SEC HOLDS ROUNDTABLE ON RULE 12b-1

Earlier this week, the Securities and Exchange Commission held a public roundtable discussion about Rule 12b-1 under 1940 Act.[1] Panelists discussed the history, costs, and benefits of the Rule, and explored potential alternatives for reforming it.

The Rule has often been described in the press, and by certain industry commentators, as controversial and of questionable benefit to fund investors. Panelists at the roundtable, including Willkie Farr & Gallagher partner Joel Goldberg, a former Director of the SEC's Division of Investment Management, painted a far different picture of the Rule, pointing to the benefits it has provided to fund investors and to the central importance of the Rule in the marketing of shares of mutual funds.

SEC Chairman Cox told the audience that the Commission would act on Rule 12b-1 in some way later this year, but provided no further insights into the Commission's plans. Buddy Donohue, Director of the SEC's Division of Investment Management, noted that reconsideration of the Rule is a top priority of the Division.

If the comments made at the roundtable serve as the basis of a Commission rule proposal relating to Rule 12b-1, the proposal will seek to improve disclosure regarding Rule 12b-1 fees paid by funds and their investors and to modify the process through which fund directors consider and approve those fees, and, perhaps, the way in which the fees are assessed. The roundtable discussion, though, did not seem to support fundamental reshaping of the Rule's principal elements.

The Commission invited public comment on Rule 12b-1 and the issues raised during the roundtable. The comment period ends on July 19, 2007.

The roundtable consisted of four panels that addressed the following: (1) historical perspectives on the Rule; (2) the role of Rule 12b-1 plans in current fund distribution practices; (3) the costs and benefits of Rule 12b-1 plans; and (4) options for reforming the Rule. Among the panelists were representatives of the securities industry, including broker-dealers, registered investment companies, and investment advisers; a representative of an insurance company; a representative of the NASD; an academic; a research analyst; and lawyers practicing in the securities industry, some of whom were former SEC staff members.

HISTORICAL PERSPECTIVES

In discussing the history of Rule 12b-1, the panelists agreed that, in adopting the Rule, the SEC (1) understood that mutual funds would pay Rule 12b-1 fees to dealers as compensation, and (2) did not intend that the Rule would be temporary. Moreover, one panelist noted that, contrary to widespread

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[1] The agenda and list of panel participants can be found at http://www.sec.gov/spotlight/rule12b-1/rule12bagenda-061907.htm.

Rule 12b-1 generally governs a mutual fund's use of its assets to pay for distribution of its shares.

belief, the Commission did not enact the Rule as a means of assisting mutual funds in reversing net redemptions.

THE ROLE OF RULE 12b-1 IN CURRENT DISTRIBUTION PRACTICES

Panelists who supported the current uses of Rule 12b-1 fees in the distribution of mutual fund shares articulated common themes. Some panelists argued that Rule 12b-1 contributes to investor choice in paying for costs associated with the purchase of mutual fund shares. According to these panelists, many investors dislike paying loads. Rule 12b-1 fees are used to pay broker-dealers and other intermediaries for distribution costs, the provision of investor services, and other costs associated with mutual funds so that investors can purchase fund shares without loads.

Other panelists asserted that small mutual funds must pay 12b-1 fees to stay in business. They explained that these funds pay financial advisers to sell their funds, pay for shelf space with financial supermarkets, and pay 401(k) plan administrators who offer the funds to plan participants. Given the small size of the funds, the panelists believed that these entities would not otherwise promote small funds.

Members of the panel agreed that disclosure of Rule 12b-1 fees needs to be improved and simplified. According to these members, disclosure should provide the overall dollar amounts paid, perhaps broken out into broad categories, but need not provide significant detail. Additional detail could be available, however, through a website or otherwise.

THE COSTS AND BENEFITS OF RULE 12b-1 FEES

Panelists generally agreed that the services supported by 12b-1 fees are necessary to, and desired by, investors. Panelists disagreed, however, on whether mutual funds should pay for those services out of their assets in the form of 12b-1 fees or investors who want the services should pay for them directly out of their own assets.

One panelist argued that Rule 12b-1 fees depress mutual fund returns. He maintained that using fund assets to compensate intermediaries increases a fund's expense ratio. According to him, costs associated with distribution of shares should be borne either by the investor directly or by the investment adviser.

Other members of the panel argued that Rule 12b-1 fees clearly benefit investors. Financial advisers, they said, provide numerous services to investors, such as investment advice, fund due diligence and tax services, among others. One member of the panel asserted that Rule 12b-1 fees align the interests of financial advisers and investors because they provide an incentive for the advisers to help the investors. He noted that services provided to clients often are integrated and fees attributable to component services cannot be disaggregated easily, making payment of a single fee more efficient than payment of multiple fees for individual services.

Panelists discussed whether a "unified fee" that would charge customers one price for all costs and services associated with the purchase of mutual fund shares would be preferable to the current system. Opinions on this idea varied. Some panelists believed that a unified fee had merit, but that the component fees still would need to be disclosed. Another took the position that a unified fee could improve competition by allowing financial intermediaries to compete on the basis of price and that, in any event, investors should have the choice of whether to pay a unified fee or a fee for each cost and service individually.

Panelists agreed that disclosure of the fees charged to investors needs to be improved, regardless of the source of fee payments. Moreover, improved disclosure would require better communication, in clear language, to be understandable to investors.

Another issue was whether investors should receive fee disclosures at the point of sale, arguably providing them with relevant information to allow them to make more informed investment decisions, or after the purchase on the theory that fee disclosures are unlikely to affect those decisions. Investors could review fee disclosures received post purchase to determine if they wanted to continue to hold shares of the relevant mutual funds or continue to use the services of the relevant intermediary.

OPTIONS FOR REFORMING THE RULE

Panelists discussed a number of reform options for Rule 12b-1. As was the case throughout the roundtable, panelists urged improved disclosure. One panelist commented that "less is more" with respect to fee disclosure to retail investors. According to her, intermediaries should disclose that investors pay a fee for fund operations and a fee for services that the intermediaries provide. She took the position that if retail investors wanted additional details on fees, they could be given information on how and where to find those details.

Two panelists noted that mutual fund investors pay for three general categories of costs: (1) portfolio management, (2) investor services, and (3) administration (for example, fund accounting and securities custody). One advocated designating all fees charged in connection with mutual fund sales to one of those categories, then disclosing the fees paid, either individually by category or in aggregate by category.

Members of the panel debated the relative merits of "externalizing" fee payments ("externalization" would require mutual fund investors to pay directly for costs and services) versus "internalizing" fee payments ("internalization" would involve mutual funds paying intermediaries for costs and services, such as through 12b-1 payments). One member explained that out of a 100 basis-point 12b-1 fee paid to an intermediary for sales of mutual fund shares (generally with respect to mutual fund B shares or C shares), 25 basis points reflect a service fee for distribution, while the remaining 75 basis points reflect pure sales compensation that is the economic equivalent of a load. In addition, he argued that the 75 basis points that the mutual funds pay are not transparent, saying that intermediaries, and not the funds, have set that level of compensation. Because the funds make the payments and the fees are opaque, he contended, investors cannot negotiate with intermediaries for better rates. If intermediaries were forced to disclose the fact and nature of the 75 basis-point fees, the panelist asserted, investors might be able to negotiate better fees with intermediaries, which would increase price competition in sales of mutual fund shares. It was unclear if the panelist proposed requiring the investor to pay the sales compensation fee directly, or if the investor would receive some sort of "rebate" on the fee from the intermediary.

Another panelist countered that externalization of fees would hurt small investors. According to him, small investors would lack the bargaining power to negotiate better fees and might be subjected to higher fees as intermediaries attempted to recover revenue lost by charging larger investors lower fees. The panelist also argued that if investors were forced to pay sales compensation fees directly, the payments would be made with after-tax dollars. He took the position that if mutual funds were permitted to use fund assets to compensate intermediaries ("internalization"), investors would not be forced to pay sales compensation with after-tax dollars, which would improve their investment returns.

Members of the panel also discussed the role of the mutual fund board of directors in supervising Rule 12b-1 plans and generally expressed support for strengthening the board's ability to exercise that supervision. A number of members argued that the non-exclusive factors for evaluating the appropriateness of a Rule 12b-1 plan, which factors are listed in the Rule's adopting release, should be updated or eliminated. Although the Rule does not require a board to approve a plan based on consideration of the factors, some panelists believed that directors nevertheless feel obligated to do so because the Commission specifically included the factors in the adopting release. These panelists took the position that updating or eliminating the factors would allow boards to consider those factors that they believe are most relevant in determining whether to approve a Rule 12b-1 plan.

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If you have any questions regarding this memorandum, please contact Barry P. Barbash (202-303-1201, bbarbash@willkie.com), Matthew B. Comstock (202-303-1257, mcomstock@willkie.com) or the 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.

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