MFDF

MUTUAL FUND DIRECTORS FORUM
The FORUM for FUND INDEPENDENT DIRECTORS

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

Re: Proposed Rulemaking Regarding Mutual Fund Distribution Fees; Confirmations, File No. S7-15-10

November 5, 2010

Dear Ms. Murphy:

The Mutual Fund Directors Forum ("the Forum")[1] appreciates the opportunity to comment on the proposed rulemaking by the Securities and Exchange Commission ("Commission" or "SEC") concerning "Mutual Fund Distribution Fees [and] Confirmations."[2]

The Forum, an independent, non-profit organization for investment company independent directors, is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through continuing education and other services, the Forum provides its members with opportunities to share ideas, experiences, and information concerning critical issues facing investment company independent directors today and serves as an independent vehicle through which Forum members can express their views on matters of concern.

Comments

I. Introduction

Director oversight of distribution- and marketing-related expenses, particularly those paid for from fund assets of open-end funds, has been problematic virtually since the original adoption of Rule 12b-1 in 1980. As the way in which fund shares are sold and

1 The Forum's current membership includes over 600 independent directors, representing 86 independent director groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

2 Proposed Rulemaking: Mutual Fund Distribution Fees; Confirmations, Securities Act Rel. No. 9128 (July 21, 2010) [75 FR 35920 (June 23, 2010)] ("Proposing Release").

distributed has become more complex, the difficulty faced by directors in overseeing these payments has only increased. Hence, by 2007, when the Forum published its "Best Practices and Practical Guidance for Directors under Rule 12b-1," we stated that:

> Rule 12b-1, as currently structured, simply does not reflect the current marketplace. Directors, who are required to evaluate 12b-1 plans to determine whether they are in the best interests of fund shareholders, are thus asked to take on a task that, in the present environment, they are not well-positioned to perform. Rule 12b-1 thus cries out for serious review and ultimately significant reform.[3]

Our *Practical Guidance Report* identified a number of reasons that explain why this is the case. In particular, we noted that funds are currently distributed through many channels, that those channels are generally not controlled by the funds, and that access to multiple distribution channels is necessary for most funds – even traditional no-load funds – to remain viable.[4] We also noted that "directors face the reality that their ability to influence the price paid for services provided by distributors of fund shares is limited and that their ability to influence precisely what services are obtained in return for participating in specific distribution channels is also likely to be restricted."[5]

We therefore commend the Commission for undertaking to reform this important area of fund regulation. As outlined below, we broadly support the Commission's approach as we believe that it could result in a system that is more transparent and fairer for shareholders than the approach of current Rule 12b-1. At the same time, however, we believe that it is of fundamental importance that the Commission provide appropriate guidance to directors on their oversight responsibilities in this proposed new system. In particular:

- The Commission should make clear that directors' *sole responsibility* is to exercise their business judgment to determine whether the distribution system and the related costs borne by shareholders are in the best interests of a fund and its shareholders.

- The Commission should eliminate references in its proposed guidance to directors' "reasonable business judgment" or to "fair and reasonable" loads that may inadvertently suggest that directors have a duty different from determining, in the exercise of their business judgment, whether payment of these costs meets the "best interests" standard.

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3 *Report of the Mutual Fund Directors Forum: Best Practices and and Practical Guidance for Directors under Rule 12b-1* (May 2007) at 17 [hereinafter "*Practical Guidance Report*"].

4 *See id.* at 1.

5 *Id.* at 10.

- The Commission should not delineate the factors directors should consider in order to allow directors to exercise their business judgment.

We describe our views in greater detail below.

II. Marketing and Service Fees: Proposed Rule 12b-2

We agree with the Commission that funds should be permitted to pay up to 25 basis points of fund assets annually for distribution-related costs. Giving funds this ability recognizes the current reality that funds must pay for access to varied, and often a significant number, of distribution channels (including traditional broker-dealers, fund supermarkets, and retirement administrators) and that each channel provides services and benefits to a fund and its shareholders. We therefore support the Commission's proposal to permit funds to pay a limited amount of these costs – which can involve a wide variety of distribution-related expenses – directly out of their own assets.

In addition, the role that directors would fill under this proposal makes considerably more sense than the requirements placed on directors by the current rule. Moreover, it is consistent with the Commission's approach of treating these expenses as similar to other types of fund expenses. Hence, eliminating the requirements that directors approve an annual plan, make unique findings with respect to the plan, and review quarterly expenses under the plan is a desirable and logical change.

That said, while the Commission states that directors should review these fees in the same manner as they review other fund expenses (and particularly those expenses that potentially create a conflict of interest), we believe that it is equally important that the Commission recognize that directors are less able to affect the level of distribution-related costs or monitor the quality of services acquired than is the case with other types of fund expenses. As we observed in our *Practical Guidance Report*, such services "often are packaged together with distribution services or come as part of a distribution platform" and that it may therefore be difficult for directors "to determine accurately the true cost of the service being provided or accurately ascertain its quality."[6] The report concluded that "analysis of the cost and quality of the service [can] quickly collapse into an inquiry into whether continued use of the distribution channel is in the best interests of fund shareholders."[7]

In light of these difficulties, we therefore believe that the Commission should emphasize under Rule 12b-2 – as the proposal currently does – that directors should review payments pursuant to the proposed rule "that create a potential conflict of interest" between the fund and any of its affiliates. Beyond that, the difficulties faced by directors in this context suggest that directors should make a finding more akin to the "best interests of the fund and its shareholders" finding that the Commission recognizes

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[6] *Practical Guidance Report* at 16.

[7] Id.

they will need to make under the proposed amendments to Rule 6c-10 regarding ongoing sales charges.

III. Ongoing Sales Charges

A. The Substantive Limits on Ongoing Sales Charges

We support the Commission's approach to limiting the time over which investors must pay ongoing sales charges. Most fundamentally, we agree that the amount of current 12b-1 fees that exceed 25 basis points per year (what the Commission now proposes to refer to as "ongoing sales charges") are essentially an alternative to front-end sales loads, and thus should be treated similarly from a regulatory perspective. Because fund shareholders are appropriately protected from excessive front-end loads, we agree that it also makes sense to prevent them from paying ongoing sales charges that, over time, also might become excessive.

There is no perfect way to do this. In particular, as the Commission recognizes, the proposed approach of cumulating, on a percentage basis, the yearly total of these fees presents problems – it does not, for example, account either for the impact of asset growth on the absolute amount paid or for the time value of money. But in a context where precise calculations would be difficult (and where class conversions based on precise calculations would likely be complex and costly to implement), we agree that the Commission's approach is an appropriate form of "rough justice" that should protect long-term fund investors from excessive ongoing sales charges without imposing unduly large implementation costs on the industry as a whole.

We also support the Commission's proposal to grandfather existing fund assets subject to 12b-1 plans for five years. While shareholders obviously would benefit from an immediate imposition of a cap on existing shares, we agree with the Commission's conclusion that existing arrangements among funds, underwriters, and others involved in fund distribution create expectations that should be respected. Five years will likely permit funds and distributors to work out alternative arrangements without unduly harming advisers and underwriters who owe ongoing obligations with respect to shares sold under existing 12b-1 plans. Moreover, the Commission's recognition in this part of the rulemaking of the existing relationships among funds, underwriters, and distributors is critical – the Commission should not leave the impression that its decision to shift to a new regulatory approach to distribution and marketing costs somehow implies that existing arrangements subject to current Rule 12b-1 were somehow illegal or ill-advised when they were established.

Finally, given that distribution will never be free, the imposition of a cap on ongoing sales charges does suggest that some distribution-related costs will ultimately be paid by other parties. Since one of these parties may be the fund's adviser, the adoption of these rules may lead to further revenue sharing. Because the Proposing Release does not address revenue sharing, we strongly encourage the Commission to examine this and related issues – including what the appropriate role of directors is with respect to revenue sharing and how underwriting-related expenses and losses are reviewed during the annual 15(c) process – at a future time.[8]

B. The Commission's Proposed Guidelines for Directors' Oversight of Ongoing Sales Charges

As part of its proposals to amend Rule 6c-10, the Commission also proposes guidance for directors charged with overseeing the payment of ongoing sales charges under the rule. We welcome the Commission's efforts to provide this guidance. As we have stated in the past, the existing guidance for directors under Rule 12b-1 is "largely irrelevant" in the context of current systems of distribution.[9] Moreover, we continue to believe that the Commission will not succeed in improving or reforming the current system created by rule 12b-1 unless, as part of its efforts, it focuses on providing directors with a sensible, appropriately limited and effective oversight role.

The Commission states that proposed Rule 6c-10 "would not impose any explicit responsibilities on fund boards of directors to approve (or re-approve) asset-based sales charges" apart from their existing "fiduciary duties with respect to the oversight of the use of fund assets."[10] For a number of interrelated reasons, we concur that it makes little sense to impose special duties on directors with respect to the payment of these fees.

Although directors certainly have oversight obligations with respect to any use of fund assets, from a market perspective, loads, whether paid up-front or on an ongoing basis, are more appropriately correlated with individual fund investors' willingness to pay them (and, implicitly, their desire to acquire the dealer-offered services associated with those charges). This should be true whether the loads are paid up front or over an extended period of time.

Because both of these types of payments exist for similar distribution-related reasons, we agree that it makes sense to link directors' oversight obligations in this area with their approval of a fund's underwriting contract. Moreover, as the Commission itself emphasizes in the release, in reviewing a fund's distribution system, fund directors

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8 Put somewhat differently, where a fund's adviser and its principal underwriter are jointly owned or controlled, it is possible to view underwriting the sale of fund shares and management of the fund's distribution system as one of the many services that the management company provides the fund. In these cases, it may well be worth exploring ways in which directors can view the management company's services in a more holistic and integrated manner, including in their oversight of management's performance a review of the success and ongoing appropriateness of the fund's distribution system in the context of all the facts and circumstances of the fund's operations.

9 *Practical Guidance Report* at 2. The Commission appears to agree with this conclusion, noting in the release that comments submitted to it in recent years "suggest that one of the fundamental premises of Rule 12b-1 – that independent directors would play an active part in setting distribution fees – does not reflect the current economic realities of fund distribution and the role 12b-1 fees play in it." Proposing Release at 47073.

10 Proposing Release at 47081.

should approve the contract with the primary underwriter (including the associated sales load structure) if, in the exercise of their business judgment, they conclude that continued distribution of fund shares pursuant to the contract "is in the best interests of the fund and fund investors."[11]

From a process perspective, directors should review the underwriting contract in the same manner they do the advisory contract – obtain all relevant information from the primary underwriter, advisor and others, and then, in the exercise of their business judgment, determine whether the contract meets the best interest standard. Characterized in this manner, the standard recognizes that directors both need to understand the way in which the shares of the funds they oversee are distributed and to recognize their fiduciary duty to oversee the expenditure of monies paid out of fund assets.

Given the above, the Commission should refine its proposed guidance in the following ways:

First, the Commission should eliminate the references to "fair and reasonable" in its description of the findings that directors make with respect to the underwriting contract and the associated sales charges. Directors review and approve the underwriting contract pursuant to the same statutory standards that apply to their review and approval of the advisory contract. Courts, including the Supreme Court in its recent decision in *Jones v. Harris*, have consistently held that, in adopting these provisions of the Act, Congress was not trying to impose a reasonableness standard on the industry.[12] Instead, the Act seeks to ensure that directors have the ability, information and resources necessary to assess whether the fund they oversee is, in all aspects, operated in its shareholders' best interests. This approach permits directors to consider the entire scope of the distribution system – namely, the underwriting contract, its associated costs and the various ways in which a fund's shares are distributed – to ensure that, in their business judgment, shareholders are benefiting from it. If the guidance instead emphasizes the cost of the underwriting system and then requires directors to make a narrow determination of whether those costs are "fair and reasonable," it will undermine this broader, more holistic approach. Moreover, describing directors' duties in this manner may well lead to unnecessary private litigation narrowly focused on whether the fees in question are, in fact, fair and reasonable.[13]

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11 Proposing Release at 47081.

12 *Jones v. Harris,* slip op. at 16 (noting that "Congress rejected a reasonableness requirement that was criticized as charging the courts with rate-setting responsibilities."). 559 U.S. ____ (2010)

13 Different boards likely could reasonably make different conclusions as to whether a particular fee is "fair and reasonable" and litigation in this area could potentially be expensive and time-consuming. As Justice Sotomayor pointed out during oral arguments for *Jones v. Harris Associates*, ". . . using the word "fair fee" in my mind is meaningless because it has to be fair in relationship to something." *See* Transcript of Oral Arguments in *Jones v. Harris Associates*, p. 14 lines 22-24.

Second, the Commission should be careful not to imply that directors should bring anything other than their business judgment to bear on their analysis of a fund's system of distribution. As the Commission and courts have always recognized, directors are *the* cornerstone in the system of investor protection created by the Investment Company Act. By placing directors in this position, the Act implicitly recognizes that each fund and each fund complex is unique, and that a board of directors provides a much more flexible and effective system of oversight and investor protection than can a series of highly specific regulations that apply uniformly to all funds irrespective of the differences among them.

By emphasizing the business judgment of the directors, a concept that encompasses the independence of the board and the robustness of its processes, the Commission will promote vigorous boards while at the same time protecting directors and their funds from unnecessary and inappropriate litigation risks. While we read the Commission's proposed guidance to recognize this, the inadvertent use of phrases such as the directors' "reasonable business judgment" could, at a later date, lead to needless litigation over whether directors are subject to an alternative standard of business judgment. We therefore urge the Commission to eliminate unneeded modifiers from its description of "business judgment" that may have unintended consequences.

Third, the Commission should not recreate the type of factors-based test that it is putatively rejecting as part of this reform proposal. We have argued before that imposing factors-based tests on directors risks limiting directors' own ability to identify factors that are relevant to a particular decision, prioritize how they weigh those factors, and ultimately act in the interests of fund shareholders.[14] Lists of factors can also increase the litigation risks faced by directors by permitting plaintiffs' attorneys inappropriately to focus on how directors dealt with a particular factor in isolation. Factors-based tests also tend to be unnecessarily rigid, and can fail to evolve as the industry and markets to which they apply inevitably change. Indeed, the Commission appears to recognize these problems as part of its rejection of the factors-based test that it originally included in its guidance on directors' review and approval of 12b-1 plans in its original 12b-1 rulemaking.

We find this approach to be a significant step forward that has the potential to free directors from work that is both largely meaningless and that creates litigation and other risks for them. At the same time, however, the Commission's proposed guidance, which lists factors believed to be relevant to the findings directors should make with respect to the underwriting contract,[15] risks recreating the precise problems that the proposal is

[14] The Supreme Court agreed that boards should be given latitude to make determinations in the interest of their funds' shareholders. "Where disinterested directors consider all of the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if the court might weigh the factors differently." *Jones v. Harris* at 2.

[15] The Proposing Release suggests that in determining whether a fund's underwriting contract is fair and reasonable, "directors should consider any factors that may be relevant, including whether the fund's distribution networks and overall structure are effective in promoting and selling fund shares

otherwise intended to correct. We urge the Commission to reject this approach and not delineate factors that directors should consider, and instead make clear that directors should, in the exercise of their business judgment, identify the factors they believe to be relevant, weigh those factors as they believe is appropriate and then determine whether the underwriting contract is in the best interests of the fund and its shareholders.

IV. Account-Level Sales Charges

We commend the SEC for proposing amendments to Rule 6c-10 that would permit fees related to distribution to be charged at the account level rather than by the fund. Industry commentators have long discussed the potential benefits of this approach, albeit generally in the context of replacing the current rule with this approach – that is, by making account-level charges the sole way in which distribution-related expenses could be charged to fund shareholders.[16]

We strongly prefer the approach that the SEC is taking in this proposal – namely, allowing the imposition of account-based charges as one of a number of options available to funds, their directors, and the investing public.[17] In particular, the Commission's proposal has the potential to provide investors with greater choice, especially those investors who prefer to identify and pay for only those distribution-related services that they desire. We also agree that this proposal will potentially improve the transparency of distribution-related costs, simplify dealer operations and reduce the conflicts of dealers that offer a wide variety of funds to their clients. Finally – and perhaps most importantly – permitting account-level charges may, in the long run, increase competition among dealers in fund shares, ultimately allowing investors to benefit from the lower costs and/or increased service levels that a competitive marketplace would likely offer.

Separately, if account-level sales charges are ultimately adopted by the industry in any significant way, the resulting system of distribution will have important benefits for fund directors. Because many of the services paid for under existing 12b-1 plans are provided directly by the dealers to fund investors,[18] and because distributors often charge

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given current economic and industry trends, any available breakpoints on advisory fees that may be attained from future growth in fund assets, and any diseconomies of scale that may arise from continued growth of fund assets." Proposing Release at 47081-82.

16 *See, e.g.,* Proposing Release at 47089 n.277.

17 In this context, we agree that a fund (or, more specifically, a fund share class) that is relying on this proposed exemption should be required to disclose in its prospectus that it is doing so and should not be permitted to charge any other ongoing sales charges.

18 *See Practical Guidance Report* at 9 (noting that one use of 12b-1 fees is to pay for "ongoing shareholder services"); *see also* Letter from Mary S. Podesta, Acting General Counsel, Investment Company Institute to Nancy M. Morris, Secretary, United States Securities and Exchange Commission (July 19, 2007) at 4 ("The primary use of 12b-1 fees is to compensate financial intermediaries for advice and other services to clients."); Letter from Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Co. to Nancy Morris, Secretary, Securities and Exchange Commission (July 13, 2007) at 1-2 (noting that Rule 12b-1 has evolved into a "means for investors to receive ongoing service from financial advisers.").

a set price for the bundled services that they provide to funds and investors, fund directors are simply not well-situated to meaningfully monitor the cost and quality of the services being provided.[19] To the extent that fund shares are sold subject to an account-level rather than fund-level charge, directors will be relieved of this otherwise ill-conceived oversight responsibility, freeing them to focus on issues where they have a more direct and beneficial impact on fund shareholders.

We recognize that this particular part of the Commission's proposal may not ultimately shift significantly the manner in which funds are sold and the way in which distribution-related costs are paid – indeed, the Commission identifies a number of reasons why the impact of this proposal may be limited, ranging from systems issues to tax inefficiency. While these obstacles may limit the extent of reliance on the proposed exemptive relief, there is no harm to investors in putting this option in place and permitting the market to decide whether the potential benefits of the proposal will lead to its being offered to investors.

V. Proposed Disclosure Amendments

We agree that the current regulatory system of 12b-1 fees often leads to disclosure that may not effectively describe to fund shareholders the ultimate level of these charges as well as their purpose and intent. Current disclosure inhibits the ability of fund investors both to compare one fund to another and to compare different share classes of the same fund. The Commission's proposal to clarify disclosure of these fees in the fee table and in sales confirmations will significantly improve the ability of shareholders to understand these fees.

VI. Conclusion

The Commission's rule proposal, considered as a whole, is a rational and sensible recognition of the reality of fund distribution. It relies on a coherent framework for analyzing distribution-related expenses, is both fairer to and provides more transparency for shareholders and outlines a more appropriate role for directors in overseeing these costs. We are therefore pleased not only that the Commission has taken on this difficult issue, but that it has also recognized the need to address the role of directors under the rule. While we believe that the Commission's attempt to delineate the role of directors is a step forward, the Commission nonetheless should further refine its approach in this area. As we've outlined above, at a practical level, the ability of directors to impact the cost and quality of distribution- and marketing-related services is often limited. Guidance that recognizes this will, in the end, permit directors to effectively exercise their business judgment on behalf of fund shareholders in areas in which they have influence while not forcing directors to attempt to provide oversight in areas in which they cannot be effective. To fail to do so risks perpetuating a system that, put most simply, no longer makes sense.

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[19] *See Practical Guidance Report* at 10-11.

We would welcome the opportunity to discuss these comments further with you. If you have any questions or would like to further discuss these comments, please contact me at 202-507-4491 or Susan Ferris Wyderko, the Forum's Executive Director, at 202-507-4490.

Sincerely,

David B. Smith, Jr.
Executive Vice President and General Counsel

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