

**SEC PROPOSES SUBSTANTIAL CHANGES IN MUTUAL  
FUND DISTRIBUTION REGULATORY SCHEME**

After almost a decade of considering the matter, the Securities and Exchange Commission on July 21, 2010 proposed a rule and rule amendments (the “Proposed Rules”) that would have the effect of establishing a new framework governing how mutual funds collect and pay fees to cover the costs of marketing and selling their shares.<sup>1</sup> Although likely resulting in major operational changes in the marketing of mutual fund shares, the Proposed Rules are not as dramatic as some in the fund business believed they could be. They would not, for example, prohibit the use of fund assets to pay for distribution or require that the costs of distribution be charged by intermediaries outside the funds -- two potential changes that had been discussed informally by SEC staff members at times over the past few years.

The Proposed Rules do contemplate the SEC rescinding Rule 12b-1 under the Investment Company Act of 1940 (the “1940 Act”) under which a mutual fund can use its assets to pay for the cost of promoting sales of its shares.<sup>2</sup> Like Rule 12b-1, the Proposed Rules would allow a fund to bear its promotional costs within certain limits and to have the ability to provide investors with alternatives for paying sales charges. Unlike Rule 12b-1, however, the Proposed Rules would cap the cumulative sales charges any investor in a fund could pay. The Proposed Rules would also seek to resolve the long-standing and often discussed difficulties fund directors have faced in annually reviewing plans adopted under Rule 12b-1.

The Proposed Rules have four principal elements:

- 1. Limits on Sales Charges.** The Proposed Rules in essence split traditional 12b-1 fees into two components: (a) ongoing sales charges and (b) marketing and service fees. The SEC’s proposal would limit the amount of sales charges that an individual investor could pay by restricting the ongoing sales charge component, while the marketing and services fee component would remain subject to the limits set by the Financial Industry Regulatory Authority, Inc. (“FINRA”) (currently 0.25 percent). Ongoing sales charges, which are used primarily to compensate financial intermediaries for distribution services and under Rule 12b-1 can be charged for the life of an individual’s investment in a fund,

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<sup>1</sup> *Mutual Fund Distribution Fees; Confirmations*, Investment Company Act Release No. 29367 (“Proposing Release”), available at <http://sec.gov/rules/proposed/2010/33-9128.pdf>.

<sup>2</sup> Although the SEC proposes to rescind Rule 12b-1 and replace it with Rule 12b-2 under the 1940 Act, proposed Rule 12b-2 would retain the provision in Rule 12b-1 that restricts certain directed brokerage practices.

would be limited to the maximum front-end sales load charged by any share class in the fund in which a person invested. The fund's payment of marketing and service fees, which are used for expenses such as advertising, sales compensation, and fund supermarket fees and services, would continue to be capped at the current limit of 0.25 percent per year out of the fund's assets.

2. **Directors' Oversight Responsibility.** The Proposed Rules' automatic limits on fund fees and charges would eliminate the need for fund directors<sup>3</sup> to explicitly approve and re-approve fund distribution financing plans. Directors would still have responsibility and a fiduciary duty to oversee ongoing sales charges and marketing and service fees in the same manner in which they oversee other fund expenses.
3. **Retail Price Competition.** The Proposed Rules describe an alternative, optional distribution model for mutual funds under which the sales charges for fund shares would be externalized. This model may encourage retail price competition by allowing a fund, if it chooses, to sell shares at net asset value through intermediaries that could themselves impose sales charges at negotiated rates, much like sales commissions on equity securities and exchange-traded funds. In theory, the optional distribution model would allow broker-dealers to charge fund shareholders directly and to establish and tailor their sales charges based on the different levels of services they provide to shareholders.
4. **Enhanced Disclosure.** In seeking to improve the transparency of fees for mutual fund investors, the Proposed Rules would require a fund to identify and more clearly disclose distribution fees. A fund would have to disclose any ongoing sales charges and marketing and service fees in its prospectus, shareholder reports and investor transaction confirmations. In addition, it would be required that transaction confirmations include the total sales charge rate that an investor would pay over the life of his or her investment.

## Comment Period

In its publication describing the Proposed Rules, the SEC has followed what appears to be an intentional recent practice of asking a significant number of questions seeking commentator input about the Proposed Rules and its consequences. All comments are due by November 5, 2010.

## Background

Adopted in 1980, Rule 12b-1 has proved to be one of the most contentious provisions under the 1940 Act. The Rule was criticized virtually from its adoption and the criticism has continued to the present.

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<sup>3</sup> The term "directors" as used in this Memorandum is intended to include trustees.

When the SEC adopted Rule 12b-1, it contemplated that 12b-1 plans would be used to solve particular distribution problems or respond to specific circumstances at the time of adoption, such as helping funds through periods of net redemptions.<sup>4</sup> The Rule, by its terms, however, was not limited to any particular type of use.

The Rule, as adopted, prohibited a registered open-end investment company -- that is, a mutual fund -- from using its own assets to pay for any distribution costs unless it made distribution payments according to a written plan, generally referred to in the mutual fund industry as a “12b-1 plan,” adopted by the fund’s board, and separately by the fund’s independent directors and by the fund’s shareholders. Board oversight requirements in Rule 12b-1 were intended, in part, to address the perceived conflicts of interest between a fund and its investment adviser that arise when a fund bears its own distribution expenses.<sup>5</sup>

The term “12b-1 fees” came to be commonly used in the mutual fund industry and the press in describing the fees paid under a 12b-1 plan. Over time, distribution practices changed and funds began charging higher 12b-1 fees seeking to compensate intermediaries for sales efforts. As a result, 12b-1 fees became widely used as a substitute for front-end sales loads as funds offered class B shares (with contingent deferred sales loads) or class C shares.<sup>6</sup> Today, a majority of funds have adopted Rule 12b-1 plans, which paid a total of \$9.5 billion in 12b-1 fees in 2009.<sup>7</sup>

## SEC Rule Proposal and Amendments

Clearly reflected in the Proposed Rules is a decision by the SEC not to turn back the clock so as to prohibit the use of fund assets to pay for distribution. On the other hand, the SEC did not consider mere tinkering with the “factors” for director consideration of Rule 12b-1 plans to be an appropriate sole means to address issues that arise when fund assets are used for distribution. The Proposed Rules recognize that asset-based sales charges have come to function like a sales load and seek to regulate them as such.

### A. Limits on Sales Charges

The Proposed Rules, like FINRA Conduct Rule 2830, would categorize current 12b-1 fees as either: (1) marketing and service fees or (2) ongoing sales charges.<sup>8</sup> Marketing and service fees, which include distribution activity expenses such as advertising and payments made to

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<sup>4</sup> See Investment Company Institute, *Report of the Working Group on Rule 12b-1* at 2 (May 2007) ([http://www.ici.org/pdf/rpt\\_07\\_12b-1.pdf](http://www.ici.org/pdf/rpt_07_12b-1.pdf)) (“Working Report”).

<sup>5</sup> See Proposing Release at 11.

<sup>6</sup> See Working Report at note 1.

<sup>7</sup> See Proposing Release at 24.

<sup>8</sup> The rules adopted by FINRA prohibit broker-dealers from selling shares of a fund that pays more than 0.25% (25 basis points) per year of fund assets as “service fees,” and more than 0.75% (75 basis points) per year of fund assets as “asset-based sales charges.” The rules thus effectively set the maximum 12b-1 fees that can be charged with respect to a fund’s shares at those amounts or less. FINRA Conduct Rules 2830(d)(5) and (d)(2)(E).

participate on third-party platforms (*e.g.*, fund supermarkets), would be subject to proposed Rule 12b-2 under the 1940 Act. Ongoing sales charges, or the charges to finance distribution activity from fund assets *in excess of* the marketing and service fee, would be subject to proposed amendments to Rule 6c-10 under the 1940 Act.

1. Proposed Rule 12b-2: Marketing and Service Fees

*a. Marketing and Service Fee Limit*

Under proposed Rule 12b-2, a mutual fund could use, as it can today, a limited amount of its assets to pay for distribution-related expenses and administrative services with respect to any class of fund shares. The maximum amount of this “marketing and service fee” would be tied to the service fee limit now imposed by FINRA Conduct Rule 2830 (currently 25 basis points or 0.25 percent annually).<sup>9</sup> A fund could use this portion of its assets to pay for *any* distribution-related expenses or administrative services, including, but not limited to, participation in fund supermarkets, trail commissions to broker-dealers, retirement plan administrator services, and advertising, printing and mailing of prospectuses.<sup>10</sup> In this way, proposed Rule 12b-2 is broader than FINRA’s Conduct Rule 2830, which defines “service fees” to include a more limited range of services.<sup>11</sup> Proposed Rule 12b-2 contains no maximum aggregate cap on the amount of marketing and service fees a fund shareholder could pay over the duration of his or her investment in a fund. In addition, under Rule 12b-2, fund directors would not be required to adopt or renew any “plan” or make any explicit findings.

*b. Shareholder Approval*

Under proposed Rule 12b-2, a mutual fund would be required to obtain the approval of a majority<sup>12</sup> of its shareholders before it could institute or increase its marketing and service fee.

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<sup>9</sup> The marketing and service fee limit is separate from and is not subject to the limitations on sales loads set out in the proposed amendments to Rule 6c-10.

<sup>10</sup> The Proposing Release makes clear that a fund need not include expenses that are not distribution-related in the 25 basis point marketing and service fee. Such an expense would include, for example, sub-transfer agent fees, which could be paid by a fund in addition to the marketing and service fee. *See* Proposing Release at note 153.

<sup>11</sup> The FINRA rule defines “service fees” as “payments by [a fund] for personal service and/or the maintenance of shareholder accounts.” FINRA Conduct Rule 2830(b)(9). These services could include responding to customer inquiries, providing information on investments, and reviewing customer holdings on a regular basis, but would not include sub-transfer agency services, sub-accounting services, or administrative services. *See* NASD Notice to Members 93-12 at question 17 (1993) (explaining the types of activities for which service fees may be used).

<sup>12</sup> Proposed Rule 12b-2 appears to incorporate Section 2(a)(42) of the 1940 Act’s definition of a vote of a majority of outstanding voting securities. Under Section 2(a)(42) of the 1940 Act, the vote of a majority of the outstanding voting securities of a fund means the vote of: (i) 67% or more of the voting securities present at such meeting, if the holders of more than 50% of the outstanding voting securities of the fund are present or represented by proxy; or (ii) more than 50% of the outstanding voting securities of the fund, whichever is less.

Shareholder approval would not be required, however, for a fund to institute a marketing and service fee with respect to a new class of fund shares.

2. Proposed Amendments to Rule 6c-10: Ongoing Sales Charges

a. *Ongoing Sales Charge Limit*

The proposed amendments to Rule 6c-10 would enable a mutual fund to deduct charges or fees to finance distribution activity from its assets *in excess of* the marketing and service fee (“ongoing sale charges”) permitted under proposed new Rule 12b-2 (25 basis points annually), subject to certain restrictions. The proposed amendments in effect would treat ongoing sales charges as another form of deferred sales load.

Under amended Rule 6c-10, a fund could deduct an ongoing sales charge to finance distribution activities at a rate established by the fund, so long as the cumulative amount of sales charges an investor paid on any purchase of fund shares did not exceed the amount of the highest front-end load that the investor would have paid had the investor invested in another class of the fund’s shares.<sup>13</sup> These limits would be based on the cumulative amount of sales charges that an investor paid in any form (front-end, deferred, or ongoing sales charges). If a fund, for example, had class A shares with a six percent front-end sales load, the fund could pay as much as six percent in total ongoing sales charges in class B shares. If another class of shares were subject to a front-end sales load of, on the other hand, two percent, a total ongoing sales charge of as much as four percent could also be charged (six percent minus the two percent front-end load) with respect to that class. In addition, a contingent deferred sales load (“CDSL”) in combination with an ongoing sales charge could be charged on fund shares, but total sales charges could not exceed the maximum sales charge limitation.<sup>14</sup>

Amended Rule 6c-10 would provide that ongoing sales charges could be assessed only until a fund’s maximum sales charge limitation is reached. Operating under this provision of amended Rule 6c-10 would appear to present potential difficult technological challenges and increased costs for a fund, as it would need, in meeting the provision, to track ongoing sales charges on an investor-by-investor basis.

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<sup>13</sup> If the Proposed Rules are adopted, the annual cap on ongoing sales charges of 75 basis points imposed by FINRA will likely be unnecessary because the Proposed Rule limits the cumulative amount of ongoing sales charges. *See* Proposing Release at 52.

<sup>14</sup> This provision would operate as follows with respect to the given facts: Assume a fund offering class A shares with a 6.00% front-end load also offers class B shares that are subject to an annual ongoing sales charge of 0.75% with a declining CDSL. The maximum CDSL that the fund could charge on a purchase of class B shares would be 5.25% in the first year, 4.50% in the second year, 3.75% in the third year, and so on. At the end of the eighth year following the purchase, the fund would be required to convert the class B shares to a share class that does not charge an ongoing sales charge. Thus, regardless of when the shareholder redeemed shares, the shareholder’s total sales load rate would never exceed 6.00%, the maximum class A front-end load rate. *Id.* at 49.

The Proposed Rules present what may be a less disruptive way of assuring that a shareholder does not pay more than the maximum permitted ongoing sales charge; a fund could establish an automatic conversion feature under which shares subject to a charge would convert into shares not subject to a charge. Using this alternative approach, once the maximum ongoing sales charge applicable to shares purchased (plus reinvested shares issued for dividends paid on them) is reached, the shares would convert automatically to a class not subject to an ongoing sales charge. The conversion would need to occur no later than the end of the month in which the investor had paid cumulative charges that approximate the amount the investor otherwise would have paid through a traditional front-end load (or, if none, FINRA's current limit (6.25 percent)).<sup>15</sup> The alternative approach would seem easier to implement with respect to class B shares, which typically convert at some point to class A shares, than with respect to class C shares, which do not typically have a conversion feature.

The maximum number of months a shareholder could remain invested in a class of shares paying an ongoing sales charge would depend, under amended Rule 6c-10, both on the maximum sales load and the rate of the ongoing sales charge. Thus, for example, if the maximum sales load applicable to a fund's shares is three percent, the ongoing sales charge could be 0.50 percent annually for six years or 0.25 percent annually for 12 years, and so on. The time period would seem to be readily calculatable and could be implemented by "tagging" shares in the way currently done for class B shares.

Unlike similar provisions in FINRA's rules, the proposed amendments to Rule 6c-10 would apply the cap on ongoing sales charges at the shareholder account level, rather than at the fund level. The ongoing sales charges would be assessed on reinvested dividends and appreciation of assets, but the reinvested shares would have the same conversion period as the shares on which the dividend was declared. Amended Rule 6c-10 would contain no requirement that a fund adopt a "plan" or that the fund's board make any specific findings.

*b. Shareholder Approval*

Under the proposed amendments to Rule 6c-10, a fund would not be permitted under any circumstances to institute, or increase the rate of, an ongoing sales charge, or lengthen the period before shares automatically convert to another class of shares that did not incur an ongoing sales charge, after any public offering of the fund's voting shares or the sale of those shares to persons who are not organizers of the fund. In short, even shareholders could not vote to make these changes. A new fund (*i.e.*, a fund that has not made a public offering), or an existing fund with respect to a new class of shares, would not, however, need to obtain shareholder approval before instituting an ongoing sales charge.

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<sup>15</sup> This provision, for example, would operate as follows: Assume that a fund offers class A shares with a 6.00% front-end load and no ongoing sales charge. The same fund could also offer a class of C shares with an annual ongoing sales charge of 0.75%, so long as: (i) the class C shares converted to class A shares in 96 months or earlier ( $[6.00\% \div 0.75\%] \times 12 = 96$  months or 8 years); and (ii) the class C shares were not subject to any other loads. *Id.*

## **B. Directors' Oversight Responsibility**

The role of fund boards with respect to distribution arrangements would be substantially different under the Proposed Rules from what it is today. This change would seem quite clearly to respond to the well-documented and often discussed difficulties boards have experienced as the uses of 12b-1 fees changed over time. Unlike Rule 12b-1, proposed Rule 12b-2 and the amendments to Rule 6c-10 would not require directors to adopt or renew a “plan” or make any special findings. The board’s participation under the Proposed Rules would not, however, be entirely eliminated. A fund’s board would have the ability to authorize the use of fund assets to finance distribution activities consistent with the limits of the Proposed Rules. Directors would still have responsibility and a fiduciary duty for overseeing marketing and services fees and ongoing sales charges, but in the same manner in which they oversee other fund expenses.

In its publication outlining the Rule, the SEC provided guidance to assist fund directors in satisfying their fiduciary duties relating to distribution-related fees and charges, including suggesting that directors of a fund evaluate: (1) the amount and use of ongoing sales charges in accordance with the same procedures the directors use to consider and approve the amount of the fund’s other sales charges in an underwriting contract under Section 15(c) of the 1940 Act and (2) whether the sales loads (including the ongoing sales charges) are fair and reasonable in light of the usual and customary charges made by others for services of similar nature and quality. The SEC has indicated that it intends to provide additional guidance to boards when or if the Proposed Rules are finalized.

## **C. Retail Price Competition**

### **1. Proposed Amendments to Rule 6c-10: Account-Level Sales Charge**

If adopted, the Proposed Rules would provide funds and intermediaries with the option to experiment with a load arrangement similar to “externalized sales charges.” Currently, investors pay the same costs for distribution when purchasing shares of a particular fund, regardless of the quality or type of services provided by the dealer through which they purchased the shares. Amended Rule 6c-10 would permit, but not require, a dealer and a fund to enable investors to choose the level of dealer services they want and, in theory, pay only for the selected services. Under this provision, a fund (or a class of the fund) could issue shares at net asset value (*i.e.*, without a sales load) and dealers could impose their own sales charges based on their own schedules and in light of the value investors place on the dealer’s services.<sup>16</sup> The amount of

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<sup>16</sup> The proposed amendment to Rule 6c-10 regarding elective account-level sales charges established by dealers would include an exemption from the requirements of Section 22(d) of the 1940 Act for funds that meet the conditions of the amended rule. Section 22(d) of the 1940 Act prohibits mutual funds, their principal underwriters and dealers from selling mutual fund shares to the public except at a current public offering price as described in their prospectus. Because mutual fund sales loads are part of the selling price of the shares, this provision 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 disclosed in the fund’s prospectus. Therefore, an exemption to Section 22(d) would be required for any fund that would utilize this alternate distribution method. *See* Proposing Release at 86 and 89.

these fees and the times at which they would be collected would not be governed by provisions of the 1940 Act.<sup>17</sup> The dealer could determine what sales charge to impose at the investor account level and when to charge it (*e.g.*, at the time of sale, upon redemption or over time). The dealer could also arrange to deduct the charge from the investor's brokerage account. The collection and setting of sales charges would in this way occur outside the fund and by agreement between a broker and its customer.

A fund seeking to rely on amended Rule 6c-10 to adopt an externalized sales charge mechanism would have to meet two conditions. First, the fund would not be permitted to impose an "ongoing sales charge" as defined in proposed amendments to Rule 6c-10 with respect to a class of shares sold subject to an externalized charge,<sup>18</sup> although the fund could charge a marketing and service fee under proposed Rule 12b-2. Second, the fund would have to disclose in its registration statement that it has elected to rely on the Rule's provisions contemplating such a mechanism.

In announcing the Proposed Rules, the SEC said that the externalized sales charge provision's purpose is to encourage and increase competition among dealers, which in turn, according to the SEC, should result in lower overall distribution costs and/or more attractive services for fund investors. The SEC and several SEC Commissioners have specifically requested comments from the industry about the usefulness and implementation of this alternative distribution method.

#### **D. Enhanced Disclosure**

In an effort designed to help fund investors make informed choices when selecting funds that impose sales charges, the SEC is proposing amendments that would increase and clarify disclosure to investors about sales charges. References to "12b-1 fees" would be removed from fund required documents and instead, registration statements, shareholder reports and investor transaction confirmations would separately disclose any "ongoing sales charges" and any "marketing and service fees" charged by funds.

Investor transaction confirmations, which are provided after a sale, would be required, under the SEC's proposal, to describe the total sales charge rate that an individual investor will have to pay.<sup>19</sup> In its proposal, the SEC expressed a need to further expand the availability of this

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<sup>17</sup> Intermediaries registered with FINRA would continue to be subject to existing limits on excessive compensation under Conduct Rules 2830 and 2440.

<sup>18</sup> The SEC is proposing the dealer-established sales charge as an alternative to an ongoing sales charge rather than as a supplement to it.

<sup>19</sup> The Proposing Release gives an example of the proposed disclosure that would need to be included in the transaction confirmations: "You will pay a maximum total ongoing sales charge of 5%, deducted from the assets of the fund in which you are investing at an annual rate of 1% over the next 5 years. You will also pay marketing and service fees of 0.25% for as long as you own the fund. 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." See Proposing Release at 70.

disclosure in the future by presenting more information about sales charges to investors at the point of sale.<sup>20</sup> This position was reiterated during the open meeting by Robert Plaze, Associate Director of the SEC's Division of Investment Management and a person who was a key participant in the drafting of the SEC's proposal, and supported by Commissioner Walter.

#### **E. Grandfathering Provisions**

The SEC has proposed a grandfathering provision that would permit a mutual fund to deduct existing 12b-1 fees (at the same or lower rate that was approved in the fund's 12b-1 plan) for a five-year period with respect to shares issued prior to the compliance date for the Proposed Rules. After the expiration of the five-year period, grandfathered shares would be required to be converted or exchanged into a class of shares that does not charge an ongoing sales charge and with a marketing and service fee that is no higher than the 12b-1 fee in effect in the previous fiscal year.

#### **F. Compliance Date**

The SEC anticipates that the compliance date with respect to the Proposed Rules, if adopted, would be at least 18 months from the effective date of their adoption in the adopting release (60 days after publication in the Federal Register) for new shares sold. The extended period before effectiveness reflects the SEC's recognition that systems and operational changes will need to be implemented in connection with the proposed changes, as well as changes to registration statements and selling and distribution agreements.

#### **G. Expected Industry Reaction**

The SEC, as suggested above, has requested comment on a number of aspects of the Proposed Rules. We expect that the SEC will receive much commentary on the Proposed Rules. We believe that the provisions intended to reduce the burdens on fund directors in connection with distribution arrangements will be lauded by directors and other industry participants alike. In our view, fund companies and fund distributors are likely to question the costs that would be incurred in establishing the systems and procedures necessary to comply with the Proposed Rules provisions, particularly those requiring distribution expenses and limitations to be calculated on an investor-by-investor basis. Fund companies and distributors may also see the Proposed Rules as inflexible and a potential roadblock in the development of new types of distribution arrangements. Finally, we would not be surprised by industry comments questioning whether the SEC has a sufficient factual basis to support adopting the various provisions specified in the Proposed Rules.

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<sup>20</sup> *Id.* at 68.

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If you have any questions regarding the matters described in this memorandum, please contact Barry P. Barbash (202-303-1201, bbarbash@willkie.com), Rose F. DiMartino (212-728-8215, rdimartino@willkie.com), Ryan Leshaw (202-303-1138, rleshaw@willkie.com), Neesa Patel (202-303-1232, npatel1@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, D.C., 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at [www.willkie.com](http://www.willkie.com).

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