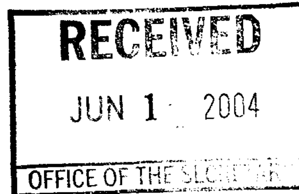

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May 10, 2004

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

Re: File No. S7-09-04

Dear Mr. Katz,

Securities America, Inc. is a broker-dealer located in Omaha, NE with over 1600 independent registered representatives throughout the United States. Mutual fund sales represent a large portion of the firm's business and we appreciate the opportunity to comment on File No. S7-09-04.

The Commission requested comment on, among several other issues, whether it should propose to rescind Rule 12b-1. An alternative approach on which the Commission expressed particular interest in receiving comments is whether the Commission should propose a refashioning of Rule 12b-1 to provide that funds deduct distribution-related costs directly from shareholder accounts rather than from fund assets. The purpose for our comment is to address these matters.

Although it has been suggested that such measures might be helpful to achieve heightened fee transparency, eliminating 12b-1 fees will likely do much more harm than good. Our firm is supportive of reasonable efforts to heighten the public's awareness of these fees. However, a wholesale elimination of 12b-1 fees would simply shift fees that investors pay towards higher front-end sales charges or other fees. This position is well supported by the 8% front-end sales loads that were traditionally charged to equity fund shareholders prior to 1980, and a recent study by Strategic Insight Mutual Fund Research and Consulting, which shows that 75% of all fund investors now choose to pay at least a portion of their fees over time, rather than at the initial purchase.[1]

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[1] Strategic Insight Overview, Mutual Fund Fees: Facts, Trends, Economies of Scale, and Market Forces, p. 8 (Jan. 2004); Investment Company Institute (hereinafter "ICI"), Fundamentals—The Cost of Buying and Owning Mutual Funds, Vol. 13, No. 1, p. 12, (Jan. 2004).

Background

As a preliminary matter, we are concerned that certain industry officials are suggesting that mutual fund expenses are "on the rise." In fact, just the opposite holds true today.[2]

Due to several widely publicized scandals involving late day trading and market timing abuses in funds, insider trading, directed brokering, etc., there is undoubtedly concern that funds have abandoned the interests of their clients.[3] As a result, substantial testimony by Representative Richard Baker and others has been rightfully devoted to these problems. However, these types of abuses are completely unrelated to the issue of whether 12b-1 fees are justified. Therefore, it would be a mistake to use these scandals as a rationale to completely overhaul the fundamental structure and economics of the fund industry, as some commentators have suggested.

Relevant Economic Factors and Trends in the Industry

The fund industry has evolved as a result of competitive forces and, on the whole, this evolution has been very beneficial to the investing public. In support, several studies conducted by the Investment Company Institute, the SEC, the GAO and others have shown that the overall cost of buying and owning funds has actually declined over time.[4]

Interestingly, the GAO report acknowledges that fund expenses have declined over the last decade. In its report, the GAO states that expense ratios among large equity mutual funds have decreased over the past 12 years.[5] Although the GAO found that there was a modest increase in expense ratios during the period of time between 1999 and 2001, the GAO also explains that the recent bear market caused fund assets to decrease, which, in turn, caused the temporary expense ratio increase.[6]

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[2] ICI, Recent Trends in the Cost of Fund Ownership, p. 1 (http://www.ici.info).

[3] Although certain regulators have asserted that the public's confidence has been shaken by the self-serving actions of fund executives and managers, a study by the Strategic Insight Mutual Fund Research Center shows that fund redemption patterns have changed very little from 1986 through the end of 2003. Notwithstanding the inception of Index Funds, and more recently Exchange Traded Funds as investment alternatives that offer less management, the fact that almost 90% of all fund investors have chosen actively-managed funds is additional support that the public's confidence may not be as shaken as has been represented by reform proponents. Strategic Insight Overview, supra note 1, p. 12-14.

[4] ICI, supra note 1, p. 2; U.S. Securities and Exchange Commission (hereafter "SEC"), Report on Fund Fees and Expenses (Dec. 2000)(Total ownership costs may have declined over the past twenty years if sales loads are taken into consideration); U.S. General Accounting Office (hereinafter "GAO"), Funds: Information on Trends in Fees and Their Related Disclosure, p. 1 (March 2003).

[5] GAO, supra note 4, p. 1.

[6] GAO, supra note 4, p. 2; See also, SEC, supra note 4 (The SEC report explains that mutual fund expense ratios typically decrease as the amount of fund assets increase. As fund assets naturally declined during the most recent bear market, this would explain the temporary increase in expense ratio data).

In reality, what has changed is the way costs are incurred. Notably, in 1980, when the SEC adopted rule 12b-1, a change began that allowed investors more choices in how to pay for the services provided by financial professionals. Prior to adopting 12b-1, the total annual shareholder cost associated with owning equity funds was 2.26%. By the end of 2002, this cost has decreased to 1.25%.[7]

Fund investors are smarter than reform proponents give them credit. Currently 83% of all equity funds bought by investors had expense ratios below that of the 1.62% average fund ratio.[8] Furthermore, the largest funds that control over 60% of all fund assets (funds with assets over $3 billion) had expense ratios of .57%, a figure which is about a third of the average ratio charged by the smallest small funds (funds with $50 million or less in assets).[9] This shows that investors place their money with companies who are perceived as efficient in their operations.

Although Senator Fitzgerald, John Bogle, and others have suggested that the confidence of mutual fund investors has been seriously shaken by certain events, statistics regarding shareholder redemptions clearly suggest otherwise. In fact, fund redemption patterns have changed little in the past twenty years, and redemption rates are actually lower today than they were in the late 1980's.[10] Notwithstanding the presence of index funds, which are said to offer low turnover, less management time, and lower expenses, nearly ninety percent of mutual fund investors still choose to keep their money in the traditional managed funds.[11] The implication from this is that these investors want help from experienced financial managers and are willing to accept the inescapable fact that such professional advice does not come free.[12]

Comments

1. **12b-1 Fees Provide Greater Flexibility in the Manner Shareholders Pay for Fees.**

As of 2001, more than 70% of all fund investors who primarily buy shares outside a 401(k) or other employer-sponsored pension plan used a financial advisor as their main source for purchasing fund shares.[13] Financial advisors provide valuable services in helping clients select suitable investments, given the unique goals and objectives of each

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[7] ICI, supra note 1, p. 2.
[8] Testimony of Mellody Hobson, H.R. 2420 (June 18, 2003)(Ms. Hill, President of Ariel Mutual Funds, testified before the Subcommittee on Capital Markets, Insurance & Government Sponsored Enterprises that 83% of all equity funds bought by investors had expense ratios below the 1.62% charged by the average fund).
[9] Strategic Insight Overview, supra note 1, p. 4.
[10] Id. at p. 12-14.
[11] Id. at p. 14.
[12] Id.
[13] ICI, supra note 1, p. 3.

client. Advisors also provide ongoing services such as monitoring clients' investments, periodically updating account objectives, rebalancing accounts, providing account statements and tax forms, etc.[14]

Financial advisors are often compensated for their services through sales loads and/or annual 12b-1 fees. Over the years, market forces have resulted in a change in the overall mix of these forms of advisor compensation. In support, the average front-end loads for equity funds have substantially declined over the last twenty-five years from 7.89% in 1980 to 5.17% in 2002.[15] While operating expenses have increased, this increase has been more than offset by the decrease in front-end loads. Therefore, the net result is an overall decline in the cost of mutual fund ownership.

It is noteworthy that a majority of fund investors have demonstrated a greater preference to pay for the services of financial advisors through annual fees rather than front-end sales loads,[16] and this has likely led to a decline in front-end sales loads, an increase in distribution fees, and the creation of "B-share" and "C-share" funds. While fee structures of funds have evolved and changed considerably, the end result to the investing public has been a decline in the overall cost of buying and owning funds.[17]

2. 12b-1 Fees Compensate Firms for Legitimate Distribution Expenses.

Many comment letters from the investing public imply that they would somehow benefit from the elimination of 12b-1 fees. However, this position fails to consider that these fees are used to compensate firms and their employees for legitimate business expenses that would otherwise be funded by higher front-end sales charges or other fees that investors would ultimately pay.[18]

We note that the Commission has received numerous comment letters from brokers (whose letters are posted on the SEC website) indicating that, without the 12b-1 fees, they would not be able to provide certain marketing and distribution-related services to their fund clients without imposing additional fees for these services. The incentive to receive commissions on the front-end of transactions, in the absence of Rule 12b-1 fees, would also result in reduced attention paid to fund shareholders after the initial sales.

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[14] Securities Industry Association comment letter to NASD Conduct Rule 2830 (by Stuart Strachan), p.3 (Oct. 17, 2003).
[15] ICI, supra note 1, p. 12.
[16] Id. at p. 4-6 (Figure 5 of page 5 illustrates that 57% of investors in equity load funds are actually invested in Class B and C shares).
[17] ICI, supra note 2, p.1; GAO, supra note 4, p. 1.
[18] ICI, supra note 1, p. 12.

In the absence of these fees, fund investing could be shut-off to a substantial number of individual investors with small account balances in the $500 to $10,000 range.[19] Thus, these investors could be forced to seek returns on equity investments by investing in individual stocks, which provide much less diversification, more risk, and potential volatility than mutual funds.

Furthermore, the variety of investment choices through different types of fund classes would obviously be eliminated in the event that 12b-1 fees were eliminated.[20] As the number of open-ended funds available is already on the decline, it can hardly be said that the elimination of these fees is in the best interests of the public.[21]

3. The Elimination of 12b-1 Fees Will Never Solve the Conflicts Inherently Present Within the Fund Compensation System.

In all businesses, some conflicts of interest are inevitable.[22] Nowhere is this premise more prevalent than the de facto dual-agency that exists among clients, broker/dealers, and fund companies. Notwithstanding the fiduciary duties that exist between the client and representative, it is the fund companies that ultimately establish the commission that the broker will earn.[23] Although broker/dealers provide some guidance on the loads and 12b-1 fees, the fund company ultimately sets the final commission rates. Short of a system where clients and broker/dealers exclusively set both the fee and the terms of the professional engagement, conflicts of interest will never be eliminated in this area.

Amazingly, it has been suggested by some that this inherent problem serves as additional justification for the elimination of marketing reimbursements through 12b-1 fees. Although we should take affirmative steps to heighten investors' awareness of the various compensation arrangements in place, certain inherent conflicts will never completely go away.

In the absence of 12b-1 fees, much of the advertising and distribution costs and burdens will likely be placed upon the shoulders of the fund companies. To compensate for these burdens, these companies would likely increase sales loads or their own internal marketing expenses. Thus, there could be a potential for a return back to the days when sales loads were 8 percent, which will increase the investor's ownership costs.[24] Coincidently, the various share options now available to investors could be eliminated by

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[19] Strategic Insight Overview, supra note 1, p. 7-8.
[20] Id.
[21] Id. at p. 8 (This study shows that the number of open-ended funds available to the public has declined from 7,228 in 2000 to 6,784 as of December 31, 2003).
[22] Barron's, Hard Facts on Soft Dollars: In Investment Research, You Get What You Pay For, D. Bruce Johnsen (March 15, 2004).
[23] Registered Rep., The Next Headache: Mutual Fund Marketing Reform, David Geracioti (July 1, 2003).
[24] ICI, supra note 1, p. 12.

such a measure. In support of this, it has been asserted by one industry study that such a measure will motivate funds to establish higher minimum investments, which could leave out over 100 million investors with accounts under $10,000.[25] At the end of the day, the conflicts remain and the public would be in even worse shape than before.

Where Do We Go From Here?

Investors should have a full picture of the costs of investing in funds. Therefore, the SEC should pursue a course that is designed to reasonably heighten an investor's awareness, rather than a plan designed to completely eliminate the payment of 12b-1 fees.

As a practical matter, we encourage the SEC to look at ways the investor's awareness of 12b-1 fees could be heightened at or near the point of sale through account applications and sale confirmations. These measures, which have been endorsed in the area of revenue sharing, could also be used to educate investors about 12b-1 fees.

Although we believe that a general reference to 12b-1 fees could be helpful in providing additional disclosure about such fees, providing an actual pro-rated expense entry on each and every account statement would be costly and could be confusing to investors.[26] Rule 12b-1 fees are used to compensate broker-dealers and representatives for a number of services that benefit the entire pool of fund shareholders (and prospective shareholders). Notably, marketing efforts paid for by 12b-1 fees lead to new sales, leading to increased assets in the fund, which may lead to economies of scale that could reduce the advisory fee percentages paid to portfolio managers. Furthermore, 12b-1 fees more closely represent operating expenses and overhead as opposed to account specific compensation. Thus, any effort to break down this expense at the individual shareholder level could be misleading. That is one reason 12b-1 fees are deducted from the fund as opposed to individual accounts, and we believe this should not be changed.

Conclusion

As previously mentioned, 12b-1 fees are used to compensate broker-dealers for legitimate business expenses that would otherwise be funded through higher front-end sales charges or other fees that investors would ultimately pay. To the extent that 12b-1 fees are eliminated, brokers and dealers will likely seek reimbursement for their distribution related activities in the form of higher front-end sales loads and other fees. To the extent that the funds should decide to take on the distribution tasks themselves, many small investors will likely be left out in the cold. At the end of the day, the public will be left

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[25] Strategic Insight Overview, supra note 1, p. 7-8.

[26] Testimony of Mellody Hobson, supra note 8 (Hobson testified before the Congressional Subcommittee that she has received comments from thousands of fund investors stating to the effect that they were overwhelmed by the amount of legal disclosure they receive and that they would prefer less disclosure than what is now being provided).

with higher front-ends fees and fewer investment alternatives. In any event, the SEC would be prudent to look at reasonable alternatives designed to heighten the public's awareness, instead of adopting a wholesale elimination of 12b-1 fees.

Thank you for the opportunity to submit these comments. If you would like to discuss any of these issues further you are welcome to contact me in writing at the following address:

Securities America, Inc.
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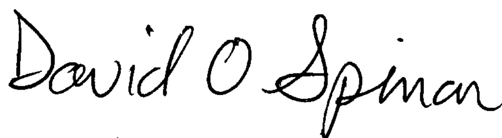
Omaha, NE 68106

Respectfully submitted,
Securities America, Inc.



DOS/CDG

David O. Spinar
Vice President and Chief Compliance Officer

DOS/CG