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COMMENT LETTER

November 5, 2010

IDC Comment Letter on SEC's Proposal To Replace Rule 12b-1 With New Regulatory Framework (pdf)

November 5, 2010 Ms. Elizabeth Murphy Secretary U.S. Securities and Exchange Commission 100 F Street, N.E. Washington, D.C. 20549-1090 Re: Mutual Fund Distribution Fees; Confirmations (File No. S7-15-10) Dear Ms. Murphy: The Independent Directors Council1 appreciates the opportunity to provide its views on the Securities and Exchange Commission’s proposal to replace Rule 12b-1 under the Investment Company Act of 1940 with a new regulatory framework.2 In light of the evolution of fund distribution since Rule 12b-1 was adopted thirty years ago, IDC commends the Commission for undertaking its comprehensive review of the rule. The proposal is sweeping and raises numerous and complex operational and other issues. The Commission will undoubtedly receive comments from a variety of interested parties, and IDC urges it to carefully consider the potential costs and other impacts of the proposal, which ultimately may be borne by fund shareholders, before enacting any significant Rule 12b-1 reform. We focus our comments on two subjects of the proposal that have been IDC’s focus throughout the discussion of Rule 12b-1 reform: modernizing the role of fund directors and enhancing shareholder understanding of distribution fees. 1 IDC serves the fund independent director community by advancing the education, interaction, communication, and policy positions of fund independent directors. IDC’s activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of $12.05 trillion and serve over 90 million shareholders, and there are approximately 2,000 independent directors of ICI member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors. 2 See Mutual Fund Distribution Fees; Confirmations, SEC Release Nos. 33-9128; 34-62544; IC-29367; File No. S7-15-10 (July 21, 2010) (“Release”). Ms. Elizabeth Murphy November 5, 2010 Page 2 of 10 I. Summary of IDC’s Position IDC applauds the Commission for seeking to provide “a more appropriate role for fund directors.” The Commission proposes to eliminate the board-related requirements of Rule 12b-1 as well as the factors included in the Rule 12b-1 adopting release. Because these changes would further the stated goal, IDC strongly supports these parts of the proposal. Indeed, IDC urges the Commission to eliminate the Rule 12b-1 requirements and factors regardless of: (i) whether it takes any other action with respect to Rule 12b-1 reform, or (ii) how it may address other matters, such as caps on fees. On the other hand, the proposed guidance relating to board oversight of ongoing sales charges is contrary to the Commission’s stated goal. Experience has shown that setting forth specific factors in

the nature of guidance can impede, rather than assist, effective and efficient board oversight as such factors can become too prescriptive and outmoded over time. Moreover, the proposed guidance is not grounded in law, is inconsistent with long-standing board practices overseeing other kinds of distribution arrangements, and suggests an inappropriate role for fund boards. Fund directors are well guided by their fiduciary duties to provide appropriate oversight of fund distribution arrangements. Accordingly, IDC strongly opposes the issuance of guidance to fund directors in this regard. IDC also shares the Commission's goal of promoting investor understanding of fees. The proposed amendments to the prospectus disclosure requirements—which would require disclosure of distribution fees using plain English terms, rather than references to rule numbers—furthers that goal, and we support these changes. The next logical step is improved point-of-sale disclosure, which would assist investors in making informed decisions regarding the investment options available to them. We question, then, why the Commission is proposing to add disclosures to confirmation statements before it has completed its consideration of point-of-sale disclosure. Moreover, the proposed confirmation statement additions have the potential to confuse investors and encourage brokers to sell other products not subject to the same requirements. We urge the Commission to not adopt additional confirmation disclosure requirements before it has first completed its review and consideration of comprehensive point-of-sale disclosure. II. Discussion IDC has long participated in the public discussion concerning Rule 12b-1 reform. In our comment letter following the 2007 roundtable, we urged the Commission to modernize the oversight role of fund directors and enhance shareholder disclosure of distribution fees, while retaining a framework that continues to provide investors with access to an array of funds and payment options.3 3 See Letter from Robert W. Uek, Chair, IDC Governing Council, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission regarding Roundtable Discussion Regarding Rule 12b-1; File No. 4-538 (July 19, 2007) ("IDC 12b-1 Letter"). Ms. Elizabeth Murphy November 5, 2010 Page 3 of 10 We are pleased that the Commission's proposal generally seeks to achieve these goals, including preserving for investors "the ability to select alternate distribution methods" and "to pay for distribution services over time." A. Modernizing the Role of Fund Directors IDC strongly supports the Commission's goal of providing a more appropriate role for boards. We have long advocated regulatory changes and initiatives that further this goal and enhance fund board effectiveness.4 In this regard, we support the staff's Director Outreach Initiative, which is based in large part on the recognition that many fund board responsibilities may appropriately be delegated, eliminated, or modified in light of changes in the industry and applicable regulations. The purpose of the initiative is to consider what the Commission can or should do in order to aid fund directors in the performance of their duties, and we urge the Commission to continue to pursue this initiative.5 IDC's letter in support of the Director Outreach Initiative and comment letters on various Commission proposals have consistently expressed the following principles regarding fund board oversight, which apply just as forcefully to the Commission's current 12b-1 proposal: • The role of a fund board is to provide oversight, and not to engage in management-level activities.6 • While regulations may establish meaningful oversight when adopted, those that require fund boards to engage in periodic reviews beyond their useful life should be eliminated 4 See e.g., IDC 12b-1 Letter, supra n. 3; Letter from Robert W. Uek, Chair, IDC Governing Council, to Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, regarding Director Outreach Initiative (February 26, 2008) ("IDC Director Outreach Letter"); Letter from Robert W. Uek, Chair, IDC Governing Council, to Florence E. Harmon, Acting Secretary, U.S. Securities and Exchange Commission, regarding References to Ratings of Nationally Recognized Statistical Rating Organizations, File No. S7-19-08 (August 29, 2008) ("IDC NRSRO Letter"). 5 Division of Investment Management staff recently issued a letter in

connection with the Director Outreach Initiative. We are hopeful that the staff will continue to issue guidance and/or take other regulatory action relating to directors' duties. See Letter from Michael S. Didiuk, Attorney-Adviser, Division of Investment Management, U.S. Securities and Exchange Commission to Dorothy A. Berry, Chair-Governing Council, Independent Directors Council, and Jameson A. Baxter, Chair, Mutual Fund Directors Forum (November 2, 2010). 6 See e.g., IDC Director Outreach Letter, supra n. 4; Letter from Michael S. Scofield, Chair, IDC Governing Council, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, regarding Money Market Fund Reform; File No. S7-11-09 (September 8, 2009). Ms. Elizabeth Murphy November 5, 2010 Page 4 of 10 as they yield formalistic routines, serve little purpose, and divert directors' attention away from more substantive matters.7 • Commission guidance, including in the form of "factors" or "checklists," generally is not necessary and may impede, rather than assist, fund directors in providing appropriate oversight.8 Because the Commission's proposal is, in part, consistent with those principles, and, in part, contrary to them, IDC offers only partial support for the proposal as it relates to fund directors. 1. Rule 12b-2 Marketing and Service Fee Under proposed Rule 12b-2, fund assets may be used to finance "distribution activity" so long as, among other things, all charges and fees do not exceed the "service fee" allowed under the NASD sales charge rule.9 Under the proposal, any charge in excess of the 25 basis point "service fee" amount would be considered an asset-based sales charge subject to amended Rule 6c-10, which would also be capped by the NASD sales charge rule. Importantly, proposed Rule 12b-2 would not require directors to adopt or renew a "plan" or make any special findings as currently required by Rule 12b-1. IDC strongly supports the proposal to eliminate the Rule 12b-1 board requirements as well as to eliminate the factors included in the Rule 12b-1 adopting release. We agree that directors would have the ability to authorize the payment of marketing and service fees consistent with their fiduciary obligations and that they would oversee the amount and uses of the fees in the same manner that they oversee the use of fund assets to pay any other fund operating expenses. Indeed, fund directors are subject to state law fiduciary duties of loyalty and care in addition to any other responsibilities imposed on them under the federal securities laws. These well-established duties have guided fund directors well in their representation of fund shareholders' interests for decades and will continue to do so in the future. 7 See e.g., IDC Director Outreach Letter, supra n. 4, and IDC NRSRO Letter, supra n. 4. 8 See e.g., Letter from Robert W. Uek, Chair, IDC Governing Council, to Florence E. Harmon, Acting Secretary, U.S. Securities and Exchange Commission, regarding Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices; File No. S7-22- 08 (September 30, 2008); IDC 12b-1 Letter, supra n. 3. 9 See Rule 2830 of the NASD Conduct Rules. Ms. Elizabeth Murphy November 5, 2010 Page 5 of 10 2. Rule 6c-10 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 point amount permitted under proposed Rule 12b-2, provided that the excess amount is considered an "ongoing sales charge" subject to its own cap and limitations. a. Elimination of Rule 12b-1 Board-Related Requirements Similar to the approach taken in proposed Rule 12b-2, the amendments to Rule 6c-10 would not impose explicit responsibilities on fund boards, as currently required under Rule 12b-1. For the reasons discussed above, we strongly support this part of the Commission's proposal. Also as noted above, we urge the Commission to eliminate the board-related Rule 12b-1 requirements and factors, regardless of what other action it may or may not take with respect to Rule 12b-1 reform. b. Section 36(a) Fiduciary Duty References The Commission refers to Section 36(a) of the 1940 Act in its discussions of board oversight of both marketing and service fees and ongoing sales charges, which we question.10 Fund directors have a fiduciary duty under state law to act in the best interests of their funds. In

overseeing the affairs of the funds, directors exercise that fiduciary duty in reliance generally on the business judgment rule on the basis of facts and presentations on matters being considered and the advice of fund and independent counsel and others. They decide, on a fully-informed basis, what is in the best interests of the funds taking into account all relevant facts and circumstances as they understand them. Board decisions under proposed Rules 6c-10 and 12b-2 would be made in light of these fiduciary duties. Section 36(a) authorizes the Commission to bring an action against a fund director for "breach of fiduciary duty involving personal misconduct in respect of any [fund] for which such person so serves or acts." It is an authorization for the Commission to pursue individual misconduct. As such, Section 36(a) establishes a standard that is completely different from that which governs normal board decision-making; indeed, it has nothing to do with board governance. Accordingly, we believe it is inappropriate for the Commission to provide guidance relating to a board's general oversight duties based on a standard by which it is authorized to remediate personal misconduct. 10 See Release, supra n. 2, at n. 156 and 63-64. Ms. Elizabeth Murphy November 5, 2010 Page 6 of 10 c. Proposed Commission Guidance In connection with board oversight of ongoing sales charges, the Commission proposes new guidance to "assist fund directors in satisfying their fiduciary duties."11 IDC strongly objects to the issuance of Commission guidance in this regard. Fund directors are well guided by their fiduciary duties to provide appropriate oversight of fund distribution arrangements. Experience has shown that attempts to set forth factors in the form of guidance can impede, rather than assist, fund directors in providing effective and efficient oversight as such factors can become too prescriptive and outmoded over time.12 Moreover, the proposed guidance is not grounded in law and would require directors to make determinations beyond their appropriate oversight role. Directors would be best assisted if they were permitted to oversee all fund distribution arrangements in the same manner, consistent with their fiduciary oversight responsibilities and unconstrained by prescriptive regulatory guidance.13 Boards are well equipped to oversee ongoing sales charges without prescriptive guidance. Fund directors have overseen distribution arrangements for decades, including before the adoption of Rule 12b-1, without any need for Commission guidance. In this regard, they typically oversee the structure and purpose of the arrangements, probe the reasons for the success or failure of the principal underwriter's plans, monitor the fees associated with the different classes of a fund, and assess the impact of the marketing and sales efforts on the funds and their shareholders. Board oversight of ongoing sales charges would be consistent with its oversight of front-end sales loads and fund distribution practices generally.14 As the Commission correctly observes, "[t]he fund paying an ongoing sales charge would, in a sense, operate merely as the vehicle by which the fund shareholder pays the underwriter what the investor would have paid in the form of a front-end load at the time shares were purchased."15 Thus, the board's oversight role should be no different simply because the sales charges are paid from fund assets rather than in a front-end sales load. Moreover, 11 See Release, supra n. 2, at 62-66. 12 Directors' experience with the factors discussed in the Rule 12b-1 adopting release also has shown that guidance in a release has the same effect as if it were part of the rule itself. 13 The Commission states that it expects to provide guidance in its adopting release and then seeks comment on the proposed guidance. See Release, supra n. 2, at 64. If the Commission were to consider additional or other guidance, different from what it has included in the Release, we request an opportunity to comment on that guidance before it becomes final. 14 The Commission quotes IDC's 12b-1 Letter, which makes this point. See Release, supra n. 2, at n. 216. 15 See Release, supra n. 2, at 63. Ms. Elizabeth Murphy November 5, 2010 Page 7 of 10 because the proposed ongoing sales charge would be tied to a reference load and capped by the NASD sales charge rule, it would not present a conflict of interest concern warranting prescriptive guidance.16 The proposed guidance is

not supported by law. Although nothing has changed in terms of the board's oversight role, the Commission now for the first time seeks to articulate standards for fund directors with respect to their oversight of fund distribution arrangements. The Commission states that it believes that "fund directors should consider the amount of the ongoing sales charge and the purposes for which it is used according to the same procedures they use to consider and approve the amount of the fund's other sales charges in the underwriting contract under section 15(c) of the Act."17 The Commission's underlying premise—that fund directors are (or should be) involved in setting the amount of the sales charge when they approve the underwriting contract—is inconsistent with a fair reading of Section 15, however: Section 15(c) requires approval of only "the terms" of the contract, which include the provisions of the contract (e.g., indemnification clauses), and not the amounts to be paid. While Section 15(a) expressly requires an advisory contract to "precisely describe[] all compensation to be paid thereunder," Section 15(b), which applies to underwriting contracts, omits that requirement. Thus, the statutory language reflects that sales charges are not a necessary component of the contract to be approved by the directors. The Commission's proposal that boards determine whether the underwriter's compensation and the sales loads are "fair and reasonable" also is not grounded in law. This standard has no statutory or regulatory basis, and, because of its subjective nature, could expose directors to litigation risk. The Commission states that the proposed approach was informed by input from independent director representatives, such as IDC, but IDC's previous Rule 12b-1 comment letter expressed a view significantly different from that described in the Commission's guidance.18 Moreover, the Commission states that the proposed "fairness and reasonableness" factors are based on its understanding of what fund boards consider, but it cites to no authority.19 16 As the Commission observes, "[f]unds and fund underwriters would have little incentive to collect ongoing sales charges at excessive rates—a class of shares paying a higher rate of ongoing sales charge would simply convert earlier to a class that does not pay an ongoing sales charge." Release, supra n. 2, at 63. 17 The Commission also asserts that "[b]y setting the maximum front-end load, the fund, its board, and the principal underwriter would also establish the maximum amount of the cumulative sales charge." Release, supra n. 2, at 54 (emphasis supplied). 18 See Release, supra n. 2, at n. 216. For example, IDC stated that while "directors should become knowledgeable as to the means through which fund shares are distributed and the principal services offered to fund shareholders,'' they ''should not be required to assess the business merits of the distribution channels used by the funds they oversee.'' See IDC 12b-1 Letter, supra n. 3. 19 See Release, supra n. 2, at n. 214. Ms. Elizabeth Murphy November 5, 2010 Page 8 of 10 The proposed guidance would further exacerbate rather than address the concerns raised in the Release. The Commission acknowledges in the Release that directors lack the bargaining power to effectively negotiate the level of fees that are paid to financial intermediaries through 12b-1 plans.20 Requiring fund boards to be involved in setting those amounts (or in determining whether they are "fair and reasonable") exacerbates the problem that exists under the current regulatory regime. The proposed guidance would put fund boards in the untenable position of purporting to set sales charge amounts when the competitive marketplace actually determines these amounts (subject to the NASD sales charge rule limitations). The guidance also would place directors in the illogical and impossible position of determining the "quality" of the services provided by the intermediary to its individual customer. Indeed, the proposed guidance suggests an inappropriate role for fund directors. Proposing guidance in the form of factors also perpetuates the concerns raised in connection with the factors included in the Rule 12b-1 adopting release. As the Commission notes, there is general agreement that the nine factors are no longer as relevant to the current uses of 12b-1 fees.21 While the Commission purports to eliminate those factors, its proposed guidance would require fund directors to

consider other factors. Thus, the proposed guidance is inconsistent with the principle that checklists and factors generally are unnecessary and can impede, rather than enhance, effective and efficient board oversight. We urge the Commission to avoid repeating the same mistake that put directors in the unfortunate position they are in today with respect to Rule 12b-1 and the factors.22 B. Enhancing Shareholder Understanding of Distribution Fees IDC supports the Commission's goal of promoting investor understanding of fees. The proposed amendments to fee table disclosures in fund prospectuses—which would require funds to use the plain English terms "ongoing sales charge" and "marketing and service fee," rather than rule numbers—furthers this goal, and we support these changes. The next logical step in furtherance of the goal is enhanced point-of-sale disclosure. Effective disclosure at the point of sale (regarding all investment products or services that brokers and other financial intermediaries sell) can help investors make informed decisions regarding the investment options available to them. We question, then, the Commission's piecemeal approach of adding lengthy 20 See Release, supra n. 2, at 35. 21 Id. 22 If the Commission determines to take no other action with respect to Rule 12b-1 reform, we urge Commission staff to, at a minimum, provide fund directors with relief from the factors included in the Rule 12b-1adopting release. Ms. Elizabeth Murphy November 5, 2010 Page 9 of 10 disclosures to confirmation statements before it has completed its consideration of the more pertinent point-of-sale disclosures.23 The proposed additions to confirmation statements, moreover, would potentially confuse investors and discourage brokers from selling funds in favor of other products not subject to the same disclosure requirements. The relevant fee information would already be provided in an easy-to-read format in the fund's prospectus. For these reasons, IDC urges the Commission to complete its consideration of point-of-sale disclosure before adding new disclosures to confirmation statements. III. Account Level Sales Charge The Commission proposes to permit an alternative distribution model under which intermediaries of funds could impose charges for sales of the fund's shares at negotiated rates. IDC expresses no view regarding the merits of this alternative approach. If the Commission determines to permit it, however, we request that the Commission confirm that fund boards would not have any responsibility to oversee, monitor, or review the sales charges imposed by intermediaries or have any oversight responsibility over this commercial relationship between the intermediary and fund investor. IV. Conclusion Given the broad and complex nature of its proposal, IDC urges the Commission to carefully consider the comments it receives regarding the potential costs and other impacts of the proposal— which ultimately may be borne by fund shareholders—before enacting any significant Rule 12b-1 reform. In addition, for the reasons discussed above, IDC urges the Commission to: • Eliminate the Rule 12b-1 board requirements and factors regardless of: (i) whether it takes any other action with respect to Rule 12b-1 reform, or (ii) how it may address other matters, such as caps on fees; • Not issue guidance to fund directors in connection with their oversight of fund distribution arrangements; and • Amend prospectus disclosure requirements to require plain English disclosures of distribution fees but not add to confirmation statement disclosures until after it has completed consideration of enhanced point-of-sale disclosure. 23 The Release notes that the staff is considering recommendations for the Commission's future consideration to enhance the information provided at the point of sale. In addition, in Section 919 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress made clear that "[n]otwithstanding any other provision of the securities laws, the Commission may issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor." See Release, supra n. 2, at n. 222. Ms. Elizabeth Murphy November 5, 2010 Page 10 of 10 If you have any questions about our comments, please contact Amy B.R. Lancellotta, Managing Director, Independent Directors Council, at (202) 326-5824.

Sincerely, Dorothy A. Berry Chair, IDC Governing Council cc: The Honorable Mary L. Schapiro The Honorable Kathleen L. Casey The Honorable Elisse B. Walter The Honorable Luis A. Aguilar The Honorable Troy A. Paredes Andrew J. Donohue, Director Robert E. Plaze, Associate Director Division of Investment Management

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