The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 24613

October 14, 2010

Draft Comment Letter on Proposed Rule 12b-1 Reform

URGENT/ACTION REQUESTED

[24613]

October 14, 2010

TO: ACCOUNTING/TREASURERS COMMITTEE No. 11-10
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 36-10
BROKER/DEALER ADVISORY COMMITTEE No. 43-10
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 49-10
OPERATIONS COMMITTEE No. 29-10
PENSION COMMITTEE No. 25-10
PENSION OPERATIONS ADVISORY COMMITTEE No. 24-10
RESEARCH COMMITTEE No. 6-10
SEC RULES COMMITTEE No. 42-10
SMALL FUNDS COMMITTEE No. 16-10
TAX COMMITTEE No. 31-10
TRANSFER AGENT ADVISORY COMMITTEE No. 60-10 RE: DRAFT COMMENT LETTER ON PROPOSED RULE 12B-1 REFORM

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] Attached is a draft of the ICI's comment letter on the proposal. The draft letter recognizes that the SEC has a number of legitimate concerns with 12b-1 fees. 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 than necessary. The major comments in the draft letter are summarized below.

> Comments are due to the SEC on November 5th. Accordingly, please provide any comments on the draft by phone or email no later than Friday, October 29th to Bob Grohowski at (202) 371-5430 or rcg@ici.org. Given the length and complexity of the letter, written comments are appreciated. We will also schedule several conference calls with various committees to discuss particular aspects of the draft. Details for those conference calls will follow in separate memoranda.

The draft 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: marketing and service fees; ongoing sales charges; new disclosures; board oversight; 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:

- 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. In order to thoughtfully address the entire range of distribution-related issues facing the SEC, the draft letter recommends that the SEC first resolve the debate over the appropriate standard of care applicable to broker-dealers, 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 draft letter expresses our belief that the SEC has not met these statutory requirements, and it urges the SEC to take a further and more careful look at its analysis before proceeding.

- The 25 basis point "marketing and service fee." The draft 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 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. It recommends that the SEC more clearly delineate the scope of Rule 12b-2 and, in particular, clarify that non-distribution service fees are permitted to be paid out of fund assets as fund expenses outside the scope of Rule 12b-2. In order for this clarification to be meaningful, the letter further recommends that the SEC provide specific guidance as to what constitutes "service fees" and other non-distribution activities.

- C shares. For many investors, particularly those with relatively smaller amounts to invest, C shares have proven to be the best available option to obtain the benefits of a flexible asset allocation account and the ongoing services of a financial professional. The draft letter expresses concern that, while the SEC did not propose to eliminate C shares, the proposal would have a significant impact on C shares to the disadvantage of many small investors. To the extent that, despite these concerns, the SEC moves forward with this part of the proposal, the letter recommends that the SEC distinguish the C share context from other contexts, such as retirement shares and money market sweep accounts, 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 draft letter 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, even if a fund has a front-end load class of shares that can serve as the reference load.

- Retirement plans. The draft letter notes that, if the rule is adopted as proposed, some funds currently used as investment options in retirement plans will be required to treat a portion of their 12b-1 fee as an ongoing sales charge and provide for a conversion period. The affected funds are generally used in smaller retirement plans. The draft letter suggests that this requirement is misplaced and will serve as a practical prohibition on the use of mutual funds for the smallest retirement plans. It urges the SEC to reconsider and permit funds to provide ongoing compensation for ongoing services rendered in the retirement context, without having to consider that compensation a form of ongoing sales charge. The letter suggests that this could be accomplished in a number of ways, including through an exception for share classes used exclusively for retirement plans or by providing guidance that would allow funds and their advisers to characterize expenses as non-distribution for these purposes.

- Money market funds. The Release does not appear to contemplate the use of 12b-1 fees by money market funds used in sweep accounts, 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. The letter suggests that requiring systems to be built to track and age 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 points out that this would be highly problematic, 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.

- Board guidance. The draft letter expresses appreciation for the SEC's efforts to modernize and streamline the role of fund boards in overseeing distribution fees, and it strongly supports the SEC's proposal to eliminate formalistic 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, arguing that it is inaccurate, inappropriate, and unnecessary.

- Confirmation statement disclosure. The proposal includes a number of new disclosure requirements in investor confirmation statements. Although the letter strongly supports changes that would improve investor understanding of distribution-related fees and expenses, it expresses the belief that some of the proposed confirm disclosure is better suited for point of sale disclosure and therefore unnecessary in a confirm. It also expresses 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 draft letter reports that we have heard mixed, and often uncertain, views on the concept of account-level sales charges. Given this reaction, the draft 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.