

**MEMO# 5215**

October 7, 1993

## **SEC RESPONSE TO CHAIRMAN DINGELL'S INQUIRY ABOUT CERTAIN PRACTICES INVOLVING 12B-1 FEES**

October 7, 1993 TO: BOARD OF GOVERNORS NO. 90-93 SEC RULES COMMITTEE NO. 88-93  
RE: SEC RESPONSE TO CHAIRMAN DINGELL'S INQUIRY ABOUT CERTAIN PRACTICES  
INVOLVING 12b-1 FEES

Congressman John Dingell, Chairman of the House Energy and Commerce Committee, recently sent a letter to the SEC inquiring about practices described in a Forbes article involving 12b-1 fees. Specifically, Chairman Dingell inquired about the continued assessment of 12b-1 fees by mutual funds closed to new investors and the payment of 12b-1 servicing fees ("trail commissions") to the estate of a deceased broker. The SEC's Division of Investment Management prepared a memorandum analyzing these two issues. In his cover letter transmitting the memorandum to Chairman Dingell, SEC Chairman Levitt noted that the Division's memorandum concludes that both of these practices are permissible under Rule 12b-1 and have been addressed by the NASD, which places limits on mutual fund sales charges. He also stated that, "[T]he Division intends to re-examine rule 12b-1 and the NASD rules to determine whether changes are necessary to prevent possible abuses arising from these practices." In addition to discussing these two issues, the Division's memorandum responds to the statement in the Forbes article that it is a "farce" to assert that the use of fund assets to pay for distribution expenses benefits fund shareholders, since fund expense ratios have increased since 1980. The memorandum states that such statements do not accurately analyze changes in fund expense ratios because they fail to account for the decrease in front-end sales loads since 1980, which has offset much, if not all, of the increase in expense ratios. In addition, such statements fail to take into account the costs for industry expansion into global markets and new shareholder services, which may have offset expense reductions resulting from increased assets. Funds Closed to New Shareholders The Division's memorandum explains that Rule 12b-1 permits a fund to spread its distribution expenses over several years and allows the payment of fees for past distribution services. Therefore, even if a fund is closed to new investors, it may continue to pay 12b-1 fees in order to compensate the distributor for its past distribution efforts. In addition, the memorandum notes that one prong of the limit imposed by the NASD on payment of 12b-1 fees is a rolling cap based on new gross sales. Thus, if a fund no longer makes new sales, it will eventually reach its cap under the NASD maximum sales charge rule and will be forced to reduce or eliminate its 12b-1 fee. Payment of Trail Commissions to the Estates of Sales Representatives The Division's memorandum states that NASD rules generally permit a registered representative to arrange for another registered representative to take over and service his client accounts and to pay him or his beneficiary continuing commissions generated on such accounts. Where a trail commission

is subject to Rule 12b-1, the memorandum explains that the fund's board has certain responsibilities with respect to that arrangement as part of the fund's 12b-1 plan. Under Rule 12b-1, the board must determine that a plan to use fund assets for distribution creates a reasonable likelihood of benefit for fund shareholders. There is nothing under current regulation that would require a conclusion by the board that the payment of trail commissions to the estate of a deceased broker would necessarily violate Rule 12b-1. In addition, the memorandum states that the treatment of trail commissions when a sales representative dies is governed by the broker-dealer's internal compensation policies and that fund boards are not required to review all internal compensation arrangements of all broker-dealer firms with which the fund's distributor has distribution arrangements. The memorandum states that the Division plans to recommend changes to Rule 12b-1 to address concerns about the board's evaluation of distribution plans and, in developing those recommendations, will carefully consider the practices described in the Forbes article. \* \* \* A copy of the Forbes article, Chairman Dingell's inquiry and the SEC's response is attached. Amy B.R. Lancellotta Associate Counsel Attachments

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