Financial Planning Hawaii

A Plea for Better Economic Impact Analysis of Proposed 12b-1 Reforms

August 24, 2011

Elisse B. Walter, Commissioner
Securities Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Commissioner Walter:

Based upon your public statements over the past year, it is my understanding that the Division of Investment Management intends to take up the issue of Rule12b-1 reform again soon and that you are generally supportive of the of the 76-page reform proposal presented by SEC Commissioner Shapiro and the Investment Management Division staff on July 21, 2010[1]. As such, the purpose of this letter is to respectfully request a more sophisticated, more accurate economic impact analysis on the specific proposal to limit the cumulative asset-based sales charges that investors may pay.

While it is clear from reading the 2010 proposal (as well as the 2004 and 2007 proposals) that the SEC staff has devoted enormous time and effort to 12b-1 reform and has considered a broad range of perspectives, the economic analysis presented by the SEC to date seems largely subjective and is limited to simply addressing concerns over the growth of 12b-1 fees over time with little realistic dollar quantification of the benefits or costs individual investors may realize from implementing the proposed reforms[2]. To ensure that proposed reform measures do not inadvertently harm investors, the importance of a more thorough economic impact analysis cannot be understated. For instance, listed below are five considerations that should be included in any realistic economic analysis, but which have been overlooked or only superficially addressed by the SEC to date:

1. **<u>Better quantify both the current composition of 12b-1 fee revenue and the reduction in fees that the SEC believes will result from the proposed change to limit asset-based fees.</u>**
The Commission has stated that a large part of its motivation to reform/repeal Rule 12b-1 is that fees have grown to more than $9.5 billion per year. However, in the SEC's 76-page proposal, the largest quantifiable estimate of investor savings from the proposed reform seems to be a tenuously derived projection of just $170 million – a seemingly miniscule (<2%) reduction in the total $9.5 billion sum[3]. If the SEC's goal is to reduce 12b-1 fees in a meaningful way, it would be helpful for the public to know the dollar amount and proportion of total revenue that is derived from each of the various sources of 12b-1 fees (e.g., service fees to no-load intermediary distributors and broker-dealer distributors of load share classes, asset-based fees paid primarily from Class C shares, fees from revenue sharing arrangements in qualified plan platforms, etc.). On this score, it should be noted that some critics of the SEC's 2010 reform proposal have suggested that, by ignoring the 401(k) revenue sharing component of 12b-1 fees, the Commission

[1] SEC File Number S7-15-10 *Mutual Fund Distribution Fees; Confirmations,; Proposed Rule*. Federal Register, Vol. 75, No. 149, August 4, 2010. http://sec.gov/rules/proposed/2010/33-9128fr.pdf
[2] See Proposed Rules, Section V. *Cost-Benefit Analysis*
[3] Page 47118, Federal Register, Vol. 75, No. 149, August 4, 2010.

is failing to address by far the largest contributor to 12b-1 fee revenue. Providing data that breaks total annual 12b-1 revenue into its sub-components would be a useful starting point.

2. **Quantify the potential impact of substitutes in negating 12b-1 investor savings.**
The SEC has expressed concern that mutual fund investors are currently paying too much in 12b-1 fees. In its reform proposal, the Commission vaguely estimates that new sales of Class C share mutual funds will fall by 10-20% from current levels resulting in $26-52 million per year in investor savings in addition to the aforementioned $170 million estimate from falling costs to existing shareholders. Although the proposal does subjectively note the existence of substitutes, it does not attempt to quantify the degree to which its proposed reforms may spark investor migration to substitutes or the amount by which such a migration might offset or potentially negate the SEC's implied cost savings from capping asset-based 12b-1 fees. For example, it is known that the average mutual fund wrap advisory fee is approximately 1.38% per year[4] – a 38% increase over the maximum annual 12b-1 mutual fund fee (.25% service charge + .75 asset based sales charge). If, as the SEC acknowledges throughout its proposal, its reform measure is likely to result in some migration to wrap fee advisory platforms, the potential obviously exists for investor costs to actually rise as a result of reform. Similarly, costs would also rise if some subset of investors who currently own Class C shares elect to switch (or, more likely, are encouraged to switch by their registered representatives) away from mutual funds to alternative products, such as variable annuities or separately managed accounts. Simply put, better supported economic analysis is needed to determine if investors will actually experience cost savings from the proposed changes.

3. **Consider the influence of registered representatives on investor decision making and the potential conflict of interest that the proposed share class conversions may create**.
All of the SEC proposals submitted for public comment to date appear to ignore the role of the registered representative in investor share class choice. From a behavioral economics perspective, it would be wise to consider the economic reality that broker-dealer representatives play a leading role in influencing investor share class decisions and that to cap asset-based sales charges might create new potential conflicts of interest between investors and their representatives. Specifically, the SEC's economic analysis should consider whether investors may be potentially negatively impacted upon the share class conversion date (presumably from C shares to A shares) by either (a) neglect, if representatives believe they are no longer being adequately compensated to attend to client mutual fund portfolios or (b), more likely, being encouraged to switch to different funds or products in which utility maximizing reps will again be compensated.

Evidence that representatives may have a propensity to encourage clients to switch funds once their compensation is reduced may be gleaned from the current experience of American Funds. As the SEC is likely aware, American Funds is one of the few "load" fund companies whose Class C shares automatically convert to Class A shares after a 10 year holding period. American Funds first introduced its Class C shares in 2001, and, thus, 2011 is the first conversion year. Early indications are that American Funds shareholders are redeeming newly converted A shares at a faster rate than other Class A shareholders.

[4] Tiburon Research and Analysis, *Financial Advisor Best Practices Survey*, 2009.

4. **Consider the possibility that economic value differences may exist across mutual fund share classes of the same fund.**

All SEC 12b-1 reform proposals and public comments since 2004 have inherently assumed that, because the underlying investments are the same across all share classes of the same fund, the only difference in the economic benefits investors receive is attributable to expense differences.

This assumption ignores the possibility that sales charge structure variations may lead to different investor behavior and, therefore, different investment outcomes. Although such a consideration is not necessarily intuitive, CRSP and Morningstar data have consistently shown that individual investor returns differ significantly (and generally negatively) from the performance of the funds in which they invest. As presented in the June 19, 2007 SEC Round Table[5], the possibility of different economic value from various share classes of the same fund was at least tacitly acknowledged and accepted by previous SEC administrations. Former SEC Investment Management Division Director Kathryn Bradley McGrath noted in her testimony that the agency welcomed asset-based fee share classes (i.e., Class C shares) because the Commission believed that that this structure better aligned client and registered representatives interests than classes with high up front sales charges or deferred sales loads. In its analysis, the current SEC administration should weigh the possibility that share classes levying asset-based fees may deliver greater economic value than alternative share classes. In support of this hypothesis, academic research and survey data have already shown that investor holding periods differ across share classes and at least one empirical academic study has found that investors in Class C shares experience better expense-adjusted performance than Class A or B shareholders[6].

5. **Consider and quantify the impact that the proposed reform proposal may have on the load share distribution channel and investor choice.**

While it is understood that the SEC is charged with placing investors' interests above those of investment companies and financial intermediaries, the Commission should also consider whether its reform measures might dramatically alter competitive forces within the mutual fund marketplace and whether such disruptions might lead to a reduction in the number of mutual funds or fund groups. The Commission has suggested that its proposal to cap asset based fees paid on class C shares will effectively level the playing field between share classes that levy up front sales charges (i.e., Class A shares) and share classes that compensate intermediaries through ongoing asset-based fees (i.e., Class C shares). However, in the 2010 reform proposal (page 8, footnote #93), the Commission observes that, while 2009 A share net inflows stood at $19 billion, compared to $39 billion into C shares, the vast majority of A share inflows were from load-waived purchases in investment advisory accounts. In other words, the notion that investors will be more equitably able to choose between upfront sales charges and ongoing asset-based charges is likely misguided, since exceedingly few investors in today's retail marketplace appear to be choosing to pay up front sales charges. Rather than leveling the playing field between A shares and C shares, the proposed cap on asset based sales charges may have the potential to eliminate the playing field altogether. In its analysis, the Commission also notes that, of the $323 billion that flowed into no-load share classes in 2009, 80% came through the RIA distribution channel in

[5] http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf

[6] Bullard, Friesen, and Sapp, *Investor Timing and Fund Distribution Channels*, 2008. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1070545

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wrap-fee accounts. In considering this information in total, the SEC should consider whether its reform proposal has the potential to spell the end of the traditional load fund distribution channel.

In summary, while the SEC should be commended for its efforts to reduce individual investor expenses and improve disclosure, the first consideration for all regulation should be that it do no harm to those it is seeking to protect. It is my sincere hope that the ideas presented herein will convince your office that a more rigorous, empirically based analysis is needed to truly determine the economic impact that the proposed 12b-1 reform measures may have on individual investors. Thank you in advance for your consideration. Please do not hesitate to contact me, if I can be of any further assistance.

Sincerely,

John H. Robinson
Honolulu, Hawaii

Mr. Robinson holds a degree in Economics from Williams College and is the owner and founder of Financial Planning Hawaii. He has written and published numerous peer-reviewed research papers on a wide range of financial planning topics and is a frequent contributor of industry thought pieces, including numerous commentaries on 12b-1 reform.

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