FPA
THE FINANCIAL PLANNING ASSOCIATION

FPA Government Relations Office
1615 L Street, N.W., Suite 650
Washington, D.C. 20036
Voice: 202.626.8770
Fax: 202.626.8233

E-mail: fpa@fpanet.org
Web site: www.fpanet.org

By Electronic Mail

May 10, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth St., N.W.
Washington, D.C. 20549-0609

Re: Release No. IC-26356; File No. S7-09-04; Proposed Rule: Prohibition on the Use of Brokerage Commissions to Finance Distribution

Dear Mr. Katz:

The Financial Planning Association ("FPA™")[1] is pleased to submit comments with respect to the SEC's proposed prohibition of directed brokerage arrangements to finance distribution of mutual fund shares and other measures to enhance disclosure of 12b-1 fees.

A. The Role of Financial Planners

Making recommendations to clients or assisting clients in their own research concerning the selection of suitable investments from the more than 15,900 mutual funds currently available constitutes a major part of the professional services offered by many FPA members. In order to create investment portfolios that assist a client in reaching personal and financial goals, this intermediary function between the mutual fund companies and the investing public requires that financial planners have access to timely and accurate information.

Registered investment advisers are subject to disclosure and fiduciary standards of the Investment Advisers Act of 1940, offering a consistent "flow through" of protections to clients holding mutual fund shares. We note that most FPA members are affiliated with

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[1] The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms, with approximately 28,000 individual members. Most are affiliated with registered investment adviser firms registered with the Securities and Exchange Commission ("SEC" or "Commission"), state securities administrators, or both. FPA maintains an advocacy office in Washington, DC and has its headquarters in Denver.

investment advisory firms and are also subject to the professional standards of the *CFP Code of Ethics and Professional Responsibility*.[2]

Full disclosure is a critical expression of FPA's core values. Rule 704 of the *CFP Code of Ethics* requires CFP® practitioners to undertake a "reasonable investigation regarding the financial products recommended to clients."[3] Improved disclosure would greatly assist financial planners in evaluating fund options for their clients and in satisfying the general requirements of Rule 704. Similarly, Rule 201 of the *Code of Ethics* requires CFP practitioners to "exercise reasonable and prudent professional judgment in providing professional services."

B. Proposed Prohibition of Directed Brokerage

The Commission is proposing amendments to Rule 12b-1 under the Investment Company Act of 1940 to prohibit funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage commissions to that broker. The proposed rule would also prohibit so-called "step-out" and similar arrangements designed to compensate selling brokers for selling fund shares.

We share the SEC's concerns that the conflicts of interest that surround the use of brokerage commissions to finance distribution are harmful to fund shareholders and fully support this portion of the Commission's proposal.

C. 12b-1 Fees

The Commission has also expressed concern that "the current practice of using 12b-1 fees as a substitute for a sales load is a substantial departure from the use of the rule envisioned by the Commission when we adopted the rule in l980" and is seeking comment on whether Rule 12b-1 should be amended "to provide that funds deduct distribution-related costs

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2 The *CFP Code of Ethics and Professional Responsibility ("Code of Ethics")* requires disclosure of material information relevant to the professional relationship, "Rules that Relate to the Principle of Fairness," rules 401(a) and (b), at 9-10. CFP® certificants also must "act in the interest of the client," "Rules that Relate to the Principle of Objectivity," Rule 202, at 9.

CFP®, CERTIFIED FINANCIAL PLANNER™ and the federally registered CFP (with flame logo) are certification marks owned by the Certified Financial Planner Board of Standards, Inc. These marks are awarded to individuals who successfully complete the CFP Board's initial and ongoing certification requirements. A subsidiary Board of Professional Review is responsible for disciplinary actions resulting from violations of the *Code of Ethics.*

3 *Code of Ethics,* "Rules that Relate to the Principle of Diligence," Rule 704, at 14.

directly from shareholder accounts rather than from fund assets" to enhance the transparency of these fees.[4]

The proposal would, in essence, shift 12b-1 fees that are paid to broker-dealers and investment advisers from being an asset-based charge to a direct deduction from a shareholder's account. Under the SEC proposal, an investor would pay the fees -- likely by redeeming fund shares -- and be shown the dollar amount of the payment on the investor's quarterly statements.

For the reasons discussed below, the FPA has grave reservations about this approach.

-Background 12b-1 Fees

Prior to Rule 12b-1, broker-dealers and registered investment advisers were compensated for their services by a one-time, upfront sales commission or "load" paid by investors when they purchased mutual fund shares. Rule 12b-1, adopted by the SEC in 1980, gave shareholders the option to pay for the service they receive from broker-dealers and investment advisers over time rather than in a single upfront payment.

This expansion of distribution payment options made mutual funds more attractive to middle income investors by giving them choices about whether to pay for advice and assistance upfront or over time.

-Uses of 12b-1 Fees Vary Widely

12b-1 fees are used to compensate investment advisers for their ongoing work and spread out the cost over the holding period rather than imposing the entire expense at the time the investment is made. These fees compensate investment advisers for services including ongoing investment advice, phone counseling, and reviewing investment strategies in a way that may be less expensive to investors than alternative fee arrangements.[5]

-Narrow Focus on 12b-1 Fees Likely to Mislead Investors

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[4] Prohibition on the Use of Brokerage Commissions to Finance Distribution, 69 Fed. Reg. 40, 9726 (Mar. 1, 2004) (to be codified at 17 C.F.R. pt. 270).

[5] According to an Investment Company Institute survey, the most common use of 12b-1 fees is covering the costs of compensating broker-dealers for the sale of fund shares and related expenses, followed by paying for expenses associated with administrative services provided to existing shareholders by third parties, such as processing shareholder transactions and maintaining shareholder records. Only five percent of the fees are used to pay for advertising and other sales promotion activities. *See* Investment Company Institute, *Background Information About 12b-1 Fees*, available at http://www.ici.org/funds/abt/ref_12b1_fees.html (last modified February 2003).

This proposal does not take into account or help inform investors about either the recipient of the fees or whether they are being spent on custodians and other third party administrators, broker commissions, wholesaler compensation, shelf space, brochures, or the cost of required compliance reporting.

Indeed, we are deeply concerned that this proposal will lead to greater investor confusion about these fees. Investors may be led to believe that the entire fee flows directly to the broker-dealer or investment adviser who recommends the fund, whereas a significant portion of it may be going to a third party administrator or custodian.

By harshly illuminating 12b-1 fees with a laser-like beam, the approach suggested by the SEC is likely to shroud the context in which these fees appear. By directing disproportionate attention on 12b-1 fees, investors may lose sight of the more important issue, i.e. the total costs and expenses of the investment and the expense ratio.

We respectfully submit that it simply does not make sense to single out one expense and make it not only the sole item with a price tag, but also the only one to be funded through the sale of fund shares.

-Tax and Administrative Burden

In a footnote to the Proposal, the SEC acknowledges "the possibility that payment of loads through periodic automatic redemptions…may result in the shareholder realizing capital gains or losses."[6]

We are deeply concerned about the administrative and tax-related consequences referenced in this footnote. Any requirement that fees be deducted directly from investor accounts will lead to complicated tax liabilities for investors whose share will be automatically redeemed on a quarterly basis. Each of these transactions will also trigger recordkeeping requirements, further adding to an already considerable administrative burden.

-Disclosure of 12b-1 Fees

Under existing SEC requirements, all mutual fund fees and expenses are disclosed in a standardized fee table at the front of the fund's prospectus. If a fund has a 12b-1 fee, it will be clearly identified in the fee table as part of the fund's annual operating expenses which are deducted from fund assets before earnings are paid to shareholders. 12b-1 fees are also included in the annual operating expenses used for determining the funds' expense ratio.

The Commission recently adopted a proposal requiring mutual funds to disclose, in dollar terms, the amount of fees and expenses paid by their shareholders.[7] Under the final rules

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[6] Prohibition on the Use of Brokerage Commissions to Finance Distribution, 69 Fed. Reg. 40, 9726 n.63 (Mar. 1, 2004) (to be codified at 17 C.F.R. pt. 270).

adopted by the Commission, semi-annual shareholders reports will be required to include the cost in dollars associated with an investment of $1,000, based on the fund's actual expenses for the period. These reports will also include the cost in dollars, associated with an investment of $1,000, based on the fund's actual expense ratio for the period and an assumed return of 5 percent per year (to facilitate cross-fund comparisons).

FPA supported this change due to its long held the belief that mutual funds should be required to provide meaningful disclosure of the total costs and expenses associated with an investment in mutual fund shares. However, the effect of this change -- effective on May 10, 2004 -- has yet to be determined. We respectfully submit that any further consideration of the proposed approach be deferred until the effectiveness of the new regulation may be determined.

-Investors Unlikely to Benefit

Let there be no doubt, elimination of 12b-1 fees will not lead to lower fund expenses.

Were 12b-1 fees to be eliminated, whether directly or by the effect of the approach discussed above, there would be numerous unforeseen and unintended consequences. There are certain to be changes in the way investment advisers and broker-dealers provide ongoing assistance and advice to their mutual fund clients. In addition:

- Funds will be forced to charge larger front-end loads to cover broker commissions and the ongoing services provided by brokers;

- Investment advisers will be forced to shift to a different compensation model for ongoing investment planning assistance for mutual fund clients;

- Investors' choices will be limited when they are forced to cope with the elimination of multiple share classes;

- There may be a greater incidence of account transactions to generate front-end sales loads as a replacement for income lost from the elimination of 12b-1 fees; and

- Small investors are likely to receive less ongoing attention and service following their purchase of mutual fund shares.

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[7] Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities Act of 1933, Release No. 33-8393 (Feb 27, 2004).

While further efforts to educate investors and enhance disclosure about 12b-1 may be warranted -- and would likely be supported by FPA -- requiring that these fees alone be debited directly to shareholders accounts is unwarranted.

We would be pleased to provide additional information requested by the SEC. Please do not hesitate to call the undersigned at (202)626-8558.

Sincerely,

Neil A. Simon, Esq.
FPA Director of Government Relations