time of the purchase (in our view, the contingent nature of the back-end load does not affect this analysis). Disclosing one in dollars and the others only as a percentage will confuse investors, with the

predictable outcome that investors will discount the amounts shown as a percentage relative to the front-end sales load. As behavioral finance research has shown, investors tend to discount the true cost of future payments. The variability of back-end loads that are based on the redemption amount, rather than purchase amount, and 12b-2 fees is not so great as to negate the substantial benefit of disclosure of the dollar amount. In both cases, the dollar amount could be based on an assumed investment return.

Disclosure of Future Payments. The disclosure of the amount of only one year's installment of an ongoing sales load will also mislead investors. For example, consider an investor purchasing \$10,000 in fund shares who has the option of choosing between a \$400 4.00 percent front-end sales load and a \$100 1.00 percent ongoing sales load paid each year for four years. If the former is presented as a percentage (4.00 percent) and a dollar amount (\$400), and the latter only as percentage (1.00 percent), or as a percentage (1.00 percent) and smaller dollar amount (\$100), the confirmation will give the misleading impression that the ongoing sales load is smaller than the front-end load. In order to minimize this potential for confusion, the total amount of the ongoing sales load should be disclosed on the confirmation.

Regarding 12b-2 fees, which can be charged in perpetuity, the amount disclosed on the confirmation could be based on an assumed holding period, for example, of five years. This kind of disclosure is already provided in the fund prospectus in the fee example, which is based on a five percent return and holding periods of one, three, five and ten years.

Comparative Disclosure. The disclosure of only the sales load actually paid by the investor fails to inform the investor of the relative cost of alternative compensation arrangements that the investor could have chosen. One of the persistent problems in the sale of multiclass shares has been the favoring of the class of shares that pays the highest compensation to the broker-dealer rather than the class that is best for the investor. This problem has been partly responsible for the virtual disappearance, under regulatory and market pressures, of Class B shares. The disclosure of fund sales compensation in the confirmation should seek to mitigate this problem by showing investors alternative compensation structures. While this disclosure may not be necessary once a more effective, pre-transaction disclosure approach has been implemented, it is necessary in the current environment in which no meaningful comparative disclosure is provided.

Other Fee Disclosure. The proposal would require that the following disclosure appear on the confirmation:

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.

We believe that this disclosure is inherently misleading because it implies that the other “fees paid . . . paid from the assets” of the fund are not distribution fees received by the broker-dealer. The appearance of this statement in the context of the disclosure of loads and service fees, coupled with the descriptor “other” to modify the “fees paid . . . paid from the assets,” strongly implies that the disclosed loads include all of the compensation received by broker-dealer and that the “other” fees include no such compensation. In fact, these “other” fees routinely include broker-dealer compensation in the form of revenue sharing payments.

While we agree that the current proposal should move forward independent of resolution of issues relating to revenue sharing payments, we cannot agree that disclosure that affirmatively conceals the existence of revenue sharing payments should be allowed, much less required. At a minimum, the required disclosure should expressly state that, if applicable, the broker receives other fees in addition to those that appear on the confirmation. Ideally, the disclosure would include the amount of such fees, but we agree that it is in the best interest of investors not to delay the proposed improved disclosure simply because it does not *fully* address revenue sharing payments.¹⁰

Breakpoints. The proposal would require the disclosure of “the amount of any applicable breakpoint or similar threshold used to calculate the sales charge.” Under this standard, it appears that the confirmation could show only the threshold at which the applied discount was triggered. For example, a 3.00 percent load charged on a gross investment of \$26,000 would require the disclosure of the \$25,000 breakpoint at which the load declined from 4.00 to 3.00 percent, but not the \$100,000 breakpoint at which the load would decline from 3.00 to 2.00 percent. In light of the extraordinary level of fraud that regulators have found in connection with broker-dealers’ application of breakpoints, in addition to a history of broker-dealers’ splitting purchases at amounts just below breakpoints, we believe that the confirmation should include the gross purchase amount at which the next load reduction would occur. Toward this end, the rule could require disclosure of the next available breakpoint or the entire breakpoint schedule as it appears in the fund’s prospectus.

We recognize that some of the issues that we have raised regarding the confirmation will assume a different posture depending on further rulemaking by the Commission. Reforms to the disclosure of revenue sharing and pre-transaction

¹⁰ We note that such disclosure may currently be required under general antifraud principles and other sources of law.

disclosure made in connection with the establishing of the brokerage relationship may substantially alter the foregoing analysis. Nonetheless, we believe that, until further reform materializes, the confirmation should provide investors with the minimum information they need to make an informed judgment about their brokers' compensation and conflicts of interest.

D. Section 22(d) Relief

We strongly support the SEC's proposed exemption from Section 22(d) of the Investment Company Act. Section 22(d) effectively permits mutual funds to fix the amount that broker-dealers charge to investors for their services. A broker-dealer must sell fund shares at the price set forth in the prospectus, and this price includes the broker-dealer's selling compensation. Discounts to sales charges based on purchase size also are dictated by the fund, rather than the broker-dealer. This creates two significant distortions in the markets for mutual funds and for brokerage and advisory services. Section 22(d) ensures that a broker-dealer that provides one level of services when it sells mutual funds will receive different levels of compensation depending on the particular fund that it sells. Section 22(d) also prevents broker-dealers from competing with one another regarding the services they provide with respect to a particular fund. Each must charge the price set by the fund.

As we have stated previously, Section 22(d) is harmful to investors in a number of respects. Section 22(d) suppresses pro-investor price competition among broker-dealers. In contrast, the competition among broker-dealers that trade shares of operating companies is intense. Since brokerage commissions were unfixed in 1975, they have steadily declined to a small fraction of earlier levels. This competition has played an important role in establishing America's financial markets as the deepest, most liquid markets in the world. Investors also have benefited through the lower costs of investing, which has allowed them to keep a larger percentage of their market returns.¹¹ Allowing broker-dealers greater freedom to compete on price will generate costs savings for investors.

Section 22(d) reinforces the conflict of interest that exists when a broker-dealer's compensation depends on which fund the broker-dealer recommends to the client. The broker-dealer's services may be identical, for example, when assisting a client in choosing between two funds, but its economic interest in recommending each fund often depends on the fund because some funds pay higher distribution compensation than others. A broker-dealer has an incentive to recommend the fund that pays the broker-dealer greater compensation, even if that selection is not the best option for the customer. Under the suitability standard that

¹¹ "[M]arket experience after the rule showed that commission rates fell into rational patterns that reflect the sales costs involved and the services provided." Proposing Release at 89 (footnote omitted).

currently applies to broker-dealers, a recommendation is defensible as long as the broker-dealer reasonably believes the higher-paying fund to be a suitable (although not necessarily the best) investment for the customer. We agree that investors should “be able to choose the level of dealer services they want and pay only for their chosen services,” Proposing Release at 92, but Section 22(d) requires an investor who wants to purchase a particular fund to pay what is effectively a fixed fee for the broker-dealer’s services, a fee moreover that is set by the fund and bears no necessary relationship to the level of personal services provided to the investor.

Section 22(d) serves no public policy interest. As noted in the SEC’s Proposing Release, the concerns that may have prompted the enactment of Section 22(d) are no longer applicable to the fund industry. Forward pricing of fund shares has removed the possibility of riskless trading of fund shares; funds have adequate, alternative means of ensuring an orderly market for fund shares; and the modernization of transaction compensation has eliminated price discrimination concerns.¹² The effect of Section 22(d) is to stifle competition and effectively to promote conflicts of interest in distribution compensation arrangements.

We applaud the Commission for taking the first step in bringing genuine competition to the distribution marketplace for load mutual funds. The Section 22(d) exemption will offer funds, broker-dealers and investors an alternative distribution compensation arrangement without limiting their existing options in any way. No party can be forced to adopt this arrangement, because the exemption would apply only where the relevant fund, broker-dealer and investor have chosen that structure. Provided that the Commission continues to seek to rationalize the regulation of distribution compensation, the Section 22(d) exemption promises to increase competition and further reduce the cost of investing.

E. “Radical” Reform and the Indeterminacy of Cost-Benefit Analyses

Some members of the financial services industry seem to oppose genuine 12b-1 reform simply because it stands for change. Just as broker-dealers oppose a fiduciary duty when providing personalized investment advice because it might upset established business practices, the fund industry defends the status quo simply because it is the status quo. This argument is no more reasonable that it was when used to excuse the mutual fund market timing, undisclosed revenue sharing, and illegally withheld commission breakpoints that have been the subject of numerous enforcement actions in the last decade. In each case, fraud had become common business practice among a large number of funds and broker-dealers. In its 2006 settlement with BISYS, the Commission found that a fund services provider had effectively bribed affiliates *27 fund complexes*.¹³ We reject the argument, which

¹² See *id.* at 88 – 89.

¹³ See *In the Matter of BISYS Fund Services, Inc.*, Inv. Co. Act Rel. No. 27500 (Sep. 26, 2006).

is often made in the context of the debate regarding the fiduciary duty, that a *common* business practice is necessarily an acceptable, much less *legal* business practice. It is not.

A related argument is that 12b-1 fee reform should be abandoned because of the disruptive effect on established practices. Yet the adoption of 12b-1 three decades ago was far more revolutionary, as was the SEC's legalization of deferred sales loads, multi-class funds and money market funds. The industry's success over the last three decades is directly attributable to the same regulatory creativity and initiative that some of its members now question because it is being exercised for the benefit of investors. If SEC rulemaking had always been held to the standard of epistemological infallibility that some would impose on 12b-1 fee reform, mutual funds would still be the same minor players on the financial services scene that they were in 1980.

As stated in the Tully Report, “[i]f the retail brokerage industry were being created today from the ground up, a majority of the Committee that developed this report would not design a compensation system based only on commissions paid for completed transactions.” Warren Buffett, a member of that Committee, was assuredly among that majority; he is an investor who appreciates the ineluctable effects of compensation structures on the incentives and actions of salespersons. He understood the inherent contradiction in the design of the commission-based compensation arrangements, as reflected in the Committee's finding that:

[t]he most important role of the registered representative is, after all, to provide investment counsel to individual clients, not to generate transaction revenues. The prevailing commission-based compensation system inevitably leads to conflicts of interest among the parties involved.

The Tully Committee concluded, however, that: “the current compensation system is too deeply rooted to accommodate radical alteration in the near-term.” It is ironic that Daniel Tully's own Merrill Lynch & Co.,¹⁴ only four years after releasing this Report, embarked on a “radical alteration” of its commission-based compensation system in announcing the roll-out of its fee-based Unlimited Advantage program. It is also ironic that Merrill Lynch did not object to the SEC's own “radical alteration” of the scope of the Investment Advisers Act in the form of the “Merrill Rule,” which initiated a decade of regulatory paralysis. Nor did the fund industry object to the “radical alteration” represented by Rule 12b-1 itself when it was adopted three decades ago.

¹⁴ It is noteworthy that Merrill Lynch was swallowed by a commercial bank as a result of the unresolved contradictions in other aspects of its business.

What was the “near-term” at the time that the Tully Report was issued has long since passed. Ten years of misguided policies, missed opportunities and regulation-by-enforcement (as often as not by non-SEC regulators) have demonstrated the folly of objections grounded primarily on the fact that reform means change. While the SEC’s policymaking has been inactive or, in the case of the Merrill Rule, regressive, business practices have continued to move forward, often in ways that benefit investors, but sometimes in ways that harm their interests. The truly harmful “radical alteration” that has occurred is the SEC’s practice of freezing regulatory policy in the face of changing business practices. Just as the creation of Rule 12b-1 represented the capacity of investment company regulation to keep pace with changes in the distribution of mutual funds, its repeal represents the essence of this adaptive model of financial services regulation.

Regulators cannot always impose systems as they would have created them “from the ground up,” but they must make incremental changes that move toward the systems that experience has demonstrated would be more efficient and more likely to engender the confidence in our markets that recent events have demonstrated is so crucial to America’s economic, social and political fabric. This kind of incremental progress inevitably causes the financial services industry to incur short-term costs, and the industry just as inevitably will argue that the short-term costs are excessive without giving any consideration to the potential long-term benefits. The regulatory debate is as dominated by destructive short-termism as Wall Street’s prevailing investing culture.

One advantage that has been exploited by the industry has been the fact that long-term benefits of regulatory reform are often more difficult to measure than the immediate administrative costs. The industry has successfully exploited this advantage in the U.S. Court of Appeals for the District of Columbia, which has recently applied an absurdly impractical cost-benefit standard in evaluating the legality of SEC rulemaking.¹⁵ It is telling that the Investment Company Institute’s 2007 comments on 12b-1 reform begin not with an evaluation of the pros and cons of the existing regulatory structure, but with a section entitled: “Importance of Economic Analysis in Rulemaking.” It is hard to know whether this introductory shot across the bow reflects a genuine concern that the Commission does not understand that its rulemaking should be based on a “thorough economic analysis,” or a veiled threat to undo the SEC’s work in the courts.

In response to this threat, the Commission should more directly address the cost of sales abuses that the existing compensation structure represents. The true cost of 12b-1 fees and Section 22(d) is more than the amount of the sales

¹⁵ See, e.g., *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. Apr. 7, 2006). While we agree that the SEC’s initial economic analysis of the costs and benefits of fund governance reform may have been inadequate, we also believe that the court’s standard of review in this respect casts doubt on the possibility of genuine regulatory reform.

compensation paid by investors. It is also the cost to investors of conflict-ridden investment recommendations. At a time in which skepticism of regulation outweighs reasoned analysis, the Commission must challenge prevailing, superficial cost-benefit constructs with specific evidence of the costs of conflicts. The adoption of Rule 12b-1 was premised on essentially unquantifiable economic benefits, and the ultimate use of 12b-1 fees was radically different from their anticipated use. If the cost-benefit standard that the industry and some courts would apply to today had been applied to Rule 12b-1, or to the rules that created multi-class shares, exchange-traded funds and money market funds, these innovations would never have occurred.

The SEC's cost-benefit analysis reads more as an *apologia* than a demonstration of the net positive benefit that 12b-1 reform will create for investors. The discussion references conflicts of interest as if they were bloodless concepts devoid of any practical effect, when in fact conflicts routinely harm investors, often in ways that are devastating to their financial security. The SEC's proposing release includes not one illustration of the fraud that conflicted selling compensation has inflicted on America's investors. Its 63-page "Cost-Benefit Analysis" includes not one specific example of the costs of sales abuses or the benefits that would have been realized by preventing them.

In short, the SEC's current analysis seems to accept the notion that is popular among academics that the value of a regulatory cost or benefit is a function of its susceptibility to easy quantification. If a problem has no data set, it is not a problem. This approach may be a well-dressed emperor among many law and economics theorists, but it has no clothes in the practical world in which Americans struggle to navigate an increasingly complex and conflict-ridden financial marketplace. We therefore urge the Commission to identify the personal and systemic destruction that abusive sales practices entail, and, in that connection, explicitly defy those who deny the existence of such benefits on the ground that they are not easily quantified.

PART II: NEXT STEPS

The SEC's proposal is as much about the overall direction of the regulation of mutual fund distribution compensation and broker-dealers' sales practices as it is about the specific reforms that are needed in connection with 12b-1 fees. As the Commission has noted, the current proposal does not address the regulation of revenue sharing payments. In fact, if the Commission does not move promptly address this issue, the proposal actually may have the effect of exacerbating problems related to revenue sharing payments. The current proposal also does not address the inadequacy of disclosure of broker-dealers' compensation and their conflicts of interest, partly because the confirmation is delivered not only after the investment decision has been made, but also after the decision to engage the broker-dealer has been made. As the Commission notes, Section 919 of the financial reform bill authorizes the Commission to "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.”¹⁶ We urge the Commission to act promptly on these issues, but not to delay action on its pending proposal out a concern for achieving, in one shot, perfect regulatory coherence.

The argument that 12b-1 fee reform should not proceed because it leaves related issues, such as revenue sharing payments, for example, unaddressed, reinforces the paralysis that has characterized much of retail securities regulation over the last few decades.¹⁷ It subscribes to a least-favored-nation theory of regulation, where every financial services provider is entitled to the least intrusive regulatory model applied to any competitor. It formalizes a race to the bottom as a regulatory guide, completely devoid of any overriding, coherent theory of the appropriate role of regulation in American life. It is not the SEC’s mission, however, to do unto investors as others do unto investors.

The pending proposal is about the very possibility of financial services reform. Can distribution compensation practices be regulated, or will the debate move from improved regulation to outright bans? This is where the debate regarding retail banking services is today, where decades of regulatory neglect have led to the creation of a new agency that, pointedly, in its earliest incarnation would have assumed control of much of the SEC’s own regulatory authority over, for example, investment advisory services. The regulation of mutual fund distribution practices has not reached this point, but it will be if moderately progressive measures are strangled in their infancy.

The Dodd-Frank Act has clearly indicated Congress’s recognition that outright bans on certain practices may be necessary. Section 913 of the Dodd-Frank Act, which authorizes the Commission to: (1) impose a fiduciary duty on broker-dealers with respect to personalized investment advice, and (2) “prohibit[] or restrict[] certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.” In particular, if adequate

¹⁶ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (July 21, 2010) (“Dodd-Frank Act”).

¹⁷ With respect to the regulation of retail investment advice, this regulatory paralysis has been partly due to the artificial and counterproductive division of responsibility for the regulation of retail investment services between separate SEC divisions. We strongly believe that this bifurcation of responsibility has been a material contributing factor to the SEC’s inability to develop effective policies with respect to mutual fund sales practices and the regulation of investment advisory services provided by broker-dealers. We also believe that the Office of General Counsel, which has long viewed its mission as solely to act as the behind the scenes “lawyer to the Commission,” has neglected its parallel responsibility to assist the Commission in managing the harmonization of its regulatory, inspections and enforcement programs. It is our hope that the study of the SEC’s internal operations and structure that is mandated by Section 967 of the Dodd-Frank Act will provide concrete guidance on these issues.

disclosure of broker-dealers' conflicts of interest cannot be established under Section 919, or fiduciary rules that indirectly achieve this purpose are not adopted, then an even broader range of sales practices that create such conflicts should be prohibited under Section 913.

A. Revenue Sharing Payments

As noted by the Commission, the current proposal does not address revenue sharing practices. We believe that it is imperative that the Commission tackle this issue as soon as possible. Notwithstanding the relatively opaque nature of 12b-1 fees, at least they are subject to partial disclosure in the fund prospectus in a fairly prominent manner and location. In contrast, investors are generally provided with no meaningful disclosure of revenue sharing payments, much less of the conflict of interest that they create.

While we support moving forward with the 12b-1 proposal, it is counterintuitive to propose reforms that require parties relying on partially disclosed 12b-1 fees to change certain business practices, as the pending proposals will require, while allowing parties that rely on undisclosed revenue sharing payments to continue undisturbed. One solution to this asymmetry would be the immediate characterization of revenue sharing payments as what they are: indirect financing of distribution activities that is subject to Section 12(b). In that case, instead of displaced 12b-1 fee revenue being shifted to revenue sharing, revenue sharing would have to fit within Rule 12b-2.

Indeed, it is not entirely clear how revenue sharing can reasonably be viewed as not reflecting a fund's indirect financing of distribution. In the Proposing Release, the Commission reiterates its policy that revenue sharing payments can be viewed as not being made from fund assets if they are made from an adviser's "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.'"¹⁸ The idea of revenue sharing payments being permissible because they are made out of an adviser's *profits*, when their character as to the investment adviser paying them is so clearly that of a marketing *expense*, reflects the kind of specious, pretzel-like analysis that is largely responsible for existing problems in the regulation of fund distribution payments. Revenue sharing is an indirect use of fund assets for distribution; it should be no less subject to Section 12(b) than other distribution payments to broker-dealers for the purpose of selling fund shares.

If the Commission is unwilling to recognize revenue sharing as the use of fund assets to pay for distribution services, then we strongly urge prompt action to rationalize the regulation of these payments with the regulation of fund distribution

¹⁸ Proposing Release at note 65 (quoting *Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Rel. No. 11414 (Oct. 28, 1980)).

practices as a whole. Limiting the perpetual stream of income available under Rule 12b-1 will place additional pressure on funds to shift compensation to under-the-table revenue sharing payments. Just as the prohibition of pay-to-place practices in the municipal securities underwriting industry increased pay-to-pay pressures on money managers, limiting 12b-1 fees may increase pressure to make revenue sharing payments. We hope that the Commission will not take as long to address revenue sharing issues as it did to address pay-to-play practices outside of the fund industry.¹⁹

B. Section 22(d) and Differential Compensation

As noted above, the receipt of different levels of compensation for performing identical services creates an incentive for broker-dealers to recommend funds that pay them higher levels of compensation. In view of Section 22(d)'s express requirement that fund shares be sold at the offering price set by the fund, one could argue that it was permissible for a broker-dealer to sell fund shares and receive different selling compensation without there being any difference in the services provided to the customer. Thus, Section 22(d) arguably shields this practice from direct challenge. Under the proposed Section 22(d) exemption, however, the fixed pricing requirement will no longer apply. Broker-dealers will be able to negotiate a single compensation rate for the services they provide and offer only funds that agree to allow this arrangement. This change warrants revisiting the continued appropriateness of permitting differential compensation arrangements.

We believe that the long-term resolution of conflicts of interest inherent in the structure of mutual fund distribution requires that the Commission continue to move the law in the direction of eliminating conflicts by prohibiting or restricting certain distribution arrangements. Section 913 of the Dodd-Frank Act authorizes the Commission to adopt rules establishing a fiduciary duty for broker-dealers when providing personalized investment advice. As noted above, Section 913 also authorizes the Commission to “prohibit[] or restrict[] certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.”²⁰ Congress recognized what the brokerage industry itself conceded in the Tully Report fifteen years ago: “differentiated compensation by product or source of product” is a concern because it “raises the question: Is the [registered representative] rendering objective advice or simply maximizing commission income?”

¹⁹ See *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Rel. No. 3043 (July 1, 2010) (adopting pay-to-play rule); *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 1812 (Aug. 4, 1999) (proposing pay-to-play rule).

²⁰ Dodd-Frank Act Section 913(g) (creating new paragraph (l) in Exchange Act Section 15).

As the Commission is aware, the high level of sales abuses associated with transactions in variable annuities is primarily the result of the higher compensation that broker-dealers receive in these transactions. Broker-dealers sell only funds that are included on their “preferred funds” list not because they are preferable for their customers, but because they are preferred by broker-dealers that benefit from the receipt of additional, undisclosed revenue sharing payments from these funds. The Commission should adopt rules under Section 913 clarifying that the receipt of differential compensation that reflects no difference in the services provided to an advisory client violates a broker-dealer’s fiduciary duty. In addition, FINRA should clarify that a broker-dealer’s receipt of differential compensation when there are no differences in the services provided violates just and equitable principles of trade under FINRA Rule 2010 and NASD Rule IM-2310-2.

The Commission should apply these principles to mutual funds as well. The proposed Section 22(d) exemption calls into question the appropriateness of funds’ continuing to pay selling compensation to broker-dealers that bears no necessary relationship to the services provided to the fund’s shareholders.²¹ It is not clear how it can be consistent with a fund director’s fiduciary duty to the fund and its shareholders to authorize the payment of a higher sales load to a broker-dealer that does not provide any additional services to fund shareholders in return. In this case, the differential compensation has the characteristics of a bribe; it benefits the fund’s affiliates and the selling broker-dealer to the likely detriment of the investor. The Section 22(d) exemption warrants revisiting the continued appropriateness of permitting funds to pay differential compensation arrangements without the funds’ directors’ having any reasonable basis for concluding that the broker-dealer’s compensation is reasonably related to the services provided.

We encourage the Commission to work toward the longer-term goal of complete elimination of fixed commissions. The proposed Section 22(d) exemption achieves this goal in principle, but it may fail in practice. It is not clear that fund complexes will view arrangements negotiated under the exemption as consistent with existing distribution arrangements. Will fund distributors accept a competitor’s ability to offer a comparably structured class of a particular fund’s shares at a lower price than the price at which the class is sold under a traditional, fixed-price model? Or will reliance on the Section 22(d) exemption effectively require that a fund complex entirely abandon its existing distribution network? The

²¹ See *In re Confirmation Requirements and Point of Sale Disclosure 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 Rel. No. 26341, at Part IV(A)(1)(b) (Jan. 29, 2004) (“In addition to conflicts of interest at the firm level, associated persons of broker-dealers face conflicts arising from financial incentives that promote the sale of some shares or share classes — or ‘differential compensation.’ Associated persons may receive higher commissions when they sell shares of a particular fund than they would if they sold the same dollar amount of the shares of another fund. They may also receive higher commissions when they sell a particular class of shares within a fund than they would if they sold the same dollar amount of another share class within that same fund.” (footnotes omitted)).

SEC's current proposals are only a first step toward a more efficient, investor-friendly mutual fund marketplace. We strongly encourage the Commission to recommend to Congress that it repeal Section 22(d) outright.

* * * * *

Mutual funds have become Americans' investment vehicle of choice in part because of the SEC's flexible use of its authority under the Investment Company Act to adapt fund regulation to changes in the financial services marketplace. Without such adaptive regulation, there would be no 12b-1 fees, multi-class funds, money market funds or exchange-traded funds. Vanguard, one of the largest managers of mutual fund assets, could not have existed without regulatory relief from some of the Act's requirements.

Notwithstanding the critical role that the SEC's exercise of its regulatory authority has played in the mutual fund industry's success, some seem to believe that this authority, once exercised, can never be modified. If the Commission determines that existing exemptive rules need, for example, the benefit of marginally more restrictive conditions (such as a requirement that the board have a chairman who is independent of the fund's investment adviser), these critics argue that this reform is overly burdensome, ignoring the fact that the Commission had the undeniable authority never to have adopted the exemptive rules in the first place. When the conditions of exemptive relief turn out to have provided inadequate protection to investors, the Commission, having created the exemption, has no authority to correct it. If this is to be the standard by which SEC rulemaking is to be measured, then the Commission needs to consider whether it is ever appropriate to grant any form of exemptive relief under any provision of the federal securities laws.

The authority to create exemptions from the Act clearly presumes the authority to modify them as the Commission gains experience with their practical effect on investors. Rule 12b-1 has facilitated the evolution of mutual fund distribution practices in ways that benefit investors, but it has also evolved in ways that are detrimental to their best interest. The SEC's proposal maintains all of the essential benefits of 12b-1 fees while substantially mitigating or eliminating many of their costs. We strongly encourage the Commission not to succumb to calls to ignore fundamental problems in the structure of mutual fund distribution compensation and to opt for the kind of minor refinements that would allow these problems to continue to fester. Only if the Commission proceeds with these and other significant reforms will mutual funds continue as a model of successful financial services regulation.

Thank you for your consideration of our comments.

Sincerely,



Mercer Bullard
Founder and President
Fund Democracy



Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc by electronic mail:

Honorable Mary Schapiro, Chairman
Honorable Kathleen Casey, Commissioner
Honorable Elisse Walter, Commissioner
Honorable Luis Aguilar, Commissioner
Honorable Troy Paredes, Commissioner

Andrew Donohue, Director, Division of Investment Management