In Rule 12b-1 Overhaul, SEC Proposes Dramatic Changes to Mutual Fund Distribution Arrangements

The U.S. Securities and Exchange Commission’s discomfort with the concept of a registered mutual fund’s use of its own assets to pay for the distribution of its shares dates back to before the adoption of Rule 12b-1 three decades ago. The SEC now plans to recast its approach, completely repealing that rule and replacing it with a framework for ongoing distribution charges that would go so far as to effectively banish any references to “12b-1.” A new Rule 12b-2, in combination with an amended Rule 6c-10 and other changes, would establish the new framework.¹

At present, it is common for a fund to generate an essentially permanent stream of ongoing distribution charges (often called 12b-1 fees), which can be used to compensate third-party marketers, pay for advertising and the like. The SEC’s proposal instead would establish a hard cap to the percentage rate of the charges that can be deducted from funds over time, with implications for funds and their directors, sponsors and marketers. The changes also would enable price competition among front-end sales commissions (loads) charged by brokers. Finally, while many expected Rule 12b-1 reform to streamline the role of fund boards of directors, the SEC proposes that directors would make annual

¹ Both current Rule 12b-1 and its proposed replacement rules apply only to open-end investment companies registered with the SEC under the U.S. Investment Company Act of 1940.
determinations with respect to the reasonableness, fairness and effectiveness of front-end sales loads and ongoing sales charges.


Summary of the New Cap

The cap would have two elements.

- First, all funds would be able to provide for an ongoing annual fee to be deducted from the fund’s assets of up to 0.25% of assets. To the extent the fee is set at a number lower than 0.25% of assets per annum, this fee could be increased up to that maximum only following approval by a vote of the shareholders.

- Second, and in addition to that fee, a fund would be able to offer one or more classes of shares that provide for a further ongoing deduction based on the fund’s assets, but with a cap so that the measure of the ongoing fees is the same as the highest front-end load that another class of the fund’s shares bears.² For example, if one class of shares provides for a 6% front-end load and no other distribution fees (beyond the up to 0.25% of assets per annum fee permitted for all funds), another class of the fund’s shares could provide for four years of deductions at 1.5% of assets, six years of deductions at 1% of assets, twelve years of deductions at 0.50% of assets, and so on. Once set, these fees could not be increased over time, even with shareholder consent.

Loads incurred by a shareholder in connection with shares that were exchanged for new shares would “carry over” and reduce the loads that can be paid by the exchanged-for shares. Also proposed are mechanisms to avoid “double dipping” through fund of funds arrangements.

This bears some resemblance to how deductions and payments under Rule 12b-1 work now. For example, in the most common “multi-class” distribution model, a mutual fund organizes several classes of shares, often along the following lines:

- Class A shares commonly provide for an up-front load and an annual Rule 12b-1 fee equal to 0.25% of the fund’s assets.

- Class B shares commonly provide for no up-front load and a higher annual Rule 12b-1 fee, with an automatic conversion to the lower fee Class A shares after a specified, multi-year holding period. If the shareholder redeems shares prior to their conversion, the shareholder nonetheless pays a contingent deferred sales load (CDSL) roughly equal to the trailing Rule 12b-1 fees that otherwise would have been paid through to conversion.

² That highest front-end commission is not proposed to be adjusted for these purposes by volume discounts or other breaks available to particular investors. Rather, the highest, unadjusted commission will be used. In cases when there is no share class that can serve as having the “reference” commission, perhaps because no other share class has a front-end commission but no ongoing sales load, the SEC proposes the maximum be set at 6.25% (a lower number than the 8.5% maximum that otherwise might be available, as described below).
Class C shares commonly provide for a low or no up-front load and a higher annual Rule 12b-1 fee, with no conversion to a lower fee share class over time.

While not all funds will have all of these share classes, many have at least some version of the “A shares” and the “C shares.” The proposed cap most directly affects the C shares in that, to avoid the cap, it effectively would require restructuring the C shares to become a version of the B shares described above, with an automatic conversion to a lower fee share class over time (i.e., once the cap is triggered as to a particular “lot” or batch of shares) and, potentially, a CDSL for shares redeemed before conversion. After conversion, shares would be subject only to the 0.25% of assets per annum fee permitted for all funds, with no other ongoing sales charge.

Disclosure Changes

The SEC proposes that the first fee (the up to 0.25% per annum fee) be called the “marketing and service fee.” The second, capped fee would be called the “ongoing sales charge.” The fees would appear under these names as separate line items in a fund’s prospectus fee and expense table.

The SEC proposes that the different fee structures across classes be described in the prospectus and, also, that the relative merits of investing in one class versus another be explained. That comparative discussion would take into account the effect of different expected holding periods. A fund’s statement of additional information would include a listing of the principal types of activities for which payments are or will be made from these fees.

Finally, the SEC proposes that various types of information appear on an investor’s brokerage confirm, including the dollar and percentage amount of any front-end load and/or expected CDSL. The confirm also would address the ongoing sales charge, with disclosure along the following lines: “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 five years. You also will pay marketing and services fees of 0.25% for as long as you own the fund.”

Fee Externalization Alternative

The SEC proposes that funds will have the option of organizing a share class with only the up to 0.25% per annum marketing and service fee (so no ongoing sales charge) and for which brokers selling the shares would set all other brokerage compensation arrangements outside the fund. This would result in any fees imposed by a broker being charged to the fund investor through the investor’s account with the broker in a manner much like the “wrap fee” accounts that are in wide use today.

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3 For this purpose, it is proposed that shares acquired by a shareholder as a result of reinvestment of dividends or other distributions would be included in the same “lot” as the shares that generated the reinvested dividends or distributions. For example, if one buys 100 shares, and those shares then grow to 150 shares as a result of dividend reinvestment through to the date when the cap relating to the original 100 shares is hit, all 150 shares would convert at once. Before conversion, it is proposed that shares acquired as a result of reinvestment be subject to the same ongoing sales charges as every other share in the lot.

4 The SEC acknowledges that confirms for mutual fund share purchases are typically received after the transaction has been consummated, but indicated that this type of disclosure might be required on a pre-transaction basis in the future.
Timetable and Compliance Dates

The SEC contemplates the new rules becoming effective 60 days after they are finalized. Any such effective date would presumably be sometime in 2011. Mandatory compliance is then phased in over time, as follows:

- First, funds would be permitted (but not required) to take advantage of the new rules upon the effective date.
- Second, there would be an 18-month transition period between the rules’ effective date and the final compliance date, in order to give fund firms the time to implement changes to systems, agreements and disclosure.
- Third, shares sold before the compliance date would be subject to “grandfathering” to allow fees to be deducted under the prior rules for up to five years, after which the relevant shares would have to convert to a share class without an ongoing sales charge (but that could be subject to the up to 0.25% per annum marketing and service fee). Boards could eliminate the quarterly reports and annual approvals required by existing Rule 12b-1 Plans under which those shares were issued.

The precise operation of both the transition period and the grandfathering proposal remain unclear. The SEC also invited comments on various other approaches to managing the phase-in period, and still other proposals could yet come forward.

What Next?

Since the changes affect thirty years of practice, it should come as no surprise that there will be complex commercial and legal issues to consider, among them the following:

- The cap will operate to reduce the total amount of deductions to be made from C shares over time. That is to the benefit of holders of those shares. But, unless the costs of fund distribution simply go down (or the volume or quality of distribution-related services being delivered declines), where as a commercial matter will that fee stream – which is now available to support those efforts – be made up?
- Will fund sponsors pay more distribution costs out of their own profits (e.g., as revenue sharing)? If so, will reduced profitability have an effect on core service levels? What will the role of fund boards be in assessing the interaction between service levels, profitability and the level of the investment advisory fee?
- Some expenses currently paid from 12b-1 fees may not have a distribution component (like some shareholder servicing arrangements). Will those types of expenses migrate out of capped distribution fee pools like those specified by the new rules and into general fund expenses? If so, what will the role of fund boards be in monitoring the conflict of interest that sponsors will have in making judgments about how to allocate mixed distribution and non-distribution expenses or in reallocating non-distribution expenses currently paid from the 12b-1 pools?
- Will fund marketers be incentivized to shift shareholders between funds more frequently so as to regularly “reset” the period in which higher, ongoing fees can be realized?

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5 The SEC clearly understands the potential for this dynamic, but alludes to it only obliquely in a lengthy footnote in which it says that it will consider revenue sharing matters at a future date.
Since the cap for all share classes for a fund would be directly related to the size of the front-end sales commission charged by the designated reference class, will there be an incentive to set that reference commission as high as possible and thereby maximize the size of the cap across all classes? The SEC acknowledges that possibility, but asserts that the highest maximum commission rate (generally, 8.5% under applicable FINRA rules) will be unpalatable for most funds, as that rate then would be used in calculating performance in advertisements. Will that really be a check?

For some time, market dynamics have operated to set basically consistent distribution fees across the industry, with fund sponsors reporting that any fund deviating from that consensus pricing will be penalized by its marketing partners. That can leave little room for actual negotiation of distribution pricing models. Will that change for the long-term? Or will sponsors, boards and marketers simply go through a briefly unsettled period before the same, longstanding market pressures again drive consistent pricing outcomes and reduce the significance of case-by-case, fund-by-fund pricing analysis?

The SEC says the cap would operate much like traditional B shares, so that the administrative mechanics of tracking shareholder ownership and providing for proper shareholder-by-shareholder conversion timetables already exists. But is the B-share analogy really compelling for all types of funds? Or will administrative and bookkeeping costs for funds that do not currently offer B shares go up? Likewise, is the B-share analogy compelling for all types of intermediaries? The SEC acknowledges, for example, that retirement recordkeepers, insurance companies and others infrequently track share holding periods.

The SEC would repeal the annual board findings currently required by Rule 12b-1, but proposes sales charge-related guidance that fund boards must take into account when annually renewing a fund’s distribution agreement. Does this really result in streamlined obligations for boards, as many observers have suggested? Or is it simply a trade-off? In any event, the range of questions already cited suggests that there will be many new issues for directors. Potentially, there also will be a return to the awkward status quo in which boards feel caught between regulatory expectations for an active role and commercial realities that dictate largely non-negotiable distribution fee levels.6

6 Emphasizing the regulatory expectations are the following SEC statements that invoke Section 15(c) in connection with reviewing sales loads:

Unlike Rule 12b-1, the proposed amendments … would not impose any explicit responsibilities on fund boards of directors to approve (or re-approve) asset-based sales charges under the proposed rule, although we fully expect boards would continue to play an important role...We believe that directors should consider the amount of the ongoing sales charge and the purposes for which it is used according to the same procedures they use to consider and approve the amount of the fund’s other sales charges in the underwriting contract under section 15(c) of the Act ... In determining whether to approve (or re-approve) the underwriting contract, the directors must exercise their reasonable business judgment to decide, among other things, whether the terms of the contract benefit the fund (or its relevant class) ..., whether the underwriter’s compensation is fair and reasonable..., and 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.
Given the centrality of these issues to the industry and the number of industry participants that are affected, the SEC should expect hundreds of comment letters. The agency will need time to absorb those comments before acting further. But the Dodd-Frank reform legislation, signed into law on the same day the SEC issued these proposals, will create tremendous practical pressure for the agency to finalize its Rule 12b-1 changes and move on expeditiously to other commitments.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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