

Should the SEC's Rule 12b-1 Survive?

September 14, 2007

Introduction

Peter J. Wallison, AEI

Today's conference on Rule 12b-1 has its roots in a false idea that has underpinned the SEC's regulation of mutual funds since at least 1966. This is the notion that the contractual relationship between an adviser and a mutual fund involves an inherent conflict of interest that provides the adviser with an opportunity to exploit the fund. This view led to the idea that the control of advisory fees by the fund's board of directors is necessary to protect the fund's investors, and ultimately to a rule such as 12b-1. I want to spend a few minutes examining how this view of the mutual fund world gave rise to Rule 12b-1 and to the view that under the rule "fund assets are being used for distribution."

Is there an inherent conflict between the investment adviser and the fund? Yes, of course, just as there is an inherent conflict between you and your dry cleaner, auto repair shop, bank and securities broker. Each of these service providers wants to earn the highest possible profit, while you want the service at the lowest possible cost. That's a conflict of interest, the same conflict that is said to exist between a mutual fund and its adviser. As we have all discovered in our role as consumers, however, we are not exploited because of this conflict of interest for one reason: competition. Each of these service providers competes with others, and we have a choice among them. Competition controls their prices, improves their services, and protects us against exploitation resulting from their desire to maximize profit.

Why, then, is competition not sufficient to protect the investors in mutual funds from exploitation? Why is it necessary to require the board of directors of each fund to control the fees charged by the adviser? Is there something about the fact that these investors are shareholders in a corporation—rather than direct purchasers of collective investment services from an adviser under a contract—that changes the nature of the relationship, so that regulation of fees rather than competition is necessary to protect investors? If so, I've never seen this satisfactorily explained. Investment advisers should be competing for investors—the industry contends that they are, and the industry structure certainly looks competitive—so it should not matter whether the investors buy shares in corporations known as mutual funds or contract directly with advisers for collective investment services. If investment advisers are competing, this should protect funds and their investors against exploitation as it does in all other cases where buyers and sellers meet in the marketplace.

However, in the parallel universe created by the SEC's notion that investment advisers are able to exploit their contractual relationships with funds—where advisory fees must be controlled by fund boards to protect investors—the idea that an adviser would have sufficient profits to pay for share distribution is evidence that the adviser is exploiting the fund. That's why Rule 12b-1 was necessary. Some regulation, it was thought, was necessary to prevent advisers from using fund assets for distribution simply by obtaining unwarranted increases in their advisory fees from all-too-compliant boards of directors. Since the advisory fee was only

supposed to compensate the adviser for fund and portfolio management, it couldn't be used by advisers for distribution. In fact, the first instance of a 12b-1 fee was approved by the SEC staff in a no-action letter in 1976. Apparently, someone on the staff had the idea that the advisory fee belonged to the adviser, who could do with it what he thought best for his business. However, the letter was later rescinded when it became clear that this notion was inconsistent with the SEC's view of the exploitative potential inherent in the contractual relationship between the adviser and the fund.

The fact that Rule 12b-1 is now being questioned is, to my mind, strong evidence of the fact that the SEC is still entangled in its Depression-era mindset that there isn't—and can never be—sufficient competition among advisers to protect investors. Until that conceptual hurdle is overcome, the mutual fund industry will be regularly plagued by SEC efforts to control what the adviser does with its revenues. Rule 12b-1 is only one example of the controls the SEC will exercise—directly through regulation, or indirectly through fund boards of directors—as long as it believes that competition among advisers is insufficient to protect fund investors. Unfortunately, the SEC's position is one of those self-fulfilling prophecies. As long as the SEC and the 40 Act continue to require boards of directors to control advisory fees, true fee-based competition will never develop, and the SEC will be able to point to the insufficiency of competition as a reason to maintain price controls.

Today, however, we are where we are. We have to take the world as it is, and force ourselves to think about Rule 12b-1 as though it represents some element of objective reality rather than the SEC's parallel universe. As long as the SEC continues to see the world this way, most advisers have no choice but to support Rule 12b-1. It's the only way that they can replicate, in part, what they could do in a competitive market.

Last June, the SEC sponsored a roundtable about Rule 12b-1 and more than twenty-five people participated in a discussion of whether the rule should be repealed, modified or continued in its current form. Most of the discussion, of course, was about what restrictions, if any, should be put on the use of fund assets for distribution of fund shares. However, because of the size of the group and the open-ended nature of the discussion, the issues were never clearly defined. If we have to live with Rule 12b-1, and to think of it as using fund assets for distribution, we might as well get a clear statement of why it is necessary and what policy issues it entails.

None of our panelists today, including our speaker, were among the participants in the SEC's roundtable, but they can speak authoritatively for or about the views of the principal groups involved—the industry, which generally supports Rule 12b-1; independent directors, who have generally authorized 12b-1 fees; fund investors; and the SEC.

After Paul Stevens' presentation today, and the panel discussion that will follow, I believe we'll all have a clear idea of the public policy issues associated with Rule 12b-1.