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May 10, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington DC 20549-0609

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

Dear Mr. Katz:

I am writing to you on behalf of Legg Mason, Inc. ("Legg Mason"), a holding company that, through its subsidiaries, is principally engaged in providing asset management, securities brokerage, investment banking and other related financial services to individuals, institutions, corporations, governments and government agencies. In our mutual funds business, we sponsor open-end and closed-end funds, including domestic and international equity funds, fixed-income funds and money market funds, which employ a variety of investment strategies. Legg Mason Wood Walker, Incorporated, our principal broker-dealer subsidiary, is a full service broker-dealer, investment adviser and investment banking firm. We appreciate the opportunity to comment on the proposed rule by the Securities and Exchange Commission (the "SEC") to prohibit the use of brokerage commissions to finance distribution, and on its request for comment on further amendments to Rule 12b-1 under the Investment Company Act of 1940.

Ban on Directed Brokerage

We support the SEC's proposed amendment to Rule 12b-1 to prohibit funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker, including through step out or similar arrangements. The Legg Mason Funds do not engage in directed brokerage arrangements and Legg Mason Wood Walker suspended acceptance of directed brokerage from distributors of all third party funds as of late 2003.

Restructuring Rule 12b-1

In response to the general request for comment on further amendments to Rule 12b-1, such as rescinding or refashioning the Rule, we support the SEC's efforts to re-examine the Rule in light of contemporary practices. However, we urge the SEC to proceed cautiously in its efforts to revise Rule 12b-1, due to the variety of fund company distribution structures in the marketplace. These differences in structure suggest that a "one size fits all" amendment to the Rule, or rescission of the Rule, may not be necessary or appropriate. At Legg Mason, we have developed a fund structure that is somewhat unique and may serve as an example worthy, perhaps, of some refinement, but certainly not rescission.

Since inception in 1982, Legg Mason Funds have offered a sole retail class of shares known as "Primary Shares." Legg Mason Funds do not offer "A" or "B" fund share classes. Although our Primary Shares have some common features of what many in the industry call "C" shares (*i.e.*, level load structure, asset-based charge), we have carefully designed our Primary Shares to align the interests of the Legg Mason Wood Walker brokers ("Financial Advisors") who sell our funds with those of our mutual fund shareholders by utilizing the Rule 12b-1 fee as a financial incentive for Financial Advisors to provide ongoing attention to shareholders' needs. Financial Advisors who sell our Primary Shares are not paid at the time of selling shares; rather, they are paid monthly based on the assets their clients held in that fund. By compensating a Financial Advisor over time, rather than upon the initial sale, we believe that Legg Mason's use of Primary Shares encourages Financial Advisors to consider the long-term goals of their customers and to provide ongoing attention and advice to existing fund shareholders. While we recognize the general perception that Rule 12b-1 fees are viewed by many as a surrogate for sales loads,[1] we note that Legg Mason's use of these fees is more related to compensation for ongoing service to fund shareholders rather than as a sales charge.

Our Financial Advisors provide a high level of service to fund shareholders by providing, among other things, asset allocation advice, rebalancing recommendations, economic and market commentary and retirement, college and other planning services, while also providing advice on a myriad of subjects (*e.g.*, refinancing) requested by the client. Our clients have an expectation that when they invest in our funds through a Legg Mason Financial Advisor, the end result is a long-term advisory relationship; our Financial Advisors also view that as their obligation to the fund shareholder. We believe that our Financial Advisors have helped Legg Mason Fund investors weather the occasional volatility that more than 20 years of our funds' history has brought and to enjoy the positive long-term returns that our mutual funds have been able to deliver. With a lower redemption rate than comparable funds, our Financial Advisors have worked hard to counsel fund shareholders in a manner consistent with their long-term best interests by advising shareholders to buy in weak markets and to capture profits in fully valued markets. Indeed, within days of the 1987 Crash, our fund shareholders benefited from their relationship with Legg Mason Financial Advisors. The Financial Advisors' advice at that time was that the Crash represented a long-term buying opportunity. Legg Mason Funds experienced

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1 *See* testimony of Paul F. Roye, Director, Division of Investment Management, SEC, before the Senate Committee on Banking, Housing and Urban Affairs (Mar. 10, 2004).

net inflows during that time, to the benefit of those shareholders. Likewise, during the post-Desert Storm/1990-91 recession period, when prices were quite attractive, we also had net inflows during a period when clients were quite defensive. Interestingly, during 2000, when the industry still had record net inflows and the market was very expensive, our largest and most successful funds had net outflows precisely because our Financial Advisors advised our shareholders about large capital gains we were taking after the great bull market. Such advice, which were detrimental to the Financial Advisors' short-term interests by resulting in net outflows, helped shareholders avoid unnecessary capital gains taxes and was consistent with the goal of the Primary Shares system to promote a long-term relationship.

We ask that the SEC carefully consider our Rule 12b-1 practices when evaluating any proposed amendments to the Rule and recognize that, contrary to the popular perception of Rule 12b-1 fees, these fees can be used to align the interests of investors and financial intermediaries. In cases in which fund companies use Rule 12b-1 fees to align fund shareholders' long-term interests with those of the financial intermediaries that sell fund shares, we propose that the SEC amplify the factors mutual fund directors are encouraged to consider in adopting Rule 12b-1 distribution plans[2] by including a discussion of how the manner of compensation to the financial intermediaries may best serve shareholders' long-term interests in providing advice and ongoing service.

Proposal to Deduct Rule 12b-1 Fees Directly from Shareholder Accounts

With respect to the proposal that funds deduct Rule 12b-1 fees directly from shareholder accounts, we caution that such deductions present (i) operational difficulties that would render this aspect of the proposal potentially more expensive to shareholders, (ii) unintended adverse tax consequences to fund shareholders and (iii) confusion for investors resulting from disaggregating these expenses from mutual fund expenses. We believe that better disclosure of fund expenses would achieve the SEC's objective of transparency, while preserving the proven efficiency and effectiveness of mutual funds as America's favorite savings vehicle.

Deduction of the Rule 12b-1 fee at the shareholder account level is, in our view, unnecessary and would be problematic for several reasons. At the retail and institutional level, Legg Mason has received minimal, if any, negative feedback from clients about the current practice of fee deductibility at the fund level. Today, our investors can simply look at the reported performance and know precisely what their actual performance net of all fees was. This is particularly important to retail investors. When our Financial Advisors explain the current fee system, the client has been satisfied that when they see our performance numbers they know it is what they actually earned, net of all fees. Our institutional clients are also well aware of fee structures and many prefer fees deducted from the fund rather than processing a separate check. Payment by an institution for fees at the account level may lead to increased costs and processing burdens.

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2 See Rule 12b-1 Adopting Release, "Bearing of Distribution Expenses by Mutual Funds," IC Rel. No. 11414 (Oct. 28, 1980).

Other significant operational issues also arise. Would the account level deduction be calculated in aggregate for all mutual fund positions, prorated according to the size of each Rule 12b-1 fee for each fund? Or, would a separate deduction for each fund be the norm? A system will also need to be built by fund companies to enter daily Rule 12b-1 accrual rates, so that Rule 12b-1 expenses can be accrued each day, and then deducted from shareholder accounts on a periodic basis. Prorations and other calculations for redemptions and exchanges would also be more complex. The additional transactions that this proposal could cause would add to client statement reporting, tax record keeping, and fund administrative expenses. The practical difficulties must be resolved, ultimately, at a cost to fund shareholders. We have estimated that the cost of complying with the proposed amendment to Rule 12b-1 to deduct the fee at the shareholder account level would be very significant.

We are also troubled that a deduction at the level of the fund shareholder may subject that shareholder to potential adverse tax consequences. To pay the Rule 12b-1 fee, a shareholder may realize taxable gains when a portion of his or her account is redeemed to pay the charge, which would not be part of a long-term shareholder's objectives when holding fund shares. In our view, this result would be wholly inconsistent with the SEC's recognition of the adverse effect that taxes can have on an investor's returns,[3] and is contrary to shareholders' best interests. In addition, the SEC is aware of the role of investor psychology in declining markets. Too often shareholders panic, which causes shortened holding periods that are detrimental to long-term results. During 2002, which ultimately turned out to be a buying opportunity in the equity markets, a fee redemption from the fund may have caused further redemptions by less sophisticated clients, harming long-term shareholders as well as those making the redemption. We fully support enhanced disclosure, but suggest to the SEC that the costs and psychological negatives outweigh the deduction proposal. Finally, disaggregation may be confusing and contribute to ill-advised investment decisions for less sophisticated investors who are not familiar with "wrap-account" protocols and price.

We thank you for the opportunity to be heard and again commend the SEC for its timely review of Rule 12b-1. If you would like to discuss our comments, or if you have any questions, please contact me or Mark Fetting, President, Legg Mason Funds, at (410) 454-3245.

Sincerely,

Raymond A. Mason
Chief Executive Officer
Legg Mason, Inc.

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[3] *See* Adopting Release, "Disclosure of Mutual Fund After-Tax Returns," Rel. No. IC-24832 (Jan. 18, 2001). "Recent estimates suggest that more than two and one-half percentage points of the average stock fund's total return is lost each year to taxes."

cc: Hon. William H. Donaldson
Chairman of the Securities and Exchange Commission

Hon. Paul Atkins
Commissioner

Hon. Roel Campos
Commissioner

Hon. Cynthia A. Glassman
Commissioner

Hon. Harvey Goldschmid
Commissioner

Division of Investment Management
Paul Roye
Director