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Comments of the Staff of the Bureau of Economics of the Federal Trade Commission*

on

COMMISSION AUTHORIZED

Proposed Regulations of the
Securities and Exchange Commission
Governing the Payment of Asset-Based Sales Loads
by Registered Open-End Investment Management Companies
File No. S7-10-88

December 14, 1988

Submitted in triplicate to:
Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C.

* These comments are the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner. Please contact staff economist Laurence Schumann at (202) 326-3359 should you have any questions regarding our comments.

I. INTRODUCTION

The SEC requests comment on several proposed amendments to rule 12b-1 of the Investment Company Act of 1940 (hereafter referred to as the Act).[1] Rule 12b-1 permits mutual funds to use fund assets to pay costs associated with the distribution of fund shares.[2] The proposed amendments would, among other things, define payments made under a distribution plan as "asset-based sales loads," prohibit funds that adopt or continue distribution plans from being held out to the public as "no-load" funds, clarify standards for approval or continuation of distribution plans, and require that payments under a distribution plan be made on a current basis and be for specific distribution services actually provided to the fund.[3]

The proposed amendments that define the payments made under a 12b-1 plan as an "asset-based sales load" and prohibit funds that have adopted 12b-1 plans from promoting themselves as no-load funds may improve investor welfare. These amendments recognize the similarity in effect and purpose of 12b-1 distributions plans and traditional sales loads and could act to protect current and potential mutual fund shareholders from being confused or misled by funds that have adopted 12b-1 plans.

On the other hand, the proposed amendments that require 12b-

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[1] 15 U.S.C. 80a-1 _et seq_.

[2] 17 CFR 270.12b-1, adopted October 28, 1980.

[3] _Federal Register_, Vol. 53, No. 119 (June 21, 1988), pages 23258-23286. Release No. IC-16431. File No. S7-10-88.

1 payments to be made on a current-year basis and that restrict the uses of 12b-1 fees may not be in the best interests of mutual fund investors. These restrictions likely will substantially reduce the feasibility of 12b-1 distribution plans as alternatives to front-end sales loads and limit the choices available to mutual fund investors. The issue, then, is whether these probable negative effects of the restrictions would be counterbalanced by probable beneficial effects.

II. FTC STAFF ANALYSIS AND RECOMMENDATIONS

The staff of the Bureau of Economics (BE) of the Federal Trade Commission submits the following comments in response to the SEC request. The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive practices in or affecting commerce.[4] Pursuant to this mandate, the FTC has provided comments to federal, state, and local legislatures and administrative agencies on matters that raise issues of competition or consumer protection policy. In particular, the staff of the Federal Trade Commission has recently examined various regulations affecting competition in capital markets and investor welfare.[5]

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[4] 15 U.S.C. §45.

[5] Examples include Hilke, Minimum Quality Versus Disclosure Regulations: State Regulation of Interstate Opened-End Investment Company and Common Stock Issues (Federal Trade Commission, 1987) and Schumann, State Regulation of Takeovers and Shareholder Wealth: The Effects of New York's 1985 Takeover Statutes (Federal Trade Commission, 1987). Over the last year, the FTC staff has submitted comments on proposed regulations

A. Background

Before adoption of rule 12b-1, sales commissions and other distribution costs were generally financed through front-end sales loads. A front-end sales load is defined as the difference between the price of a security and that portion of the proceeds from its sale that is invested by the issuer. Typically, a portion of a front-end sales load is used to pay sales commissions to brokers and the remainder is used by the fund's distributor (typically, an affiliate of the fund's management company) to pay processing or other distribution costs. Under the authority granted by section 22(b) of the Act, the National Association of Securities Dealers (NASD) rules specify that sales charges may be no greater than 8.5% of the offering price.[6]

Rule 12b-1 permits, subject to specified conditions, a mutual fund to adopt a plan to use a portion of fund assets to finance activities primarily intended to result in the sale of fund shares. Unlike a front-end load fee that is paid at the time of purchase, 12b-1 plans charge an annual fee and typically specify a maximum annual payment as a percentage of net asset

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affecting investors to the Securities and Exchange Commission and the Delaware, New Jersey, New York, and Texas state legislatures.

[6] Some funds charge "back-end" sales loads that are assessed when fund shares are redeemed. The 8.5% limit on sales charges set by the NASD applies to the sum of all charges levied whether through front-end loads, back-end loads, or a combination of both; however, the limit does not apply to 12b-1 payments.

value.[7] Different plans have maximum 12b-1 fees ranging from less than 0.25% of a fund's net asset value (NAV) to 1.25% of NAV.[8] 12b-1 plans are generally used alone or in conjunction with a contingent deferred sales load (CDSL)[9] as a substitute for a front-end load fee; however, some funds have adopted 12b-1 plans to supplement front-end loads.

The proposed amendments to 12b-1 address certain practices that have developed under the existing rule. As noted in the SEC proposal, the innovative use of rule 12b-1 has resulted in a wide variety of distribution arrangements and practices that were not anticipated at the time that the rule was adopted. Practices that are of particular concern to the SEC include 1) the use of the label "no-load" by funds that have adopted 12b-1 plans, 2) "reimbursement plans" that allow annual distribution spending to exceed annual payments by the fund, and 3) "compensation plans"

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[7] Under Rule 12b-1, a plan may continue for more than one year only if it is approved annually by a majority of the fund's board of directors and of the disinterested directors. Thus, strictly speaking, a 12b-1 plan applies for a single year and is not a recurring annual charge.

[8] J. A. Haslen, The Investor's Guide to Mutual Funds, Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1988, at 57.

[9] A CDSL is a type of sales load paid, if at all, at the time shares are redeemed. A CDSL typically starts at 5 or 6% of the original purchase price of the shares redeemed and declines by 1% for each year the shares are held by the investor. Thus, if a fund charges a 6% CDSL and an investor redeems his shares within one year of their purchase, he pays a 6% sales load, if he redeems his shares within two years, he pays a 5% sales load, and so on. Unlike 12b-1 payments, CDSLs are subject to NASD sales load regulations. They are generally used in conjunction with 12b-1 plans to insure that investors redeeming shares fully repay any deferred distribution costs.

in which payments made by the fund are not tied to the level of distribution spending.

B. Labelling and Disclosure of 12b-1 Fees

As discussed above and in various sections of the SEC proposal, 12b-1 fees are typically used to pay sales commissions and other types of distribution costs traditionally covered by sales loads. Whereas front-end sales loads are charged at the time mutual fund shares are initially purchased and applied to distribution costs at the time of sale, fees assessed under 12b-1 plans enable shareholders to spread the payments for distribution services over time. The proposed amendment to 12b-1 designating 12b-1 charges as "asset-based sales loads" recognizes that 12b-1 plans serve essentially the same purpose as traditional front-end loads, and should be thought of as a form of load fee spread over time rather than paid at the time of purchase.

From the time that the Act was passed by Congress in 1940 to the time that rule 12b-1 was adopted in 1980, the terms "load fund" and "no-load fund" conveyed to mutual fund investors precise characteristics of the particular types of funds. Load funds were typically sold by brokers who received commissions from fees (sales loads) charged investors at the time of sale; no-load funds were typically sold directly to investors, with the funds' underwriters absorbing any costs arising from the sale and distribution of the funds' shares. With the adoption of rule

12b-1, mutual funds that did not charge traditional load fees have been able to finance brokers' commissions and other distribution costs through 12b-1 distribution plans. While 12b-1 plans serve the same purpose as sales loads, rule 12b-1 does not currently define or refer to such plans as "asset-based sales loads." Consequently, some funds that have adopted 12b-1 plans advertise or otherwise promote themselves as no-load funds. Since mutual fund investors have for many years believed that the term "no-load" refers to funds that do not charge investors fees to cover brokers' commissions or other distribution costs, some investors may be confused or misled by funds with 12b-1 plans that hold themselves out to the public as no-load funds.[10] The designation of 12b-1 fees as "asset-based sales loads" can, therefore, be viewed as a disclosure to current or potential mutual fund investors of the true purpose and role of 12b-1 fees. When viewed in this light, characterizing 12b-1 funds as "no-load" funds differs little from characterizing funds charging front-end sales loads as "no-load" funds. Thus, the adoption of amendments that would (1) designate 12b-1 plans as "asset-based sales loads" and (2) prohibit funds that adopt 12b-1 plans from promoting themselves as no-load funds, could act to prevent potentially misleading and deceptive claims by mutual funds.

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[10] According to footnote 197 in the SEC proposal, the SEC has received hundreds of letters from individual investors complaining of the "hidden loads" created by 12b-1 plans. Many of these investors claim to have been misled by sales literature or salesmen into thinking that a particular fund did not charge for distribution, when in fact it assessed 12b-1 fees.

C. Amendments Affecting "Reimbursement" Plans

A "reimbursement plan" is a common type of 12b-1 plan that is a major concern to the SEC. Under this type of plan, a fund's distributor advances on the fund's behalf the cost of brokers' commissions and other distribution expenses associated with the sale of fund shares. The distributor is later reimbursed through 12b-1 fees. When distribution costs incurred in any given year exceed the maximum annual fees allowed by the plan, the excess distribution costs are typically "carried forward" in anticipation of repayment under the plan in future years.

The SEC is concerned with the magnitude of distribution spending carried forward from prior years, and the possibility that some investors who leave a 12b-1 fund do not pay their *pro rata* share of the distribution expenditures. Further, since the level of actual distribution spending is often determined by fund distributors under a reimbursement plan, the SEC believes that the review of annual distribution expenditures by fund directors may not adequately protect shareholders.

To address these concerns, the SEC proposes rule 12b-1(c)(1)(ii). This rule restricts the ability of a fund to pay for distribution expenses incurred on the fund's behalf in prior years, thereby insuring that distribution services financed under 12b-1 plans are paid for on a current basis. Rule 12b-1(c)(1)(ii) essentially prohibits reimbursement plans.

Before adopting such a restrictive rule, however, the SEC might want to consider the extent of the problem,[11] the potential costs of the rule, and solutions that might already be in use or might be adopted at less cost to investors. Adoption of rule 12b-1(c)(1)(ii): (1) limits the choices available to mutual fund investors by denying them an opportunity to pay distribution costs over time rather than up front;[12] and (2) may potentially reduce competition among mutual funds by deterring entry of new funds.[13]

As noted above, 12b-1 plans typically charge annual fees as a percentage of the fund's net asset value; consequently, distribution costs borne by a new fund's distributor typically

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[11] The SEC proposal provides anecdotal evidence of large unreimbursed expenditures, but does not provide any systematic evidence of how widespread the problem actually is.

[12] The SEC has recently recognized the potential benefits to mutual funds and investors of spreading distribution payments over time by proposing rule 6c-10 (<u>Federal Register</u>, Vol. 53, No. 217 (November 9, 1988), pages 45275-45285). This rule, if adopted, would allow, among other things, for deferred payments of traditional (i.e., not "asset-based") sales loads. Under this rule, th payment of distribution charges over time would no longer be a unique characteristic of 12b-1 plans; nevertheless, even if this rule is eventually adopted, it is far from clear that eliminating the "spread-load" characteristics of 12b-1 plans would be beneficial or even necessary. If investors prefer mutual funds with 6c-10 fee structures over 12b-1 funds, competition among funds would force the eventual demise of 12b-1 plans.

[13] Currently, a large number of mutual funds exist and competition among them can be fierce; consequently, limits on new entry in the industry would not, in itself, necessarily reduce competition. Nevertheless, entry into the industry by new funds is a highly important method by which diversified portfolios containing new and innovative financial products become available to small investors. Thus, regulations that act to restrict entry in the industry may potentially lessen competition by preventing an important means by which innovation enters the industry.

exceed the maximum payments allowed under the 12b-1 plan. Currently, distributors of new funds willingly bear these start-up costs since they can be reimbursed through 12b-1 fees assessed in later years. The SEC proposal requiring that payments under the distribution plan be made on a current year basis prevents distributors from spreading the start-up costs over time. The proposal suggests that one alternative available to funds is to raise the maximum amounts payable under the 12b-1 plan; however, if distribution costs are of similar magnitude for funds that charge 12b-1 fees as they are for funds that charge sales loads, then the requirement that payments be made on a current year basis necessitates that 12b-1 fees be of a magnitude similar to an alternative sales load. Any benefits that investors may receive from spreading distribution costs over time would be lost. Moreover, since management companies no longer would be permitted to defer reimbursement to later years, and since funds typically have high start-up costs, the proposed rule may discourage the entry of new 12b-1 funds.

Under SEC regulations that became effective May 1, 1988,[14] mutual funds must disclose in their annual prospectuses the level of 12b-1 fees as a percentage of average net assets and the amount of any unreimbursed distribution spending incurred in previous years under 12b-1 plans. Such disclosures should act to minimize potential harm to investors that could result from high

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[14] See "Consolidated Disclosure of Mutual Fund Expenses," 53 FR 3192, February 4, 1988.

levels of unreimbursed spending. If investors view high levels of unreimbursed spending as potentially harmful, or if high levels of unreimbursed spending induce directors to continue plans that are not in the best interest of the funds or their shareholders, then shareholders can choose to invest their savings in different mutual funds. Thus, competition among funds should act to keep unreimbursed distribution spending from reaching levels viewed as potentially harmful by mutual fund investors.

The disclosures should encourage funds with 12b-1 plans to initiate solutions to these problems. For example, many funds with 12b-1 plans have already adopted CDSLs to avoid the problem of shareholders redeeming their shares before having fully repaid the expenditures incurred to sell them. Alternatively, if funds attempt to levy excessive 12b-1 fees on current shareholders to pay the distribution costs incurred on behalf of former shareholders, the shareholders will "vote with their feet" and invest their funds in other mutual funds. However, we would expect competition among funds for investment capital to force funds to find solutions. Thus, the required disclosure of the levels of 12b-1 fees and unreimbursed spending, in combination with the high level of competition among mutual funds, may protect the interests of mutual fund investors without the need for effectively prohibiting reimbursement plans. It is possible that there was not enough time to determine the effectiveness of the new disclosure rules by the date of the SEC's proposal. We

recommend that the SEC determine to what extent the new disclosure rules and actions taken by the funds themselves (such as the adoption of CDSLs) may alleviate perceived problems, and how much of a problem remains.[15]

Even if the SEC rejects the notion that the combination of disclosure and competition can act to protect the interests of mutual fund shareholders, the SEC could consider substantially less restrictive means than the effective prohibition of such plans. In conjunction with amendment 12b-1(c)(1)(ii), the SEC proposes amendment 12b-1(b)(5) that is designed to eliminate, within a reasonable time, unreimbursed distribution spending existing at the time rule 12b-1(c)(1)(ii) becomes effective. One less restrictive alternative to 12b-1(c)(1)(ii) is to adopt a modified amendment 12b-1(b)(5). The amendment might require directors to take actions to reduce the level of unreimbursed excess distribution spending whenever the amounts carried forward become sufficiently large. The levels of unreimbursed expenditures that would invoke such action could be specified in the rule as a percentage of net assets. Excessive unreimbursed expenditures carried forward could be reduced over time and the problems associated with them avoided. Requiring that 12b-1 plans include such provisions could satisfy the SEC's concerns

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[15] Some problems may remain because shareholders cannot conduct transactions costlessly and do not receive information instantaneously. The recently proposed rule 6c-10 (see footnote 11), if adopted, would greatly facilitate the adoption of CDSLs by eliminating the need for funds to obtain individual exemptive orders prior to charging CDSLs.

with excessive unreimbursed expenditures without denying investors the choice of paying for distribution expenditures over time through reimbursement plans.

D. Amendments Restricting the Use of "Compensation" Plans

A second type of 12b-1 plan that concerns the SEC is a "compensation" plan. Under this type of plan, the annual level of payments is fixed in advance, typically as a percentage of the fund's net assets, and is not necessarily related to the level of distribution services provided by the recipient of the fees, generally the fund's principal underwriter. While the value of distribution services received by the fund could exceed the amount paid under the plan, such an arrangement could possibly result in the fund paying more than reasonable compensation for the services actually provided. In the extreme, the fund could pay its distributor 12b-1 fees and receive no services at all in return.

To address these concerns, the SEC is proposing a number of amendments to rule 12b-1 that would effectively prohibit compensation plans. Rule 12b-1(b)(9) requires that amounts accrued under a fund's 12b-1 plan reasonably correlate each quarter with the fund's distributional expenses. Rule 12b-1(c)(1)(i) prohibits the use of fees assessed under a 12b-1 plan for nondistributional expenses by limiting their use to reimbursement for specific sales or promotional services identified in the plan.

Before adopting these reforms, the SEC should reconsider whether these restrictions on the use of 12b-1 fees are necessary. The restrictions intended to limit the use of compensation plans may act to induce funds to use traditional sales loads rather than 12b-1 plans. As a consequence, investors that prefer spreading load payments over time may be denied this alternative. The success of funds assessing 12b-1 fees reflects the desirability of this type of sales load to investors.

12b-1 fees serve essentially the same purpose as sales loads. These fees are, as recognized by the SEC, an "asset-based sales load." In practice, 12b-1 payments constitute a sales load that is spread over time rather than paid entirely at the time of share purchase or redemption. With a traditional front-end sales load, typically, fund distributors and brokers split the load fee; a portion of the sales load is paid to the broker as a commission and the remainder is paid to the distributor. The portion of the sales load that reverts back to the distributor may be used to pay for distribution services, but the distributor is not required to apply all (or any) of these fees to actual distribution services, unlike 12b-1 fees under the proposed amendments. Here, the SEC is proposing that restrictions be placed on the use of one type of sales load, an asset-based sales load, that are not imposed on an alternative front-end sales load.[16] Such restrictions will discourage the use of

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[16] That management companies might view front-end sales loads and 12b-1 fees as substitutes for one another is strongly supported by a recent article that appeared in The Wall Street

12b-1 plans, which will harm those mutual fund investors who would prefer to pay sales loads over time rather than up front.[17]

The rules governing 12b-1 plans already provide several safeguards for investors. The SEC does not cite evidence that these existing safeguards are inadequate, and therefore might want to consider further investigation of current market conditions. One safeguard is that rule 12b-1, as adopted in October 1980, relies heavily on the fund's directors, particularly the disinterested directors, to protect the interests of the fund and its shareholders. Whether or not fund distributors earn "profit" on 12b-1 fees in any given year or quarter is of no more concern than whether or not distributors earn profits from traditional sales loads, as long as the directors fulfill their fiduciary duties and insure that 12b-1 plans are structured in the interest of the fund and its shareholders. Further, fund directors have the authority to deal with potential abuses by fund distributors.

Journal Friday, September 9, 1988 (p. 23). In this article, The Wall Street Journal described a new mutual fund pricing plan to be introduced by Merrill Lynch & Co. that would allow mutual fund shareholders the option of either paying an initial sales charge or paying annual marketing and distribution fees. Merrill Lynch is offering such a pricing plan presumably because some investors prefer (and are, therefore, better off by) paying distribution charges over time, while other investors prefer to pay distribution charges all at once.

[17] Alternatively, if the existing 12b-1 safeguards are inadequate, it may well be that similar problems are manifested for front-end sales load funds. In such a case, the interests of efficiency and symmetry may lead to the conclusion that the same restrictions now proposed for 12b-1 funds be applied as well to front-end sales load funds.

Second, disclosure requirements already established by the SEC protect shareholders from excessive or unnecessary fees. Annual rates-of-return reported to current and potential shareholders in a fund's prospectus must be calculated net of all fees, including those assessed through 12b-1 plans. As discussed above, under current SEC rules, a fund's prospectus must list in its fee table the level of 12b-1 fees as a percentage of the fund's net asset value. Furthermore, a number of popular business and financial magazines and newsletters periodically publish detailed comparisons of mutual funds' returns and fees.[18] Distributors that attempt to earn excessive profits through 12b-1 plans by receiving payments that do not correspond to services provided shareholders will find that the funds that they distribute do not provide competitive returns to shareholders. As long as shareholders can "vote with their feet," competition among the large number of funds available will further protect the interests of fund investors.

III. SUMMARY

The SEC proposes a number of amendments to rule 12b-1 designed to address certain practices that have developed under the rule. The SEC proposals to designate 12b-1 fees as "asset-

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[18] Appendix A of "Comments of the Bureaus of Competition, Consumer Protection, and Economics of the Federal Trade Commission on Proposed Regulations of the U. S. Securities and Exchange Commission Governing Performance Claims and in Advertising by Investment Companies" (December 22, 1986) provides a list of eight magazines and seventeen newsletters that regularly compare mutual fund performance.

based sales loads" and prohibit mutual funds that have adopted 12b-1 plans from promoting themselves as "no-load" funds should promote competition among mutual funds and benefit mutual fund investors by improving investors' understanding of the nature and purpose of 12b-1 plans.

On the other hand, the proposed amendments that would prohibit excess distribution expenditures from being carried forward and restrict the uses of 12b-1 payments by fund distributors may harm investors. 12b-1 fees are a type of sales load, an "asset-based sales load," that provide mutual fund investors with a valued and beneficial alternative to traditional sales loads to finance distribution costs. The prohibition on excess distribution spending could severely limit the ability of new funds to offer investors the choice of spreading load payments over time through 12b-1 plans. Moreover, less restrictive alternatives to an effective ban on reimbursement plans are available. The proposed restrictions on the use of 12b-1 payments would impose limitations on distributors of funds with 12b-1 plans that are not imposed on distributors of funds with traditional sales loads. These amendments will likely lessen the willingness of fund distributors to use 12b-1 fees as an alternative to traditional sales loads, and, consequently, limit the choices available to them. It is, of course, for the SEC to decide whether these potential costs of the adoption of the restrictions cited above are outweighed by the potential benefits to investors in terms of certainty and security.