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SEC Proposes New Distribution Framework

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TO: ACCOUNTING/TREASURERS MEMBERS No. 22-10
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SALES FORCE MARKETING COMMITTEE No. 4-10
SMALL FUNDS MEMBERS No. 42-10
TAX MEMBERS No. 24-10
TRANSFER AGENT ADVISORY COMMITTEE No. 41-10 RE: SEC PROPOSES NEW DISTRIBUTION FRAMEWORK

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 expenses related to 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 proposal is described below. Comments on the proposal are due on or before November 5, 2010.

I. Background

The SEC adopted rule 12b-1 in 1980. The rule permits funds to compensate brokers and other financial intermediaries out of fund assets, subject to specific conditions, for services they provide shareholders related to the distribution of fund shares.

On a number of occasions since 1980, the SEC has considered whether the rule needs to be updated to reflect the current economic realities of the fund marketplace. Most recently, the SEC held a 12b-1 roundtable in June 2007. In connection with the roundtable discussions, the SEC received nearly 1,500 comment letters.

The proposal includes a description of the history of rule 12b-1, the SEC's experiences with administering the rule, the SEC's observations of changes in how funds distribute their shares, and its views on the evolving needs of shareholders. For additional information on the history of rule 12b-1, ICI research related to fund distribution, and ICI's past positions on ideas to reform the rule, visit the ICI's 12b-1 Resource Center at http://www.ici.org/rule12b1fees.

II. The SEC's Proposal for a New Distribution Framework

The SEC proposes a new rule, rule 12b-2, and a number of amendments to various rules and disclosure forms that would create a new framework, replacing current rule 12b-1. Rule 12b-1 would be rescinded in its entirety.

There are four basic elements to the proposed framework: i) a new "marketing and service fee" under new rule 12b-2; ii) the treatment of "ongoing sales charges" under rule 6c-10; iii) new disclosure requirements related to marketing and service fees and ongoing sales charges; and iv) a new option for "account level sales charges" where funds issue shares at net asset value to dealers, who would set and collect their own commissions and sales charges on those shares. Each of these is described below.

A. Proposed Rule 12b-2: The Marketing and Service Fee

The SEC proposes a new rule 12b-2, which would permit funds, with respect to any class of fund shares, to deduct a fee of up to the maximum rate of the service fee allowed under rule 2830 of the NASD Conduct Rules (which is currently 25 basis points or 0.25 percent annually) from fund assets to pay for "distribution activities." [2] "Distribution activities" are defined as "any activity which is primarily intended to result in the sale of shares issued by a fund, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature." [3] The Release states that:

Funds may use the proceeds of the marketing and service fee to pay for, for example, the ongoing cost of participation on a distribution platform such as a fund supermarket, giving investors a convenient way of buying shares; for paying trail commissions to broker-dealers in recognition of the ongoing services they provide to fund investors; or for paying retirement plan administrators for the services they provide participants (and which relieve the fund from providing such services). In addition, funds (including no-load funds) may use the marketing and service fee to pay for shareholder call centers, compensation of

underwriters, advertising, printing and mailing of prospectuses to other than current (*i.e.,* prospective) shareholders, and other traditional distribution activities. [4]

The Release also notes that "to the extent that funds need not rely on proposed rule 12b-2 to charge expenses that can clearly be identified as not distribution related (e.g., sub-transfer agency fees), funds could instead characterize those expenses as administrative expenses and thus keep total asset-based distribution fees within the 25 basis point limit of the marketing and service fee." [5]

Unlike rule 12b-1, rule 12b-2 would not require directors to adopt or renew a written plan or make any special findings. Rather, fund boards would have the ability to authorize the use of fund assets to finance distribution activities consistent with the limits of the rule and their fiduciary obligations to the fund and fund shareholders. The Release notes that the SEC intends "that the board (including the independent directors) would oversee the amount and uses of these fees in the same manner that it oversees the use of fund assets to pay any other fund operating expenses, particularly those that create a potential conflict of interest for the fund's investment adviser or other affiliated persons." [6]

B. Proposed Amendments to Rule 6c-10: The Ongoing Sales Charge

Ongoing Sales Charges. The proposed amendments to rule 6c-10 would permit funds to deduct asset-based distribution fees in excess of the 25 basis points permitted under rule 12b-2, provided that the excess amount is considered an "ongoing sales charge." Funds would not have to adopt a written plan in order to impose an ongoing sales charge, and fund boards would not be required to make any special findings. [7] The Release states that, "in short, the proposed rule would treat ongoing sales charges as another form of deferred sales load."

The rate of an ongoing sales charge could be established by the fund, provided that the cumulative amount of ongoing sales charges does not exceed 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). [8] The Release provides the following example:

> For example, if a fund has class A shares with a six percent front-end sales load, the fund could pay as much as six percent in total ongoing sales charges in class B shares. If another class of shares charges a front-end sales load of, for example, two percent, a total ongoing sales charge of as much as four percent could also be charged (six percent minus the two percent front-end load) with respect to that class. [9]

Automatic Conversion. The Release states that a fund could satisfy the maximum sales charge limitation by providing that the shares purchased would automatically convert to another class of shares without an ongoing sales charge "no later than the end of the month during which the fund would have paid on behalf of the investor the maximum amount of permitted sales load based on the cumulative rates charged each year." Funds would be free to set their own conversion schedules:

> Thus, for example, if the maximum sales load for the fund is three percent, the ongoing sales charge could be 50 basis points annually for six years. Alternatively, the fund could collect 25 basis points annually for 12 years, 75 basis points annually for four years, 150 basis points annually for two years, and

so on. [10]

The proposal contemplates that each purchase (or each "lot") would have a separate conversion period, and the shares associated with each lot would be programmed to convert on a particular date. The maximum length of the conversion period would be unaffected by any subsequent increase or decrease in the value of the shares purchased. The Release recognizes that the automatic conversion feature will have implications on fund operations, but states that "we expect that funds and intermediaries will be able to utilize existing transfer agency and other recordkeeping systems that administer funds issuing class B shares, which we believe operate in a manner similar to the proposed conversion provision or could be easily adjusted to do so." [11]

CDSLs. A fund could impose a contingent deferred sales load (CDSL) in combination with an ongoing sales charge, but total sales charges could not exceed the maximum sales charge limitation.

Quantity Discounts and Scheduled Variations. The proposed amendments to rule 6c-10 would not require (but would permit) funds to apply any quantity discounts or scheduled variations in the front-end load for which the investor may qualify when determining the reference load for an ongoing sales charge.

Reinvested Dividends. The proposal would permit funds to offer to invest shares acquired pursuant to a reinvestment of dividends or other distribution in the same share class as the shares on which the dividend or distribution was declared. If the share class has an ongoing sales charge, however, the reinvested shares would have the same conversion period as the shares on which the dividend or distribution was declared. As a result, reinvested shares may incur an ongoing sales charge, but would convert to a share class without an ongoing sales charge no later than the conversion date of the shares on which the dividend or distribution was declared.

C. Proposed Disclosure Amendments

Transaction Confirmations. The SEC proposes to amend rule 10b-10 to require confirmations to set forth information regarding front-end and deferred sales charges, as well as ongoing sales charges and marketing and service fees. Under the proposal, transaction confirmations would disclose the amount of any sales charge that the customer incurred at the time of purchase, in percentage and dollar terms, along with the net dollar amount invested in the security and the amount of any applicable breakpoint or similar threshold used to calculate the sales charge. If the customer may pay a deferred sales charge upon redemption of the shares (such as a CDSL), the transaction confirmation must disclose the maximum amount of that charge, expressed as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable. If, after the time of purchase, the customer will incur any ongoing sales charge or marketing and service fee, purchase confirmations would disclose the following information: the annual amount of that charge or fee, expressed as a percentage of net asset value; the aggregate amount of the ongoing sales charge that may be incurred over time, expressed as a percentage of net asset value; and the maximum number of months or years that the customer will incur the ongoing sales charge. [12] Confirmations further would be required to include the following statement (which may be revised to reflect the particular charge or fee at issue):

In addition to ongoing sales charges and marketing and service fees, you will

> also incur additional fees and expenses in connection with owning this mutual fund, as set forth in the fee table in the mutual fund prospectus; these typically will include management fees and other expenses. Such fees and expenses are generally paid from the assets of the mutual fund in which you are investing. Therefore, these costs are indirectly paid by you.

Finally, confirmations for transactions in which a customer redeems or sells a mutual fund security the customer owns would disclose the amount of any deferred sales charge the customer has incurred or will incur, expressed in dollars and as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable. [13]

Prospectus and SAI Disclosure. The proposal would amend a number of requirements in Form N-1A. Specifically, it would amend the fee table requirements to replace the current "Distribution [and/or Service] (12b-1) Fees" heading with an "Ongoing Sales Charge" heading, which would relate to the proposed ongoing sales charge. A new subheading to the "Other Expenses" category called "Marketing and Service Fee" would be added. Funds would be required to include each of these line items in their fee tables only if they charge the relevant fee.

The proposal would also replace the requirement for prospectus disclosure related to 12b-1 plans with new disclosure related to the fees described in the proposal:

- Disclosure as to whether the fund charges a marketing and service fee or an ongoing sales charge and, if it does, the rates of the fees and the purposes for which they are used.
- If the fund deducts an asset-based distribution fee for services provided to fund investors, it would need to describe the nature and extent of the services provided.
- If a fund imposes an ongoing sales charge, it must disclose the number of months (or years) when the shares will automatically convert (to another class without the charge) and after which the shareholder would cease paying the charge.
- If a fund offers multiple classes of shares in a single prospectus (each with its own method of paying distribution expenses), it would have to describe generally the circumstances under which an investment in one class may be more advantageous than another class.

The proposal would largely delete the current disclosure requirements in statements of additional information (SAIs) related to 12b-1 plans, although it would retain a requirement to disclose the principal activities paid for through asset-based distribution fees (both ongoing sales charges and marketing and service fees). The Release notes that, as proposed, the amendment would not require disclosure of dollar amounts.

The proposal would make several other minor or conforming amendments to Form N-1A, Schedule 14A (which governs proxy solicitations), and Forms N-3, N-4 and N-6.

Account Statements. The Release specifically requests comment on whether the SEC should pursue recommendations made by the GAO that funds should be required to disclose in account statements the actual dollar amount of fees and expenses that each shareholder directly or indirectly has paid as an investor in the fund. The Release states that the SEC believes this is unnecessary given the improved transparency of distribution related expenses that would result from the proposed amendments, but nonetheless seeks comment on whether that belief is correct.

D. Proposed Amendments to Rule 6c-10: Account-Level Sales Charges

The SEC is proposing to amend rule 6c-10 to provide funds with "an alternative approach to distributing fund shares through dealers if the fund so chooses." Proposed rule 6c-10(c) would provide an exemption from Section 22(d) of the 1940 Act, permitting a fund in certain circumstances to offer its shares or a class of its shares at a price other than the current public offering price stated in the prospectus.

The account-level sales charge alternative would be available to any fund with respect to all of its shares, or any class of its shares. The exemption is optional, and funds may choose not to take advantage of it and continue to distribute their shares only with sales charges established by the fund.

In order for a fund to rely on the section 22(d) exemption provided in proposed rule 6c-10(c), it would have to meet two conditions. First, the fund (with respect to that share class) would not be permitted to impose an ongoing sales charge. The fund could, however, charge a marketing and service fee pursuant to proposed rule 12b-2. [14] Second, the fund would have to disclose in its registration statement that it has elected to rely on the exemption.

Dealers would be free to establish and collect their own commissions or other types of sales charges to pay for distribution, and the amount of these fees (and the times at which they would be collected) would not be governed by the 1940 Act. The Release notes that intermediaries registered with FINRA would continue to be subject to existing limits on excessive compensation under NASD Conduct Rules 2830 and 2440.

E. Other Issues Discussed in the Release

Shareholder Approval. Under the proposed rules, a new fund (i.e., a fund that has not made a public offering), or an existing fund with respect to a new class of shares, would not need to obtain shareholder approval before instituting a marketing and service fee or an ongoing sales charge. After the fund or class has been sold to the public, a fund would be required to obtain the approval of a majority of shareholders before it could institute or increase a marketing and service fee. Ongoing sales charges could not be instituted or increased in existing funds, or lengthened in duration, regardless of shareholder approval.

Application to Funds of Funds. Proposed rule 12b-2 would permit both an acquiring fund and an acquired fund in a fund of funds arrangement to charge a marketing and service fee, as long as the total of the fees charged by the funds together does not exceed the NASD service fee limit (currently 25 basis points). An acquiring fund and an acquired fund could not, however, both charge an ongoing sales charge. Under proposed rule 6c-10(b)(1)(iv), an acquiring fund that relies on the rule to deduct an ongoing sales charge could not acquire the securities of another fund that imposed an ongoing sales charge. An acquiring fund that did not charge an ongoing sales charge would not be subject to this restriction and would therefore be free to invest in funds imposing an ongoing sales charge.

Application to Funds Underlying Separate Accounts. The proposed rule and rule amendments would apply to funds that serve as investment vehicles for insurance company separate accounts that offer variable annuities or life insurance contracts. Thus, an underlying fund could charge a marketing and service fee up to the NASD sales charge rule limit on service fees. Asset-based distribution fees in excess of the marketing and service fee would be deemed ongoing sales charges and subject to the requirements of the

proposed amendments to rule 6c-10. Like other mutual funds, in order to impose an ongoing sales charge under proposed rule 6c-10(b), an underlying fund (or the insurance company sponsor) would have to keep track of share lots attributable to contract owner purchase payments, and provide for the automatic conversion of shares by the end of the conversion period. The Release notes that the SEC understands that insurance company separate accounts may not currently track and age shares because they generally do not offer underlying funds with CDSLs. It states that "under our proposal, insurance companies would either have to develop this capability or offer only shares of classes that do not impose an ongoing sales charge."

Proposed Conforming Amendments to Rule 11a-3. Section 11(a) of the 1940 Act requires exchanges between funds to be based on the relative net asset values of the shares to be exchanged. Rule 11a-3 provides a conditional exemption permitting funds and fund underwriters to charge a sales load on shares acquired in certain exchanges between funds within the same fund group. Rule 11a-3(b)(4) requires that funds, in determining any sales load due upon an exchange, give shareholders credit (i.e., reduce the amount of sales load charged on the purchase of new shares) for their previous payment of sales loads on the shares exchanged, but does not require funds to give shareholders credit for the payment of any rule 12b-1 fees. The proposal would amend rule 11a-3(b)(4) to require funds to also give shareholders credit for the payment of ongoing sales charges.

Rule 11a-3 also prohibits funds from imposing a deferred sales load at the time of an exchange. Under the rule, a fund may not treat an exchange as a redemption for purposes of assessing a deferred sales load, and thus may impose a deferred sales load only when the acquired shares are ultimately redeemed. The proposal would modify the "tolling" provision of rule 11a-3 to permit funds, in determining the amount of deferred sales load due upon ultimate redemption, to provide credit only for the sales charge component of any asset-based distribution fee, i.e., the ongoing sales charge. Because the marketing and service fee is not considered to be an alternative sales charge, the SEC would not require funds to give credit for such fees when determining the sales load payable upon an exchange. In addition, the SEC proposes to modify the rule to clarify that funds must provide credit for ongoing sales charges in terms of the cumulative rate of the ongoing sales charge previously paid rather than the amount of fees paid.

Other Conforming Amendments. The Release includes several other conforming amendments, including proposed amendments to rules 17a-8, 17d-3 and 18f-3 and Form N-SAR under the 1940 Act and Regulation S-X under the Securities Act of 1933.

III. Potential Impact of the Proposed Rule Changes

The Release contains a section describing the SEC's views on the potential impact of the proposed rule and rule amendments on various constituencies. [15]

Fund Investors. The Release suggests that the proposal would make it easier for fund investors to understand fund expenses, protect investors from the imposition of excessive sales loads, and promote a fairer allocation of distribution costs among investors who invest through different share classes by limiting the extent to which one class of shares (e.g., class C shares) may bear these costs. In addition, the Release suggests that the proposed rule amendments may lead to lower distribution costs as a result of greater transparency of fund expenses and the potential for greater retail price competition.

Fund Intermediaries and Distributors. The Release recognizes that the intermediaries most

affected by the proposal are broker-dealers that currently receive payments from the sale of classes of fund shares that pay 12b-1 fees that exceed 25 basis points (e.g., class C shares). The Release speculates that for shares issued after the compliance date, "fund underwriters would likely reduce the stream of payments when the shares convert to a class that pays no more than 25 basis points of asset-based distribution expenses (e.g., class A shares) or else find a different source of revenue to fund the payments." The Release addresses the assertion that 12b-1 fees associated with level load funds (often 100 basis points) pay for valuable ongoing investment advice provided by the intermediary, and are an alternative to mutual fund wrap fee programs, which often charge a 100 basis point (or greater) wrap fee. In this regard, the Release states:

> The use of fund assets to finance personal advisory services (rather than support fund distribution), however, raises issues regarding whether those advisory services provided by an intermediary to a customer years after the sale ought to be payable from fund assets. Such expenditures arguably do not relate to the operation of the fund or to the distribution of its shares. [16]

Fund Managers and Principal Underwriters. The Release suggests that the proposal "would largely preserve existing distribution arrangements, and should provide fund managers, directors, etc., with greater legal certainty regarding many distribution financing practices that have developed over the years." More specifically, the Release suggests that:

> We anticipate that the proposed rules, if adopted, would shift the focus from whether fund expenses are increased by a 12b-1 fee to whether the sales charges imposed by a particular fund are appropriate in light of the services provided by the intermediary. This is the issue we believe investors should be exploring before they decide to invest in a fund and pay sales charges. [17]

Small Fund Groups. The Release recognizes the important role rule 12b-1 has played in permitting smaller fund groups [18] to compete with larger fund groups for the attention of intermediaries, particularly in the context of participation in fund supermarkets. It expresses the belief that the proposal "would preserve [small funds'] ability to compete with larger fund groups" and would not require many small funds to restructure their fund classes. [19]

Retirement Plans. The Release recognizes that many funds offered through tax-advantaged retirement plans, such as 401(k) plans, use fund assets to compensate plan administrators for services provided to plans and plan participants, including recordkeeping, sub-accounting, transaction processing, account maintenance services, and participant education.

The Release suggests that many of these funds should not be impacted by the proposal. Noting that approximately 80 percent of 401(k) plan assets are held in mutual fund share classes that pay no 12b-1 fees or 12b-1 fees of 25 basis points or less, the Release states that "we would therefore expect that [these] funds could continue to make the payments from the proceeds of the marketing and service fee." It also states that some of the remaining funds "may identify a portion of those expenditures as not distribution related and treat them accordingly, and may thus be able to reduce their distribution related payments so that they do not exceed the limits of the marketing and service fee." [20]

The Release recognizes that other funds, however, may be required by the proposal to treat a portion of their current 12b-1 fee as an ongoing sales charge and provide for a conversion

period. The Release acknowledges, in this regard, that many plan administrators currently do not track and age shares, and suggests that "plan administrators would have to either develop this capability, which most other intermediaries have, or offer only classes of shares that do not impose an ongoing sales charge, i.e., classes of shares that carry an asset-based distribution fee of only 25 basis points or less." [21]

The Release also recognizes that some funds offer "R shares" with 12b-1 fees of between 50 and 100 basis points, and that the SEC staff estimates that these types of share classes account for less than two percent of plan assets. The Release states that "treating amounts deducted in excess of 25 basis points as an ongoing sales charge and eventually converting these shares may not be a viable option for retirement plans with [these] R share classes" and "our proposal would likely make [these] R shares a less attractive investment option for plans to offer." [22]

IV. Anticipated Effective and Compliance Dates and Transition Provisions

The Release states that the SEC would expect to provide for an effective date within 60 days of issuing a release adopting the proposed amendments, and a compliance period of at least 18 months after the effective date for funds to come into compliance with rule 12b-2, amended rule 6c-10, and the other amendments, for new shares sold.

The proposal includes a five year "grandfathering" period. Funds would be required to comply with the new rule and rule amendments with respect to all shares issued after the compliance date of the new rules. The SEC would provide a five-year grandfathering period after the compliance date for share classes issued prior to the compliance date, and that deduct fees pursuant to rule 12b-1 as it exists today, after which those shares would be required to be converted or exchanged into a class that does not deduct an ongoing sales charge. New sales would not be permitted in grandfathered share classes after the compliance date of the new rules.

The Release suggests that the five-year grandfathering period "would provide time for funds and dealers to revisit and revise existing arrangements…allow the existing 12b-1 classes to wind down in an orderly manner [and] allow sufficient time for funds and their boards to institute any necessary conversion or exchange procedures, and prepare to transition all remaining assets out of grandfathered 12b-1 classes."

V. Request for Comments

The Release requests comment on all aspects of the proposed framework for distribution, both generally and through over 250 specific questions.

Robert C. Grohowski
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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.

[2] The Release notes that this would allow the NASD (now FINRA) to change the level, pending approval by the SEC.

[3] This is identical to the description of distribution in rule 12b-1.

[4] Release, at text accompanying footnote 159.

[5] Release, at footnote 153.

[6] Release, at text accompanying footnote 157.

[7] The Release states, however, that "directors will continue to have fiduciary obligations under state law and section 36(a) of the [1940] Act to consider whether use of the fund's assets to pay ongoing sales charges, within the proposed caps, is in the best interest of the fund and fund investors. We expect to provide guidance in our adopting release for this proposal, to assist fund directors in satisfying their fiduciary duties." The guidance the SEC would propose to include in its adopting release can be found on pages 64-65 of the Release.

[8] If the fund does not have a class of shares that qualifies, the reference load is the maximum sales charge rate permitted under rule 2830(d)(2)(A) of the NASD Conduct Rules, which is currently 6.25%. This may occur, for example, if a fund does not offer a class of shares with a front-end load, or offers the front-end load class with asset-based distribution fees of more than 25 basis points.

[9] Release, at 47.

[10] Release, at 49.

[11] Release, at text accompanying footnote 181.

[12] The Release notes that this disclosure could be made relatively simply, suggesting, for example: "You will pay a maximum total ongoing sales charge of 5%, deducted from the assets of the fund in which you are investing at an annual rate of 1% over the next 5 years. You also will pay marketing and service fees of 0.25% for as long as you own the fund." Release, at text accompanying footnote 227.

[13] In the Release, unrelated to the replacement of rule 12b-1, the SEC also proposes to amend rule 10b-10 to require disclosure of the first date on which certain debt securities may be called. See pages 76-77 of the Release.

[14] The Release notes that a fund relying on proposed rule 6c-10(c) would be permitted to use the marketing and service fee to support the fund's marketing and sales efforts, including advertising, sales material, and call centers, while permitting dealers to collect loads, fees, and other account-based charges to support the dealers' sales assistance and other services provided to its customers.

[15] Release, at 121-132.

[16] See Release at pages 124-125 and footnote 372.

[17] Release, at 126.

[18] For these purposes, the SEC defines small funds as “a group of related management companies (funds) that has net assets of $50 million or less as of the end of its most recent fiscal year.”

[19] Release, at 128.

[20] Release, at 130.

[21] Release, at 131.

[22] Release, at 131.
