

**MEMO# 17427**

April 27, 2004

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

[17427] April 27, 2004 TO: PENSION COMMITTEE No. 23-04 PENSION OPERATIONS ADVISORY COMMITTEE No. 34-04 SEC RULES COMMITTEE No. 37-04 SMALL FUNDS COMMITTEE No. 25-04 RE: DRAFT INSTITUTE COMMENT LETTER ON PROPOSED BAN ON DIRECTED BROKERAGE ARRANGEMENTS AND FURTHER REFORM OF RULE 12b-1 As we previously advised you, the Securities and Exchange Commission has published for comment proposed amendments to Rule 12b-1 under the Investment Company Act of 1940 that would prohibit mutual funds from compensating their selling broker-dealers through the use of directed brokerage arrangements.\* The Proposing Release also seeks comment on whether Rule 12b-1 should be amended further, including whether it should be rescinded. A draft of the Institute's comment letter on the proposal is attached and summarized below. Comments on the proposal must be filed with the SEC by Monday, May 10th. The Institute will hold a conference call on Monday, May 3rd at 3:00 p.m. EST to discuss the Institute's draft comment letter. The dial-in number for the call is (888) 790-1714, and the pass code is 45248. If you plan to participate, please send an e-mail to Stephanie Holly at sholly@ici.org. If you are unable to participate in the call, please provide your comments before the call, if possible, to Rachel Graham by phone (202-326-5819), fax (202-326-5827) or e-mail (rgraham@ici.org).

**I. Ban on Directed Brokerage Arrangements**

The draft letter generally supports the Commission's proposal to amend Rule 12b-1 to prohibit a mutual fund from compensating a broker-dealer for promoting or selling its shares by directing brokerage transactions to that broker or through the use of step-out and similar arrangements designed to compensate selling brokers for their sales efforts. The draft letter supports the Commission's proposal to require funds to implement, and their boards to approve, policies and procedures reasonably designed to ensure that the fund's

\* 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 relating to SEC Release No. IC-26356 (Feb. 24, 2004) ("Proposing Release"), which release is available on the SEC's website at <http://www.sec.gov/rules/proposed/ic-26356.htm>. 2 selection of broker-dealers is not influenced by considerations about the sale of fund shares. The letter states, however, that it is critical for this requirement to act as a safe harbor under both Rule 12b-1 and Section 17(e)(1) under the Investment Company Act so that a fund's legitimate brokerage allocations will not be second-guessed. The Proposing Release does not provide an anticipated compliance date. The draft letter recommends that

the proposed ban on directed brokerage arrangements, if adopted by the Commission, become effective 120 days after the date that the Commission approves final amendments implementing the ban, so that mutual funds have sufficient time to implement the policies and procedures described above. Do members agree with the recommended transition period?

II. Further Reform of Rule 12b-1

In response to the Commission's request for comment on possible additional amendments to Rule 12b-1, the draft letter discusses the dramatic changes in fund distribution practices since the rule was first adopted. It then outlines current uses of 12b-1 fees and describes substantive regulation and disclosure of 12b-1 fees. The draft letter recommends that the Commission modify the rule so that it reflects current fund distribution practices without compromising investor protection. More specifically, it recommends the following changes:

**Annual Board Approval of 12b-1 Plan.** The draft letter recommends eliminating the current annual board approval requirement because this requirement inappropriately reinforces the notion of 12b-1 fees as a temporary measure aimed at addressing a "problem." Under the Institute's recommendation, board approval would be required only for the implementation of a new 12b-1 plan or a material change to an existing plan. We request members' views on whether the letter should recommend changing the standard for approval of a 12b-1 plan from a finding by the board that there is a reasonable likelihood that the plan will benefit the fund and its shareholders to a finding that implementation of the proposed 12b-1 plan would not be an improper use of fund assets.

**Guidance to Fund Directors.** The draft letter recommends that the Commission provide updated guidance, based on current fund distribution practices, as to the factors that may be relevant to fund directors in determining whether to approve a 12b-1 plan. It notes that directors should not be required to consider certain specified factors; rather, the directors should determine, in the exercise of their business judgment, which factors are relevant to their determination. In addition, the factors should be tailored to reflect, for example, the intended purpose(s) of the payments to be made under the 12b-1 plan. The draft letter lists examples of possible updated factors. We request members' views on whether the proposed factors are appropriate and/or whether there are other factors we should recommend.

**Annual Review of 12b-1 Plan.** The draft letter recommends that the Commission revise Rule 12b-1 to require that fund directors receive, and review, annual reports concerning the operation of the fund's 12b-1 plan. The reports should include, among other things, amounts expended under the plan and the purposes of those expenditures. The draft letter recommends eliminating the quarterly reports currently required by the rule.

3 The draft letter also responds to the Commission's specific request for comment on whether it should "refashion" Rule 12b-1 so that funds would deduct distribution-related costs directly from shareholder accounts rather than from fund assets. The draft letter expresses agreement that this approach may seem appealing at first blush. It then discusses the many operational and tax-related issues that such installment loads would raise. It states the Institute's belief that Rule 12b-1 offers many of the benefits of installment loads while avoiding the problems that such loads would entail. The draft letter concludes that on balance, fund shareholders would be worse off if the Commission eliminated Rule 12b-1 as it exists currently and imposed an installment load system in its place. We request member input on the possible operational issues raised by installment loads.

Rachel H. Graham  
Assistant Counsel Attachment (in .pdf format)