Supporting Literature

(1) Transcipt of SEC 12b-1 Roundtable, June 19, 2007, Panel 1 Discussion.
http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf
(2) American Bar Association Section of Business Law, Public Comment Letter to SEC, May 14, 2004.
http://www.abanet.org/buslaw/committees/CL410000pub/comments/20040518115044.pdf
(3) Report of The Mutual Fund Task Force: Mutual Fund Distribution,
http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p013690.pdf
(4) *Shareclass Warfare – A Counter Perspective on the Legitimacy of 12b-1 Fees as They Apply to Advisor-Distributed Share Classes,* Journal of Financial Planning, October 2004.
http://www.fphawaii.com/files/48530/Journal%20of%20FP%20Article%20Share%20Class%20Warfare%20Nov04.pdf

Elizabeth Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

RE:

Other Release No.: 34-62544, IC-29367
File No.: S7-15-10
Mutual Fund Distribution Fees

Dear Ms. Murphy:

On July 21, 2010 the SEC released a proposal to rescind Rule 12b-1 and to restructure and reform mutual fund distribution fees through an alternative set of rules referred to collectively as Rule 12b-2. In releasing its 278 page proposal, the SEC has sought public comment on many details of its plans for reform. This submission addresses two broad aspects of the plan – the basic premise for the proposal as outlined in the Chairman's video commentary and the economic models used to justify the reforms. Specifically, this response seeks to correct certain misstatements of fact that form the foundation of the SEC's case for rescinding 12b-1, and to challenge the naïve and simplistic economic model the agency is using to support its initiative.

Correcting Revisionist History

The basis for the SEC's proposal to rescind Rule 12b-1 is outlined in Chairman Schapiro's July 21, 2010 Open Meeting commentary, the text of which reads as follows:

"Rule 12b-1 was borne of a period in the late 1970s when funds were losing investor assets faster than they were attracting new assets. And, self-distributed funds were

emerging, in search of ways to pay for necessary marketing expenses. At the time, it was thought that investors would benefit if a fund could "grow" by using some of its own assets to market itself and make distribution payments. This, it was believed, would result in improved economies of scale and, ultimately, lower expenses. Even though funds last saw such sustained conditions nearly thirty years ago, rule 12b-1 has remained intact, even though it was premised on the idea that a fund could use 12b-1 fees as a short-term solution to the problem of shrinking fund assets. The imposition of 12b-1 fees, however, has been anything but short-term. In fact, very quickly these fees evolved from payment for advertising and marketing to an alternate form of compensation—or sales load—paid to intermediaries selling fund shares. In addition, 12b-1 fees compensate broker-dealers and other fund intermediaries for ongoing marketing and related services including recordkeeping, transfer agency services and overall investor education and consultation. Despite the evolution in the use of 12b-1 fees—and their emergence as a pervasive element of mutual fund intermediary compensation—the SEC's rules have not evolved. In my view, the regulatory scheme should be squared with the current mutual fund distribution framework—and investor expectations of how they pay for fund sales loads and services. In essence, 12b-1 fees have become a means to pay broker-dealers and mutual fund intermediaries **indirectly** ***out of fund assets, rather than*** **directly** ***out of the investor's pocket. And as the use of 12b-1 fees has evolved, the aggregate dollars paid have ballooned. These fees amounted to $9.5 billion in 2009, nearly $12 billion in 2008 and exceeded $13 billion in 2007—compared to just a few million dollars in 1980 when they were first permitted."***

As well-intentioned as the agency may be in its efforts to protect individual investors, the above statements contain numerous factual inaccuracies regarding the origin, intent, and subsequent evolution of Rule 12b-1. The suggestion that 12b-1 was adopted in 1980 as a short term measure to help support mutual fund companies at a time when they were suffering net outflows is simply not true. Similarly, the suggestion that the SEC adopted Rule 12b-1 in 1980 because it believed the use of 12b-1 fees to pay for distribution expenses would lead to fund asset growth that, in turn, would produce economies of scale that would benefit investors through lower expense ratios is both incorrect and a distortion of the historical record. Proof of this challenge to the SEC's rhetoric is provided in two primary sources – (1) the text of the June 19, 2007 SEC 12b-1 Roundtable Panel 1 discussion, and (2) a May 14, 2004 public comment letter from the American Bar Association's Section of Business Law to the SEC detailing the administrative history of Rule 12b-1.

On June 19, 2007, the SEC hosted a public roundtable discussion to address many aspects of Rule 12b-1. The first panel of the forum was devoted to presenting a historical perspective on the rule. The panelists included Dick Grant, who, as special counsel to the Director of the Division of Investment Management, was the principal architect of Rule 12b-1 and Joel Goldberg, who was a staff attorney with the SEC's Division of Investment Management at the time the rule was adopted and served as Division Director in 1981 and 1982. The panel also included Katherine Bradley McGrath, who served as Investment Management Division Director from 1983-1988. The panel was overseen by current Investment Management Division Director Buddy Donohue. In his opening remarks to the panel Attorney Goldberg states**,**

"I would like to start by disposing of one of the myths surrounding the adoption of Rule 12b-1. The myth is that Rule 12b-1 was adopted in response to concerns about net redemptions. In fact, net redemptions had ceased long before Rule 12b-1 was proposed or adopted. It had nothing to do with it."

In his testimony, Attorney Goldberg goes on to note that, while certain mutual fund companies suggested to the SEC that the ability to use a portion of their management fees to pay for marketing and advertising might enable them to achieve economies of scale that would lower investor expense ratios, the SEC was not persuaded by this argument. In fact, the true intent of the SEC in adopting was to promote long term innovation and competition in mutual fund industry in hopes that new distribution methods would arise to compete with the 8.5% up front sales charges that dominated the mutual fund landscape at that time. These sentiments were echoed by Attorney Grant who commented,

"I guess I'm going to be the third person on the panel to emphasize this particular point -- and not that that's a surprise; I think we all had it in mind -- a number of people in a number of ways have questioned whether the Commission anticipated or intended that payments to dealers would become part of the framework of the cost of selling fund shares. And the answer to that question is, absolutely. The Commission understood that, the Commission expected that. And as a person who lived with this rule – and, in fact, had designing such a rule in my job description at the time – I can tell you that it was my main hope that, if such a rule was done, its major benefit would be the reduction – and, in some cases, the elimination of front-end sales loads."

Attorney Grant also went on to note,

"…the Commission was not going to regulate the amount or the nature of 12b-1 fees. [There was] A clear expectation that people would use their imagination to come up with things that were, in fact, not anticipated at the time."

"…The other thing I would say about the factors is that they reflected the concerns at the time, in the sense that they talk about problems that might be addressed by a 12b-1 fee. But they were clearly not regarded as a temporary fix. Instead, to say it one more time, it was a basic decision to let boards oversee a business judgment about how to use the fund's assets to promote distribution."

These statements, along with the entire text of the Panel 1 discussion, are directly at odds with the historical perspective presented by Chairman Schapiro in her opening remarks and in the introduction of the SEC's 278 page reform proposal. Additionally, the Chairman's remarks seem to suggest that subsequent SEC administrations may have been asleep at the switch with respect to monitoring new applications of distribution fees under the rule. Attorney Grant's statement makes clear that the SEC administration that adopted Rule 12b-1 fully anticipated that distribution fees might be used to compensate broker dealers. A reading of the ABA's review of the administrative history of Rule 12b-1 documents and supports the recollections of Attorneys Grant and Goldberg, and also illustrates that, contrary to Chairman Schapiro's assertion, the SEC has historically been quite proactive in monitoring the evolution of the rule as new applications have arisen. As an example, Attorney McGrath, in her Roundtable testimony, described the SEC's attentive monitoring efforts and the complexity of the issues from 1985-1990. Interestingly, she expressed that the SEC, during her tenure, hoped that ongoing 12b-1 fees (i.e., level-load class C shares) would replace up-front sales charges. This is the exact opposite position of the one taken by the current SEC administration. To quote Attorney McGrath,

"My two cents on all of this, you know, Americans like to pay on time. And most investors really don't know how long they're going to stay in a fund. So -- and one of the reasons they buy mutual funds is because they know they can get out whenever they want. So, you know, I don't think front-end loads are the answer. People hate them. They also don't like deferred sales loads, because that causes them to feel they're stuck. So, it would be nice if something could be worked out to continue asset-based fees, if we can figure out how to clearly explain them to investors so they know what they're paying, and what they're getting."

That the SEC is basing its call to repeal Rule 12b-1 on a misinformed understanding of history is difficult to comprehend. Current Investment Management Division Director Buddy Donohue, who, along with Chairman Schapiro, is spearheading the new proposal, was one of the moderators for the 12b-1 Roundtable Panel 1 discussion. His opening remarks at the Roundtable were nearly identical to those of Chairman Schapiro's July 21 open meeting commentary, and they were summarily repudiated by the Panel 1 participants – the senior SEC officials who drafted and adopted the rule in 1980. For her part, Chairman Schapiro's version of Rule 12b-1 history is also somewhat surprising given her experience and public statements during her tenure at FINRA. Specifically, in 2004 and 2005, during her leadership at FINRA (formerly NASD), she served as Chairman of the Mutual Fund Task Force, the ad-hoc committee charged with researching mutual fund distribution fees under Rule 12b-1 and reporting to the SEC. After nearly a year of research and information gathering, the Task Force submitted its final report to the SEC. Included in this report were the following statements:

"The Task Force reviewed the history of Rule 12b-1, including the purposes for which it was adopted and the use of the rule by the fund industry…The Task Force believes that many of the developments in distribution payments since the adoption of Rule 12b-1 have benefited investors by allowing them to choose to pay distribution costs up-front, over time, or when fund shares are redeemed. At the same time, the variety and complexity of these choices, and the fact that many distribution costs are incurred at the fund level, may tend to obscure the extent of these costs and the incentives that they may create. The Task Force concludes that the most important changes that the Commission should consider are those that make the costs and potential conflicts associated with mutual fund distribution more visible to the retail investor."

"In 2004, the Commission issued a release seeking public comment on ways to improve Rule 12b-1. The Release seeks comment on whether the rule should be rescinded or amended to provide that funds may deduct distribution-related costs directly from shareholder accounts, but not from fund assets. Proponents assert that account-level fees would allow an investor to pay distribution costs over time, but would be more transparent to the customer than fund-level expenses such as Rule 12b-1 fees and revenue sharing payments. Nevertheless, the conversion of Rule 12b-1 fees from the fund level to the shareholder account level would require costly systems changes by fund distributors, transfer agents and intermediaries. Moreover, it is unclear where this approach would leave directly distributed funds that today pay their distribution costs out of fund assets. A simpler way to make all fund fees and expenses transparent – including the costs of distribution – would be to mandate better point of sale disclosure to the investor."

Regardless of the SEC's motivations, a reading of the 12b-1 Roundtable transcript along with the ABA's public comment letter conclusively prove that the historical pretext the SEC is using to advance its reform agenda is not accurate and is potentially misleading to the public. As presented above, the statements made by Chairman Schapiro in her open meeting commentary are not matters of opinion - they are misstatements of fact with very little room for ambiguity.

The Economics of Mutual Fund Choice

The crux of the SEC's proposal to rescind and replace Rule 12b-1 involves limiting the cumulative asset-based 12b-1 fees (i.e., 12b-1 fees over and above the standard 25 basis point service fee) paid by investors who purchase alternative share classes to the total of the upfront sales charge they would have paid had they purchased traditional class A shares. Given that the SEC chose to exclude revenue sharing agreements under 401(k) platforms from its reform agenda, the proposal most dramatically affects the so-called "level load" share classes, herein broadly referenced as "class C shares". According to the proposal, the expense structure of class C shares would effectively convert to that of class A shares once the cumulative asset-based 12b-1 expenses equal the upfront sales charge the investor would have paid had he purchased class A shares instead. Thus, for an equity mutual fund with a 5.75% up front sales charge, traditionally structured class C shares with a .75% annual asset-based 12b-1 charge would convert to class A shares in approximately 7.5 years. Breakpoint eligible purchases would shorten the conversion time frame accordingly. At the heart of this proposal is the SEC's concern that investors are paying too much of their hard earned savings in the form of 12b-1 fees. As noted by Chairman Schapiro, "***These fees amounted to $9.5 billion in 2009, nearly $12 billion in 2008 and exceeded $13 billion in 2007—compared to just a few million dollars in 1980 when they were first permitted."*** Of course, it should also be pointed out that in 1980 there were only around 600 mutual funds, total mutual fund assets were less than $100 billion, and, as noted previously, the mutual fund marketplace was dominated by 8.5% sales loads. Since the 1980s, mutual funds have become immensely popular with investors and there are now more than 9,000 mutual funds with total assets in the trillions of dollars.

To determine whether the SEC's proposal will benefit or potentially harm investors requires a more detailed economic analysis. In terms of the economic case for reform, the implicit argument presented by the SEC is that the drag of higher expenses on long term class C shareholders hurts performance relative to investors who elect to pay up front sales charges. This argument was advanced in a 2003 white paper produced by SEC staff member Lori Walsh, and has been echoed periodically in the academic literature as well. If two funds hold exactly the same investments, it stands to reason that the one with higher cumulative expenses will suffer inferior performance over longer time periods. In reality, however, this pricing model is overly simplistic and does not accurately reflect the actual economics of mutual fund choice.

To begin, the SEC's model contains one significant flawed assumption – that investor behavior and performance, adjusted for expense ratio differences, is the same across all share classes. In fact, it is not, and the reason it is not is that investor behavior differs depending upon the share class purchased. For example, it is well established that investor holding periods differ across share classes and between load and no-load funds. It is also documented that investors across all mutual fund share class variations tend, due to the timing of their buy and sell decisions, to underperform the funds in which they invest. On this point, a 2007 academic study sponsored by no-load index fund advocate Zero Alpha Group found that investors in pure no-load funds (i.e. funds with no 12b-1 fees) underperform the funds in which they invest by an average of .78% per year while investors in legal no-loads (funds with no sales charge but a .25% 12b-1 fee) underperform by 1.91%, and investors in load funds as a group underperform by 1.82% per year[1]. Interestingly, and directly on point with this discussion, the ZAG study found that investors in class C mutual funds underperform the funds in which they invest by an average of 1.33% per year, while investors in class A shares underperform by an average of 1.62% per year. Although other empirical evidence of variations in investor experiences across share classes of a single fund exist as well, this example clearly illuminates the flaws in the SEC's model.

Additionally, the SEC's economic model fails to consider the influence of the "invisible hand" of incentives (particularly those of the financial advisors) in investor mutual fund selection decisions. To borrow a quotation from the best selling book <u>Freakonomics</u>, *"Incentives are the cornerstone of modern life. And understanding them – or, often, ferreting them out – is the key to solving just about any riddle, from violent crime to sports cheating to online dating."* As noted in aforementioned testimony of Katherine Bradley McGrath, previous SEC administrations appear to have been keenly aware of role of incentives in mutual fund choice. In particular, during Attorney McGrath's tenure, there seems to have been a consensus that mutual fund share classes that compensate brokers through ongoing asset-based 12b-1 fees better aligned client-advisor interests than mutual funds sold with an up front sales commission. This position is

1 Bullard, Friesen, and Sapp**;** ***Investor Timing and Fund Distribution Channels***, Zero Alpha Group Working Paper, Dec 2007 (JEL Classifications: G11, G20)

consistent with the widespread movement away from commission-based sales of investment products over the past three decades in favor of fee-based alternatives. The impact of economic incentives on mutual fund share class decisions was also explored in detail in a 2004 **Journal of Financial Planning** piece entitled *"Shareclass Warfare – A Counter Perspective on the Legitimacy of 12b-1 fees in Advisor Distributed Mutual Funds"*. Through numerous examples, the paper demonstrates that the influence of advisor incentives, or, alternatively, the absence of certain conflicts of interest, makes class C shares a superior choice relative to commission-based A and B shares. The current 12b-1 reform proposal seems to represent a step away from fee-based compensation and back toward commission-based sales. Of course, it should be noted that investors could still purchase class C shares under the SEC's proposal. However, to the extent that brokers who steer their clients to class C shares will experience a dramatic reduction in compensation upon the A share conversion date, the SEC, in its voluminous reform proposal has failed to consider the possibility that C share investors may be adversely impacted by either neglect from the advisor after his compensation is reduced or by a recommendation to switch to an alternative form of investment that will resume compensation to the advisor.

Similarly, the SEC's economic analysis also fails to consider the existence and potential impact of substitutes. For example, it is reasonable to assume that a fair number of advisors may recommend that their clients switch from class C shares to wrap-fee mutual fund advisory accounts. One potential negative effect of such a switch may be that the wrap fee expenses are higher than the ongoing 12b-1 fees. The average level of wrap fees nationwide is approximately 1.3% per year vs. the 1.0% total (service + asset fee) 12b-1 expense in class C shares. This difference may be attributable to the additional layer of custodial administration expenses in wrap accounts that are not found in class C shares. Indeed, there are undoubtedly some advisors who recommend class C shares to their clients because they tend to be a cheaper alternative to wrap accounts. Variable annuity contracts, which may compensate brokers through ongoing fees paid from so called "Mortality Expenses" may also be a beneficiary of 12b-1 reform. Simply put, substitutes abound, and it seems likely the expense savings the SEC is envisioning may be lost as advisors migrate their clients to these alternative products and platforms.

In sum, the basic economic argument presented by the SEC is that investors who purchase class C shares for the long term pay too much (and therefore suffer lower returns) relative to purchasers of traditional class A shares. However, this discussion has illustrated that this economic model is naïve and simplistic. The SEC has presented no clear evidence that investors will actually benefit financially from the reform and a basic understanding of the influence of economic incentives on mutual fund choice decisions suggests that investors will likely end up paying more for investment services.

SUMMARY

In an era in which the SEC has been apologetic for numerous regulatory shortcomings, the SEC's downright dogged pursuit of 12b-1 reform over the past seven years is a mystery wrapped around an enigma. On one hand, the SEC contends that investors are paying too much in cumulative 12b-1 fees, while, on the other, it seemingly turns a blind eye to so called "2 and 20" hedge funds and has no apparent objection to ongoing investment advisory wrap fees (which average nearly 35% higher than class C share 12b-1 fees) or to exorbitant ongoing expenses within variable annuity and insurance contracts. Similarly, while the SEC may be regarded as noble in its efforts to improve disclosure of 12b-1 fees, the one application of Rule 12b-1 that is arguably ripe for reform and which has been the target of numerous high profile television and print media exposes is the use of 12b-1 fees (including so called "revenue sharing" agreements) in group annuity 401(k) platforms. On this score, the latest SEC proposal summarily dismisses the notion of such reform in footnote #459 by stating that these types of reform measures might be too disruptive to "existing distribution systems". Equally puzzling is the extensive discussion in the introduction section of the 278 page proposal (pages 29-35) of the views expressed during the June 2007 SEC 12b-1 Roundtable to the virtual exclusion of the comments of the Panel 1 participants. Regardless of the SEC's inclinations in pursuing the repeal of Rule 12b-1, the purpose of this submission has been to conclusively demonstrate that the SEC's historical pretext for reforming 12b-1 is misinformed and that its basic economic argument is irrefutably flawed. To the extent that the SEC is truly motivated to protect the interests of individual investors, the current proposal to rescind and replace Rule 12b-1 should scrapped. However, the forceful tenor of the SEC's recent public comments leaves one with the distinct impression that, to paraphrase a line from a classic western, Rule 12b-1 will receive a proper public hearing after which it will be properly hung. Nonetheless, the opportunity to submit this commentary is sincerely appreciated.

Quixotically yours,
John H. Robinson
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Mr. Robinson is a Honolulu-based, dual-registered financial advisor. He has written and published numerous papers and op-ed pieces on topics pertaining to advisor compensation and ethics.