SEC Proposes New Rule and Related Amendments to Replace Rule 12b-1

On July 21, 2010, the Securities and Exchange Commission (the "SEC") voted unanimously to propose a new rule and 13 related rule and form amendments intended to modernize the regulation of how the assets of open-end investment companies (mutual funds) may be used in the promotion and sale of fund shares. Proposed after many years of debate regarding whether Rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act") reflects current economic realities and serves the best interests of fund investors, the SEC's proposed rule and related amendments, which would replace Rule 12b-1 in its entirety, represent a significant rethinking of the regulation of asset-based distribution fees.

The proposed rule and related amendments would allow funds to continue to bear promotional costs, within certain limits, and would preserve the ability of funds to provide investors with alternatives for paying sales charges (e.g., at the time of purchase, at the time of redemption or through a continuing fee charged to fund assets). However, the new rule and related amendments would limit the cumulative sales charges each investor pays, regardless of the manner in which they are imposed. The SEC's proposing release (the "Proposing Release") states that the new rule and related amendments are designed to protect individual investors from paying disproportionate amounts of sales charges in certain share classes, promote investor understanding of fees, eliminate outdated requirements, provide a more appropriate oversight role for fund directors and allow greater competition among funds and intermediaries in setting sales loads and distribution fees. The SEC has requested comments regarding the proposals by November 5, 2010.

Proposed Rescission of Rule 12b-1

Since its adoption in 1980, Rule 12b-1 has permitted mutual funds to use fund assets to promote sales of fund shares. Rule 12b-1 was adopted in response to a period of prolonged net redemptions in the 1970s, as well as the development of money market funds and no-load fund groups, which did not charge sales loads but required a source of revenue to support their direct selling efforts. Against this backdrop, Rule 12b-1 was adopted in the belief that using fund assets to support the sale of fund shares could benefit fund shareholders by increasing economies of scale and reducing fund expense ratios. Over time, funds began to lower front-end sales loads, adopt 12b-1 plans with higher fees and use 12b-1 revenue to compensate fund intermediaries for sales efforts, rather than simply defraying promotional costs. While this was done with the overt involvement of the SEC through the granting of exemptive orders to permit contingent deferred sales charges ("CDSCs") and multiple-class arrangements, as time went on, the SEC and members of the SEC staff began to express concerns that 12b-1 fees, together with CDSCs, were being used as substitutes for front-end sales loads, were confusing and anti-competitive, encouraged certain "hidden charges," and were inconsistent with the objective of facilitating lower expenses for shareholders.[1] Many industry participants countered these concerns, noting that Rule 12b-1 had facilitated efficient, widespread delivery of investor services, had provided alternatives to front-end sales commissions, and had leveled the playing field for new and smaller fund firms.

[1] The SEC and members of its staff have also expressed concern regarding the frequency and amount of payments made by fund advisers to broker-dealers and others distributing fund shares, a practice commonly known as "revenue sharing." The Proposing Release notes that the SEC remains concerned that fund revenue sharing payments may give broker-dealers and other recipients incentives to market particular funds or fund classes, and that such incentives create conflicts of interest that may not be adequately disclosed in fund registration statements. The Proposing Release suggests that the SEC will continue to consider further rule amendments related to revenue sharing.

In the Proposing Release, the SEC seems to address its concerns by proposing to rescind Rule 12b-1 in its entirety and replace it with a new regulatory framework. According to the Proposing Release, many of the original assumptions underlying Rule 12b-1 no longer reflect current marketplace realities, including the role that 12b-1 fees play in the distribution of fund shares and the role of fund boards in approving distribution arrangements. As a result, the SEC determined to rescind, rather than amend, Rule 12b-1 and eliminate use of the term "12b-1 fee" in fund disclosure. In place of Rule 12b-1, the SEC has proposed a new regulatory framework which, like NASD Rule 2830, would differentiate between the two constituent parts of current 12b-1 fees (asset-based sales charges and service fees).[2]

Proposed Rule 12b-2 and "Marketing and Service Fee"

The SEC is proposing to adopt Rule 12b-2 under the 1940 Act, which would permit funds to deduct a "marketing and service fee" of up to 25 basis points (0.25% of net assets) annually from fund assets to pay for distribution activities. As proposed, Rule 12b-2 would permit this fee to be used for any type of distribution cost. However, the Proposing Release anticipates that the fee would primarily be used to pay for activities for which servicing fees may be currently used under FINRA rules, trail commissions to broker-dealers selling fund shares, and other expenses such as fees paid to fund supermarkets and retirement plan administrators. In addition, the Proposing Release states that funds (including no-load funds) may use the fee to pay for shareholder call centers, compensation of underwriters, advertising, printing and mailing of prospectuses, and other traditional distribution activities. Rule 12b-2 would require the "marketing and service fee" to be clearly disclosed in a fund prospectus fee table and other relevant documents as a fund operating expense.

Although fund directors would be required to approve the adoption of a marketing and service fee, they would not be required to approve a distribution plan, make any special findings or consider specific factors in connection with that approval.[3] The Proposing Release indicates that fund boards would be expected to oversee the amount and use of the marketing and service fees in the same manner that they oversee the use of fund assets to pay fund operating expenses, particularly those that create a potential conflict of interest with the fund's adviser or other affiliated persons. The Proposing Release, however, does not provide any guidance regarding the frequency with which boards should review the marketing and service fees or on what terms they might determine that a particular fee is not appropriate. Separately, Rule 12b-2 would require funds imposing a new marketing and service fee, or increasing the rate of an existing marketing and service fee, to obtain shareholder approval. Shareholder approval would not be required to institute such a fee for a new class of shares.

Proposed Amendment to Rule 6c-10 and "Ongoing Sales Charges"

Cap on Ongoing Sales Charges. The SEC is proposing to amend Rule 6c-10 under the 1940 Act to allow funds to charge asset-based distribution fees in excess of the 0.25% marketing and service fees discussed above, so long as the excess amount is treated as an "ongoing sales charge" that is subject to certain restrictions. Specifically, Rule 6c-10 would cap ongoing sales charges, such that the cumulative amount of any ongoing sales charges (determined as a percentage of net asset value) charged by a share class (plus any front-end load or CDSC paid by that share class) could not exceed the amount of the highest front-end load an investor would have paid if the investor had invested in another class of shares of the same fund, referred to as the "reference load."[4] Unlike FINRA's current, fund-level sales charge limits, the proposed methodology does not include an interest factor reflecting the time-value of money, although the SEC does recognize that the amount of the fee ultimately collected will fluctuate with fund

[2] The Proposing Release suggests a five-year grandfathering period for shares of existing classes issued prior to the compliance date for the final, amended rules that deduct fees pursuant to Rule 12b-1 as it exists today, after which those shares would be required to be converted or exchanged into a class that does not deduct an ongoing sales charge. New sales would not be permitted in grandfathered share classes after the compliance date of the amended rules.

[3] With the rescission of Rule 12b-1, fund boards would be relieved of the requirement to approve and annually renew distribution plans.

[4] The Proposing Release offers the following example: If a fund has 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 charges a front-end sales load of, for example, 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.

performance and the possible reinvestment of distributions. For funds that do not have any shares with a front-end sales load, the default reference load would be the maximum sales charge permitted under NASD Rule 2830(d)(2), which is currently 6.25%. In the Proposing Release, the SEC specifically solicits comments on whether the maximum limit should be tied to FINRA's rules or should be determined by fund boards.

The proposal appears to be aimed squarely at Class C shares (which typically provide for an ongoing 0.75% distribution fee without conversion to another share class) and other share classes for which investors currently pay asset-based sales charges until redemption. Class B shares would appear to remain viable under the new regulatory scheme, albeit in some cases with changes to CDSC schedules or conversion periods.[5] The proposal also appears to represent an implicit determination by the SEC that enhanced disclosure, including "point of sale" disclosure, is not enough to address its concerns over asset based sales charges, even though the asset-based sales charge structure may be more tax-efficient than other economically similar alternatives (e.g., broker wrap fees). If the proposal is adopted, funds and their sponsors will likely need to restructure their arrangements with third parties, such as retirement plan sponsors, where such arrangements provide for distribution payments to be made for the life of the investment. The Proposing Release acknowledges that imposing a cap on ongoing sales charges could encourage broker-dealers to recommend switching between fund families once an investor reaches the ongoing sales charge limit, and the SEC specifically solicits comment on this point.

Tracking and Automatic Conversion. The cap on ongoing sales charges would be implemented by requiring shares to automatically convert to a class with no ongoing sales charges (other than marketing and service fees) once the cap has been reached. Rule 6c-10 would require fund complexes to either track the dollar amount of ongoing sales charges paid by each shareholder account, or to determine at the time of purchase the maximum number of months that the investor will incur the ongoing sales charges.[6] This conversion would be required to occur no later than the end of the month during which the fund would have paid the maximum amount of sales charges cumulatively permitted with respect to each shareholder. Each purchase or "lot" of shares would have a separate conversion period and the maximum length of the conversion period would be unaffected by any subsequent increase or decrease in the value of shares purchased. According to the Proposing Release the SEC believes that fund intermediaries will have the ability to transfer share lot histories (because, for example, of the industry's ability to track the aging of Class B shares by monthly lots); however, it specifically solicits comments on the operational feasibility of the proposal. In addition to the feasibility of implementing the new regime from an operational perspective, funds would need to consider whether their organizational documents could provide for the conversion rights contemplated under the proposal.

Quantity Discounts. Proposed rule 6c-10 would permit, but not require, funds to apply quantity discounts or scheduled variations in the front-end load for which the investor may qualify when determining the reference load for the cap on ongoing sales charges. (As a practical matter, this would multiply the number of lots that would need to be tracked for each monthly grouping of purchases.) The SEC expresses concern in the Proposing Release that requiring funds and their intermediaries to calculate a different reference load for each purchase of fund shares may introduce greater cost and complexity and could affect the willingness of funds and their underwriters to offer quantity discounts or scheduled variations on front-end sales loads. The Proposing Release specifically solicits comments on whether funds should be required to incorporate scheduled variations in the front-end load when determining a shareholder's reference load.

[5] Both Class B and Class C represent a declining portion of mutual fund net sales.

[6] As discussed below, proposed amendments to Rule 10b-10 would require transaction confirmation statements to include the maximum ongoing sales charge that may be incurred over time, as a percentage of net asset value, and the maximum number of months or years that the customer will incur the ongoing sales charge.

Ongoing Sales Charges May Not Be Increased. As proposed, Rule 6c-10 would prohibit any fund from instituting or increasing the rate of an ongoing sales charge for a class of shares after the public offering of the class, or from increasing the conversion period if this would increase the cumulative amount of ongoing sales charges imposed. The Proposing Release states that the institution or increase of an ongoing sales charge after a shareholder has agreed to pay a defined cumulative ongoing sales charge would be akin to retroactively renegotiating the terms of the contract without the explicit consent of the shareholder. Even though the 1940 Act would permit fund directors to approve a higher front-end sales load because such load would affect new investors only, Rule 6c-10 would not permit the cap on ongoing sales charges to adjust to the new front-end sales load to respond to changing distribution needs. The Proposing Release notes that shareholder approval is "not relevant" for ongoing sales charges, given that proposed Rule 6c-10 would not permit ongoing sales charges to increase. However, the SEC solicits comments regarding whether to permit shareholder approval of an increase in ongoing sales charges, and, if permitted, whether the fund or the underwriter should bear the cost with respect to soliciting shareholder proxies to approve or increase the rate of such fees.

Role of Fund Directors. Under amended Rule 6c-10, although fund directors would be required to approve the adoption of asset-based distribution fees, they would not be required to make any special findings or consider specific factors in connection with that approval. Directors would continue to have fiduciary obligations under the 1940 Act and state law in considering whether use of the fund's assets to pay ongoing sales charges is in the best interest of a fund and fund investors. The Proposing Release recommends that directors consider the amount of the ongoing sales charges and their intended purpose according to the same procedures used to consider sales charges in an underwriting contract under Section 15(c) (e.g., considering the nature, scope and quality of the services, and whether the sales loads are fair and reasonable in light of the usual and customary charges made by others for comparable services). However, the Proposing Release solicits comments on the overall approach to refashioning the role of the board of directors in overseeing asset-based distribution fees, and the SEC intends to issue additional guidance, when it adopts the new rules in final form, to assist fund directors in satisfying their fiduciary duties.

Proposed Amendments to Rule 6c-10 and "Account-Level Sales Charges"

Under the current regulatory framework established by Section 22(d) of the 1940 Act, broker-dealers are precluded from competing with each other by setting their own sales charges on funds they sell or negotiating sales charges with their customers. Instead, fund companies (rather than brokerage firms) set their own sales load schedules (which may include waivers or discounts for specific classes of purchasers), and all brokers that sell the funds are bound by those schedules. Under a proposed elective provision to Rule 6c-10, a fund could issue shares at net asset value (i.e., without a sales load) and broker-dealers could impose their own sales charges on such shares. The exemption would be available through an optional election made by a fund in its registration statement.

In practice, the elective provision would permit the unbundling of the sales charge components of distribution from the price of fund shares (similar to the distribution model for ETFs). Funds making the election would still be permitted to charge the 0.25% marketing and service fee permitted by Rule 12b-2, but would not charge any front-end sales load, CDSC, or ongoing sales charge. Instead, dealers would be free to establish and collect their own commissions or other types of sales charges from their customers to pay for distribution, subject to applicable FINRA rules and restrictions. For example, dealers could offer an array of funds from different fund groups and could sell each fund according to a single price schedule that takes into account volume of a customer's transactions with that dealer (rather than the size of the purchase in a particular fund), as well as the nature and quality of services offered. The Proposing Release specifies that the broker-dealers' fees and the times at which they are collected would not be governed by the 1940 Act.

The Proposing Release states that unbundling the sales charge components is intended to permit investors to choose among levels of service, thereby better matching their needs. The SEC also suggests that unbundling may simplify broker-dealers' operations, permitting them to process transactions on a single, uniform fee structure, and may ameliorate broker-dealer conflicts that encourage them to recommend funds based on the amount of compensation received from selling the funds. It is not clear, however, how well investors will be able to compare the different services that broker-dealers will offer and whether comparable price quotes from competing brokers will be readily available. In addition, investors will not benefit from having distribution-related sales charges deducted from their accounts pre-tax, and will therefore pay the broker-dealers' account sales charges with post-tax dollars and will pay taxes on higher fund returns. Separately, the SEC suggests that this unbundling is operationally feasible, based on the experiences of separately managed accounts and wrap accounts that operate on an externalized distribution model, but specifically solicits comments regarding the potential disadvantages of an externalized alternative distribution model.

Related Rule and Form Amendments

- *Rule 10b-10 under the Securities Exchange Act of 1934*
  - Transaction confirmations for purchases of fund shares would be required to include detailed information regarding any front-end and deferred sales charges, ongoing sales charges and marketing and service fees. For example, if after purchase a customer will incur any ongoing sales charge or marketing and service fee, the confirmation statement must disclose, among other items, the annual amount of the charge or fee as a percentage of net asset value, the aggregate amount of the ongoing sales charge that may be incurred, as a percentage of net assets, the maximum charge that may be incurred over time, as a percentage of net asset value, and the maximum number of months or years that the customer will incur the ongoing sales charge.[7]
- *Rule 11a-3 under the 1940 Act*
  - Rule 11a-3, which permits funds and fund underwriters to charge a sales load on shares acquired in certain exchanges between funds, would be modified to provide for 1) shareholder credit for the payment of ongoing sales charges, and 2) tolling credit for the sales charge component of any asset-based distribution fee (i.e., ongoing sales charges), rather than the full, historical 12b-1 fee paid with respect to acquired shares.
- *Rules 17a-8, 17d-3 and 18f-3 under the 1940 Act*
  - Amendments to these rules would replace all references to Rule 12b-1 with references to Rules 12b-2 and 6c-10, as applicable.
- *Form N-1A, Item 19(g) (Fund Registration Statements)*
  - Amendments would rescind sections that require disclosure concerning the material aspects of a fund's Rule 12b-1 plan and related agreements, but would maintain the substance of the disclosure intended to permit investors to understand how asset-based distribution fees are used.

[7] As noted above, the Proposing Release also suggests that a fund could track the actual sales charges paid by an investor for purposes of determining when shares convert to a class without sales charges, which appears inconsistent with the requirement to state the maximum sales charge period in the confirmation.

- *Schedule 14A (Fund Proxy Statements)*
    - Amendments would, among other things, 1) require shareholder approval before instituting or increasing the rate of marketing and service fees deducted from fund assets in existing share classes, 2) eliminate references to board involvement in approving asset-based distribution fees, and 3) eliminate the requirement that funds disclose the aggregate amount of distribution fees paid by the fund in the previous year.

Comments on the proposed rules should be submitted to the SEC by November 5, 2010. The SEC has indicated an intention to set a compliance date that is at least 18 months after the adoption of any final rule changes.

Contact Information

If you have any questions about the SEC's proposals, please contact the Ropes & Gray attorney who normally advises you.

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