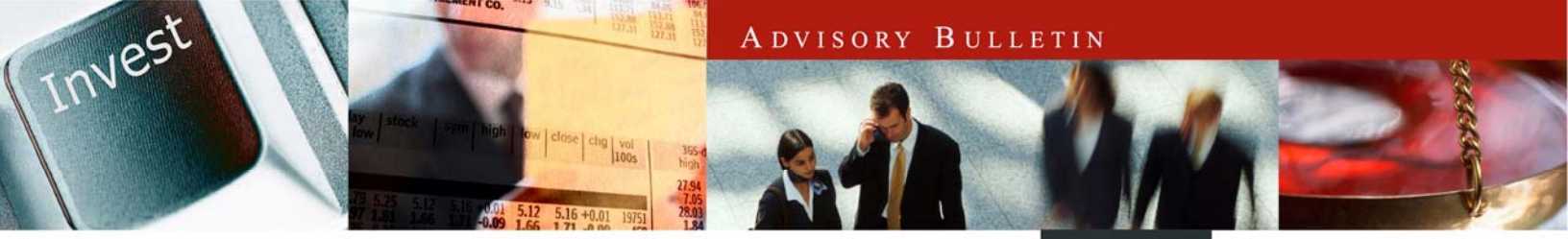

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INVESTMENT MANAGEMENT UPDATE

SEC Proposes Rescinding Rule 12b-1 and Overhauling of Mutual Fund Distribution Fees

On July 21, the Securities and Exchange Commission (SEC) proposed rescinding Rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act") and adopting a new rule and amendments to existing rules and forms designed to place limits on fund sales loads, improve transparency of fees and encourage retail price competition, while revising the oversight responsibilities of fund directors and trustees and minimizing the disruption of current distribution agreements.[1] The proposals are a recognition by the SEC that a portion of 12b-1 fees functions like a sales load that is paid over time and should be subject to the requirements and limitations applicable to traditional sales loads.

SALES LOAD LIMITATIONS

The SEC proposes to eliminate Rule 12b-1 in its entirety.[2] In its place, the agency would permit funds to deduct two types of asset-based distribution fees: "marketing and services fees" and "ongoing sales charges." These fees would be subject to different restrictions on the maximum amount that could be deducted from shareholder accounts and the length of time over which the fees and charges could be assessed.

Marketing and service fees. Under proposed Rule 12b-2, funds may, with respect to any class of shares, deduct a marketing and service fee from fund assets to pay for distribution activities. The amount of the fee could not exceed the maximum rate of the service fee allowed under NASD Conduct Rule 2830, which currently is 0.25 percent annually. The marketing and service fee could be deducted for as long as a shareholder owned shares of the fund.

The marketing and service fee could be used for any type of distribution activity. In addition to paying for services of the type currently permitted by Conduct Rule 2830, the fee could be used to pay trail commissions to broker-dealers selling fund shares, platform fees for access to fund supermarkets, recordkeeping fees to retirement plan administrators, the expenses associated with shareholder call centers, compensation to underwriters, advertising expenses, the cost of printing and mailing prospectuses to prospective investors and expenses related to other types of distribution activities. While proposed Rule 12b-2 would not preclude a fund from paying for mixed expenses (i.e., distribution and non-distribution) under the rule, to the extent that a fund does not need to rely on proposed Rule 12b-2 to charge expenses that can clearly be identified as non-distribution related (e.g., sub-transfer agency fees), the fund could instead characterize those expenses as administrative expenses and thus keep total asset-based distribution fees within the limit of the marketing and service fee.

Ongoing sales charge. Under proposed amendments to Rule 6c-10 under the 1940 Act, any charge in excess of the maximum annual marketing and service fee permitted under proposed Rule 12b-2 would be considered an ongoing sales charge, which would be subject to limits on amounts deducted and the length of time the charge could be assessed. Unlike current 12b-1 fees, ongoing sales charges would be treated as another form of deferred sales charge.[3]

Under the proposed amendments, a fund could deduct an ongoing sales charge from fund assets provided the cumulative ongoing sales charges imposed on a purchase of fund shares do not exceed the shareholder's "maximum sales load." A shareholder's maximum sales load would be calculated by multiplying the total dollar amount invested by the highest sales load rate that the shareholder would have paid if, at the time of the purchase of fund shares, the shareholder had purchased shares of a class offered by the fund that does not have an ongoing sales charge and for which the shareholder qualifies according to the fund's registration statement.[4] In other words, if a fund offers Class A shares, the maximum sales charge it could collect from an investor in Class B or Class C shares would be the maximum the investor would have paid had the investor invested in Class A shares with the maximum front-end load.[5] If the fund does not offer another class with a front-end load, then the shareholder's maximum sales load is calculated by reference to the maximum sales charge permitted under NASD Conduct Rule 2830(d)(2), which currently is 6.25 percent of the amount invested.[6] In addition, proposed amendments to Rule 6c-10 would not require (but would permit) funds to apply any quantity discounts or scheduled variations in the front-end load when calculating a shareholder's maximum sales load.

Conversion feature. A fund could stay within the maximum sales charge limits by providing that shares automatically convert to another class of shares without an ongoing sales charge *no later than* the last day of the calendar month during which the cumulative ongoing sales charge rates exceed the shareholder's maximum sales load rate.[7] Each purchase, or "lot," would have a separate conversion period, and the shares associated with each lot would be programmed to convert on a particular date. The conversion feature is designed so that funds and fund intermediaries would not be required to keep track of the actual dollar amount of ongoing sales charges paid by each individual shareholder account and the maximum conversion date can be easily communicated to investors at the time of purchase.

Reinvested dividends. If dividends or distributions are reinvested in a share class that has an ongoing sales charge, the reinvested shares would have the same conversion period as the shares on which the dividend or distribution was declared. As a result, the reinvested shares would convert to a share class without an ongoing sales charge no later than the conversion date of the shares on which the dividend or distribution was declared.

RETAIL PRICE COMPETITION: ACCOUNT-LEVEL SALES CHARGES

The SEC also proposes amending Rule 6c-10 to permit a fund or class to elect to offer shares at a price other than the public offering price described in the prospectus (i.e., at net asset value). Intermediaries could then impose their own sales charges based on their own schedules and the

services they offer investors.[8] The amount of the sales charge imposed by intermediaries and the time at which they would be collected would not be governed by the 1940 Act. However, intermediaries registered with FINRA would continue to be subject to existing compensation limits in NASD Conduct Rules 2830 and 2440.

A fund making this election could not impose an ongoing sales charge, but it could impose a marketing and service fee. In addition, a fund relying on Rule 6c-10 would have to disclose in its registration statement that it has elected to rely on the exemption, which would allow interested investors the ability to better understand the distribution structure of the fund.

The SEC describes this proposal as the unbundling of the sales charge components of distribution from the price of fund shares, similar to the existing ETF distribution model. The SEC argues that this "externalized" fee structure will benefit both intermediaries and investors by simplifying broker-dealer operations and encouraging competition, while allowing investors to negotiate commissions and select and pay only for the level of dealer services they want. A fund using an externalized fee structure could simplify its operations and shorten its prospectus by eliminating the need for multiple share classes.

BOARD RESPONSIBILITIES

Neither proposed Rule 12b-2 nor the proposed amendment to Rule 6c-10 would require fund directors to adopt a written plan, approve the fees and charges annually, make any special findings or comply with any fund governance requirements. Rather, in instituting a marketing and service fee, the SEC anticipates that a fund board, in the exercise of its fiduciary duties and consistent with the proposed rule, would oversee the amount and uses of the marketing and service fees in the same manner that it oversees the use of fund assets to pay any other fund operating expenses, particularly those that create a potential conflict of interest for the fund's investment adviser or other affiliated persons.

While fund directors would not have any explicit responsibilities to approve (or re-approve) ongoing sales charges under the proposed amendments to Rule 6c-10, the SEC expects that fund boards would continue to have fiduciary duties with respect to the oversight of the use of fund assets under state law and under Section 36(a) of the 1940 Act. In the proposing release, the SEC states that it believes that fund 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 a fund's other sales charges in the underwriting contract under Section 15(c) of the 1940 Act. Further, the SEC states that fund directors can and should view ongoing sales charges as integral parts of a fund's sales load structure to which they give their assent when they annually approve the fund's underwriting contract.

SHAREHOLDER APPROVAL

Under proposed Rule 12b-2, after a fund or share class has been sold to the public, approval by a majority of shareholders would be required before the fund or class could institute, or increase the rate of, a marketing and service fee. However, shareholder approval would not be required for a new fund or new share class to institute a marketing and service fee.[9]

Under the proposed amendments to Rule 6c-10, after the fund or share class has been sold to the public, a fund would not be permitted to institute or increase an ongoing sales charge, even if shareholder approval is obtained.[10] A new fund or a new share class of an existing fund would not need to obtain shareholder approval before instituting an ongoing sales charge.

IMPROVING FEE TRANSPARENCY

Transaction confirmations. The SEC proposes amending Rule 10b-10 under the Securities Exchange Act to require confirmations to set forth information regarding front-end, deferred and ongoing sales charges, as well as marketing and service fees. Transaction confirmations for purchases would be required to disclose the following:

- *Front-end sales loads.* Transaction confirmations for purchases would disclose the amount of any front-end sales charges that the shareholder incurred at the time of purchase, in percentage and dollar terms, along with the net dollar amount invested in the fund and the amount of any applicable breakpoint or similar threshold used to calculate the sales charges.
- *Deferred sales loads.* If the shareholder could be subject to a deferred sales charge upon redemption of the shares, the transaction confirmation provided at the time of purchase would be required to disclose the maximum amount of any deferred sales charge that the shareholder may pay in the future. The amount would be expressed as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable.
- *Ongoing sales charges and marketing and service fees.* If, after the time of purchase, the customer will incur any ongoing sales charge or marketing and service fee, the purchase confirmation would disclose the annual amount of that charge or fee, expressed as a percentage of net asset value; the aggregate amount of the ongoing sales charge that may be incurred over time, expressed as a percentage of net asset value; and the maximum number of months or years that the customer will incur the ongoing sales charge.

Transaction confirmations for purchases also would be required to include the following statement (which may be revised to reflect the particular charge or fee at issue):

> "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. Therefore, these costs are indirectly paid by you."

Transaction confirmations for sales or redemption of fund shares would be required to disclose the amount of any deferred sales charge the shareholder has incurred or will incur, expressed in dollars and as a percentage of the net asset value at the time of purchase or at the time of redemption or sale, as applicable.

Prospectus and SAI disclosure. The SEC proposes amending Form N-1A, the registration form for open-end investment companies, to improve understanding of the distribution-related charges that shareholders directly and indirectly incur as a result of investing in a fund. Amendments to Form N-1A would:

- Revise the fee table by deleting the heading "Distribution [and/or Service] (12b-1) Fees" and replacing it with "Ongoing Sales Charges."
- Add a new subheading to the "Other Expenses" category called "Marketing and Service Fee."
- Amend Item 12(b), which currently requires funds that have adopted 12b-1 plans to disclose information about the operation of the plan in the prospectus, to require funds to disclose whether they charge a marketing and service fee or an ongoing sales charge and, if they do, to disclose the rates of the fees and the purposes for which they are used. A fund deducting a marketing and service fee would need to describe the nature and extent of the services provided, while a fund imposing an ongoing sales charge would be required to disclose the number of months (or years) before the shares automatically convert to a class without an ongoing sales charge. A fund offering multiple classes of shares in a single prospectus (each with its own method of paying distribution expenses) would be required to describe generally the circumstances under which an investment in one class may be more advantageous than another class.
- Amend Item 19(g) of Form N-1A to eliminate the requirement that a fund describe in detail the material aspects of its 12b-1 plans and related agreements, and instead require disclosure of the principal activities paid for through asset-based distribution fees (both ongoing sales charges and marketing and service fees). As proposed, the amendment would not require disclosure of dollar amounts.
- Amend Item 25 to add a paragraph (d) requiring funds electing to rely on the exemption from Section 22(d) of the 1940 Act provided by Rule 6c-10(c) to state that the fund has made this election; and eliminate existing Item 28(m) of Form N-1A, which requires a registered fund to attach its Rule 12b-1 plan and any related agreements as an exhibit to its registration statement.

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

Effect on Funds of Funds

Proposed provisions in both Rule 12b-2 and Rule 6c-10 would restrict the layering of marketing and service fees and ongoing sales charges when one fund (the "acquiring fund") invests in shares of another (the "acquired fund").

Marketing and service fees. Proposed Rule 12b-2 would permit both an acquiring fund and an acquired fund in a fund-of-funds arrangement to charge a marketing and service fee, as long as the total of the fees charged by the funds together does not exceed the NASD service fee limit, currently 0.25 percent annually. Thus, under proposed Rule 12b-2(b)(2), if an acquiring fund deducts a marketing and service fee of 0.1 percent annually, it would be limited to investing in other funds that deduct a marketing and service fee of no more than 0.15 percent annually.

Ongoing sales charge. Under proposed Rule 6c-10(b)(1)(iv), an acquiring fund and an acquired fund could not *both* charge an ongoing sales charge. Rather, an acquiring fund that relies on the rule to deduct an ongoing sales charge could not acquire the securities of another fund that imposed an ongoing sales charge. An acquiring fund that did not charge an ongoing sales charge would not be subject to this restriction and would therefore be free to invest in funds imposing an ongoing sales charge. An acquiring fund would determine its ongoing sales charge as the amount it deducts from fund assets in excess of *its* marketing and service fee, without regard to any acquired fund's marketing and service fee.[11]

Effect on Funds Underlying Separate Accounts

Funds that serve as investment vehicles for insurance company separate accounts that offer variable annuities or life insurance contracts would be treated like other mutual funds and the proposed rule and rule amendments would apply. Thus, an underlying fund could charge a marketing and service fee up to the NASD sales charge rule limit on service fees. Asset-based distribution fees in excess of the marketing and service fee would be deemed ongoing sales charges and subject to the requirements of the proposed amendments to Rule 6c-10. Like other mutual funds, in order to impose an ongoing sales charge under proposed Rule 6c-10(b), an underlying fund (or the insurance company sponsor) would have to keep track of share lots attributable to contract owner purchase payments, and provide for the automatic conversion of shares by the end of the conversion period. If an insurance company separate account currently does not track and age shares, insurance companies would either have to develop this capability or offer only shares of classes that do not impose an ongoing sales charge.

Effect on Retirement Plans

Many investors invest in mutual funds through tax-advantaged retirement plans, such as 401(k) plans. Plan administrators provide plans and plan participants with a variety of services, including recordkeeping, sub-accounting, transaction processing, account maintenance services and participant education, for which they are compensated by the fund. Some funds use fund assets to

compensate plan administrators, while others make payments to plan administrators and financial intermediaries pursuant to a Rule 12b-1 plan.

Ongoing sales charge. Some funds with 12b-1 fees in excess of 0.25 percent will be required to treat a portion of their 12b-1 fee as an ongoing sales charge and provide for a conversion period. If a plan administrator currently does not track and age shares, it would have to either develop this capability or offer only classes of shares that do not impose an ongoing sales charge, i.e., classes of shares that carry an asset-based distribution fee of 0.25 percent or less.

Class R shares. Class R shares are created especially for retirement plans and typically carry a 12b-1 fee of 0.5 percent to 1 percent that generates sufficient revenue to pay for a substantial amount of plan expenses. Treating amounts deducted in excess of 0.25 percent as an ongoing sales charge and eventually converting these shares may not be a viable option for retirement plans with Class R shares because plan expenses are ongoing. The proposed rules, therefore, could make Class R shares a less attractive investment option for plans to offer.

TRANSITION AND GRANDFATHERING

Compliance date and transition period. The SEC expects an effective date within 60 days of issuing a release adopting the proposed amendments and a compliance period of at least 18 months after the effective date in the adopting release for funds to come into compliance with Rule 12b-2, amended Rule 6c-10 and the other amendments, for new shares sold.

For funds that decide to convert current 12b-1 share classes to conform to the proposed rules, proposed Rule 12b-2 would prohibit a fund from instituting a marketing and service fee unless the fee has been approved by a vote of at least a majority of outstanding voting securities. However, a shareholder vote would not be required if the fund currently deducts from fund assets annual 12b-1 fees of 0.25 percent or less and does not increase the rate of the fee; or reduces the amount of the 12b-1 fees it currently deducts to an annual rate of 0.25 percent or less and renames the 12b-1 fee a "marketing and service fee." Proposed Rule 12b-2 also would not require funds that currently impose a 12b-1 fee to obtain shareholder approval if the combined ongoing sales charge and marketing and service fee would not exceed amounts that could be deducted under a 12b-1 plan in effect at the time the proposed amendments, if adopted, become effective. In those instances, funds only would be required to separate the 12b-1 fee into a marketing and service fee and an ongoing sales charge and treat each fee in conformity with the new rule and rule amendments.

Grandfathering period. The proposal includes a "five-year grandfathering period." Funds would be required to comply with the changes discussed above with respect to all shares issued after the compliance date of the new rules. The SEC would provide a five-year grandfathering period after the compliance date for share classes issued prior to the compliance date that deduct fees pursuant to Rule 12b-1 as it exists today. During the grandfathering period, funds could continue to charge 12b-1 fees on grandfathered share classes at the same (or a lower) rate as was approved in the fund's 12b-1 plan. A fund that wants to increase the rate of distribution fees would have to comply

with the proposed new rules. During the grandfathering period, boards may eliminate the mandatory provisions of 12b-1 plans that require board annual approval and quarterly reports, and that allow for board or shareholder termination of plans. A fund's board, however, would continue to oversee the 12b-1 plan and could terminate the plan at any time. New sales would not be permitted in grandfathered share classes after the compliance date of the new rules.

At the expiration of the grandfathering period, grandfathered shares would be required to be converted or exchanged into a class that does not deduct an ongoing sales charge. Because under Rule 12b-1 and proposed Rule 12b-2 a shareholder vote is required to materially increase the rate of a 12b-1 fee, the marketing and service fee of the class that the grandfathered shares are exchanged or converted into cannot be not be higher than the 12b-1 fee charged on the shares in the last fiscal year. This requirement is designed to ensure that shareholders are not transitioned into a class that charges higher asset-based distribution fees than they agreed to when they originally bought the fund.

AMENDMENTS TO OTHER 1940 ACT RULES

Rule 11a-3. Proposed amendments to Rule 6c-10 would treat traditional sales loads and the ongoing sales charge similarly. Accordingly, the SEC proposes two changes to Rule 11a-3 under the 1940 Act.

- *Credit for ongoing sales charges paid.* In order to ensure that shareholders are credited for all sales charges previously paid in connection with a purchase of fund shares, the SEC proposes amending Rule 11a-3(b)(4) under the 1940 Act to require funds to also give shareholders credit for the payment of ongoing sales charges.
- *Deferred sales loads upon exchange.* The proposed amendments would modify the "tolling" provision of Rule 11a-3 to permit funds, in determining the amount of deferred sales load due upon ultimate redemption, to provide credit only for the sales charge component of any asset-based distribution fee, i.e., the ongoing sales charge. Because the marketing and service fee is not considered to be an alternative sales charge, a fund would not be required to give credit for such fees when determining the sales load payable upon an exchange. In addition, the proposed amendment would modify Rule 11a-3 to clarify that a fund must provide credit for ongoing sales charges in terms of the cumulative *rate* of the ongoing sales charge previously paid rather than the *amount* of fees paid.

Rule 17a-8. Rule 17a-8 allows for affiliated funds to merge in the absence of a shareholder vote, if, among other conditions, the 12b-1 fees of the surviving company are no greater than the 12b-1 fees of the merging company. The proposed amendments would preserve this protection by amending Rule 17a-8 to replace references to Rule 12b-1 with references to Rule 12b-2(b) or (d) and Rule 6c-10(b).

Rule 17d-3. When the SEC adopted Rule 12b-1 in 1980, it also adopted Rule 17d-3, which grants an exemption for funds to enter into agreements with certain affiliated persons and the fund's principal underwriter in connection with the distribution of its shares, provided that such an

agreement is in compliance with Rule 12b-1, among other requirements. The proposed amendments would revise Rule 17d-3(a) to replace the reference to 12b-1 with references to Rule 12b-2(b), Rule 12b-2(d) and Rule 6c-10(b) in order to permit a fund to enter into an asset-based distribution fee arrangement with an affiliated underwriter.

Rule 18f-3. Rule 18f-3 permits funds to offer multiple classes of fund shares. Section (f) of the rule permits funds to convert shares of one class to shares of another class after a specified period of time, provided that, among other things, the expenses (including 12b-1 fees) charged to the converted class are no higher than the expenses of the original share class. Under the proposed amendments, funds will still be able to convert shares under the same conditions. The SEC believes that expenses attributable to proposed Rule 12b-2 and proposed amendments to Rule 6c-10 should be taken into account when making these conversions, much like Rule 12b-1 expenses are today. Therefore, the proposed amendments would amend Rule 18f-3(f)(ii) to delete the reference to 12b-1 fees and replace it with references to fees under Rule 12b-2(b), Rule 12b-2(d) and Rule 6c-10(b).

FOR MORE INFORMATION

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[1] *Mutual Fund Distribution Fees; Confirmations*, Release Nos. 33-9128, 34-62544 and IC-29367 (July 21, 2010), available at http://www.sec.gov/rules/proposed/2010/33-9128.pdf.

[2] Section (h) of Rule 12b-1 would be preserved as Rule 12b-2(c).

[3] As a form of deferred sales load, all payments of ongoing sales charges to intermediaries would constitute transaction-based compensation. Intermediaries receiving those payments thus would need to register as broker-dealers under Section 15 of the Exchange Act unless they can avail themselves of an exception or exemption from registration. Marketing and service fees paid to an intermediary may similarly require the intermediary to register under the Exchange Act.

[4] The sum of the rates of any sales load (including a deferred sales load) incurred in connection with the purchase of fund shares and any sales loads or ongoing sales charges previously paid with respect to an exchanged security within the same group of investment companies would be deducted from this amount.

[5] The SEC provides the following example. If a fund has Class A shares with a 6 percent front-end sales load, the fund could pay as much as 6 percent in total ongoing sales charges in Class B shares. If another class of shares charges a front-end sales load of, for example, 2 percent, a total ongoing sales charge of as much as 4 percent could also be charged (6 percent minus the 2 percent front-end load) with respect to that class.

[6] In the case of shares exchanged within the same group of investment companies, the highest applicable sales load rate of the acquired security or the exchanged security is used to calculate the maximum sales load.

[7] The maximum number of months in a conversion period is determined by dividing the shareholder's maximum sales load rate by the ongoing sales charge rate and multiplying the result by 12.

[8] Proposed Rule 6c-10(c). Proposed Rule 6c-10 exempts funds from the retail price maintenance requirements of Section 22(d) of the 1940 Act.

[9] Proposed Rule 12b-2(b)(3). Because the proposal would eliminate the need for a distribution plan as currently required by Rule 12b-1, the disclosure required in Item 22(d) of Schedule 14A is no longer relevant. Therefore, the SEC proposes to amend Item 22(d) of Schedule 14A, as well as replace the term "distribution plan" used in Schedule 14A with the new defined term "Marketing and Service Fee."

[10] Proposed Rule 6c-10(b)(3).

[11] Proposed Rule 6c-10(d)(11).