Business Law Section
AMERICAN BAR ASSOCIATION

321 North Clark Street
Chicago, IL 60654
(312) 988-5588
Fax: (312)988-5578
www.ababusinesslaw.org
businesslaw@abanet.org

November 5, 2010

Via e-mail to: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Re: File No. S7-15-10
Release No. IC-29367
Mutual Fund Distribution Fees; Confirmations

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities (the "Committee" or "we") of the Section of Business Law (the "Section") of the American Bar Association (the "ABA"), in response to the request for comments by the U.S. Securities and Exchange Commission (the "Commission") in its July 21, 2010 proposing release referenced above[1] (the "Proposing Release"). The Commission proposed a new rule and rule amendments that would replace Rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act"), the rule that has permitted registered open-end management investment companies ("mutual funds" or "funds") to use fund assets to pay for the cost of promoting sales of fund shares for the past 30 years. The new rule and rule amendments would continue to allow funds to pay promotional costs within certain limits and preserve the ability of funds to provide investors with alternatives for paying sales charges.

The comments expressed in this letter (the "Comment Letter") represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section.

---

1 *See* Mutual Fund Distribution Fees; Confirmations (SEC Rel. No. IC-29367 (July 21, 2010)).

Overview

The Committee supports the Commission's general goals of, among other things, protecting individual investors from paying disproportionate amounts of sales charges, promoting investor understanding of fees, and providing a more appropriate role for fund directors. The Committee's comments are intended to further these goals. With this in mind, the Committee recommends the following:

- Proposed Rule 6c-10 should maintain the effective, easy to administer method of calculating the "conversion period" for a share class with an ongoing sales charge to convert to a class without such a charge.
- A fund's board of directors should be permitted to use an industry-standard reference rate to determine the maximum ongoing sales charge for the fund, rather than be required to limit the ongoing distribution fees to the highest front-end sales charge imposed by the fund.
- A fund's board of directors should be permitted to use its own discretion, in the exercise of its fiduciary duty giving weight to factors it believes are important, in considering and approving marketing and service fees, and sales charges.
- The Commission, in the adopting release, should provide guidance on the circumstances under which an intermediary that receives marketing and service fees would be required to register as a broker-dealer.
- If it is the Commission's intent to offer further guidance regarding revenue sharing, it should do so at a later time and in a forum that will better facilitate a balanced discussion.
- The proposed Rule 12b-1 grandfather provision should be revised, as discussed in this Comment Letter, to better accommodate the full range of class structures and practices present in the industry.

Ongoing Sales Charge Conversion Calculation

Proposed Rule 6c-10 represents a simple but effective means of ensuring that cumulative charges paid by investors under a deferred-load arrangement will bear a reasonable relationship to the sales commissions payable under the alternative front-load arrangement. The calculation of a fixed conversion date relies on existing shareholder accounting methodologies, and disclosure of that date provides an effective means of communicating the essence of the deferred-load arrangement to investors. We recommend that the Commission maintain the proposed effective, easy to administer method of calculating the "conversion period."

Ongoing Sales Charge Limit

The proposed amendments to Rule 6c-10 would permit ongoing distribution fees to be deducted from fund assets if the fees in excess of 0.25% (the marketing and service fee amount permitted under the proposed Rule 12b-2) are treated as an ongoing sales charge, subject to certain limitations and an automatic conversion feature. Effectively, the amendments to Rule 6c-10 would treat ongoing distribution fees as an ongoing charge similar to a sales load. The proposal would limit the ongoing distribution fees to the highest front-end sales charge imposed on any class of the same fund.

This proposal has the potential to create confusion among investors and intermediaries. Mutual funds charge a range of sales charges depending in large part on the costs associated with their individual distribution channels. One fund, for example, may charge a 4.00% front-end sales charge, while another may charge 5.25%. Under the proposal, the boards of different funds will be arbitrarily limited as to their choices of appropriate distribution fees for similar funds sold through similar sales channels. Further, investors and intermediaries may have to choose between hundreds of different variations of distribution fee arrangements, as they will vary according to the front-end load charged to other clients of shares. Because the highest permissible ongoing distribution fee to be charged to one fund will be different from that charged to other similar funds (despite similar classes of shares), it will potentially be more difficult for intermediaries and investors to effectively compare multiple funds' and classes' fees and expenses.

Each fund's potential range of distribution fees would be different from every other fund's potential range. Those funds that currently charge lower sales charges would be limited, under this proposal, to a lower ongoing distribution fee, which may effectively reduce sales activities for the fund and in turn diminish the benefits that investors receive through economies of scale. We are also concerned that funds may be inclined to consider offering additional share classes with the highest permissible front-end sales charges simply to provide themselves greater flexibility in the amount of ongoing sales charges that may be charged. These changes may result in additional expenses to a fund and operational inefficiencies.

We recommend that a fund's board of directors be permitted to use an industry-standard reference rate (such as the FINRA cap on sales charges as a standard) to determine the maximum ongoing sales charge for the fund, rather than limiting it to the highest front-end sales charge imposed by the individual fund. This standardization will allow greater board flexibility and at the same time permit fund groups to offer similar share classes with ongoing sales charges to similar investors, without the artificial limitations of the charges imposed on the class with a front-end load.

Board of Director Duties

The Proposing Release notes states that a fund's board would have a fiduciary duty to consider whether the use of fund assets to pay ongoing sales charges would be in the best interests of the fund. The Proposing Release then proposes to link the front-end and ongoing sales charges to the process of approving a principal distributor contract. In doing so, the Commission states that boards must exercise their "reasonable business judgment" to decide, among other things, whether the terms of the fund's sales loads (including ongoing sales charges) are "fair and reasonable" and the fund's overall distribution structure is "effective."

We believe that the suggested "reasonable business judgment" standard and "fair, reasonable and effective" findings are needlessly specific, particularly in light of the Commission's intention (reiterated several times in the Proposing Release) to move away from mandating specific findings. In our view, the Commission should make clear in its adopting release that its intention is not to create a new legal standard, but instead to remind fund directors of their need to comply with existing fiduciary duties under state law to act in the best interests of the fund and its shareholders. Broad discretion should be left to individual boards in the exercise of their fiduciary duties to give weight to those factors they believe to be most material to their decisions.

Thus, in order to approve a fund distribution arrangement, a board should conclude that the proposed arrangement is in the best interests of the fund and its shareholders. While this will typically include a board's consideration of sales loads in light of industry practice and any other relevant factors, it is not the same as either the "reasonable business judgment" standard or "fair, reasonable and effective" findings suggested in the Proposing Release, any one of which would represent a meaningful expansion beyond state law.

In the case of ongoing sales charges and deferred load arrangements, it would seem sufficient for the board to conclude that providing shareholders this optional method of paying the sales commission is in the best interests of the fund. This treatment would seem to accord with the Commission's view, stated in the Proposing Release, that ongoing sales charges should be viewed as another form of sales load.

We also respectfully submit that the Commission's discussion may best focus on the well-established fiduciary duty owed under state law, rather than seeking to also incorporate Section 36(a). References to Section 36(a) are, in our view, unnecessary and likely confusing to all involved, as they are relevant only when directors engage in personal misconduct and because the Section has been afforded inconsistent treatment by courts to date.

Broker-Dealer Status

Footnote 168 of the Proposing Release states that "marketing and service fees paid to an intermediary may . . . require the intermediary to register [as a broker-dealer] under the

[Securities Exchange Act of 1934 ("Exchange Act")]."[2] Marketing and service fees are described in proposed Rule 12b-2(b)(2) as charges and fees deducted from fund assets to finance distribution activity.[3] Like Rule 12b-1 fees, the likely recipients of marketing and service fees will be registered investment advisers, recordkeeping providers, third-party administrators, banks and other unregistered financial intermediaries, in addition to registered broker-dealers.

Unregistered intermediaries may be reluctant to accept marketing and service fees if there is uncertainty as to whether the receipt of such fees would require registration under the Exchange Act. Thus, we suggest that the Commission provide guidance in the adopting release on the circumstances under which the Commission believes that an intermediary receiving marketing and service fees would be required to register as a broker-dealer.

Revenue Sharing

The discussion in footnote 65 of the Proposing Release, relating to revenue sharing goes beyond what we believe is required in the context of Rule 12b-1 reform. We recommend that the adopting release succinctly state that related matters of revenue sharing and point of sale disclosures will be considered by the Commission at a later time (assuming that is the Commission's intent) and that the Commission is not proposing to add to its existing revenue sharing guidance at this time.

We also have two specific comments with respect to footnote 65.

- First, and most important, is the implicit conclusion that revenue sharing is, as a general matter, problematic: Expenditures have always been made by advisers or their affiliates in connection with fund distribution have always been present -- from operating an affiliated principal underwriter at breakeven or a loss, to hiring marketing personnel to consider and promote existing and new products, to revenue sharing. Unlike that neutral observation, the footnote both begins and ends with a statement of Commission concern about revenue sharing and includes statements about the increasing "frequency" and "amount" of revenue sharing in a manner that suggests growth is a problem. If the

---

2 Section 3(a)(4) under the Exchange Act defines "broker" to mean "any person engaged in the business of effecting transactions in securities for the account of others." The term "dealer" is defined in the Exchange Act to mean "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."

3 "Distribution Activity" is defined in Rule 12b-2(e)(2) as any activity which is primarily intended to result in the sale of shares issued by a fund, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature.

Commission has concerns regarding revenue sharing, we believe that the topic deserves a far more complete discussion than the somewhat cryptic reference in the footnote, and suggest that the Commission consider issuing a release inviting public comment, or arrange for a roundtable or other forum to specifically address revenue sharing.

- Second, by referring to a multiplicity of broad ideas within the same footnote, the footnote risks conflating separate issues. For example, a broker-dealer's failure to adequately disclose conflicts of interest is a wholly separate issue from whether an adviser is charging an excessive advisory fee; an advisory fee does not become less or more excessive based on the degree of disclosure a broker-dealer provides the broker-dealer's customers.

Again, we recommend that the adopting release clarify that the Commission is not attempting to add to existing revenue sharing guidance at this time.

<u>Grandfather Provisions</u>

Rule 12b-2 – Calculation Methodology

The current construction of paragraph (d)(3) of proposed Rule 12b-2 may favor fund complexes that utilize "compensation-type" Rule 12b-1 plans over fund complexes that utilize "reimbursement-type" Rule 12b-1 plans.[4] Proposed Rule 12b-2(d)(3) provides that, within 5 years after the compliance date of the rule, all shares of a share class operating under a Rule 12b-1 plan must be converted into shares of a class that does not deduct an ongoing sales charge and that does not deduct a marketing and service fee *in excess of the annual rate of the fee paid under its Rule 12b-1 plan in the most recent fiscal year*. Rule 12b-1 fees paid under a reimbursement-type plan can fluctuate from year to year depending on, among other things, the distribution activity of the fund's principal underwriter during the year. Such distribution activity can fluctuate due to a fund complexes' financial condition, whether the fund's particular investment strategy is currently in favor, competition and other factors. As a result, the amount spent under a reimbursement-type Rule 12b-1 plan can be less than the maximum amount permitted under the plan.

It is possible, therefore, that Rule 12b-1 fees paid under a reimbursement-type plan during the prior fiscal year on shares that have reached the required 5-year conversion date could

---

4 Under a compensation-type 12b-1 plan, the level of payments to be made by a fund is not specifically related to the level of distribution services to be provided by the recipient of the payments, typically the fund's principal underwriter. Reimbursement-type 12b-1 plans tie fund payments to the level of distribution services provided, up to a maximum annual amount. *See* SEC Rel. No. IC-16431 (June 13, 1988) (discussing generally the development and use of compensation-type plans and reimbursement-type plans).

exceed the Rule 12b-1 fees paid by the share class into which the shares were intended to convert. For example, the fees paid under a reimbursement-type Rule 12b-1 plan for Class C shares may be less than 25 basis points in a particular fiscal year for the reasons noted. In that event, Class C shareholders could not be converted into Class A shares that had charged a 25 basis point marketing and service fee during the fund's prior fiscal year. This would be true even if the current anomalous situation was due to unique market conditions that arose during the prior fiscal year and the fund's Class C shares had historically paid higher Rule 12b-1 fees than Class A shares. In this circumstance, the fund complex may be forced to create a new class of shares that does not charge a marketing and service fee to ensure that the marketing and service fee of such class will not exceed the fee paid under the Class C Rule 12b-1 plan during the most recent fiscal year.

Fund complexes utilizing compensation-type Rule 12b-1 plans would not face this issue because the fees paid under these plans are fixed and do not fluctuate from year to year. A proposed solution would be to recast proposed Rule 12b-2(d)(3) to require conversion of shares of a share class into shares of a class that do not deduct a marketing and service fee *in excess of the maximum fee permitted to be charged under its Rule 12b-1 plan.* The maximum fee would be deemed to be the ceiling established by the reimbursement-type plan (*i.e.*, 100 basis points in the above example). This change would eliminate the potential for anomalous situations in a conversion year and will create greater parity between fund complexes with reimbursement-type plans and those with compensation-type plans.

Grandfather Provision of Rule 12b-2 – Mandatory 5-Year Conversion

The mandatory 5-year conversion that would be required by proposed Rule 12b-2(d)(3) may disrupt existing financing arrangements for Class B shares and disadvantage fund complexes that have securitized Rule 12b-1 fees payable by Class B shareholders. Proposed Rule 12b-2(d)(3) provides that *within 5 years after the compliance date of the rule,* all shares of a share class operating under a Rule 12b-1 plan must be converted into shares of a class that do not deduct an ongoing sales charge and that do not deduct a marketing and service fee in excess of the annual rate of the fee paid under its Rule 12b-1 plan in the most recent fiscal year. Underwriters of funds with Class B shares typically advance sales commissions to selling investment professionals, and certain fund complexes have financed this effort by securitizing future Class B Rule 12b-1 fees. The securitized Rule 12b-1 fees are generally sold to a third party financial institution and the proceeds from the sale are used by the underwriter to advance sales commissions to selling investment professionals.

In the event that the Class B Rule 12b-1 fees are terminated prior to the scheduled conversion of Class B shares to another share class (typically Class A), the underwriter or an affiliate may be responsible to pay the third-party financial institution the amount of any shortfall. In other cases, the purchasing third-party financial institution takes the risk of a termination of a Rule 12b-1 plan and a resulting shortfall. Forcing a conversion of Class B shares on a date that is earlier than the scheduled conversion date of the shares may cause the third-party financial institution to receive less than the full value of the assets it purchased or otherwise require the fund's underwriter or its affiliate to make up the difference. Disrupting commercial arrangements in this manner to benefit Class B shareholders, to whom full disclosure was made of the sales charge schedule that applied to their purchase (in the prospectus), seems to us inequitable. In our view, a more equitable solution to shareholders, fund sponsors and third-party intermediaries that purchase Rule 12b-1 fees would be to permit Class B shares to convert according to their existing conversion schedule.

* * *

The Committee appreciates the opportunity to comment on the Proposing Release and respectfully requests that the Commission consider the comments and recommendations set forth above. Members of the Committee are available to discuss these comments should the Commission or the staff so desire.

Very truly yours,

/s/ Jeffrey W. Rubin
Jeffrey W. Rubin, Chair of the Committee
on Federal Regulation of Securities

Drafting Committee:
Robert A. Robertson, Drafting Coordinator
Diane E. Ambler
Mark Amorosi
Jay Baris
Matthew DiClemente
John W. Gerstmayr
Nathan Greene
Benjamin Haskin
John Hunt
Jesse Kanach
Rachel Kuo

cc: Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
Kathleen L. Casey, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner
Andrew J. Donohue, Director, Division of Investment Management