SEC Proposes Reform of Rule 12b-1, Mutual Fund Distribution Payment Framework

On July 21, 2010, the Securities and Exchange Commission (“SEC”) proposed a new rule and form amendments that would restructure the regulatory framework for payments by mutual funds for the marketing and distribution of fund shares (the “Proposal”). The Proposal, which was unanimously approved for public comment, would continue to allow the use of fund assets to pay for distribution expenses, but would implement a new approach to regulating such payments. This new approach would break out the types of fees currently paid pursuant to Rule 12b-1 under the Investment Company Act of 1940 (the “1940 Act”) into two components—fees for marketing and services, and asset-based sales charges. As described in more detail below, the Proposal involves, in its key aspects:

- the rescission of Rule 12b-1 under the 1940 Act,
- the adoption of a new Rule 12b-2 under the 1940 Act, which would permit mutual funds to continue to make ongoing “marketing and service fee” payments, subject to a fee cap of 25 basis points per year,
- the adoption of amendments to Rule 6c-10 under the 1940 Act (which currently permits funds to charge deferred sales loads) to permit funds to deduce an “ongoing sales charge” from fund assets in excess of the marketing and service fee as an alternative to a traditional front-end sales load, but which would be subject to a cumulative fee cap on sales charges,
- a substantial reduction in the duties imposed on fund boards by eliminating certain provisions that have required boards to take certain actions and make special findings relating to the payment of asset-based distribution fees,
- the adoption of rule and form amendments to require enhanced disclosure of sales charges, marketing and service fees and other fees in mutual fund registration statements, shareholder reports, and transaction confirmations, among other documents, and
- the adoption of amendments to Rule 6c-10 under the 1940 Act to allow mutual funds to establish classes of shares to sell through broker-dealers that would determine their own sales compensation, rather than simply imposing the sales charges described in the prospectus as required under current law.

I. Restructuring and Limiting Asset-Based Distribution Fees

The Proposal, which would rescind Rule 12b-1 in its entirety, would break out the types of fees currently paid under Rule 12b-1 plans into two components, as follows.

A. Marketing and Service Fees

Rule 12b-2 would permit funds to pay an asset-based fee for “distribution activities,” which would be known as a “marketing and service fee.” The amount of the fee
could not exceed the service fee limit under NASD Conduct Rule 2830 (now administered by FINRA), which is currently 25 basis points annually. Unlike NASD Conduct Rule 2830, which limits the types of expenses that qualify for payment as service fees, the marketing and service fee under Rule 12b-2 could be used for any “distribution activity.” Rule 12b-2 would define the term “distribution activity” broadly and in the same manner as it is described in current Rule 12b-1 as “any activity which is primarily intended to result in the sale of shares issued by a 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.”

The proposing release specifically states that marketing and service fees may be used to pay (1) costs associated with participation on a distribution platform, such as a fund “supermarket,” (2) trail commissions to broker-dealers in recognition of the ongoing services they provide to fund investors, (3) retirement plan administrators for services provided to participants, (4) for shareholder call centers, (5) servicing fees like those currently permitted by NASD rules, and (6) for other traditional distribution-related services. The proposing release also states that, as with Rule 12b-1 fees, a fund could pay for non-distribution-related services, such as sub-transfer agency type services, with its marketing and service fee. Any expense that could be identified as non-distribution-related, however, could be characterized as such and paid for using fund assets other than through marketing and service fees.

Rule 12b-2 would not require a fund’s board of directors to adopt a plan related to a marketing and service fee or make any special findings regarding this fee. “Rather, fund boards would have the ability to authorize the use of fund assets to finance distribution activities consistent with the limits of the rule and their fiduciary obligations to the fund and fund shareholders.” The SEC refers to the federal fiduciary standard in Section 36(a) of the 1940 Act (which establishes a federal cause of action for breaches of fiduciary duty arising from personal misconduct), as well as the state fiduciary duties of care and loyalty. Fund boards, including independent directors, would be responsible for overseeing the amount and use of marketing and service fees as they do other asset-based fees, particularly those fees where a potential conflict of interest may arise between a fund and its investment adviser or other affiliated persons.

While fund boards would not be required to make special findings prior to implementing a marketing and service fee, Rule 12b-2, like Rule 12b-1, would require a fund to seek shareholder approval before it could institute or increase a marketing and service fee if the fund’s shares have been publicly offered or otherwise sold to persons who are not organizers of the fund. If Rule 12b-2 is adopted by the SEC, funds seeking to implement a marketing and service fee would not be required to obtain shareholder approval if (1) the fund currently is subject to a Rule 12b-1 fee that is 25 basis points or less and the fee rate is not increased or (2) the fund reduces its Rule 12b-1 fee to 25 basis points or less and renames the fee a “marketing and service fee.”

B. Ongoing Sales Charges

The Proposal also would amend Rule 6c-10 under the 1940 Act to allow funds to deduct asset-based distribution fees in excess of the annual 25 basis point limit on marketing and service fees, subject to certain cumulative limits. The cumulative amount of these fees, which would be characterized as “ongoing sales charges,” together with any other sales charges would not be permitted to exceed, in percentage terms, the highest front-end sales load imposed by a share class of the same fund that does not impose an ongoing sales charge (the “reference load”). If a fund does not have such a share class, the reference load would be the maximum amount permitted under NASD Conduct Rule 2830 for funds that impose an asset-based sales charge and a service fee (currently 6.25%). Under the Proposal, 1 Rule 6c-10 currently permits funds to charge deferred sales loads.

2 As an example, the SEC stated that if a fund’s Class A shares are subject to a 6% front-end sales load and no ongoing sales charge, its Class C shares could charge an ongoing sales charge of 0.75% for up to eight years, assuming that the Class C shares do not impose any other sales charges.

3 Among other things, NASD Conduct Rule 2830 prohibits FINRA-member broker-dealers from selling funds that impose fees and charges, including asset-based sales charges and ...
funds could continue to charge a front-end sales load or a contingent deferred sales load together with an ongoing sales charge, but the cumulative sales charges could not exceed the proposed limit.

The sales charge limit would be based on the cumulative amount of sales charges that an individual investor pays in any form. This approach differs from the current approach to sales charge limits under NASD Conduct Rule 2830, which limits how much fund underwriters may collect in asset-based sales charges (a fund-level or share-class-level cap) rather than how much individual shareholders will pay, directly or indirectly, in sales charges (a shareholder account-level cap).

In assessing compliance with this requirement, funds would not be required to track the actual dollar amounts of ongoing sales charges or other charges paid by individual shareholder accounts. Instead, funds could satisfy this limitation by ensuring that shares purchased would automatically convert to another share class without an ongoing sales charge by the end of the month during which the fund would have paid on behalf of the investor the maximum amount of permitted sales charges based on the cumulative rates charged each year (the “conversion period”).

Because the maximum length of the conversion period would be based on the rate of ongoing and other sales charges, rather than amounts collected, a fund or intermediary could readily determine the length of the conversion period at the time of purchase.

Therefore, funds would be required to track investors’ purchases, and ensure that they convert at the appropriate time. Each purchase, or “lot,” would be tracked separately, and the shares in each lot would convert at the same time. Similarly, when fund shares are transferred from one fund intermediary to another, the receiving intermediary would have to continue to track those shares for purposes of calculating the length of the conversion period. Dividends and other distributions reinvested in the same class of shares would be given the same conversion date as the shares on which they were declared.

In addition, the Proposal would permit, but not require, funds to apply quantity discounts or scheduled variations in front-end sales loads when determining the reference load applicable to a particular purchase. Funds also would be permitted to offer scheduled variations in the length of conversion periods, and would be permitted to offer shares that would convert to a share class without ongoing sales charges earlier than would otherwise be required under the Proposal.

Although some funds would face greater difficulties in complying with the Proposal than others, generally, any fund currently deducting Rule 12b-1 fees in excess of 25 basis points per year would have to re-evaluate its operations. The SEC has suggested that some of those funds would be able simply to reduce these fees to 25 basis points or less by separately accounting for any non-distribution related fees currently paid under the Rule 12b-1 plan. Funds not able to take advantage of this option would be required to restructure their distribution systems and might, for example, be required to amend their share classes to add conversion features and establish new share classes into which share classes imposing ongoing sales charges could convert.

As with marketing and service fees, funds would not be required to adopt a plan for ongoing sales charges nor would amended Rule 6c-10 require fund boards to make any special findings relating to these charges. Consistent with directors’ fiduciary duties, fund boards would, however, have to consider whether an ongoing sales charge is in the best interests of a fund and its shareholders. The proposing release contains proposed guidance to

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4 Based on the example in footnote 2, eight years after an investor purchases Class C shares, those Class C shares would automatically convert to Class A shares.

5 In addition, because the maximum lengths of conversion periods would be unaffected by any subsequent increase or decrease in the value of the shares purchased, the actual dollar amounts of ongoing sales charges would vary based on the fund’s performance and likely would only approximate the actual amount of the front-end sales load the investor would have paid if he or she had purchased shares in the share class with the highest front-end sales load.

6 For omnibus accounts, this would require a transferring intermediary to provide share lot histories to the new intermediary.
Fund directors in this area, stating that a fund’s board should consider the amount and purpose of an ongoing sales charge in the context of approving and annually renewing the fund’s underwriting contract. The SEC guidance would recognize that directors “can and should” view ongoing sales charges and marketing and service fees as “integral parts” of a fund’s load structure.

The SEC also stated in the proposed guidance that, in assessing an underwriting contract, directors should exercise their “reasonable business judgment” to determine, among other things, whether (1) the contract benefits the fund and its shareholders, (2) the underwriter’s compensation is fair and reasonable, and (3) any sales charges, including an ongoing sales charge, are “fair and reasonable in light of the usual and customary charges made by others for services of similar nature and quality.” Directors would consider all relevant factors when assessing the “fairness and reasonableness” of a contract, including the efficacy of a fund’s distribution network and overall structure, breakpoints on advisory fees, and any economies or diseconomies of scale.

A fund would not be permitted to institute or increase an ongoing sales charge after the relevant fund shares have been publicly offered or otherwise sold to persons other than the fund’s organizers (unlike for marketing and service fees). A fund also could not increase the length of a conversion period applicable to a share class imposing ongoing sales charges.

**C. Compliance Period and Grandfathering of Rule 12b-1 Fees**

The proposing release states that, if adopted, new Rule 12b-2, amended Rule 6c-10 and the other proposed amendments would become effective within 60 days of issuing an adopting release. For sales of new shares, the Proposal provides that funds would be allowed a period of 18 months after the effective date to comply with the new rule and amendments (the “compliance period”). After the compliance period, any shares issued by a fund would be required to comply with the new rule and amendments. Shares issued prior to the end of the compliance period that are subject to Rule 12b-1 fees would be allowed a five-year grandfathering period after the compliance period has ended. New sales in grandfathered share classes would not be permitted after the end of the compliance period.

Under the Proposal, the five-year grandfathering period would permit qualified share classes to continue to charge Rule 12b-1 fees at the same or a lower rate as approved in a fund’s Rule 12b-1 plan. If a fund sought to increase its distribution fees, it would have to comply with the proposed new rules. During the grandfathering period, a fund’s board of directors could vote to eliminate the board annual approval, quarterly reporting, and board and shareholder termination requirements currently in the fund’s Rule 12b-1 plan. A fund’s directors would, however, continue to oversee the Rule 12b-1 plan and could terminate the plan at any time. After the five-year period has lapsed, a fund would be required to convert or exchange grandfathered shares into a share class without an ongoing sales charge and with the same or a lesser marketing and service fee as the Rule 12b-1 fee charged to the grandfathered shares for the last fiscal year. The SEC is specifically seeking comment on any alternative approaches to transition existing shares into share classes that would comply with the new rule and amendments.

**II. Revised Disclosure Requirements**

**A. Mutual Fund Disclosure Requirements**

The Proposal would require mutual funds to provide revised or additional disclosures concerning their use of marketing and service fees and ongoing sales charges as follows:

- Funds imposing ongoing sales charges would be required to disclose these charges in the fee tables in their prospectuses under the heading “Ongoing Sales Charge,” which would replace the heading currently labeled “Distribution [and/or Service] (12b-1) Fees.” Funds imposing marketing and service fees would be required to disclose these fees as a separate category of “Other Expenses” under the subheading “Marketing and Service Fee.”

- Funds would no longer be required to disclose in their prospectuses narrative information about Rule 12b-1 plans, but would be required to disclose if they charge marketing and service
fees or ongoing sales charges and, if so, the rates of these fees and the purposes for which they are used. If these fees were charged for services provided to fund investors, a fund also would be required to describe the nature and extent of those services. If applicable, funds also would be required to disclose the number of months or years after which the shares would automatically convert to a share class without an ongoing sales charge.

- Funds offering multiple classes of shares in a single prospectus would be required to describe generally the circumstances under which an investment in one class may be more advantageous than another class.
- Funds would no longer be required to disclose information about Rule 12b-1 plans in their statements of additional information, but would still be required to describe any marketing and service fees and/or ongoing sales charges, and the principal activities for which they are used. Unlike current requirements applicable to Rule 12b-1 fees, the revised disclosure need not include the dollar amounts spent on any identified activity.
- Funds would be required to disclose marketing and service fees and ongoing sales charges in the financial statements included in registration statements and shareholder reports in a manner consistent with their revised fee tables, as discussed above.
- Unless they maintained grandfathered share classes, funds would no longer be required to provide information specifically related to Rule 12b-1 plans in periodic reports.

The Proposal also would make conforming changes to the disclosure requirements governing proxy statements and registration statements used by insurance company separate accounts.

B. Broker-Dealer Disclosure Requirements

The Proposal would require broker-dealers to provide enhanced disclosures on transaction confirmations concerning the imposition of marketing and service fees, ongoing sales charges, and other charges. This would reverse previous guidance from the SEC and its staff, which permits broker-dealers to exclude from confirmations information about mutual fund sales charges if the investor received a fund prospectus containing that information. Under the Proposal, broker-dealers would be required to provide the following information in their confirmations, as applicable:

- the amount of any front-end sales charge in percentage and dollar terms, together with the net dollar amount invested and any applicable breakpoints;
- the maximum amount of any deferred sales charge, as a percentage of net asset value at time of purchase or redemption;
- the annual amount of any marketing and service fees or ongoing sales charges and the aggregate amount of ongoing sales charges that may be incurred over time, both expressed as a percentage of net asset value, and the maximum number of months or years that the investor will pay ongoing sales charges;
- a statement to the effect that the investor will indirectly pay other asset-based fees charged by the fund, such as management fees, in addition to any marketing and service fees or ongoing sales charges; and
- for redemptions, the amount of any deferred sales charge incurred or to be incurred, expressed in dollars and as a percentage of net asset value.

The Proposal also would require broker-dealers to disclose sales charges in periodic statements provided in lieu of transaction confirmations in connection with investment company plans and periodic plans and transactions in money market mutual funds. In addition, in the release describing the Proposal, the SEC noted that its staff is evaluating point-of-sale disclosure requirements to complement the new confirmation disclosures described above.

III. Retail Price Competition

Currently, Section 22(d) of the 1940 Act effectively fixes the prices at which fund shares may be
offered, including any applicable sales charges, to the prices described in the prospectus. This provision prevents dealers in fund shares from attempting to compete with one another, or otherwise negotiating the sales charges associated with fund shares. The SEC staff has recommended that Section 22(d) be amended to end retail price maintenance since at least 1992. The Proposal would amend Rule 6c-10 under the 1940 Act to allow, but not require, funds and dealers to subject fund sales charges to market forces.

As amended, Rule 6c-10 would provide an additional exemption from Section 22(d) to allow funds to offer their shares without a front-end sales charge at net asset value and to allow dealers in those shares to set and impose their own sales charges. The amount of dealer-imposed charges, and the manner and timing of their collection, would be left to the dealers’ discretion, subject to compliance with other applicable requirements (e.g., FINRA rules concerning excessive compensation). Thus, the Proposal would allow mutual funds—like exchange-traded funds—to unbundle the sales charge components of distribution from the price of fund shares. This would be a significant departure from current law, under which sales compensation for fund shares effectively is set by fund boards or fund sponsors.

This “unbundling” is intended to subject sales charges to competition in the marketplace, and generally to permit funds to use “externalized” fee arrangements. For example, if permitted by a fund and selling dealer, investors would be able to choose the level of services they require and pay for only those services. Dealers also would be able to offer fund shares in multiple fund complexes based on a single, uniform fee schedule, which would remove the complexity and potential for confusion caused by the various distribution fee models currently in use at different individual fund complexes. In general, allowing funds and dealers to operate under this alternative model is intended to make sales charges more transparent and to allow market participants to tailor them to the needs of investors.

This alternative distribution model would only be available for funds, or particular share classes, that do not impose ongoing sales charges. A fund or share class using this model would, however, be permitted to impose marketing and service fees. A fund seeking to use this model also would be required to disclose in its statement of additional information that it has elected to do so. A fund or share class seeking to take advantage of this alternative distribution model would be required to amend its selling agreements with dealers in those shares or enter into new agreements to grant the dealers the authority to set their own compensation, as contemplated by the Proposal.

IV. Effect on “Supermarkets” and Similar Arrangements

Significantly, as noted above, the SEC confirmed that funds would be able to use marketing and service fees to continue to pay fund “supermarkets” and generally to pay other distribution and non-distribution expenses. The SEC also confirmed that funds currently paying more than 25 basis points per year in Rule 12b-1 fees would be permitted to characterize fees that can clearly be identified as not distribution-related as administrative fees, based on board findings as under existing staff guidance. These administrative fees would be excluded from the calculation of marketing and service fees. This is significant because by reclassifying these fees, a fund may be able to reduce its marketing and service fee to 25 basis points or less and thus avoid the limitation on ongoing sales charges and the need to track and convert fund shares.

V. Effect on Funds of Funds

Under the Proposal, both an acquiring and acquired fund would be permitted to charge a marketing and service fee, but the cumulative fees charged by both funds could not exceed 25 basis points per year. This approach is consistent with current NASD Conduct Rule 2830, which limits a fund of funds to a combined service fee of 25 basis points and prohibits a fund of funds from characterizing itself

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7 Rule 22d-1 under this section permits scheduled variations to the charges that are described in the prospectus.
9 As noted above, Rule 6c-10 currently permits funds to charge deferred sales loads.
as “no load” if it imposes combined service fees and asset-based sales charges in excess of 25 basis points. In contrast, either of the acquiring fund or the acquired fund, but not both, would be permitted to impose an ongoing sales charge.

VI. Effect on Insurance-Dedicated Funds, Retirement Plans, and Particular Share Classes

The SEC noted in the proposing release that it believes many funds and intermediaries would be able to use existing recordkeeping and transfer agency systems to comply with the Proposal’s limit on ongoing sales charges, and particularly the automatic conversion feature, because those systems currently are used to track and convert B shares. The SEC acknowledged, however, that certain intermediaries, such as insurance company separate accounts and certain retirement plan administrators, may currently lack the technological capability to implement this aspect of the Proposal. These intermediaries would be required to develop this capability or only offer funds that do not impose ongoing sales charges. The impact of this requirement may be limited in the insurance-dedicated fund context, as asset-based distribution charges for such funds in many cases do not exceed 25 basis points per year; however, this is not always the case. In addition, share classes offered by other types of funds, which rely on indefinite distribution-related payments in excess of 25 basis points per year, like some Class C and Class R shares, would face additional difficulties in complying with the Proposal.

VII. Other Rule Amendments

A. Rule 11a-3 under the 1940 Act

Rule 11a-3 governs exchanges between funds within the same fund group. Among other things, Rule 11a-3 limits the total combined sales load—i.e., all sales loads incurred on both the exchanged and acquired shares—that may be charged on shares that have been subject to an exchange. The rule also limits the amount and timing of permissible deferred sales loads. The Proposal would amend Rule 11a-3 to reflect that, under the Proposal, ongoing sales charges are treated similarly to sales loads. Generally, under the Proposal, shareholders would be given credit—i.e., would receive a reduction in an otherwise applicable sales load—for ongoing sales charges paid with respect to the shares being exchanged. In calculating a permissible sales load applicable to an exchange, Rule 11a-3 currently provides credit for previously paid sales loads, but not for fees paid under Rule 12b-1. The Proposal also would amend provisions of Rule 11a-3 that currently give credit for Rule 12b-1 fees when calculating permissible deferred sales loads to provide that such credit would only be given for previously paid ongoing sales charges, and not marketing and service fees. The Proposal also would clarify that funds must provide credit for ongoing sales charges based on the rates of those charges, not the actual amounts paid.

B. Rule 17a-8 under the 1940 Act

Under Rule 17a-8, funds may merge with affiliated funds without first receiving an exemptive order from the SEC and without shareholder approval if, among other things, the Rule 12b-1 fees of the surviving fund are no greater than those imposed by the merging fund. The Proposal would retain the relief provided by this rule by replacing the current reference to Rule 12b-1 fees with references to marketing and service fees, ongoing sales charges, and grandfathered Rule 12b-1 fees.

C. Rule 17d-3 under the 1940 Act

Rule 17d-3 effectively permits a fund, without first receiving an exemptive order from the SEC, to enter into distribution-related agreements with certain affiliates and the principal underwriter to facilitate a Rule 12b-1 plan. Any agreements permitted under the rule must comply with Rule 12b-1. The Proposal would preserve the relief provided by this rule by replacing the current reference to Rule 12b-1 with references to the rules governing marketing and service fees, ongoing sales charges, and grandfathered Rule 12b-1 fees.

D. Rule 18f-3 under the 1940 Act

Rule 18f-3 permits funds to offer multiple classes of shares. Under the rule, funds may convert one share class to another after a specified period of time if, among other things, the expenses of the converted class, including Rule 12b-1 fees, are no higher than those charged by the original class. The Proposal...
would preserve the relief provided by this rule by replacing the current reference to Rule 12b-1 with references to the rules governing marketing and service fees, ongoing sales charges, and grandfathered Rule 12b-1 fees.