

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

Remarks of
Paul Schott Stevens

President & CEO
Investment Company Institute

American Enterprise Institute

September 14, 2007
Washington, DC

Thank you, Peter (Wallison), for your kind introduction and for organizing this event. Among public policy organizations in Washington, AEI brings a focus to financial markets regulation that is unique and vitally important, and I congratulate you on your outstanding leadership of this program. While we sometimes disagree, I also thank you for the focus that you have brought specifically to mutual funds – an industry that serves more than 90 million investors and has a unique, complex scheme of regulation deserving close study. Today’s forum extends that focus to another issue of real significance to the fund industry that is now under active consideration at the SEC.

I’m going to go out on a limb here and say that Rule 12b-1 under the Investment Company Act of 1940 may not be the most exciting matter on the agenda of Washington policymakers. But this is by no means a reflection of its importance. Adopted 27 years ago, Rule 12b-1 has played a significant part in the development of the modern fund business. Today, more than 70 percent of US mutual funds have some form of 12b-1 plan.¹ The Rule impacts literally millions of investors, thousands of funds and myriad financial intermediaries.

The SEC is right to take stock of how a rule of this kind is working. In fact, all financial services regulators should periodically re-examine long-standing rules and consider the necessity or desirability of any changes. That is sound regulatory policy. I commend Chairman Cox for initiating this process with respect to Rule 12b-1. But the very importance of the Rule – and the extent of the market’s reliance upon it – also counsels a rigorous analysis of the need for, nature of and likely impact of any proposed changes.

As I have suggested before, a necessary first step is to identify a market problem or failure requiring regulatory action. If there is a problem necessitating intervention, all possible options should be considered, with a sharp eye toward the interests of investors, including relative costs and benefits. Approaches that would erode qualities Congress has singled out for special attention in our securities laws – namely, efficiency, competition and capital formation – demand close scrutiny.

As former SEC Chief Economist Chester Spatt has observed, “[t]he economic analysis of a rule should reflect not just why a proposed rule is better than the status quo, but also why the proposal would be an improvement over the relevant alternatives.”²

Applying these principles to Rule 12b-1, what problems do reform advocates point to as evidence of the need for regulatory change?

A. Eliminate or Further Limit 12b-1 Fees

Some commentators characterize 12b-1 fees as a “dead weight” on fund performance, as needless costs that return little or no benefit to investors. These critics argue for eliminating the rule altogether, or imposing much lower limits on 12b-1 fees, evidently with the expectation of significant cost savings to the investing public.

This is a false hope. The “do-it-yourself” fund buyers who prefer to make investment decisions on their own are a distinct minority. ICI research indicates that fully 80 percent of investors who hold funds outside of an employer-sponsored retirement plan turn to financial advisers and other intermediaries for help and advice.³ And considering the central place that funds occupy in the financial picture of millions of average investors, their instinct to seek out professional assistance is a good thing.

These investors typically buy, hold, and sell fund shares through broker-dealers, banks, insurance companies or financial planners. They also transact and hold shares through fund supermarkets or retirement plan platforms sponsored by broker-dealers or other intermediaries.

In these arrangements, intermediaries provide a variety of services to their customers, including ongoing advice and information, administrative support, and recordkeeping.

In these varied settings, Rule 12b-1 lets investors pay over time for the bundle of valuable services they receive, rather than doing so through sales charges at the time of purchase. The costs that investors incur under Rule 12b-1 would not disappear if the rule did, they simply would migrate elsewhere. In the process, investors and intermediaries alike would lose the flexibility and efficiency that the rule provides for financing these services.

Commentators who urge that 12b-1 fees be eliminated or drastically reduced often argue that current distribution costs are “too high.” Historical trends suggest that we can rely on the operation of market forces to address this concern. In fact, as Figure 1 demonstrates distribution costs for both stock and bond funds have decreased by over 70 percent since Rule 12b-1 was adopted. As shown in Figure 2, overall fund fees (of which distribution costs are a part) have declined by 50 percent during the same time period.

In any event, it is not apparent that eliminating or lowering the limit on 12b-1 fees would produce further reductions in the total distribution costs that fund investors incur. To the contrary, externalizing distribution costs would compel intermediaries to shift to a different compensation model for the ongoing services they provide to many fund investors. Such services clearly have a value and will command a price in the market. Deprived of the operational efficiencies of the current “mutualized” model (where fees are set, collected and remitted through the fund), intermediaries would need to develop, operate, and maintain a proprietary compensation scheme. The resulting cost – likely to be higher – would be passed on to investors. Smaller shareholder accounts could prove to be far less attractive in this environment, posing the risk that some investors could be squeezed out of business models emerging from such a change.

Eliminating or further limiting 12b-1 fees would impact shareholders in other ways as well: it would deprive them of flexibility they now enjoy to select share classes that best suit their needs and to pay for associated services through their fund. This flexibility is a hallmark of the system of multiple share classes in the current marketplace, including classes of shares specifically designed to help investors meet their goals of saving for retirement and paying for college.

R shares, for example, a relatively new innovation, are intended for retirement plan platforms and generally have 12b-1 fees ranging from 25 to 100 basis points. This range allows employers who offer 401(k) plans some flexibility in sharing plan administration costs with their employees, a feature that can be crucial to the ability of smaller employers to offer a 401(k) plan in the first place.

Likewise, some Section 529 College Savings Plans offer share classes with 12b-1 fees between 25 and 100 basis points. The fees pay intermediaries who help investors decide which of the dozens of available 529s to invest in and fashion a financial plan that’s right for them. Capping or eliminating 12b-1 fees would limit investors’ access to these services.

Finally, curtailing Rule 12b-1 would have a competitive impact as well, especially for smaller fund complexes. Small funds are innovators in the fund industry. They often offer specialized products, like single-state municipal bond funds or socially responsible funds, or serve discrete segments of the market. A recent news article noted that the best performing small funds often do better than similarly high-ranking large firms, regardless of the securities owned or investment style followed.⁴

Small funds, however, can be especially dependent on brokers and other intermediaries to make their funds available to investors. Rule 12b-1 is critically important to this process.

Melody Hobson, President of Ariel Capital Management, observed at the recent SEC Roundtable on Rule 12b-1 that her complex “could not exist” without 12b-1 fees.⁵

B. Impose 12b-1 Fees at the Shareholder Account Level

Other commentators have asserted that investors are not sufficiently aware of the nature and purpose of 12b-1 fees, because the fees are deducted directly from fund assets rather than from shareholder accounts. These commentators argue that charging the fees not through the fund but instead to the individual shareholder’s account would provide them greater visibility. Presumably, this greater visibility would put downward pressure on these fees or prompt investors to avoid them and shop elsewhere.

It is worthwhile testing the premise of this “hidden fees” argument. ICI research indicates that investors consider a wide range of information before purchasing mutual fund shares. A 2006 ICI survey found that three-quarters of all investors review or ask questions about a fund’s fees and expenses before a purchase.⁶ Undoubtedly, the attention investors pay to costs has contributed to the continuing decline in overall fund fees and distribution expenses over time, as depicted in Figures 1 and 2.

If 12b-1 fees are hidden, they are hiding in plain sight: They occupy a prominent place in the fee table that is enshrined in the risk-return summary at the front of every fund prospectus. They are featured in Morningstar and similar reports. And of course all fund performance data are reported net of 12b-1 fees and other expenses. Would an account level charge actually be more “transparent”? I am not aware of any empirical evidence that shareholders have a better appreciation of the account level fees that some funds charge (like Vanguard’s \$20 annual maintenance fee imposed on some small accounts) than they do fund level fees.

From a shareholder cost perspective, moreover, account-level or externalized fees are hardly an improvement on the *status quo*. Consider the higher tax costs they would entail. Under current law, investors enjoy a tax benefit from paying fees through the fund: 12b-1 fees reduce fund income and that allows investors to report lower taxable income. If, instead, fees for advice, administrative support and recordkeeping were externalized, the vast majority of fund shareholders would have higher taxable income – and a higher tax bill. As depicted in Figures 3 through 6, ICI calculates that for some share classes, externalizing all or substantially all distribution fees would result in an after-tax account balance as much as 3 percent lower after 10 years and as much as 13 percent lower after 40 years. Account-level fees also would complicate tax compliance for shareholders, because fees paid for different kinds of services likely would be subject to different tax rules.

In its 2001 release adopting the requirement that funds disclose after-tax returns, the SEC noted that the “tax efficiency of a mutual fund . . . can be very important to an investor in a taxable account, particularly a long-term investor . . .”⁷ I agree. The relative tax efficiency of mutual funds and other products is of concern to the investing public and a ground for keen competition among investment products. Is it in the interest of investors for the SEC to make mutual funds less tax efficient and hand fund investors a bigger tax bill? This would not seem to be a promising avenue of reform.

Externalizing fees also would have significant operations implications. It would necessitate very costly and time-consuming systems changes at all levels of distribution by fund distributors, transfer agents, and other intermediaries. I cannot estimate the incremental costs of retooling the back office of funds and their intermediaries for this purpose – but certainly it is not trivial. For all of these reasons, the costs of externalizing distribution fees would seem to outweigh the hypothesized benefits.

C. Improve Disclosure of 12b-1 Fees

Still other commentators have suggested that, within the framework of a fund's prospectus, we can do a better job of informing investors about 12b-1 fees and other fund fees. This is, as always, a worthy and important objective. It is entirely fair to ask whether individual investors are as knowledgeable as we would like them to be about the nature and purpose of the fees they pay and other key aspects of fund investing. I believe that existing disclosure regulations go very far in this direction, but further improvements are worth considering.

The SEC already is considering ways to improve overall fund disclosure, such as by allowing funds to use a short-form disclosure document that provides key information about a fund, including its risk-return characteristics, historical performance, portfolio holdings, and fees – something like the quick-start card that comes with new consumer electronic products. Everything we have learned about how to impart technical information effectively to a broad audience urges a reform of this kind, and it surely would help fund investors to focus on 12b-1 fees, among other things.

One basic proposition here is to communicate in “plain English” – and avoid formulations that only a '40 Act lawyer can understand. The term “12b-1” is likely about as clear to a financial novice as “ERA” is to someone who's never seen a baseball game. Rule 12b-1 fees deserve a new name and associated disclosure that clearly conveys their purposes.

An additional way to improve investor awareness and understanding of 12b-1 fees would be to require that brokers and other financial intermediaries inform their customers directly about 12b-1 fees and other compensation they receive. Getting this right will be tricky, however. Careful consideration must be given to the ways financial advisers actually interact with clients, the role that the Internet can play in making information available, and the needs and expectations of clients themselves. What's more, the policy issue here is larger than 12b-1 fees or even mutual funds. It logically extends to other, competing financial products as well, and should – indeed, must – be thought of in those terms. Otherwise, in our zeal to “perfect” mutual fund disclosure, we could establish real disincentives for intermediaries to offer funds to their customers and disadvantage them vis-à-vis competing products.

D. Clarify Role of Fund Boards

In the 27-year career of Rule 12b-1, mutual fund investing has evolved dramatically. 401(k) plans, 529 Plans, fund supermarkets – all these and more were unheard of in 1980. In light of these developments, many independent fund directors and other commentators have urged that the SEC take the opportunity to update its guidance to fund boards concerning their responsibilities under Rule 12b-1. Directors focus on how out-of-date portions of the Commission's adopting release have become, especially those “factors” the SEC suggested for board consideration when approving a 12b-1 plan. They also argue that ministerial requirements, like quarterly review of amounts expended under a 12b-1 plan, should be reconsidered. Especially in light of the role now played by chief compliance officers of funds, such review should be an annual exercise, freeing up time at fund board meetings for other matters. These concerns from the director community are well placed and should be heeded by the SEC.

E. Conclusion

In closing these remarks, let me remind you that Rule 12b-1 was the product of extended and meaningful SEC consideration in the 1970s that included public hearings, several rounds of public comment, and five releases over a course of four years.

The rule, as finally adopted, prohibited an open-end fund from using its own assets to pay for any distribution costs unless it had adopted a written plan approved by the fund's board and its shareholders and the fund's distribution payments were made pursuant to the plan. The rule did not include any restrictions on the types of distribution activities that funds could finance and, in fact, was intended to be flexible enough to allow funds to develop new distribution practices – as, in succeeding years, they certainly have.

The SEC generally provided that, within the framework of the rule, discretion would lie with fund boards, and particularly independent directors, regarding the fund's distribution-related activities. Recognizing the dynamic nature of the fund industry, the rule's adopting release stated that the SEC and its staff would monitor the rule's operation closely and be prepared to make adjustments in light of experience to make the restrictions on the use of fund assets for distribution more or less strict.

Fast forward 27 years. Mutual funds currently have over \$11 trillion in assets and more than 90 million shareholders.⁸ Rule 12b-1 is essential to a complex infrastructure that makes mutual fund investing available to these millions of investors. As I mentioned earlier, I commend the SEC for its decision to review Rule 12b-1. In doing so, however, the Commission should recognize that the rule, for all the ways it might be improved, is basically a success story –for the fund industry and, more importantly, for investors.

Peter, thank you again for organizing this event and for inviting me to speak. I look forward to the discussion with you and our distinguished colleagues on the panel.

¹ According to the Institute's research using data from Lipper and internal data collected by the Institute, as of May 2007, 5,151 funds (out of 7,032) or 73 percent of all mutual funds including variable insurance products were paying 12b-1 fees to intermediaries.

² Speech by SEC Staff: "Economic Analysis and Cost-Benefit Analysis: Substitutes or Complements?" by Chester S. Spatt, Chief Economist and Director, Office of Economic Analysis, Securities and Exchange Commission, Washington, D.C. (March 15, 2007) at 2.

³ As of 2003, more than 80 percent of all shareholders owning fund shares outside a 401(k) or other employer-sponsored pension plan owned fund shares through financial intermediaries. See "Ownership of Mutual Funds Through Professional Financial Advisers," *Fundamentals*, Vol. 14, No. 3, Investment Company Institute (April 2005), available at <http://www.ici.org/fundamentals/fm-v14n3.pdf>.

⁴ See "Mutual Funds: In Hunt for Top Funds, Don't Ignore Little Guys," by Jonathan Burton, *Dow Jones Newswires*, (September 4, 2007).

⁵ See Unofficial Transcript, SEC Division of Investment Management, Rule 12b-1 Roundtable (June 19, 2007) at 67, available on the SEC's website at <http://sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf>.

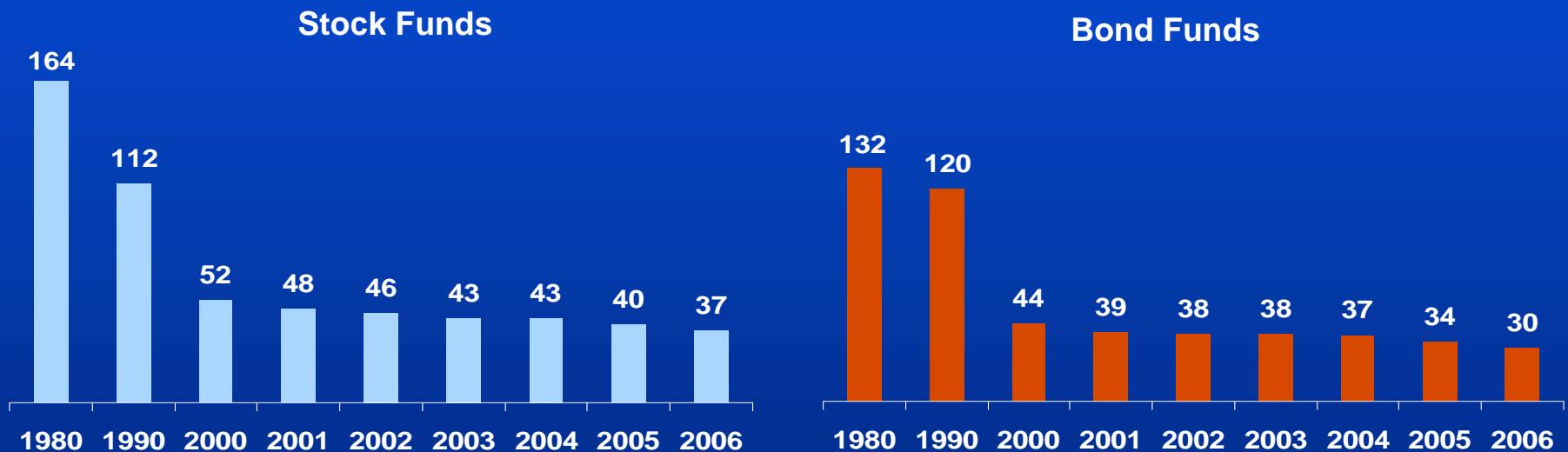
⁶ See "Understanding Investor Preferences for Mutual Fund Information," Investment Company Institute (2006) at 3, available at http://www.ici.org/statements/res/rpt_06_inv_prefs_full.pdf.

⁷ Disclosure of Mutual Fund After-Tax Returns, SEC Release No. IC-24832 (January 18, 2001) at 4, 66 FR 9002 (February 5, 2001) at 9003.

⁸ See “Trends in Mutual Fund Investing,” Investment Company Institute (July 2007), available at http://www.ici.org/stats/latest/trends_07_07.html#TopOfPage.

Figure 1: Distribution Costs of Mutual Funds*

Basis points, 1980–2006, selected years

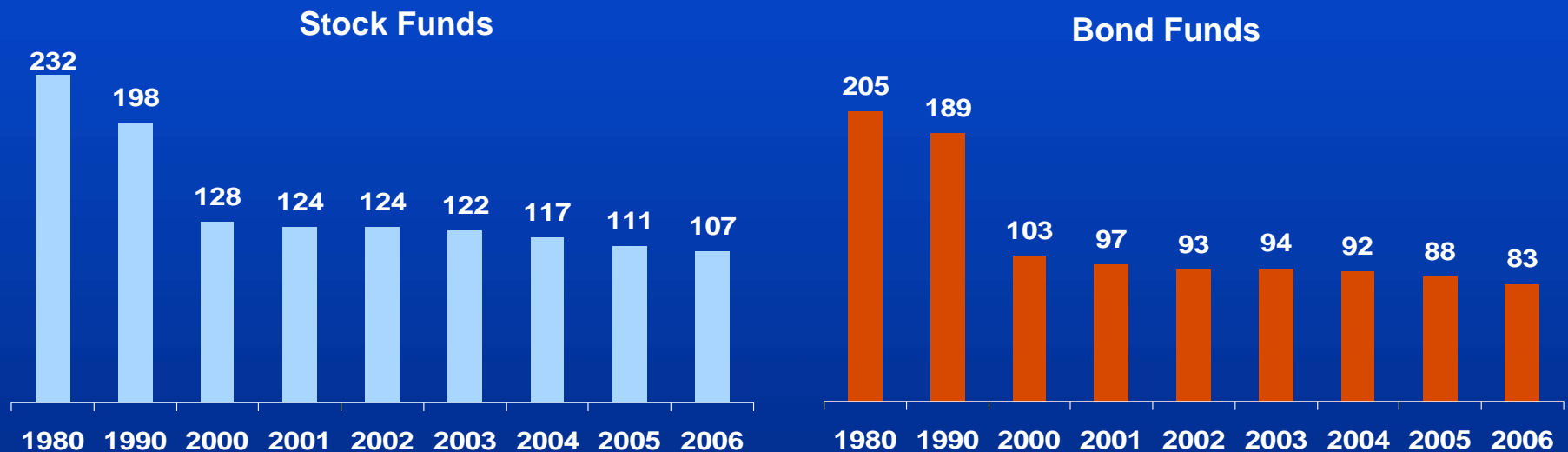


*The distribution costs of stock and bond funds are the sum of the asset-weighted average 12b-1 fees and the asset-weighted average total annualized loads for each group. The annualized load is the conversion of the one-time load payment into annual payments made over the life of the investment.

Sources: Investment Company Institute; Lipper; ValueLine Publishing, Inc; CDA/Wiesenberger Investment Companies Services; © CRSP University of Chicago, used with permission, all rights reserved; and Strategic Insight Simfund

Figure 2: Total Fees and Expenses Incurred by Stock and Bond Fund Investors*

Basis points, 1980–2006, selected years

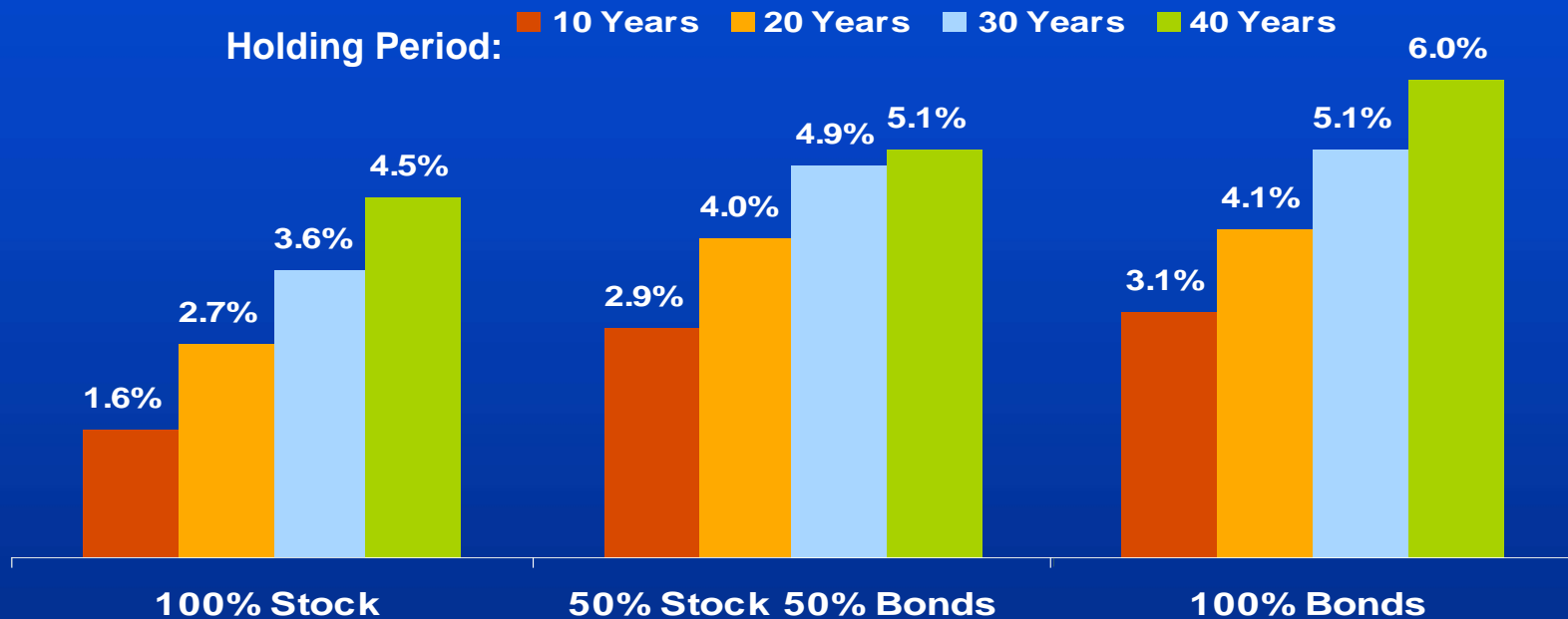


* Total fees and expenses are calculated as an asset-weighted average of annual expense ratios and annualized loads for individual funds. The annualized load is the conversion of the one-time load payment into annual payments made over the life of the investment.

Sources: Investment Company Institute; Lipper; ValueLine Publishing, Inc; CDA/Wiesenerberger Investment Companies Services; © CRSP University of Chicago, used with permission, all rights reserved; and Strategic Insight Simfund

Figure 3: Percent Reduction in After-Tax Balance with Account-Level Fees (B Shares)

One time share purchase, 35% tax rate



Stocks assumed to yield 9.25 percent annually with 0.75 percent short-term capital gain and 2.0 percent qualified dividends. Bonds assumed to yield 6.0 percent, with the entire return assumed to be interest. In the case of both 12b-1 fees and account-level charges, fees are assumed to be 1 percent for the first 8 years and 0.25 percent thereafter. 12b-1 fees count first against interest income, then non-qualified dividends, then short-term gains, then qualified dividends; 12b-1 fees cannot be taken against long term gains. Account-level fees assumed to be allocated as 0.25 percent to service (which continues after 8 years), 0.60 percent to commission and 0.15 percent to interest expense. Taxpayer assumed to be unable to deduct account-level service fee due to 2.0 percent AGI floor. Account-level interest charge deductible against investment income. Account-level commission charge is added to basis. Capital loss upon sale of bond funds assumed to reduce long-term capital gain income.

Figure 4: Percent Reduction in After-Tax Balance with Account-Level Fees (C Shares)

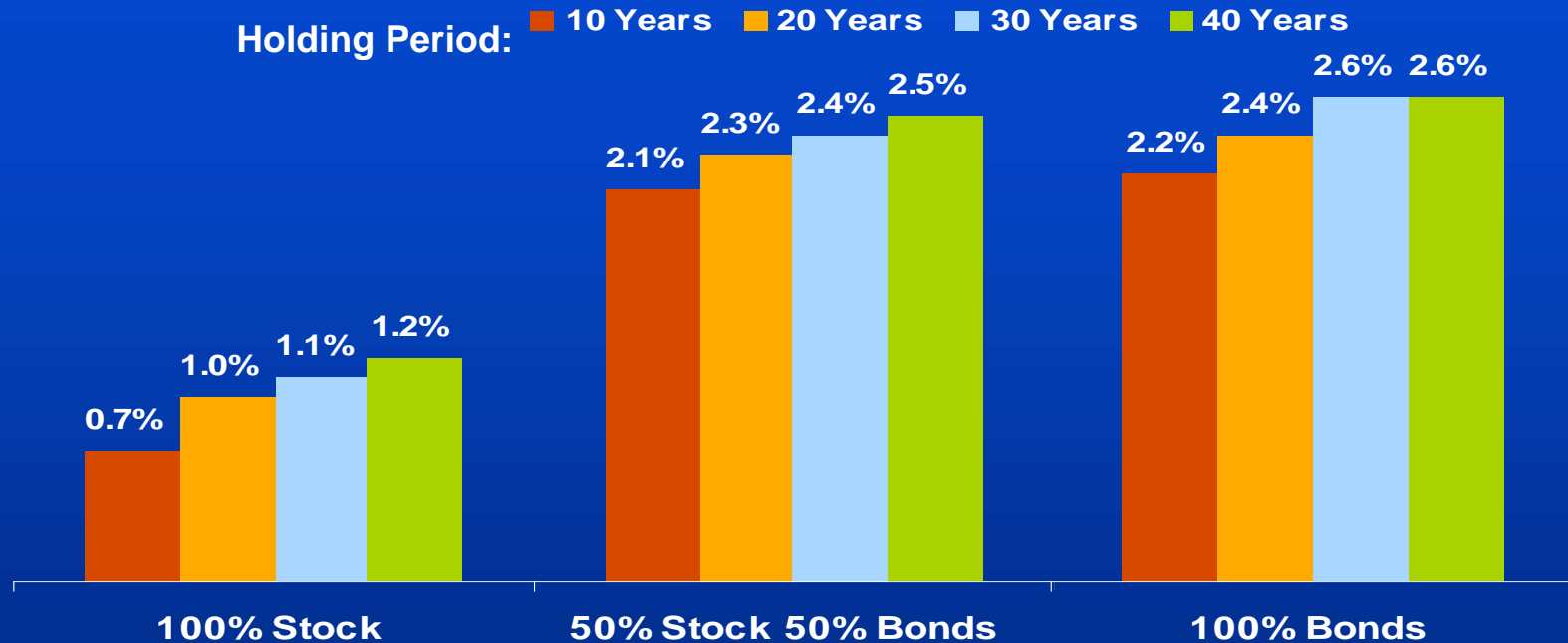
One time share purchase, 35% tax rate



Stocks assumed to yield 9.25 percent annually with 0.75 percent short-term capital gain and 2.0 percent qualified dividends. Bonds assumed to yield 6.0 percent, with the entire return assumed to be interest. Fees are 1 percent in the case of both 12b-1 fees and account-level charges. 12b-1 fees count first against interest income, then non-qualified dividends, then short-term gains, then qualified dividends; 12b-1 fees cannot be taken against long term gains. Taxpayer assumed to be unable to deduct account-level fees due to 2-percent AGI floor. Ordinary income taxed at 35 percent; qualified dividends taxed at 15 percent.

Figure 5: Percent Reduction in After-Tax Balance with Partial Account-Level Fees (B Shares)

One time share purchase, 35% tax rate



Stocks assumed to yield 9.25 percent annually with 0.75 percent short-term capital gain and 2.0 percent qualified dividends. Bonds assumed to yield 6.0 percent, with the entire return assumed to be interest. In the case of both 12b-1 fees and account-level charges, fees are assumed to be 1 percent for the first 8 years and 0.25 percent thereafter. 12b-1 fees count first against interest income, then non-qualified dividends, then short-term gains, then qualified dividends; 12b-1 fees cannot be taken against long term gains. With account-level fees a 0.25 percent 12b-1 fee remains. For the first 8 years additional account level fees of 0.75 percent are charged, with 0.60 percent allocated to commission and 0.15 percent to interest expense. Taxpayer assumed to be unable to deduct account-level service fee due to 2.0 percent AGI floor. Account-level interest charge deductible against investment income. Account-level commission charge is added to basis. Capital loss upon sale of bond funds assumed to reduce long-term capital gain income.

Figure 6: Percent Reduction in After-Tax Balance with Partial Account-Level Fees (C Shares)

One time share purchase, 35% tax rate



Stocks assumed to yield 9.25 percent annually with 0.75 percent short-term capital gain and 2.0 percent qualified dividends. Bonds assumed to yield 6.0 percent, with the entire return assumed to be interest. Total fees are 1 percent in the case of both 12b-1 fees and partial account-level charges. With partial account level fees 12b-1 fees are 0.25 percent and account level fees are 0.75 percent. 12b-1 fees count first against interest income, then non-qualified dividends, then short-term gains, then qualified dividends; 12b-1 fees cannot be taken against long term gains. Taxpayer assumed to be unable to deduct account-level fees due to 2-percent AGI floor. Ordinary income taxed at 35 percent; qualified dividends taxed at 15 percent.