



July 19, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

Re: Roundtable Discussion Regarding Rule 12b-1; File No. 4-538

Dear Ms. Morris:

The Independent Directors Council¹ welcomes the opportunity to comment on possible reforms to Rule 12b-1 under the Investment Company Act of 1940. In light of the evolution of fund distribution since Rule 12b-1 was adopted in 1980 and the complex nature of the subject matter, IDC commends the Commission for undertaking a comprehensive review of the rule. IDC also appreciates the approach the Commission has taken in first holding a roundtable on the subject and then encouraging public comment from all interested persons prior to proposing specific changes to the rule.

Over the course of close to three decades, Rule 12b-1 has operated to the significant benefit of funds and their investors. The use of 12b-1 fees has promoted the establishment by financial services firms of numerous programs and services designed to help fund investors navigate among a widening array of fund choices. Investors also now have access to far more funds, as well as options in how they wish to pay for initial and ongoing advice and shareholder servicing. Moreover, in many instances, 12b-1 fees help advisers more effectively manage a fund's portfolio because new sales of fund shares offset redemptions of fund shares. Recognizing these beneficial consequences, IDC supports retaining the framework of Rule 12b-1 and believes that changes to the rule should take the form of enhancements and clarifications to adapt the rule to the modern world of fund distribution. In this regard, IDC strongly opposes the suggestion made at the roundtable to "externalize" 12b-1 fees and

¹ IDC serves the fund independent director community and provides a venue to advance the education, communication, and policy positions of fund independent directors. The activities of IDC are led by a Governing Council of independent directors of Investment Company Institute member funds. The Investment Company Institute's members collectively oversee 98 percent of all assets in U.S. mutual funds on behalf of approximately 93.9 million shareholders in more than 53.8 million households. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

charge them at the individual account level because of the adverse tax consequences to shareholders and potential operational costs and other burdens of this approach.²

In encouraging public comment, the Commission noted its particular interest in ideas for alternative approaches to the issues raised by Rule 12b-1. In response to this request, IDC's preliminary recommendations focus on two areas of reform that were discussed at the roundtable and on which there appeared to be general agreement: modernizing the oversight role of directors and enhancing investor understanding of 12b-1 fees. Specifically, IDC recommends that the Commission:

- Modify the role of directors in overseeing 12b-1 plans to reflect the activities financed by 12b-1 plans by:
 - Limiting board oversight of 12b-1 fees used for advice and shareholder servicing to initial approval of the 12b-1 plan and general ongoing oversight; and
 - Retaining board oversight of 12b-1 fees used for advertising, marketing and promotion as it is today, with the exception of eliminating the rule's quarterly board reporting requirement;
- Clarify the standard for board approval of 12b-1 plans; and
- Enhance shareholder disclosure about the amount and use of 12b-1 fees.

I. Modernization of Board Oversight

As the Commission and others evaluate potential reforms to Rule 12b-1, it is important that there be a common understanding of the appropriate role of fund directors in overseeing fund distribution arrangements, including those financed by Rule 12b-1 plans.

The current fund distribution system is very different from the one that existed when Rule 12b-1 was adopted.³ While distribution systems and the uses of 12b-1 fees have evolved significantly

² See Letter from Mary S. Podesta, Acting General Counsel, Investment Company Institute to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated July 19, 2007 at 7-10; *Report of the Working Group on Rule 12b-1*, Submitted to the Investment Company Institute Board of Governors (May 2007) at 15-16.

³ Today, the overwhelmingly predominant use (98%) of 12b-1 fees is for professional advice (initial and ongoing) and shareholder servicing. Only a small fraction (2%) of 12b-1 fees are used by funds for promotion, advertising and other miscellaneous expenses. See "How Mutual Funds Use 12b-1 Fees," *Fundamentals*, Vol. 14, No. 2, Investment Company Institute, February 2005, available at <http://www.ici.org/fundamentals/fm-v14n2.pdf>.

over the past 27 years, the process that fund directors must follow under Rule 12b-1 in considering and approving the payment of 12b-1 fees has not. Some fund directors and their counsel read Rule 12b-1 as currently written to require that directors engage in a fairly detailed review of their funds' distribution arrangements. Such a review is at odds with the role of fund directors as general overseers of the interests of shareholders.

IDC believes that the role of directors in overseeing 12b-1 plans should be consistent with the role of directors in overseeing front-end sales loads and fund distribution practices generally. Our strong view is that the appropriate role of fund boards should be one of general oversight, stemming from their fiduciary duties and consistent with their responsibilities to ensure that 12b-1 plans operate in the best interests of shareholders. Specifically, directors should become knowledgeable as to the means through which fund shares are distributed and the principal services offered to fund shareholders. Directors also should monitor for conflicts of interest involving the fund, its adviser and their affiliates that may arise in connection with distribution activities. While directors should periodically inquire generally about the existence of such conflicts, fund advisers and distributors have the principal responsibility for identifying conflicts and bringing them to the attention of directors.

On the other hand, in exercising their general oversight responsibilities, directors should *not* be required to assess the business merits of the distribution channels used by the funds they oversee. Nor should directors be obligated to evaluate the performance of intermediaries through which fund shares are sold or the business practices of those intermediaries, such as how the intermediaries compensate their employees or whether 12b-1 compensation they receive from funds is rebated to their clients or customers.

II. Recommendations for Reform

In an effort to modernize board oversight of 12b-1 plans, IDC recommends that the Commission prescribe the level of board oversight according to the activities financed by a fund's use of 12b-1 fees. Specifically, director oversight of 12b-1 fees used for *advice and shareholder servicing* should be treated differently than director oversight of 12b-1 fees used for *advertising, marketing, and promotion*. This recommendation, in addition to IDC's recommendations that the Commission clarify the standard for board approval of 12b-1 plans and enhance shareholder disclosure about the amount and use of 12b-1 fees, is discussed more fully below.

A. Modify the Role of Directors in Overseeing 12b-1 Fees

1. Director Oversight of 12b-1 Fees Used For Advice and Shareholder Servicing

IDC recommends that board oversight of 12b-1 fees used for advice and shareholder servicing be limited to initial approval of the plan and general ongoing oversight, which would include the right

of a fund's independent directors to terminate a 12b-1 plan at any time. This right is especially important in egregious circumstances. Boards should not be required to annually renew 12b-1 plans that contemplate payments for advice and shareholder servicing or receive quarterly reports with respect to these 12b-1 payments.

IDC's recommendation that the Commission eliminate the annual board renewal requirement is based on the nature of 12b-1 payments for advice and shareholder servicing. They are payments made to financial intermediaries who are chosen by fund shareholders and with whom the shareholders have ongoing relationships. They are not the types of payments that typically raise potential conflicts of interest between the fund, its adviser, and their affiliates and trigger the need for annual board consideration.

Moreover, the annual renewal requirement suggests that directors have a decision to make with regard to the continuation of a 12b-1 plan. In reality, however, underwriters of funds with Class B and Class C shares typically advance sales commissions to selling investment professionals and, at times, finance this effort by borrowing from financial institutions using future 12b-1 fees as collateral. We are not aware of any board that has failed to renew a 12b-1 plan (or is likely to do so) in light of the need to recoup advanced sales commissions and existing securitizations of 12b-1 financing. On a related note, the need to recoup advanced sales commissions and existing securitizations of 12b-1 financing are reasons why a fund might continue to charge 12b-1 fees after it is closed to new investors. In addition, ongoing 12b-1 fees of all classes of shares of closed funds are used to compensate financial intermediaries for ongoing advice and shareholder servicing.

IDC also recommends the elimination of the rule's quarterly reporting requirement. Such frequent reporting to the board is not necessary to enable the board to carry out its responsibilities and can become a diversion away from board review of more substantive matters. The fund's chief compliance officer or another person designated by the board could provide periodic reports to the board regarding any irregularities or material changes in distribution practices or expenditures.

2. *Director Oversight of 12b-1 Fees Used For Marketing*

With respect to 12b-1 fees used for the marketing of a fund, IDC recommends that the Commission retain the procedural requirements under the rule that the board initially approve and annually renew the plan. Unlike 12b-1 fees used to pay financial intermediaries, 12b-1 fees used for marketing generally are paid to the adviser or its affiliates and, therefore, may be perceived by some to raise potential conflicts of interest. For this reason, IDC recommends that Rule 12b-1, when applied to payments for marketing, continue to require initial and annual board approval, as well as the ability of the fund's independent directors to terminate the plan at any time.

IDC recommends that the Commission eliminate the quarterly board reporting requirement for Rule 12b-1 plans used to pay for advertising, marketing and promotion. The basis for this recommendation is the same as discussed above. That is, in IDC's view, such frequent reporting to the board is not necessary to enable the board to carry out its oversight responsibilities and can become a diversion away from board review of more substantive matters. The fund's chief compliance officer or another person designated by the board could update the board on 12b-1 matters on an "as-needed" basis.

B. Clarify Standard for Board Approval

In any potential reform or discussion of the oversight role of boards, IDC recommends that the Commission clarify that boards, whether approving or renewing a 12b-1 plan, may make their determinations based on factors relevant to the facts and circumstances of the funds they oversee. Specifically, IDC recommends that the Commission clarify that directors do not have to apply the nine factors that the Commission suggested in its release adopting Rule 12b-1.⁴ Many of these factors are no longer germane to the business realities surrounding today's uses of 12b-1 fees. For example, factors that are associated with resolving a temporary distribution "problem" faced by funds generally are not relevant to the oversight of ongoing advice and other services provided to fund shareholders and financed by 12b-1 fees.

IDC recommends that, rather than revise these factors as some have suggested, the Commission eliminate the suggestion that boards should consider any specifically enumerated factors when considering a 12b-1 plan that contemplates the use of 12b-1 fees either for advice and shareholder servicing, or marketing. The considerations that may be relevant to one board may not be relevant to another. Specifying factors raises the risk that they, too, will become obsolete over time or that they will be irrelevant for some boards or under some circumstances.

IDC also recommends a technical clarification to the language contained in Rule 12b-1. Specifically, the rule requires boards, when initially approving or annually renewing a 12b-1 plan, to determine that "there is a reasonable likelihood that the *plan* will benefit the [fund] and its shareholders" (emphasis added). This language should be revised to more explicitly and accurately state the standard that the *activities financed by the plan* have a reasonable likelihood of benefiting the fund and its shareholders. IDC's recommendation to clarify the language contained in the rule would more accurately reflect the current uses of 12b-1 fees. The clarification would more effectively enable boards to make findings that the monies paid under a 12b-1 plan are for purposes that benefit shareholders, rather than findings that relate to the quality of the services (*e.g.*, professional advice) provided to shareholders, which is not readily ascertainable by fund directors. This clarification should apply to

⁴ See Bearing of Distribution Expenses by Mutual Funds, SEC Release No. IC-11414 (Nov. 7, 1980).

board consideration of 12b-1 fees used both for advice and shareholder servicing, and for advertising, marketing and promotion.

C. Enhance Shareholder Disclosure of 12b-1 Fees

There was general agreement among the participants in the Commission's roundtable that more effective disclosure to shareholders regarding the use of 12b-1 fees is needed. IDC agrees and believes that improvements in the disclosure provided to investors would enhance their understanding of the fees and the services that they receive for the fees. Rather than referring to 12b-1 fees by the number of the rule under the Investment Company Act, IDC recommends that the Commission prescribe descriptive terminology for the fees being paid. This would ensure consistency across the fund industry and help promote investor awareness and understanding of the use of the fees. IDC recognizes that one term may not be sufficient given the wide variety of usage of 12b-1 fees, but some suggestions to consider may include, "sales and service charge," "third-party advice," or "marketing."

In addition to mandating a descriptive and consistent nomenclature for the use of 12b-1 fees, the Commission should require that effective disclosure about the amount and use of 12b-1 fees be provided to potential investors at the "point of sale." This disclosure would promote investor understanding of the use of 12b-1 fees and would help them make informed decisions regarding the investment options available to them and how they will pay for advice and services. As a general matter, IDC recommends that the Commission make any point of sale disclosure requirements applicable to all investments that brokers and other financial intermediaries sell. IDC believes that such disclosure requirements would benefit all investors, not just mutual fund investors. Moreover, a point of sale disclosure requirement applicable to the sale of mutual funds, but not other investments, such as separately managed accounts or hedge funds, could discourage brokers from selling funds. This outcome would be detrimental to both investors and the fund industry.

III. Conclusion

IDC commends the Commission's efforts to review Rule 12b-1 and to consider appropriate reforms. Fees paid pursuant to Rule 12b-1 are an integral part of the fabric of fund distribution. The rule benefits shareholders by giving them access to a broad array of fund options and choices in how they wish to pay for initial and ongoing advice and services. Fund directors are significant participants in the operation of 12b-1 plans, and IDC welcomes the opportunity to offer its views as the Commission undertakes its review of the rule.

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IDC appreciates the opportunity to comment on possible reforms to Rule 12b-1. We look forward to commenting on the Commission's specific reform proposal when it is published for comment. If you have any questions about our preliminary recommendations or would like to meet with us to discuss them, please contact Amy B.R. Lancellotta at 202-326-5824.

Sincerely,



Robert W. Uek
Chair, IDC Governing Council

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth
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