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SEC Proposes Revisions to Mutual Fund Distribution Fees (Rule 12b-1) and Disclosure

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On July 21, the Securities and Exchange Commission (SEC) proposed new rules and disclosure requirements that, if adopted, will significantly change the existing framework governing the use of mutual fund assets to pay for distribution (the Proposal).[1] The Proposal has widespread implications not only for mutual funds and their boards of directors and investment advisers, but also for broker-dealers and other financial intermediaries that sell fund shares or service fund shareholder accounts.

Background

Adopted in 1980, Rule 12b-1 under the Investment Company Act of 1940 (Investment Company Act) permits a mutual fund to use fund assets to pay broker-dealers and others for providing services that are primarily intended to result in the sale of the fund's shares. In the years since the rule's adoption, the mutual fund industry has seen tremendous growth and experienced significant changes in the way that mutual funds are offered and sold. In the Proposal, for example, the SEC notes the transition from mutual funds being primarily sold by brokers to being distributed significantly through fund supermarkets and other types of intermediary arrangements. The SEC also notes the emergence of multiclass arrangements that accommodate selling through multiple distribution channels. Relying on data from the Investment Company Institute, the SEC observes that in 2009 mutual funds paid $9.5 billion in Rule 12b-1 fees and that more than half of Rule 12b-1 fees were paid to broker-dealers and other financial intermediaries for providing services to investors after the sale of fund shares.

Based on the belief that the distribution framework established under Rule 12b-1 no longer reflects the economic realities of modern-day mutual fund distribution, the SEC's Proposal would rescind Rule 12b-1 and replace it with a new framework that would separately regulate what the SEC identifies as the two primary component parts of Rule 12b-1 fees: services fees and asset-based sales charges. Service fees, which would be capped at a relatively low amount and would compensate intermediaries for sales and services, would be permitted under new Rule 12b-2. Asset-based sales charges, which also would be capped but at significantly higher amounts, would be governed by amendments to Rule 6c-10. In addition, for the first time, the Proposal would permit broker-dealers (rather than the individual funds) to establish their own sales charges on the sale of fund, which the SEC believes will foster retail price competition among dealers in mutual fund shares. The Proposal also impacts the role of a mutual fund's board of directors in overseeing the distribution of the fund's shares. While the adoption by individual boards of distribution plans based on specific determinations and findings as required under existing Rule 12b-1 would be eliminated, the Proposal is clear that directors will continue to have fiduciary obligations under state law and Section 36(a) of the Investment Company Act to oversee the use of fund assets to pay for distribution.

Elements of the Proposal

Marketing and Service Fee—Proposed Rule 12b-2. If adopted, the Proposal would rescind Rule 12b-1 and replace it with Rule 12b-2, which would permit funds to deduct a "marketing and service fee" from fund assets to

[1] *See* Mutual Fund Distribution Fees; Confirmations, Securities Act Release No. 9128, Exchange Act Release No. 62,544, Investment Company Act Release No. 29,367 (July 21, 2010), *available at* http://sec.gov/rules/proposed/2010/33-9128.pdf.

pay for "distribution activities." The definition of "distribution activities" would carry over unchanged from the current definition under Rule 12b-1(a)(2).[2] A Rule 12b-2 marketing and service fee would be capped at the service fee limit established under FINRA (NASD) Rule 2830 (currently 25 basis points (0.25%) annually). A fund may use marketing and service fees for the following purposes:

- Payments for personal service and/or the maintenance of shareholder accounts
- Trail commissions to broker-dealers selling fund shares
- Fees paid to fund supermarkets, which can be distribution related
- Payments to retirement plan administrators for services provided to plan participants (and which relieve the fund from providing such services)
- Traditional distribution activities, such as shareholder call centers, compensation of underwriters, advertising, and printing and mailing of prospectuses to other than current (i.e., prospective) shareholders

The Proposal would require a fund to obtain shareholder approval of the adoption of, or any increase in, a marketing and service fee after the public offering of the fund or the particular share class. With respect to fund-of-funds arrangements, Rule 12b-2 would permit both an acquiring fund and an acquired fund to charge a marketing and service fee, so long as the total of the fees charged by the funds together does not exceed the FINRA (NASD) service fee limit (25 basis points).

Although the Proposal would eliminate the requirement that fund boards adopt a distribution plan and make specific findings and determinations with respect to such plan, the Proposal makes clear that fund boards will continue to have fiduciary obligations under state law and Section 36(a) of the Investment Company Act to oversee the use of fund assets to pay the marketing and service fee. In this regard, fund boards would be required to approve the adoption of the marketing and service fee under the Proposal, and it is the SEC's intention that fund boards would oversee the amount and uses of the marketing and service fee in the same manner that it oversees the use of fund assets to pay other fund operating expenses, particularly any instances that create a potential conflict of interest with a fund's investment adviser or other affiliated persons. The SEC release did not contain any specific guidance as to what factors should be considered by fund boards when determining whether the level of the marketing and service fee is (or is not) appropriate for a particular fund.

Ongoing Sales Charges—Amendments to Rule 6c-10. The Proposal would amend Rule 6c-10 under the Investment Company Act to permit funds to charge asset-based distribution fees in excess of the marketing and service fee permitted under Rule 12b-2. Such excess amount would be called an "ongoing sales charge," subject to aggregate limits imposed under Rule 6c-10.[3] As long as the rate is consistent with the cumulative maximum sales charge limit, funds will be free to determine the rate of the ongoing sales charge.[4] The cumulative sales charge limit would apply separately to each share purchased by a shareholder. The maximum cumulative charge would be determined by reference to the highest front-end sales load charged by any class of shares of the fund that does not impose an asset-based sales charge or, if no such class exists, a default rate of 6.25% (the FINRA (NASD) limit). In effect, the Proposal would replace the current FINRA (NASD) fund-level cap on asset-based sales charges with an individualized per-share cap.

The Proposal permits funds to comply with the maximum sales charge limits by automatically converting any shares subject to an ongoing sales charge to another class of shares without an ongoing sales charge (but which

[2] Proposed Rule 12b-2(e)(2) would define "distribution activities" as any activities "primarily intended to result in the sale of shares issued by the fund, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature."

[3] The SEC notes in the Proposal that all payments of ongoing sales charges to intermediaries would constitute transaction-based compensation and that such intermediaries would, therefore, need to be registered as a broker-dealer under Section 15 of the Securities Exchange Act of 1934, unless they can avail themselves of an exception or exemption from registration.

[4] Although the SEC does not propose to specify the annual maximum rate at which a fund could deduct annual ongoing sales charges, under the FINRA (NASD) sales charge caps such fees are currently limited to a maximum of 75 basis points (0.75%) of fund assets annually. The SEC release states that if the Proposal is adopted, the annual FINRA (NASD) sales charge cap may be unnecessary because the cumulative amount of ongoing sales charges would be capped, although the SEC release does not explicitly indicate that the FINRA (NASD) sales charge cap will be repealed.

may charge a Rule 12b-2 marketing and service fee) no later than the end of the month during which the cumulative limit has been reached. To facilitate this conversion, funds and their intermediaries could either track the actual dollar amount of ongoing sales charges paid by each shareholder account or determine at the time of purchase of each lot of shares the maximum number of months that the shareholder is permitted to pay the ongoing sales charge. The SEC states that fluctuations in the value of the shares would not affect the maximum length of the conversion period. Further, shares acquired through reinvestment of dividends and distributions could incur an ongoing sales charge, but would be required to convert to a share class without an ongoing sales charge no later than the conversion date of the shares on which the dividend or distribution was declared. The Proposal also would adopt conforming amendments to Rule 11a-3 under the Investment Company Act that would require a shareholder's maximum sales charge limitation to be reduced if the shareholder previously paid a sales load on fund shares that the shareholder subsequently exchanged for shares of the current fund.[5]

The following example illustrates how the cumulative limits on asset-based sales charges could be structured:

> If a fund has Class Y shares with a 6% front-end sales load and Class Z shares with a 2% front-end sales load, the fund could charge as much as 4% in total ongoing sales charges with respect to the Class Z shares. For Class Z shares, this 4% ongoing sales charge could be 100 basis points annually over a four-year period, 50 basis points annually over an eight-year period, or 25 basis points annually over a 16-year period, and so on.

The SEC release further indicates that funds would have the option to do the following:

- Offer scheduled variations in the conversion period to a particular class of shareholders or transactions, subject to compliance with Rule 22d-1

- Apply any quantity discounts or scheduled variations in the front-end load for which the investor may qualify when determining the maximum sales charge limitation for an ongoing sales charge

- Impose a contingent deferred sales load in combination with an ongoing sales charge, subject to the maximum sales charge limitation

However, funds are prohibited from (i) instituting or increasing the rate of an ongoing sales charge after the public offering of the shares, or (ii) increasing the amount of time after which a share class will automatically convert to a class of shares that does not have an ongoing sales charge, if it would increase the cumulative amount of ongoing sales charges imposed. These prohibitions apply regardless of shareholder approval.

With respect to fund-of-funds arrangements, an acquiring fund that deducts an ongoing sales charge would not be permitted to acquire the securities of another fund that imposes an ongoing sales charge.

Under the Proposal, fund boards would be required to approve the adoption of any asset-based sales charges, but no specific findings or determinations would be required. The SEC release indicates that fund directors will continue to have fiduciary obligations to oversee the use of fund assets to pay ongoing sales charges, and advises fund boards to consider the amount of the ongoing sales charges and the purposes for which they are being used in accordance with the same procedures used by boards for evaluating sales loads in the fund's principal underwriter's contract under Section 15(c). The SEC release further indicates that fund boards should determine, after consideration of all relevant factors, whether the ongoing sales charges are fair and reasonable in light of the usual and customary charges made by others for similar services. The SEC intends to issue additional guidance to boards to assist them in satisfying their fiduciary duties, if and when the Proposal is adopted.

Account-Level Sales Charges—Amendments to Rule 6c-10. In an effort to foster price competition among dealers offering mutual funds, the Proposal includes a novel alternative approach to distributing fund shares. Proposed Rule 6c-10(c) would permit funds to offer their shares at net asset value (i.e., without a sales load) and broker-dealers could impose their own sales charges on such shares, tailoring them to different levels of shareholder service. These fees could be paid directly by the investor or charged to the investor's brokerage account and could be charged at the time of sale, over a period of time, or upon redemption. The amount of these

[5] Rule 11a-3 under the Investment Company Act governs exchanges between mutual funds in the same fund group.

fees (and the times at which they would be collected) would not be governed by the Investment Company Act, but FINRA (NASD) limits on compensation would apply.

The exemption provided under Rule 6c-10(c) is optional and may be relied on by a fund with respect to all of its shares or any of its classes of shares. In order to rely on the exemption provided under Rule 6c-10(c), a fund (with respect to the particular share class) would not be permitted to impose an ongoing sales charge, but could charge a marketing and service fee pursuant to proposed Rule 12b-2. In addition, funds relying on Rule 6c-10(c) would be required to disclose in their registration statements that they have elected to rely on the exemption provided by Rule 6c-10(c).

Disclosure—Amendments to Form N-1A. The Proposal would revise several disclosure requirements set forth in Form N-1A, which is the registration form for mutual funds. The fee table disclosure requirements of Item 3 would be amended to replace the current line item reference to 12b-1 fees with "Ongoing Sales Charge," and a new subheading to the "Other Expenses" category called "Marketing and Service Fee" would be added to the fee table. Funds would need to include these line items only to the extent that they charge the applicable fees.

The Proposal would also revise Item 12(b) of Form N-1A to require the following:

- Disclosure of whether a fund charges marketing and service fees or ongoing sales charges and, if applicable, the rates of the fee and the purposes for which the fee is used

- Disclosure of the nature and extent of services provided to fund investors in exchange for any marketing and service fee or ongoing sales charge deducted from fund assets

- Disclosure, by funds that impose an ongoing sales charge, of the number of months (or years) until the shares will automatically convert to another class without a charge and after which the shareholder would cease paying the charge

- Disclosure, by funds that offer multiple classes of shares in a single prospectus, of the general circumstances under which an investment in one class of shares may be more advantageous than investment in another class of shares

As proposed, the amendments to Form N-1A do not require disclosure of specific dollar amounts. Conforming amendments are also being made to Schedule 14A, which sets forth information required in a proxy statement.

Disclosure—Mutual Fund Transaction Confirmations. The Proposal would amend Rule 10b-10 under the Securities Exchange Act of 1934 to require mutual fund transaction confirmations to set forth detailed information regarding front-end and deferred sales charges, as well as ongoing sales charges and marketing and service fees. With respect to customers who will incur a marketing and service fee or ongoing sales charge, transaction confirmations would be required to include the following information:

- The annual amount of the ongoing sales charge or marketing and service fee (expressed as a percentage of net asset value)

- The aggregate amount of the ongoing sales charge that may be incurred over time (expressed as a percentage of net asset value)

- The maximum number of months or years that the customer will incur the ongoing sales charge

- The following statement: "In addition to ongoing sales charges and marketing and service fees, you will also incur additional fees and expenses in connection with owning this mutual fund, as set forth in the fee table in the mutual fund prospectus; these typically will include management fees and other expenses. Such fees and expenses are generally paid from the assets of the mutual fund in which you are investing. Therefore, these costs are indirectly paid by you."

Compliance Dates and Transition Period

The SEC contemplates the new rules becoming effective within 60 days of publication of the final rule release, and funds are permitted to rely on the new rules at such time. The SEC would allow a period of 180 days after the

effective date for funds to come into compliance with the new rules with respect to shares issued after the compliance date. For shares issued prior to the compliance date, a five-year grandfathering period would apply to allow funds to continue to deduct fees pursuant to Rule 12b-1 as it exists today. New sales would not be permitted in a grandfathered share class after the compliance date, but dividends or other distributions on the grandfathered shares could be reinvested in the same share class. After the five-year period, the grandfathered shares would be required to be converted or exchanged into a class that does not deduct an ongoing sales charge. However, such class could charge a Rule 12b-2 marketing and service fee, except that such marketing and service fee cannot be higher than the Rule 12b-1 fee charged on the grandfathered shares in the most recent fiscal year before the class's conversion.

During the five-year grandfathering period, fund boards could eliminate mandatory provisions of Rule 12b-1 plans that require annual board approval and the delivery of quarterly board reports. However, directors would continue to exercise responsibility over the 12b-1 plans in accordance with their general oversight responsibilities.

If funds decide to convert or amend their current share classes that rely on Rule 12b-1 to conform to the proposed rules, Rule 12b-2 would prohibit a fund from instituting a marketing and service fee without shareholder approval, subject to certain exceptions. Specifically, transition from a Rule 12b-1 fee to a Rule 12b-2 fee would be permitted without shareholder approval if (i) the fund currently deducts from fund assets annual Rule 12b-1 fees of 25 basis points or less, and does not increase the rate of the fee; or (ii) the fund reduces the amount of the Rule 12b-1 fees it currently deducts to an annual rate of 25 basis points or less, and renames the Rule 12b-1 fee a "marketing and service fee."

Open Issues, Implications, and Effects

The Proposal is designed to completely overhaul the existing framework governing the use of mutual fund assets to pay for distribution, a framework that has evolved steadily since 1980. As one might expect, a Proposal of this scope raises significant business, compliance, and legal issues that affect mutual funds, their boards of directors, their investment advisers, and the financial intermediaries that sell fund shares and service fund shareholders. Some of the more significant issues are highlighted and summarized below:

Board Oversight/Workload. Although not without issues, and not without detractors, a well-established legal and regulatory framework had developed around Rule 12b-1 through guidance provided by the SEC and the courts, as well as through development of FINRA (NASD) rules governing broker-dealers. In particular, this framework provided guidance to boards regarding their duties to oversee the use of fund assets for distribution. How the SEC will fill this newly created void remains to be seen. Will the additional guidance provided by the SEC in the adopting release provide fund boards with the clarification and simplification of their duties that they desire? Based on the SEC release, it seems reasonable to conclude that, at a minimum, a board's 15(c) process for evaluating the fund's principal underwriter contract, and the fees paid in connection therewith, will be given greater emphasis and scrutiny under the revised rules.

Adoption of the Proposal could result in substantial changes in the configuration of fees that funds pay for distribution and shareholder services, if for no other reason than brokers and other intermediaries will look for other sources of income if payments characterized as sales charges are reduced. In this regard, we expect that the new system may require greater board involvement in the establishment and ongoing oversight of a fund's payment of nondistribution fees to financial intermediaries, such as subtransfer agency, subaccounting, and administrative service fees. Further, to the extent the Proposal has the indirect effect of increasing the amount of "revenue sharing"[6] payments being requested from a fund's adviser and its affiliates by financial intermediaries to support the distribution of the fund, expectations for board oversight of such payments may also increase. If so, boards would expect the SEC to provide guidance with regard to these related matters.

Payments to Financial Intermediaries and for Retirement Plan Services. Many financial intermediaries currently receive fees from mutual funds for the distribution and service activities they perform for the fund and shareholder accounts. In addition, mutual fund fees are frequently used to pay for services provided to shareholders that are retirement plans, either by a financial intermediary or as part of a bundled services arrangement. In many cases, the fees are paid through mutual fund Rule 12b-1 plans in amounts that are in excess of the fee limits imposed under the Proposal. Accordingly, mutual funds will be required to develop new

[6] "Revenue sharing" generally refers to payments made by fund advisers or their affiliates out of their own "legitimate profits" to financial intermediaries for providing fund distribution or services to fund shareholders.

compensation arrangements for these parties. Absent a change in the final rule, a likely consequence is that funds will seek to recharacterize, to the extent permissible, services currently provided by financial intermediaries and for retirement plans as nondistribution services in order to allow the funds to continue to pay for such services outside the scope of the Rule 12b-2 limit (25 basis points) and without treating such payments as an ongoing sales charge. For example, such fees have historically included non–Rule 12b-1 shareholder service fees, administrative services fees, and subtransfer agency fees. However, even after modifying fee arrangements, such compensation amounts may not represent full compensation for the services. As contemplated by the SEC in the proposing release, any shortfall will likely be made up through increased revenue-sharing payments by the fund's adviser or its affiliates. In light of the above, a possible unintended consequence of the Proposal would be an increase in the amount of revenue-sharing payments, which could reduce the transparency of the fees paid to financial intermediaries for the sale of fund shares.

Recordkeeping Obligations to Track Fund Shareholders. If adopted, the Proposal would require mutual funds (or their service providers or financial intermediaries) to track the cumulative amount of sales charges that an investor pays on the purchase of fund shares. Similar to the way they handle the administration of monitoring for breakpoint discounts in fund sales loads, mutual funds are likely to push this requirement down to their selling broker-dealers and other financial intermediaries. It remains to be seen what type of liability mutual funds will have for any failure of the fund or, maybe more importantly, of its intermediaries to monitor the limits imposed on ongoing sales charges. In addition, the likely cost of implementing this aspect of the Proposal may be quite burdensome for certain types of intermediaries. Intermediaries will be required to implement systems that can track shareholder accounts that are transferred between intermediaries, track specific share lot histories, and track shares purchased through the reinvestment of dividends and distributions. As noted in the SEC proposing release, retirement plan administrators typically have not tracked this information in the past and will likely need to enhance their recordkeeping systems as a result of the new rules. Whether intermediaries pass these increased costs along to the funds (or to funds' advisers in the form of increased revenue-sharing payments) remains to be seen. In addition, given the possible complexity of the task, it will be interesting to see whether funds and financial intermediaries comment on the reasonableness of the 180-day compliance implementation period contemplated by the Proposal.

Account-Level Sales Charges. Section 22(d) of the Investment Company Act essentially fixes the price at which mutual fund shares may be sold because all dealers in a fund's shares must sell shares at the same sales load (or scheduled reduction) disclosed in the fund's prospectus. Further, Section 22(d) precludes dealers from competing with each other by establishing their own pricing schedules or negotiating different terms with their customers. Section 6(c) of the Investment Company Act provides the SEC with broad authority to adopt rules that exempt persons and transactions from the provisions of the Investment Company Act where such exemptions are necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the Investment Company Act. Citing its belief that Congress's intent was unclear when it provided mutual funds the authority to control their distribution, the SEC has proposed Rule 6c-10(c), which provides an exemption from Section 22(d) of the Investment Company Act to permit broker-dealers to deduct account-level sales charges. Rule 6c-10(c) would allow broker-dealers to freely establish and collect their own commissions or other types of sales charges on the sale of mutual fund shares. Fostering price competition among fund intermediaries with respect to fees charged for the sale of fund shares in the hope that such fees will be lower as a result may be a commendable SEC goal. However, it remains to be seen how the SEC will satisfy its obligation under Section 6(c) of the Investment Company Act to provide a legal basis for the exemption set forth in proposed Rule 6c-10(c) given the specific language of Section 22(d). This issue may be debated in the upcoming months, especially if one subset of fund intermediaries feels that aggressive price competition among dealers in mutual fund shares will generally benefit another subset of fund intermediaries (e.g., discount brokers). Moreover, if the Proposal is adopted and dealers are permitted to establish and impose their own sales charges, the fund prospectus would no longer serve to inform shareholders of the costs associated with investing in the fund. The SEC may need to consider whether additional rulemaking is appropriate to ensure that dealers provide fund investors with timely and adequate disclosure of their fees and charges, perhaps reviving the "point of sale" disclosure initiative it proposed in 2004.

Churning of Mutual Fund Accounts. The Proposal seeks to limit the amount of ongoing sales charges that an investor may be charged and, therefore, the Proposal also seeks to limit the amount of fees that may be received by a financial intermediary with respect to such investor's investment in the fund. Fund intermediaries may be motivated to move their customers into new fund holdings in order to continue to receive payments of the ongoing sales charge. If the Proposal is adopted, funds would be mindful to inquire as to whether their financial intermediaries have developed policies and procedures reasonably designed to detect this type of churning of their clients' mutual fund holdings. Funds also may want to inquire as to whether and to what extent the

discontinuance of payments to the financial intermediary will affect the level of service provided to fund shareholders investing through such intermediary.

***Non–Rule 12b-1 Shareholder Service Plans*.** The marketing and service fee established under proposed Rule 12b-2 would permit funds to deduct from fund assets fees up to 25 basis points to pay for various distribution and service activities, including personal services and/or the maintenance of shareholder accounts. Currently, certain funds pay up to 25 basis points from fund assets for personal services and/or the maintenance of shareholder accounts in reliance on FINRA (NASD) Rule 2830(b)(9) pursuant to a non–Rule 12b-1 shareholder service plan. These fees are permitted outside of a Rule 12b-1 plan, and in some cases pre-date the adoption of Rule 12b-1, because the fund's assets are used to provide bona fide services and not to provide distribution. A question remains, however, whether such non–Rule 12b-1 shareholder service plans will continue to exist under the new regulatory structure. As proposed, the SEC rules seem to permit a fund to deduct from fund assets both a non-Rule 12b-1 shareholder service fee and a Rule 12b-2 "marketing and service fee," provided that the Rule 12b-2 marketing and service fee does not exceed 25 basis points and the total amount deducted from fund assets between the two fees for personal service and/or the maintenance of shareholder accounts does not exceed 25 basis points. In effect, the Proposal and the FINRA (NASD) rules seem to continue to allow a fund to have both non–Rule 12b-2 shareholder service fee up to 25 basis points and a Rule 12b-2 distribution fee up to 25 basis points.

The SEC's proposing release is available at: http://sec.gov/rules/proposed/2010/33-9128.pdf.

Further Questions

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