Global Private Client Group

800 Scudders Mill Road – 3D
Plainsboro, New Jersey 08536
FAX 609 282 0817

Merrill Lynch

May 10, 2004

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

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

Ladies and Gentlemen:

Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") appreciates the opportunity to comment on the amendments and requests for comments relating to rule 12b-1 (the "Proposal") that the Securities and Exchange Commission (the "SEC" or "Commission") has proposed under the Investment Company Act of 1940 ("Investment Company Act").[1]

I. BACKGROUND

A. Merrill Lynch

Merrill Lynch is registered as a broker-dealer under Section 15 of the Securities Exchange Act of 1934, as amended (the "1934 Act"), and as an investment adviser under Section 203 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). In addition to offering Merrill Lynch proprietary funds, Merrill Lynch has selling agreements with approximately 140 fund companies and currently offers approximately 11,700 individual mutual fund share classes to its customers. Merrill Lynch has approximately 11.1 million customer positions in retail brokerage accounts that are invested in mutual funds and serves approximately 5.4 million additional retirement plan participants who have mutual fund investments. In 2002, Merrill Lynch executed over 130 million fund transactions (excluding money market transactions) for these customers. Currently, Merrill Lynch supports the transactions of over $300 billion in mutual fund assets. Merrill Lynch employs over 13,500 Financial Advisors who provide advice and guidance to Merrill Lynch clients relating to a variety of financial products and services, including mutual funds.

Merrill Lynch is a wholly owned subsidiary of Merrill Lynch & Co., Inc. ("ML&Co."), one of the world's largest financial services firms. Its affiliates include Financial Data Services, Inc. ("FDS"),

[1] Investment Company Act Release No. 26356 (Feb. 24, 2004); 69 Fed. Reg. 9726 (Mar. 1, 2004) ("Proposing Release").

a registered transfer agent that serves as the transfer agent for Merrill Lynch's proprietary mutual funds, and Merrill Lynch Investment Managers, the investment management unit of ML&Co.

B. Current Rule 12b-1 under the 1940 Act

Rule 12b-1 under the 1940 Act requires that any payments by a fund in connection with the distribution of its shares must be made in accordance with a written plan approved by its board of directors, including a majority of the independent directors. The plan must provide, among other things, that it may be terminated at any time by vote of a majority of the independent directors or a majority of the fund's outstanding voting securities. In addition, Rule 12b-1 requires that (1) a fund's board and independent directors annually approve the fund's 12b-1 plan so long as they determine that there is a reasonable likelihood that the plan will benefit the fund and its shareholders; (2) the directors quarterly review the amounts spent under the 12b-1 plan and the reasons for the expenditures; and (3) the board, the independent directors, and fund shareholders must approve any material increase in a fund's 12b-1 fee.

II. DISCUSSION

A. Proposed Prohibition on the Direction of Brokerage for Fund Sales

Pursuant to the Proposal, Rule 12b-1 would be amended to (1) prohibit a mutual fund from compensating a broker-dealer for promoting or selling the fund's shares by directing portfolio securities transactions to that broker or dealer; (2) prohibit a fund from engaging in so-called "step-out" and similar arrangements designed to compensate selling brokers for selling the fund's shares; and (3) provide that a mutual fund may not direct portfolio transactions to a selling broker-dealer unless it (or its investment adviser) has implemented certain policies and procedures. These policies and procedures are to be reasonably designed to prevent: (1) the persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities from considering broker-dealers' promotional or sales efforts in making those decisions, and (2) the fund, its adviser, or its principal underwriter from entering into any arrangement under which the fund directs brokerage transactions, or revenue generated by those transactions, to a broker-dealer to pay for the promotion or sale of the fund's shares.

We support the Commission's desire to eliminate practices that are detrimental to a fund and its shareholders. However, we do not agree that, consistent with current regulations, a fund adviser's consideration of fund sales as a single factor in determining which broker-dealer to direct portfolio brokerage "involves unmanageable conflicts of interest that may harm funds and fund shareholders." Therefore, we do not agree that an absolute prohibition on the consideration of fund sales as a factor in an investment adviser's decision to allocate brokerage to a broker-dealer is necessary to protect funds and their shareholders.

It appears that some of the practices described in the Proposing Release that the Commission believes to be problematic may not have been consistent with existing regulations. As an alternative, the Commission should consider (1) requiring enhanced disclosure relating to the direction of brokerage; (2) identifying the specific types of arrangements that would be improper; (3) requiring the fund board to review and adopt reasonable policies and procedures in directing brokerage for fund portfolio transactions specifically describing the circumstances in which the sale of fund shares may be considered; and (4) implement enhanced review and enforcement of existing regulations.

However, if the Commission determines to adopt a rule prohibiting the consideration of fund sales in any manner, it is critical that the amended rule clearly states that a fund would not be deemed to violate any prohibition on the direction of brokerage transactions solely by reason of having directed portfolio transactions to a broker-dealer that also offers the fund's shares. Without such a "safe harbor" provision, we believe that the rule would have unintended and anticompetitive implications. For example, a prohibition on the allocation of brokerage based on sales could have the potential to improperly discourage funds from using selling brokers for portfolio transactions because they would not need to affirmatively prove that sales of fund shares were not considered. This could result in funds not using the brokerage firm that could provide best execution, thus unintentionally harming fund shareholders. Adoption of a safe harbor would ensure that a fund's use of a selling broker-dealer to execute transactions in the fund's portfolio securities would not, in and of itself, subject the fund to potential liability. Such a safe harbor provision is consistent with the statements made by Division of Investment Management Director Paul Roye during the Commission's February 11, 2004 open meeting regarding the Proposed Rule. In his remarks, Mr. Roye specifically indicated that the rule was not intended to prevent the direction of fund portfolio transactions to broker-dealers who can provide best execution, simply because they distribute fund shares.

B. Further Amendments to Rule 12b-1

1. In General

The Proposing Release requests comment on whether the Commission should propose additional amendments to Rule 12b-1 or even propose to rescind the rule. While it may be appropriate to modify Rule 12b-1 in certain respects, we do not believe that Rule 12b-1 should be rescinded. We believe that any amendments should recognize a fund's continued ability to pay distribution-related expense through a Rule 12b-1 plan.

In connection with mutual funds made available through full service broker-dealers such as Merrill Lynch, customers typically pay sales charges that are intended, in substantial part, to compensate the broker-dealer and the client's financial advisor for the financial guidance and advice provided to the client. These charges may be assessed through (1) front-end sales charges that are deducted from amounts invested by the client, (2) back-end or contingent deferred sales charges that are deducted from the redemption proceeds, and/or (3) asset-based sales charges paid by the fund pursuant to a Rule 12b-1 plan.

We believe that Rule 12b-1 fees provide substantial benefits to mutual fund investors, particularly those that rely on the advice and guidance of a financial advisor. The most notable of these benefits is choice, i.e., the ability to purchase mutual fund shares without a front-end sales charge and to pay distribution costs over time and still receive the advice and guidance of a financial advisor.[2] Entities such as Merrill Lynch make available to their clients, the funds of many different fund

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[2] As discussed below, we believe that deducting asset-based distribution costs from shareholder accounts is not an adequate substitute for Rule 12b-1 fees in this regard.

families, allowing customers to select the fund that best meets their investment needs. Investors might desire to purchase mutual fund shares without a front-end sales charge for any number of reasons, including one or more of the following: (1) investors may desire that all of their initial monies be invested at the outset, rather than having the sales charge (potentially up to 8.5%) deducted at the time of investment, (2) payment of asset-based sales charges through Rule 12b-1 fees allows investors to more efficiently invest and reallocate their assets in more than one fund family's mutual funds, and (3) the customer may desire that their financial advisor is compensated on an asset-based arrangement rather than on a per transaction basis.

In addition, it appears that the costs of distribution has declined substantially since the introduction of Rule 12b-1.[3] While there are likely several competitive forces behind that decline, we believe that the available alternatives to both investors and funds provided by Rule 12b-1, have substantially contributed to those cost reductions to the benefit of shareholders.

Moreover, we believe that the existing regulatory structure governing distribution-related fees paid by funds is sufficient to address any potential abuses or conflicts of interest. As discussed above, Rule 12b-1 provides substantial safeguards relating to the adoption, ongoing oversight and amendment of any Rule 12b-1 plan and the fees paid pursuant thereto. These safeguards include shareholder, board and/or independent director review and approval. In addition, Form N-1A requires substantial disclosure in a fund's prospectus or statement of additional information relating to Rule 12b-1 fees. Moreover, Rule 2830 of the NASD Conduct Rules places limits on the maximum sales charges that may be placed on mutual fund share transactions, including those paid by a fund pursuant to a Rule 12b-1 plan. In particular, the rule identifies and imposes annual and cumulative limits on 12b-1 fees (described in the rule as "asset-based sales charges") that are designed to approximate the rule's limits on front-end sales charges.[4] The Rule also places limits on the front-end or deferred sales charges that may be imposed on a fund that pays asset-based sales charges or service fees.

2. Deducting Distribution Costs from Shareholder Accounts

The Proposing Release requests comment on whether the Commission should amend Rule 12b-1 to provide that funds deduct distribution-related costs directly from shareholder accounts rather than from fund assets. We believe that the costs and adverse impact on investors of replacing Rule12b-1 payments with such a requirement would outweigh any benefits, including the following:

The costs of creating and implementing the systems necessary to support the deduction of distribution-related costs directly from shareholder accounts would be significant for both mutual fund transfer agents and other intermediaries such as Merrill Lynch that process fund transactions. For example, Rule12b-1 fees currently are deducted from the fund in essentially one process at the fund level. Deducting distribution-related costs directly from shareholder accounts would require the daily calculation of individual distribution fees to shareholder customer specific lots and the processing of

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[3] *See* Investment Company Institute Study, "Mutual Fund Distribution Channels and Distribution Costs" (July 2003).

[4] *See* NASD Conduct Rule 2830(d). For example, the rule limits 12b-1 fees to a maximum of 1.0 percent of a fund's average net assets per year, which may include a service fee of up to 0.25 percent, and imposes a lifetime cap on 12b-1 fees that is based upon a percentage of fund sales.

individual fees to these specific transaction lots monthly (and daily in the case of redemptions). This process would increase the one calculation currently conducted by the fund to literally millions of calculations by the fund's transfer agent and other intermediaries. Modification of the systems and processes would include, but not be limited to, the following: application development, tax aggregation, tax reporting, trade corrections, funds transfer, client billing, transaction processing, margin, cash sweep, fund reconciliation, data history and retention, fund attribute database and commissions. These activities would burden shareholders with increased cost and undermines one of the key features that mutual fund investors find attractive: the pooling of many investors into one efficient, bundled investment vehicle.

In addition, we believe that there would be substantial adverse tax consequences and increased recordkeeping burdens for fund shareholders if distribution fees were deducted from shareholder accounts. The SEC staff itself has stated that the "tax law complications would make the method essentially impossible" and recognized that "installment loads likely would not be used without tax reform."[5]

Finally, the reporting of distribution fees deducted from shareholder accounts would be confusing to customers. For example, a separate calculation of a fee would need to be deducted for each fund purchase lot held in the account. For customer fund positions comprised of multiple purchase lots, those fees would need to be aggregated and charged to the customer's account, presumably on a monthly basis. This process would need to be repeated for each fund held in the customer's account. Thus, it would be extremely difficult for investors to fully understand the full nature and basis of the fees deducted from their account.

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We appreciate the opportunity to share our thoughts with the Commission regarding the proposed changes to Rule 12b-1 and look forward to working with the Commission with regard to these matters. We would be happy to discuss any issues relating to Rule 12b-1 with you at your convenience.

Sincerely,

William J. Rittling
First Vice President

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[5] Division of Investment Management, Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992), at 327, 329.