The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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INSTITUTE COMMENT LETTER ON PROPOSED BAN ON DIRECTED BROKERAGE ARRANGEMENTS AND FURTHER REFORM OF RULE 12B-1

[17493] May 11, 2004 TO: COMPLIANCE ADVISORY COMMITTEE No. 48-04 PENSION COMMITTEE No. 27-04 PENSION OPERATIONS ADVISORY COMMITTEE No. 38-04 SEC RULES COMMITTEE No. 43-04 SMALL FUNDS COMMITTEE No. 29-04 RE: INSTITUTE COMMENT LETTER ON PROPOSED BAN ON DIRECTED BROKERAGE ARRANGEMENTS AND FURTHER REFORM OF RULE 12b-1 The Institute has prepared the attached comment letter on the Securities and Exchange Commission's proposed amendments to Rule 12b-1 under the Investment Company Act of 1940, which would prohibit mutual funds from compensating their selling broker-dealers through the use of directed brokerage arrangements. The letter also responds to the Commission's request for comment on whether Rule 12b-1 should be amended further, including whether it should be rescinded.1 The letter is briefly summarized below. Proposed Ban on Directed Brokerage Arrangements • The letter supports the proposed ban. It also supports requiring funds to implement, and their boards to approve, policies and procedures reasonably designed to ensure that a fund's selection of broker-dealers is not influenced by considerations about the sale of fund shares. • The letter recommends the adoption of a safe harbor stating that no fund would be deemed to have violated the ban on directed brokerage arrangements solely by reason of having directed portfolio transactions to a broker-dealer that also sells the fund's shares, if the fund has implemented, and its board of directors (including a majority of its independent directors) has approved, the types of policies and procedures contemplated by the proposal. 1 See Institute Memorandum to Compliance Advisory Committee No. 31-04, Pension Committee No. 10-04, Pension Operations Advisory Committee No. 19-04, SEC Rules Committee No. 20-04, and Small Funds Committee No. 15-04 [17167], dated March 2, 2004. 2 • The letter recommends a transition period of 120 days after the Commission approves a ban on directed brokerage arrangements so that funds and their boards have sufficient time to implement and approve the required policies and procedures. Further Reform of Rule 12b-1 • The letter discusses the fact that, for most of their history, 12b-1 plans have been widely used on a continuing basis to serve as a substitute for front-end sales loads and/or to pay for administrative and shareholder services that benefit existing fund shareholders. It states that, in contrast, 12b-1 plans are used only in limited instances to subsidize the costs of promoting the fund. • The letter states that the current uses of 12b-1 fees are consistent with the rule's administrative history and that, over the past two decades, regulatory actions by the Commission and the staff have helped to create the infrastructure to support these uses of 12b-1 fees. The letter also makes the point that

there is nothing inappropriate about the payment of 12b-1 fees by funds that are closed to new investors. • The letter states that possible modifications to Rule 12b-1 should be evaluated in light of: (1) the ways that mutual funds use 12b-1 fees; and (2) the substantial investor protections afforded by the regulatory and disclosure requirements that must be satisfied by funds imposing 12b-1 fees. • The letter recommends that the Commission: (1) update its guidance to fund directors with respect to the factors that directors may wish to consider in approving a 12b-1 plan; and (2) eliminate the rule's quarterly reporting requirement. • The letter recommends the following factors, based on the industry's experience with Rule 12b-1: • If the fund intends to pay for shareholder and administrative services under its 12b-1 plan, the directors should consider: (1) the nature of the services to be rendered; and (2) whether the fee for these services is reasonable in relation to (a) the value of those services and the benefits received by the fund and its shareholders and (b) the costs that would otherwise be incurred by the fund or payments that the fund would be required to make to another entity to perform the same services. • If the fund intends to use its 12b-1 plan to compensate intermediaries for services that they provide to their customers at the time of sale, the directors should consider competitive conditions in the intermediary marketplace, including comparative 12b-1 fees of other funds. • The cost of a 12b-1 plan to the fund and its shareholders, including the effect of 12b-1 payments on the expense ratio and investment performance of the fund. 3 • Whether the intended use of fund assets for distribution and/or to pay for administrative and shareholder services is generally fair to the shareholders who bear those costs. In the case of a multiple class fund, one relevant consideration might be whether the fund offers a conversion feature. • The Commission requested comment on whether it should require funds to deduct distribution costs from shareholder accounts rather than from fund assets. The letter responds that such an approach would cause serious tax and operational difficulties for funds and their shareholders and that assessment of 12b-1 fees at the fund level remains the best way to give fund investors the choice of paying for distribution costs over time. Rachel H. Graham Assistant Counsel Attachment (in .pdf format)
