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October 20, 2010

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

Re: Mutual Fund Distribution Fees (File No. S7-15-10)

Dear Ms Murphy:

We applaud your attention to 12b-1 fees as well as your desire to increase transparency and encourage better competition for the benefit of fund investors. Your distribution-fee proposal takes a few steps forward, but in our opinion does not go far enough in addressing shortcomings of fund-fee transparency. Until various expense categories are labeled and accounted for consistently across mutual funds, investors will not have the information they need to make well-informed decisions. Capping one part of the expense ratio will do no good until all costs are forced into the right buckets and labeled accurately. This is a once-in-a-generation opportunity to clean up a broader problem with fund expense ratios and help investors understand how their money is being spent.

As it stands, your proposal will have the biggest impact on C shares, effectively making them a less-attractive alternative to a fee-based platform for receiving advice. That trend has already started without the help of your proposal. American Funds already converts its C shares to A shares after a period of time to make the fees charged between the two comparable. And C shares are only a small, and shrinking, part of the fund industry. At the end of 2009, assets in C shares represented less than 5% of industry assets. We ask you to consider that the largest impact of your proposal will be aimed at only a small corner of the industry, and thus touch a small number of investors. Given the role that mutual funds play in the futures of millions of Americans, wider-sweeping review is necessary.

Billions of dollars are collected and spent each year to manage, sell, service, and market mutual funds. A complicated and deliberately opaque web of revenue sharing, broker incentives, platform fees, and consulting fees exists in the background.

Cleaning up and limiting 12b-1 fees will make some difference, but these costs have historically found new life in other parts of the expense ratio. Consider the Jones v. Harris Supreme Court case. One takeaway from the ruling was that management fees charged on a mutual fund are not comparable with those charged on an identically managed institutional account. Why? Because mutual fund management fees pay for a lot more than just investment management. It should cost no more or less to manage institutional assets as it does to manage mutual fund assets. When pressed on the differences, fund companies point to service and distribution-related costs, which are unrelated to the research resources needed to manage the money. The Jones v. Harris case also found that the Oakmark fund's board of directors had been left in the dark regarding many of the details needed to make a true comparison. The SEC has an opportunity to eliminate such disconnects between fee labels and reality.

Take another example: Shareholders buying "no-transaction-fee" funds on supermarket platforms such as Fidelity or Schwab pay 0.40% for the privilege. Funds often pay for some of the charge with 12b-1 fees, but a portion always comes through the management levy. Participating in a supermarket platform has nothing to do with management. It is a distribution strategy. What's troubling is that a very significant component of fund expenses is not being properly documented. Investors transacting on those large platforms don't realize the true cost of fund distribution, even though it's their money being spent.

While it is true that investors are receiving benefits from the services layered into their funds' expense ratios today, they have no way to tell if the value received is commensurate with the price paid. Unless the full expense ratio is cleaned up, fund investors, fiduciaries, board members, and analysts will never have a way to judge. Better clarity around fund expenses will happen only if you mandate it.

We urge you to consider a sweeping overhaul of fund expense ratios, from top to bottom, that would break fees into appropriate, easy-to-understand buckets and standardize the accounting. Morningstar's President of Fund Research, Don Phillips, suggested this type of reform when invited to participate in the 12b-1 fee roundtable hosted by the SEC in 2007.

We suggest that expense ratios be broken down into the following four buckets:

Management
This is the fee charged to actually run the money from an investment standpoint and is agnostic to whether the fund is a retail mutual fund or institutional separate account. It pays for the portfolio managers, research analysts, traders, computer modeling software and equipment, Bloomberg terminals, trading platforms, and outside research. This should also include the research services received from soft dollars.

Sales and Marketing
This fee covers the full cost of selling and distributing the fund, including shelf-space arrangements with broker/dealers, advertising campaigns, and costs to be included on supermarket platforms. Some fund companies employ armies of fund wholesalers to pitch funds to advisors. Others forgo the expensive platforms, making them harder to access, and spend miniscule amounts on sales and marketing. Regardless of the strategy, the costs come out of the fund, so investors should be given a clear rundown of how much is coming out of their assets to participate in these programs and grow the funds they're in.

Advice
We've partitioned off an "advice" bucket that is distinct and separate from sales and marketing because there are meaningful differences between the two services. Advice is the fee charged by the fund and passed through to the broker, advisor, and/or wrap manager as compensation for ongoing advice, portfolio management, and service. Advice is sometimes paid for with fund assets and sometimes paid for outside of the fund. Investors should be able to quickly assess how much they are paying for the services of an advisor or broker and should know how it is being deducted. This is a legitimate service that has hid in the coffers of 12b-1 fees in the past, but should have a clear price tag and common-language label associated with it.

Administrative Overhead
This portion of the expense ratio covers the administrative costs of running the operation, transfer agency, record keeping, and board oversight.

Each of these activities is a legitimate use of fund assets, but, without knowledge of how much is being funneled where, fund shareholders have no way to know if the balance between those activities is in line with their needs and expectations.

You stated that you are "proposing a new approach to asset-based distribution fees that is designed to benefit shareholders while minimizing disruption of current arrangements." We believe our suggestions would go much further to benefit shareholders without being overly disruptive to current arrangements. We are not suggesting that you wipe out the arrangements existing in the background. We only ask that you help bring them to light with clean accounting and accurate labels.

The industry will raise objections. It will argue that it's too hard to allocate expenses in the appropriate buckets. Every business faces pricing and accounting challenges, but is able to comply. You can be sure that many of these arrangements between fund companies and distribution partners are already being accounted for behind the scenes. Most fund companies have already set a price on their true management activities for institutional accounts and trusts. The industry may also argue that the overall expense ratio is all that matters. Yet, funds that spend a large portion of their fees selling and skimp on management have different prospects than those that don't. And, given that investors in the funds are paying for those activities, they have a right to know where their money is going. Mutual fund companies are the stewards of trillions of dollars and should be held to the highest standards of public disclosure.

Transparency and simplicity have made mutual funds the vehicle of choice for decades. Yet, over the years, we've ended up with a cloudy landscape of meaningless accounting, confusing share classes, and fee jargon that make mutual funds less competitive. This is evidenced by the large proportion of fund assets moving to cheap institutional shares and ETFs. We encourage you to step in and help bring the virtues of simplicity and transparency back to the mutual fund industry.

Sincerely,

Karen Dolan, CFA
Director of Fund Analysis
Morningstar, Inc.