INVESTMENT COMPANY INSTITUTE

MEMO# 24689

November 5, 2010

ICI Comment Letter on the SEC Proposal to Replace Rule 12b-1 with a New Distribution Framework

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TO: ACCOUNTING/TREASURERS MEMBERS No. 37-10
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 48-10
BOARD OF GOVERNORS No. 8-10
BROKER/DEALER ADVISORY COMMITTEE No. 55-10
INVESTMENT COMPANY DIRECTORS No. 27-10
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 57-10
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PENSION OPERATIONS ADVISORY COMMITTEE No. 27-10
SEC RULES MEMBERS No. 115-10
SALES FORCE MARKETING COMMITTEE No. 6-10
SMALL FUNDS MEMBERS No. 70-10
TAX MEMBERS No. 32-10
TRANSFER AGENT ADVISORY COMMITTEE No. 75-10 RE: ICI COMMENT LETTER ON THE SEC PROPOSAL TO REPLACE RULE 12B-1 WITH A NEW DISTRIBUTION FRAMEWORK

As you know, the Securities and Exchange Commission (SEC) has proposed sweeping changes to the rules and disclosure requirements related to the use of fund assets to pay for the distribution of fund shares. [1] The proposal would rescind rule 12b-1 under the Investment Company Act of 1940 (the 1940 Act) and replace it with a new framework for "marketing and service fees" and "ongoing sales charges." It would also amend rule 6c-10 under the 1940 Act to provide funds with an option to issue shares at net asset value to dealers, who would then be free to establish and collect their own commissions or other sales charges to pay for distribution.

The ICI has submitted the attached comment letter on the proposal. The letter recognizes that the SEC has a number of legitimate concerns with Rule 12b-1 and 12b-1 fees, and commends the SEC for its attempt to address these concerns. Ultimately, however, the letter expresses our belief that the proposal places the agency in the inappropriate role of a ratemaker, and is far more extensive and intrusive than necessary.

The letter provides our views on the rulemaking in general, as well as a number of specific comments, concerns, and recommendations on five major elements of the proposal: ongoing sales charges; marketing and service fees; board oversight; new disclosures; and the proposed exemption from Section 22(d) that would allow for a new distribution option. Our major comments, concerns, and recommendations include the following:

General Comments

- Timing of the proposal. This proposal comes at a time when the SEC is also actively considering the harmonization of standards of care for investment advisers and broker-dealers and contemplating new point of sale disclosure rules. The letter recommends that, in order most thoughtfully to address the entire range of distribution-related issues facing it, the SEC ought to first resolve the debate over the appropriate standard of care applicable to broker-dealers, and then address point of sale disclosure, confirm disclosure, and Rule 12b-1.
- The SEC's economic analysis. As required by statute, the SEC must weigh the anticipated benefits of a rulemaking against any resulting costs and burdens for investment companies generally and small funds in particular. The letter questions whether the proposal has met the statutory requirements, and urges the SEC to take a further and more careful look at its analysis before proceeding. The letter notes that, to assist in this regard, we are conducting our own economic analysis, which we expect to file by the end of the month as a supplement to the letter.

Ongoing Sales Charges

- The concept of "functional equivalence." The proposal would allow funds to impose "ongoing sales charges" up to a reference load. The letter notes that the central concept underlying much of this part of the proposal is that a portion of what is currently paid for with 12b-1 fees is the functional equivalent, paid over time, of a front-end sales load. The letter states that we strongly disagree that in every context, a 12b-1 fee that exceeds 25 basis points is the functional equivalent of a front-end sales charge. It argues that in many instances a hard cap on aggregate compensation is not warranted. The services in those instances continue; the compensation must as well.
- C shares. For many investors, particularly those with relatively smaller amounts to invest, C shares have proven to be the best way available to obtain the benefits of a flexible asset allocation account and the ongoing services of a financial professional. The letter expresses our concern that, while the SEC did not propose to eliminate C shares, the proposal would have a significant impact on these shares as we know them and disadvantage many small investors. To the extent that, despite our concerns, the SEC moves forward with this part of the proposal, the letter recommends that it should distinguish the C share context from other uses of 12b-1 fees, such as for retirement shares and money market funds, where the use of 12b-1 fees is far different from the use of a front-end sales charge.
- The "reference load" used to cap ongoing sales charges. The proposal would limit the cumulative amount of ongoing sales charges to a "reference load," which would be the highest sales load rate on a class of the fund with no ongoing sales charge (e.g., the maximum front-end load for the fund's class A shares). The letter outlines some of the operational and practical difficulties with this type of non-standardized reference load, and recommends that the SEC treat the FINRA sales charge limit of 6.25 percent as the reference load for purposes of determining the maximum amount

of ongoing sales charge in all cases.

- Retirement plans. The current use of 12b-1 fees in the retirement plan context is clearly not the functional equivalent of a front-end sales charge. Accordingly, the letter recommends that the SEC take steps to permit funds to provide ongoing compensation for ongoing services rendered in the retirement plan context, without having to treat that compensation as a form of ongoing sales charge. The letter outlines two possible ways for the SEC to do this: by providing guidance to the effect that certain ongoing services provided to plans and their participants are not "primarily intended to result in the sale" of fund shares and therefore not "distribution activities" and/or by directing FINRA to craft a separate cap for retirement shares that would reflect the unique nature of the ongoing services provided by brokers in that context. In essence, this latter recommendation would allow for a higher marketing and service fee for classes of fund shares used exclusively for retirement plans.
- Money market funds. The use of 12b-1 fees in the money market fund context is clearly not the functional equivalent of a front-end sales charge; money market funds are not sold with a front-end sales charge. The Release does not appear to contemplate the use of 12b-1 fees by money market funds, either with respect to marketing and service fees or ongoing sales charges. The letter recommends that, before the SEC goes forward with this rulemaking, it should carefully consider the application of the rules in this context, and in doing so should reject the notion that 12b-1 fees in excess of 25 basis points must in this case be treated as an ongoing sales charge subject to conversion. It argues that requiring systems to be built for money market funds to track and age their shares, including, for example, the daily investment of overnight balances in a sweep account, would be costly and pointless.
- Reinvested dividends and distributions. The proposal would permit the reinvestment of dividends and distributions in a share class with an ongoing sales charge, subject to the same conversion schedule as the shares on which the dividend or distribution was declared. The letter explains that this would be highly problematic for operational reasons, and recommends instead that the final rule permit funds to convert dividend and distribution reinvestments proportionately, based on the total shares held in an account at the next scheduled periodic conversion date.
- The five year "grandfathering" period. The proposal includes a five year "grandfathering" period, after which all shares sold before the compliance date would be required to be converted or exchanged into a class that does not deduct an ongoing sales charge. The letter recommends that the SEC consider alternatives that would eliminate or at least mitigate disparities between the length of the grandfathering period and the length of conversion schedules for funds with smaller ongoing sales charges. More specifically, the letter suggests that the SEC may wish to consider providing longer grandfathering periods for fund shares with 12b-1 fees in one or more defined bands (e.g., a grandfathering period of fifteen years for fund shares with 12b-1 fees between 25 and 50 basis points). Or, it might consider allowing funds to overlay their conversion schedule on existing share classes, provided that the fund gives credit to existing shareholders for their holding periods.

Marketing and Service Fees

- The letter expresses our appreciation for the SEC's recognition that funds bear ongoing distribution-related expenses that benefit the fund and existing fund shareholders in a variety of ways, and appreciation for the recognition that, at a certain level, there is no need for a written plan to be approved annually by the fund's board. The letter expresses our concern, however, that with a cap of 25 basis points, funds and their advisers will be under a great deal of pressure to carefully define what constitutes "distribution activities" for purposes of Rule 12b-2. Accordingly, the letter requests that the SEC provide unequivocal statements in any final rulemaking that, at a minimum, administrative services, non-distribution service fees, and non-distribution payments to retirement plan recordkeepers are outside the scope of Rule 12b-2.

Board Guidance

- The letter expresses our appreciation for the SEC's efforts to modernize and streamline the role of fund boards in overseeing distribution fees, and our strong support for the SEC's proposal to eliminate board requirements like annual approvals of 12b-1 plans and quarterly reviews of 12b-1 fees. The letter opposes, however, the SEC's proposed guidance for directors. We see it as inaccurate, inappropriate, and unnecessary.

Confirmation Statement Disclosure

- The proposal includes a number of new disclosure requirements in investor confirmation statements ("confirms"). The letter notes that while we strongly support changes that would improve investor understanding of distribution-related fees and expenses, we believe that some of the proposed confirm disclosure is better suited for point of sale disclosure and therefore unnecessary in a confirm. The letter also expresses our concern about the potential that complicated, fund-specific confirms may have the unintended consequence of incenting brokers to sell other products not subject to the same requirements.

Account-level Sales Charges; the 22(d) Exemption

- The letter notes that our members have expressed mixed, and often uncertain, views on the concept of account-level sales charges. Given this reaction, the letter strongly recommends that the SEC conduct further study on the range of views and likely outcomes from account-level sales charges before proceeding on this aspect of the proposal.

Robert C. Grohowski
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Securities Regulation - Investment Companies

Attachment (in .pdf format)

endnotes

[1] SEC Release Nos. 33-9128; 34-62544; IC-29367 (July 21, 2010) (the "Release"). The Release can be found on the SEC's website at http://www.sec.gov/rules/proposed/2010/33-9128.pdf. For additional background, see ICI Memorandum No. 24449, dated July 28, 2010.