May 21, 2004

VIA EMAIL

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Request for Comments on Proposed Rule: Prohibition on the Use of Brokerage Commissions to Finance Distribution
File No. S7-09-04

Dear Mr. Katz:

The Financial Services Group of Dechert LLP is pleased to have the opportunity to comment on the Commission's proposed amendments to Rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act"), and related requests for comments as set forth in Investment Company Act Rel. No. 226356 (Feb. 24, 2004) (the "Release").

Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and worldwide. Among these are U.S. registered open-end and closed-end funds, investment advisers and independent directors of funds. In developing these comments, we have drawn on our long experience in the investment management industry, while being most mindful of the interests of fund shareholders. Although we have discussed the matters addressed in the Release with some of our clients, the comments that follow reflect our own views, and not necessarily those of any client of the firm.

We applaud the Commission's continuing efforts to protect investors in mutual funds and combat potential conflicts of interest that may arise in connection with investment company operations. The Release sets forth a very thorough, thoughtful discussion of the many complex issues that have arisen under Rule 12b-1 since its adoption in 1980.

We believe that the proposed amendment of Rule 12b-1 to prohibit the use of fund portfolio brokerage, or related remuneration, to compensate a broker or dealer for the promotion or sale of fund shares is unduly restrictive. While this practice raises potential conflicts of interest, those conflicts are similar to those raised by any use of fund assets to pay for services that are primarily intended to result in the sale of fund shares, and can be addressed effectively in a comparable manner. In addition, we offer our views on certain aspects of the requests for comments on further proposed amendments to, or abolition of, Rule 12b-1.

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I. Proposed Ban on Use of Brokerage for Distribution

In connection with the proposed amendments to Rule 12b-1, the Commission asked for input regarding the existence of alternatives to an outright ban on the use of brokerage to finance distribution-related activities. Such an alternative already exists, and is used by a number of fund companies with the knowledge and acquiescence of the Commission staff. Many fund companies have implemented Rule 12b-1 plans that authorize the use of recaptured brokerage commissions, or credits derived from brokerage transactions, to pay for services that are primarily intended to result in the sale of fund shares.[1] Accordingly, we recommend that the proposed amendment to Rule 12b-1 be modified to prohibit use of fund portfolio brokerage, or related remuneration, to finance distribution-related activities unless done in accordance with a plan adopted under Rule 12b-1.

The Commission correctly notes that fund portfolio brokerage is a fund asset that, subject to the terms of Section 28(e) of the Securities Exchange Act of 1934, as amended, generally must be used for the benefit of the fund generating the brokerage. Use of fund assets to pay for distribution-related activities pursuant to a Rule 12b-1 plan is a well-established use of fund assets to benefit the fund. There are no inherent conflicts between the nature of fund brokerage (*i.e.*, a fund asset) and its use to finance distribution that would not be adequately dealt with by subjecting the arrangement to Rule 12b-1. These conflicts are not "unmanageable"; rather, they should be addressed in the same manner as the inherent conflicts of interest that may be deemed to arise in connection with use of "hard" fund assets to pay for distribution-related activities.

Rule 12b-1 was specifically designed to address these conflicts, which a number of registrants have recognized. While the provisions of so-called "brokerage enhancement" Rule 12b-1 plans vary, the plans generally authorize the direction of brokerage transactions, subject to the adviser's best execution obligations, to a broker-dealer that has agreed to revert a portion of a fund's brokerage commissions, or some type of "credit", to the fund or its distributor. The recaptured brokerage commissions or credits then are used in accordance with the terms of the plan to pay for distribution-related services or shareholder services of the type commonly paid for under Rule 12b-1 plans.

Operation of such a plan should not be deemed to entail unmanageable conflicts. Authorization of an investment adviser to allocate brokerage to a broker-dealer that has agreed to give up a portion of the commission in no way relieves the adviser of its best execution responsibilities.[2] Accordingly, there is no reason to conclude that such a plan will inherently result in payment of higher brokerage commissions. Further, unlike many of the situations described in the Release, operation of this type of Rule 12b-1 plan would be subject to explicit disclosure obligations, as Form N-1A requires disclosure about the operation of Rule 12b-1 plans, including fee table disclosure regarding the costs associated

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1 An early example of such a plan is discussed at length in the definitive proxy statement of Endeavor Series Trust (File No. 811-5780) (Jan. 22, 1998).

2 *E.g.*, Investment Company Act Rel. No. 20472 (Aug. 11, 1994) and Securities Exchange Act Rel. No. 23170 (Apr. 23, 1986).

with a Rule 12b-1 plan. Further, use of brokerage in this way would afford fund boards and shareholders with the benefits of the procedural and substantive protections of Rule 12b-1. A fund board, including a majority of trustees/directors who are not interested persons of the fund and who have no direct or indirect financial interest in the plan, must initially approve the plan after determining, consistent with the board members' fiduciary obligations, that the plan is reasonably likely to benefit the fund and its shareholders. The board must review expenditures under the plan on a quarterly basis, and reapprove the plan on an annual basis. Further, if implemented after commencement of a fund's operations, a plan must be approved by shareholders via proxy materials that are subject to Commission staff review. Accordingly, there is a well-defined process for supervision of the use of fund brokerage in this manner, as long as it is done within the context of a Rule 12b-1 plan. In addition, use of fund brokerage to further distribution of a fund within the constraints of a Rule 12b-1 plan would also permit the implementation of a structure that addresses the concerns that may be deemed to arise under Section 17(e)(1) of the 1940 Act in connection with this use of fund assets.[3]

Fund brokerage is, in many respects, comparable to other fund assets that, consistent with the terms of Rule 12b-1, may be used for distribution-related services. The Commission has recognized that, subject to board oversight and appropriate disclosure, fund brokerage can be used to pay for services that a fund otherwise would pay for with "hard" assets.[4] We believe that fund boards, and Rule 12b-1, have sufficient credibility to oversee use of fund brokerage to pay for distribution-related services, and believe that the Commission has overreacted to the abuses that may have occurred.

II. General Requests for Comments

The Release solicited comments on a variety of topics relevant to Rule 12b-1 plans. In particular, the Release requested comments on whether the Commission should propose to rescind the rule, and whether Rule 12b-1 plan fees should be assessed by redemption of fund shares held in individual investor accounts. We strongly believe that neither approach is desirable. Rule 12b-1 continues to play an important role in providing consumers with choices regarding how they pay for distribution. Flexibility of this type has proven to be valuable to both consumers and the securities industry. We believe that the Release greatly overestimates the benefit of the shareholder account-based approach to distribution payments, while underestimating the benefits derived from the ability to pay for distribution over time through a Rule 12b-1 plan. Further, such an approach likely would have adverse

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3 Recapture of fund brokerage for use by the fund's distributor in obtaining distribution-related services that benefit the fund generating the brokerage generally should not be deemed to result in the "compensation" of a fund affiliate (or an affiliate of such an affiliate) "for" the purchase or sale of "property" by or to the fund, within the meaning of Section 17(e)(1). *See*, *e.g.*, *Decker v. Securities and Exchange Commission*, 631 F.2d 1380 (10th Cir. 1980) and *Letter to American Council of Life Insurance, the Investment Company Institute and the National Association of Variable Annuities* (pub. avail. May 30, 1996).

4 *E.g.*, Investment Company Act Rel. No. 21221 (July 21, 1995) (adopting rule and form amendments relating to directed brokerage arrangements).

consequences for long-term investors, including added complexity and costs, as well as adverse tax effects.

A. Fostering Investor Choice

Prior to the adoption of Rule 12b-1 in 1980, funds were not permitted to charge asset-based fees to finance activities performed in connection with the distribution of their shares. Since the adoption of Rule 12b-1, many retail fund groups have adopted multi-class structures to provide shareholders with a variety of options with respect to the payment of distribution expenses. While most retail mutual funds continue to offer shareholders the option to pay for distribution-related expenses primarily through a front-end sales load, many investors prefer not to pay front-end sales loads. While some of these investors may invest through direct distributed no-load funds, others prefer to purchase funds through a financial intermediary, which reasonably expects to be compensated for its assistance with the purchase. To serve this latter group, many funds also offer arrangements that allow shareholders to pay distribution-related expenses over time through Rule 12b-1 fees, often in conjunction with contingent deferred sales charges. Shareholders who invest in these types of funds are able to avoid the payment of a front-end sales charge, with the related advantage of having a larger initial amount invested in the fund. Further, through multi-class arrangements permitted by Rule 18f-3, investors have an array of choices as to how, and when, they wish to pay distribution-related expenses, including Rule 12b-1 fees, with respect to particular funds and investment managers. We strongly believe that funds and investors should continue to be given choices regarding how they wish to pay for distribution, rather than the necessarily more limited array of options that would result from a rescission of Rule 12b-1, or the rigidity of a shareholder account-based approach to assessing distribution payments.[5] Instead of a limitation or abolition of choices, we support Commission efforts to ensure that investor choices are made on the basis of fully-disclosed, clear information.[6]

B. How Rule 12b-1 is Used by the Industry

As recognized by the Commission in the Release, Rule 12b-1 has had a profound effect on how funds are distributed. As noted previously, prior to the adoption of Rule 12b-1, investors paid distribution-related expenses through front-end sales loads, which generally were not subject to regulatory restrictions.[7] According to a recent study published by the

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5 We also note that abolition of Rule 12b-1 may reduce not only shareholder choice in terms of paying for distribution, but also may reduce investor choice in terms of investment management firms that make their services available via funds on a retail basis, as abolition may significantly disadvantage firms that do not have captive sales forces.

6 In this regard, the Commission's "point of sale" disclosure proposals should significantly enhance investor understanding of the impact of Rule 12b-1 fee payments. *See* Securities Exchange Act Rel. No. 49148 (Jan. 29, 2004).

7 NASD Conduct Rule 2830 now effectively limits mutual fund sales loads (including front-end and contingent deferred sales charges) to 8.50% of the fund's offering price, for funds

Investment Company Institute ("ICI"), when Rule 12b-1 was adopted in 1980, approximately 60% of mutual funds charging front-end sales loads charged a maximum sales load of 8.00% or more, and the average maximum front-end sales load was 7.40%.[8] By 2001, less than 1% of mutual funds charging a front-end sales load charged maximum sales loads of 8.00% or more, and the average maximum front-end sales load was 4.90%.[9]

This downward trend in front-end sales loads is attributable, at least in part, to increased competition for investor assets (which is fostered by the availability of alternative distribution cost structures), and a shift of the costs of distribution away from one-time sales charges to ongoing fees paid under Rule 12b-1 plans. For example, while front-end sales loads constituted 100% of distribution-related costs borne by investors prior to the adoption of Rule 12b-1 in 1980, by 2001, Rule 12b-1 fees constituted an estimated 48% of the distribution-related costs of equity funds that charged sales loads (front-end, contingent deferred or a combination thereof) and 49% of the distribution-related costs of bond funds that charged sales loads (front-end, contingent deferred or a combination thereof).[10]

Another relevant development is a shift in how Rule 12b-1 fees are used. The bulk of Rule 12b-1 fees currently are not used to pay marketing expenses for the sale of shares to new investors, but rather to pay distributors and brokers who sell or have already sold fund shares and persons who provide ongoing services to existing shareholders. A 1999 ICI study, cited by the ICI Study discussed above, stated that, based on survey data at the time, only about 5% of revenues from Rule 12b-1 fees were being spent for marketing efforts, with 63% used to compensate broker-dealers (including reimbursements to the fund distributor for financing charges arising from advances to broker-dealers for the sale of fund shares) and the remaining 32% for servicing activities.[11]

The use of Rule 12b-1 plans has occasioned a significant shift in how retail mutual fund investors pay for distribution-related expenses. As a result, such investors now typically pay much lower sales loads (front-end, contingent deferred or a combination thereof) in connection with their investments, and instead pay a larger portion of distribution-related expenses on an ongoing basis through Rule 12b-1 fees. Moreover, the purposes for which the payments are made is now generally focused more on compensation for past sales efforts (and related advancements by fund distributors of commissions in connection with

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that do not impose asset-based sales charges. Lower maximums apply to funds imposing Rule 12b-1 fees.

8 Brian K. Reid and John D. Rea, *Mutual Fund Distribution Channels and Distribution Costs*, INVESTMENT COMPANY INSTITUTE PERSPECTIVE, Vol. 9, No. 3, at 17 (July 2003) ("ICI Study").

9 *Id*.

10 *Id*. at 16-18.

11 *Id*. at 19.

the same) and ongoing services for existing shareholders, rather than on new marketing or sales efforts.[12]

Furthermore, the Commission staff has long been aware of this shift in how distribution expenses are paid by investors. In July of 1993, FORBES magazine published an article criticizing, among other practices, the payment of Rule 12b-1 fees by closed funds.[13] In response to this article, Representative John D. Dingell, Chairman of the House Committee on Energy and Commerce, asked the Commission's Acting Chairman to "have someone look into this matter" and advise the Committee as to "what the Commission is doing to monitor this area and whether [the Commission has] taken or intend[s] to take any enforcement action or to revise rule 12b-1."[14]

On August 19, 1993, then-Chairman Arthur Levitt responded to Representative Dingell with a memorandum, authored by the staff of the Commission's Division of Investment Management, specifically addressing the propriety of continuing Rule 12b-1 payments by closed funds ("Commission Memo"). In the Commission Memo, the staff noted that "even if a fund closes to new investors, it may continue to pay 12b-1 fees in order to compensate the distributor for past distribution efforts" because "Rule 12b-1 permits a fund to spread its distribution expenses over several years and allows payment of fees for past distribution services."[15] In the Commission Memo, the staff noted that NASD Conduct Rule 2830 was a response to the Commission's 1988 proposal to limit the use of Rule 12b-1 fees for payment of past distribution expenses, and that the Commission had taken no further action on this proposal, relying on NASD Conduct Rule 2830 to "deter excessive 12b-1 sales charges."[16]

We believe that the Release overestimated the benefits of a shareholder-account based approach when it stated that "existing shareholders would not pay the costs of selling to new fund shareholders . . . ." As implemented by the industry, and as previously recognized by the Commission staff, Rule 12b-1 fees are far more commonly used to compensate brokers and others for past sales of shares and for services to existing shareholders. The NASD sales charge limitations, Commission staff pronouncements, and industry practice all lend support to this conclusion. Accordingly, the proposed change would not occasion any significant shift in how Rule 12b-1 plan assets already are used. Further, concerns about

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12 It is worthy of note that the abolition of Rule 12b-1, or a change to an account-based system of paying distribution costs, may significantly disrupt existing contractual relationships between distributors and brokers, as well as between distributors (and their affiliates) and financiers of so-called "B share financing" arrangements.

13 *See Night of the Living Fees,* FORBES, July 19, 1993, at 236. The article also criticized the practice of paying Rule 12b-1 fees to a dead broker's estate. *Id.*

14 Letter from Chairman John D. Dingell, Chairman of the House Committee on Energy and Commerce, to Mary L. Shapiro, Acting Chairman, Securities and Exchange Commission, July 21, 1993.

15 Commission Memo at 3.

16 *Id*.

payment by individual shareholders of an excessive share of distribution costs are already adequately addressed by NASD Conduct Rule 2830.

C. Additional Complexity and Costs, and Investor Confusion

Although the charges under a shareholder-account based approach to distribution payments would appear on monthly statements, as a practical matter the funds would need to redeem shares each month in a sufficient amount to pay the distribution related costs. The statement would also include any purchases of shares, other redemptions, dividend payments, and any reinvested dividends and would also reflect changes in the net asset value on a per share basis. Purchases of additional shares would result in additional distribution related fees on a going forward basis and the proceeds of redemptions (both requested redemptions and redemptions made to pay the distributions fees) would be reduced by a portion of the unpaid distribution fees (and carrying charge) that would vary based on the amount redeemed. The amount of distribution fees (and the carrying charge) that would appear on a specific monthly statement would also be impacted by the timing of purchases and redemptions. Additional complexity would result if the fund is also independently charging redemption fees on certain redeemed shares. In light of these factors, we believe that there would be substantial shareholder confusion and it would, as a practical matter, be difficult for a shareholder to determine the effect of the distribution fees on investment performance as compared to other factors.

A shareholder based distribution system would also result in increased costs to the funds that would result from an increase in the number of shareholder statements. Funds that do not currently send monthly statements would presumably need to do so in order to reflect the charges and the associated redemptions of shares. The redemptions of shares to pay the distribution fees (which could often involve relatively small amounts) would result in increased transfer agent fees. Further, the implementation of a shareholder based approach and the tracking of unpaid fees and carrying charges would also clearly involve significant additional costs.

D. Tax Consequences

A shareholder based approach would also result in significant tax disadvantages and complexities to shareholders. For example, redemptions of shares would result in the recognition of any gain on redeemed shares In contrast, any losses on redemptions may be disallowed under the "wash sale" rule if there is a purchase of shares in the fund within a period beginning 30 days before the redemption and ending 30 days after the redemption.[17]

The tax treatment of the distribution fee similarly would result in additional complexity to shareholders. If such charges are viewed as commissions, they would be reflected as a reduction of the amount realized on the redeemed shares to the extent that the charge is attributable to such redeemed shares, and any remaining amount would presumably be

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[17] *See* Section 1091 of the Internal Revenue Code of 1986, as amended (the "Code). Disallowed losses are generally added to the basis of the purchased shares that resulted in the application of the wash sale rule.

added to the tax basis of the remaining shares.[18] It would be extremely difficult for shareholders (and intermediaries) to keep track of the tax basis of both redeemed and retained shares, and this difficulty would be further magnified if there are additional purchases and redemptions and reinvested dividends. Having monthly redemptions to pay the fees would also necessitate dealing with the complexity of computing gains and reallocated basis for each monthly redemption.

E. Other Considerations

There would also be substantial difficulties in replacing Rule 12b-1 fees with any account-based system. Each shareholder who purchased shares, including those purchasing shares in classes that are charged Rule 12b-1 fees, did so based on the economic arrangement set forth in the prospectus at the time of such purchase. There are existing contracts between funds and distributors and contracts and arrangements with brokers and fund supermarkets and recipients of payments for servicing shareholders accounts. In some cases, the distributor has transferred the cash flow from future Rule 12b-1 fees in connection with financing and/or securitization transactions. It would not be either reasonable or practical for the Commission to attempt to, in effect, change these existing contractual and economic relationships especially with respect to existing shareholders in existing funds.

III. Conclusion

We wholeheartedly support the Commission's efforts to re-examine Rule 12b-1 and its relevance for today's marketplace. We believe that Rule 12b-1 continues to serve a useful and valuable function for mutual funds and mutual fund investors by fostering investor choice while subjecting use of fund assets for distribution-related services to significant board and regulatory scrutiny. As has been demonstrated during the approximately twenty-four years since its adoption, Rule 12b-1 can evolve to continue to serve the interests of both the industry and investors. We believe that Rule 12b-1 provides a framework for using a fund asset such as brokerage or related remuneration to enhance fund distribution in a manner that is consistent with the purposes of the rule and subject to appropriate oversight. Accordingly, we dispute that this use of brokerage poses "unmanageable" conflicts. In addition, we believe that the proposed shift to a shareholder account-based approach to distribution payments by redeeming fund shares offers little benefit to investors (which may be achievable by other means), while posing clear drawbacks.

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18 The tax treatment of the carrying charge is not certain. If it is viewed as an interest expense, the deductibility by individual shareholders would generally be limited under the investment interest limitations under Section 163(d) of the Code. Any portion of the fee that may not be viewed as a commission may also be subject to limitations on deductibility for "miscellaneous itemized deductions" under Section 67(c) of the Code. Funds are now generally able to deduct fund expenses, including Rule 12b-1 fees, with a resulting reduction in the amount of taxable distributions to shareholders. *See* Rev. Rul. 94-70, 1994-2 C.B. 17.

We appreciate the opportunity to comment on the Commission's proposed rule amendments.

Sincerely,

Dechert LLP