12b-1 Fees:

Seriously, Why Are We Still Paying These?

*By Sundeep R. Patel, Esq.**

Even the best-laid plans often go wrong. Rule 12b-1 of the Investment Company Act of 1940 (the "1940 Act") is an example of how well-planned legislation can turn out to be a real-life nightmare. This article is written as a persuasive argument for the Securities and Exchange Commission ("SEC") to amend Rule 12b-1 and to better educate prospective and current investors about 12b-1 fees. Part I of this article provides the historical development of Rule 12b-1 and Part II provides analysis and recommendations for the Rule.

Historical Overview

Section 12(b) of the 1940 Act prohibits a mutual fund from acting as a distributor of its securities in contravention of any SEC rules. Historically, the SEC interpreted the statutory language of Section 12(b) to mean mutual funds cannot finance,

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directly or indirectly, the distribution of their shares.[1] Because of the SEC's position, prior to the enactment of Rule 12b-1, mutual funds sold through investment advisers and other sales professionals compensated these people for providing shareholders with ongoing investment advice through "front-end" sales loads.[2]

In 1979, the SEC proposed the adoption of Rule 12b-1. The SEC stated in the accompanying release that "[t]he Commission is taking these actions because it believes that directors and shareholders of open-end management investment companies should be able to make business judgments to use their assets for distribution in appropriate cases...."[3]

In 1980, the SEC adopted Rule 12b-1, which permits funds to pay distribution-related costs.[4] The Rule prohibits an open-end fund from using its own assets to pay for distribution-related costs — such as marketing and advertising — without a written plan adopted by the fund's board and shareholders. When the SEC first adopted the Rule, it thought that 12b-1 plans would solve particular distribution problems such as advertising.[5] The

Rule is silent, however, on the types of distribution activities that the fund can finance. In fact, the SEC specifically noted that Rule 12b-1 does not restrict the kinds of payments a fund may make; rather, discretion lies with fund boards regarding the fund's distribution-related activities.[6]

Initially, funds used 12b-1 fees to pay advertising and marketing distribution fees. Since the late 1980s, however, the vast majority of funds have used these fees as a way to "give shareholders the option to pay for services they receive from sales professionals over time rather than a single up front payment."[7] While some investors purchase fund shares directly from the company sponsoring them, the vast majority of people purchase shares through sales representatives such as broker-dealers or investment advisors.[8] Therefore, today, the primary purpose of these fees is to compensate broker-dealers and financial advisers for the advice and services they provide their clients.[9] 12b-1 fees have evolved as a method by which funds use in place of, rather than as a supplement to, traditional front-end sales loads to cover the costs of distribution of shares.[10] Such plans spread the cost that would

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be charged at the time of an investor's initial purchase over an extended period of time.

Early on, the SEC recognized that mutual funds misused 12b-1 fees.In 1988, the SEC proposed an amendment to Rule 12b-1 that would, among other things, require payments under a 12b-1 plan to be made on a current basis, be traceable to the specific actual distribution services provided to the fund, and require annual shareholder approval in order to continue the 12b-1 plan.[11] In 1992, the SEC's Investment Management Division issued a report recognizing that fund companies face inherent conflicts of interest when using fund assets to promote distribution, and because of the variety of methods now available to finance distribution expenses, regulation of one method would necessarily affect others.[12]

Then in 2000, the Investment Management Division issued another report that seemingly affirmed the current uses of 12b-1 fees by concluding that the "current statutory framework's primary reliance on disclosure and procedural safeguards to determine mutual fund fees and expenses... is sound and operates in the manner contemplated by Congress."[13] The Fees Study recommended that the SEC adjust Rule 12b-1's requirements to "reflect changes in the manner in which funds are marked and distributed and the experience gained from observing how Rule 12b-1 has operated since it was adopted in 1980."[14] In 2003, Congress considered a variety of possible amendments to the 1940 Act, including revisions to a fund's ability to finance the distribution of its shares, however, Congress did not enact any of these amendments. Then in 2004, the SEC asked for comment on whether to rescind Rule 12b-1.[15] And, finally, in March 2005, the National Association of Securities Dealers ("NASD") issued a report that included discussion on updating the requirements of Rule 12b-1.[16]

Analysis and Recommendations

Recent media coverage and industry professional commentary have questioned whether Rule 12b-1 continues to serve a beneficial purpose for current and prospective investors.[17] Current proposals range from improving disclosures of the fees charges to eliminating Rule12b-1.

Additionally, the implementation of one additional disclosure that could increase investor understanding of fees associated with a purchase of a fund would be to include a list of terms and a fee table in the prospectus.[18] Such a disclosure would better inform investors of "possible conflicts of interest that could compromise the adviser's responsibility to control fund costs and provide investors a satisfactory return."[19]

Another change the SEC could implement would be to change the definition of a "no-load" fund. Currently, NASD rules prohibit any fund with a front-end load or a 12b-1 fee, except where the 12b-1 fee does not exceed 25 basis points, from being referred to as a "no-load" fund.[20] The purpose of this rule was to help investors distinguish between funds that use low 12b-1 fees from those that use high 12b-1 fees as an alternative to front-end sales charges.[21] The problem here is that to the ordinary investor, the term "no-load" likely means that the fund is not charging either a sales charge or a distribution fee.

These disclosure improvements, along with making fund prospectuses less difficult to understand,[22] would provide investors with more confidence in making investments with funds. The use of shorter, more concise disclosure documents that provide this key information would significantly enhance the transparency of fund fees and expenses associated with purchasing fund shares.

Another problematic area of Rule 12b-1 that the SEC should examine is board guidance under the Rule. Currently, Rule 12b-1 requires a fund's board of directors to give weight to nine different factors, all of which would be useful in determining, whether fund assets would be used for distribution expenses.[23] The problem here is that Rule 12b-1 has evolved since its initial

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inception in 1980. As discussed above, the industry does not use 12b-1 plans to solve distribution-related problems; rather, plans are used as a substitute for advice and services provided by financial advisors and broker-dealers. While a fund's board should play a supervisory role in the overview and implementation of a fund's 12b-1 plan, the business judgment standard should protect fund directors. Such a change would give a fund board more flexibility to deal with the fund's chosen use of 12b-1 fees. For example, if a fund chooses to have low 12b-1 fees, then the board could direct the fund's plan towards a distribution goal. However, if the fund wanted to charge higher fees as a way to compensate investment advisor professionals, then the fund directors would need to direct the fund's 12b-1 plan towards a service and compensation oriented scheme. Either way, because different funds use 12b-1 fees for different purposes, it makes no sense for the SEC to replace the list of current factors, because no set of factors exists that would be relevant to the different circumstances that boards may face.

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Conclusion

While 12b-1 plans still serve a valid function, they are not used solely to pay for distribution-related expenses as the SEC originally contemplated. Thus, changes to Rule 12b-1 are both appropriate and necessary. BLB

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1 *See* Securities and Exchange Commission, Statement on the Future Structure of Securities Markets, 37 Fed. Reg. 5286 (Mar. 14, 1972).

2 A front-end load is a commission or sales fee charged at the time of the initial purchase for an investment. It is deducted from the investment amount and, thus, lowers the size of the investment. *See* INVESTOPEDIA http://www.investopedia.com/terms/f/front-endload.asp (last visited June 11, 2007).

3 *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 6119, 1979 WL 193460 (S.E.C. Release No. 6119) at *1 (Sept. 7, 1979).

4 *See* Bearing of Distribution Expenses by Mutual Funds, SEC Release No. IC-11414, 1980 WL 20761 (S.E.C. Release No.11414) (Oct. 28, 980).

5 Robert Schroeder, *Regulators Will Review Fund's 12b-1 Fees*, WALL STREET JOURNAL (May 30, 2007) at C11 (quoting SEC Chairman Christopher Cox, "[t]oday's uses of 12b-1 fees have strayed from the original purposes underlying the rule, and it is time for a thorough re-evaluation").

6 *See* Bearing of Distribution Expenses by Mutual Funds, SEC Release No. IC-11414 (Nov. 7, 1980).

7 Investment Company Institute website, *Background Information About 12b-1 Fees*, http://www.ici.org/funds/abt/ref_12b1_fees.html (last visited June 8, 2007) (noting that many investors prefer this option as opposed to paying for these services up front because these fees allow "their entire investment to be put to work for them immediately instead of having it reduced initially by a sales commission").

8 Investment Company Institute, *How Mutual Funds Use 12b-1 Fees*, Vol. 14 No. 2 (Feb. 2005).

9 *See id.* (A 2004 Investment Company Institute survey showed that funds use most of their 12b-1 fees to "compensate financial advisers and other financial intermediaries for assisting fund investors before and after they purchase fund shares").

10 *See* Arthur Z. Gardiner, *Distribution of Investment Company Shares under Rule 12b-1*, 548 PLI/Corp 91, 121 (1987).

11 *See* Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431, 1988 SEC LEXIS 1206 at *40 (Jun. 13, 1988). 53 Fed. Reg. 23258, at 23259 (June 21, 1988).

12 *See* U.S. SECURITIES AND EXCHANGE COMMISSION, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, at 291297 (May 1992), http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

13 DIVISION OF INVESTMENT MANAGEMENT, REPORT ON MUTUAL FUND FEES AND EXPENSES (Dec. 2000) *available at* http://www.sec.gov/news/studies/feestudy.htm (last visited May 29, 2007).

14 *Id.*

15 Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26356 (Feb. 24, 2004).

16 NASD, Report of the Mutual Fund Task Force: Mutual Fund Distribution, *available at* http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p013690.pdf (last visited Feb. 25, 2008).

17 *See* Christopher Cox, Chairman, Securities and Exchange Commission, Address to the Mutual Fund Directors Forum Seventh Annual Policy (Apr. 13, 2007) *available at* http://www.sec.gov/news/speech/2007/spch041207cc.htm.

18 U.S. Gen. Accounting Office, Greater Transparency Needed in Disclosures To Investors 36 (2003).

19 *Id.*

20 *See* Nat'l Ass'n of Sec. Dealers Conduct Rule 2830(d) (promulgating rules for investment by various kinds of funds).

21 *See* Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Excange Act Release No. 34-30897, 57 Fed. Reg. 30985-02 (July 7, 1992) (approving the NASD's proposed change to 17 CFR pt. 430.19b-4).

22 *See* Investment Company Institute, Understanding Investor Preferences for Mutual Fund Information (2006), *available at* http://www.ici.org/statements/res/rpt_06_inv_prefs_full.pdf (synopsizing trends of investors and shareholders in making investment decisions, finding investors embrace the internet and do not consult SEC-required annual reports).

23 *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. IC-11414. 45 Fed. Reg. 73,898 (Nov. 7, 1980) (approving changes to 17 CFR pts. 239, 270, and 274, which adopted disclosure and reporting requirements).