The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

May 24, 2004

Comment Letter on Benefits Provided Through 12b-1 Fees, May 2004

May 24, 2004

The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Donaldson:

The Commission recently requested public comment on whether it should propose changes to Rule 12b-1 under the Investment Company Act of 1940 to address issues that have arisen under the rule, or propose to rescind the rule. The Investment Company Institute[1] supports the Commission's reevaluation of the rule. We are particularly pleased that the Commission is soliciting the views of all interested parties before determining what, if any, changes to propose, and have submitted our specific recommendations for modernizing the rule in a separate letter.[2]

As our earlier letter indicated, mutual fund distribution practices have changed dramatically since Rule 12b-1 was adopted in 1980. Indeed, it is because of these changes that we think it is timely and prudent for the Commission to reexamine the rule. Most notably, the predominant use of 12b-1 fees for most of their history has been as a substitute for front-end sales loads and/or to pay for administrative and shareholder services that benefit existing fund shareholders. Although these uses were not anticipated when the rule was first adopted, they are consistent with the Commission's stated intent that the rule be sufficiently flexible to cover new distribution financing methods that the industry might develop.

A recent article in the Wall Street Journal that highlighted an academic paper by an SEC staff economist unfortunately presented an unbalanced view of the purpose of 12b-1 fees.[3] The article stated that the paper (described in the article as an "SEC study") examined 12b-1 fees "from both the vantage point of the original purpose [of the fees] and their current use." As reported in the article, however, the paper dismissed the use of 12b-1 fees as a substitute for front-end sales loads as "inappropriate."[4] Thus, the paper's economic analysis and findings are based on the premise that the purpose of 12b-1 fees is to produce lower overall expense ratios through asset growth and economies of scale – a premise that ignores the current uses of these fees. In discussing the paper's findings, the article leaves

a negative impression about the impact of 12b-1 fees on fund shareholders. But in fact, because it disregards how 12b-1 fees are currently used, the paper has little bearing on whether investors benefit from them.

We wish to point out that other well-regarded researchers have recognized for some time that 12b-1 fees serve primarily as an alternative to front-end loads and that this use of the fees can provide additional choices and benefits to fund shareholders. 5 The Commission itself as well as its staff also have acknowledged the current uses of 12b-1 fees on many occasions. Indeed, the use of 12b-1 fees as an alternative to front-end loads and/or to pay for ongoing services provided to fund shareholders could not have succeeded without several Commission regulatory actions that helped build the infrastructure to support their use in these ways. Undoubtedly, the Commission took these actions only after concluding that doing so was consistent with the interests of investors. Contrary to the implications of the article, experience demonstrates that these uses of 12b-1 fees benefit investors in several ways – by allowing them the option of paying distribution costs over time, by giving those who choose to own funds through a particular distribution channel access to funds that otherwise might not be available to them and, where used to pay for ongoing services to shareholders, by acting as an incentive for financial professionals to continue to provide such services. Even a prominent industry critic has recognized these benefits. 6

As the Commission continues to consider possible changes to Rule 12b-1 and the public debate of these issues proceeds, we reiterate our recommendation that any reevaluation of Rule 12b-1 should take into account the benefits of the current uses of 12b-1 fees.

Sincerely,

Matthew P. Fink
President

Enclosure

cc: The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

Paul F. Roye, Director
Division of Investment Management

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes8,632 open-end investment companies ("mutual funds"), 621 closed-end investment companies, 126 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about $7.545 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

2 Letter from Amy B.R. Lancellotta, Acting General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated May 10, 2004.

3 Tom Lauricella, Mutual-Funds Sales Fees Just Enrich Firms, SEC Study Says, Wall Street Journal, May 13, 2004 (discussing Lori Walsh, "The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns," 2004).

4 The arguments put forth in support of this position contain factual inaccuracies and omit important, relevant information. For example, as noted in the article, the paper cites "a significant difference in the level of transparency between loads and 12b-1 fees." In this regard, the paper asserts that the load charge is clearly stated on the confirmation statement that the investor receives from his broker, whereas the investor is never explicitly told the total amount of 12b-1 fees that he has paid. In fact, disclosure of mutual fund sales loads on confirmation statements is not currently required. The Commission has issued a proposal that would impose such a requirement, which the Institute supports. As part of the same proposal, broker-dealers would be required to provide quantitative disclosure of 12b-1 fees to investors both before a mutual fund purchase and on confirmation statements. The Institute also supports this aspect of the Commission's proposal.

The article also notes the paper's claim that 12b-1 fees can be charged as long as an investor owns a fund. There is no mention in the paper or the article of NASD rules that impose maximum caps on 12b-1 fees based on a percentage of fund sales, or the fact that investors in funds that pay 12b-1 fees as an alternative to a front-end sales load typically convert to another class of shares with no or a low 12b-1 fee after several years. Moreover, in cases where 12b-1 fees are paid to compensate intermediaries for providing ongoing services to fund shareholders, it is entirely appropriate for the fee to continue as long as an investor owns the fund. The paper completely ignores the use of 12b-1 fees to pay for ongoing services to fund shareholders.

5 See, e.g., Jeffry L. Davis, "A New Look at SEC Rule 12b-1," Securities Regulation Law Journal, 1995, Vol. 23, 184-210; See Edward S. O'Neal, "Mutual Fund Share Classes and Broker Incentives," Financial Analysts Journal, Sep/Oct 1999, 55(5), 76-87. An Institute Senior Economist also has analyzed 12b-1 fees taking into account their role as a substitute for front-end loads. See S. Collins, "The Effect of 12b-1 Plans on Mutual Funds, Revisited," March 2004. A copy of this paper is enclosed.

6 See "12b-1 Fees: Politics and Policy," Fund Democracy Insights, Vol. 1, Issue 4 (Sept. 2001)("Fund Democracy Insights").
