

## **BoardIQ**

### **Opinion: Complexities Grow in 12b-2 World**

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While the SEC's proposal to rescind Rule 12b-1 is certainly a step in the right direction, it would make the director's role more complicated because of the way mutual funds are marketed and distributed.

The SEC's proposal would establish defined limits on fund sales and distribution charges and eliminate the requirement that directors evaluate and approve annual fund distribution plans. Boards would remain responsible for authorizing the use of fund assets for distribution purposes; they would also maintain their fiduciary responsibilities to oversee sales charges and marketing and servicing fees.

This means that Rule 12b-1's formal procedures would be replaced with heightened and more nuanced fiduciary responsibilities, complicated further by the way funds are now sold. The old days of investing directly with several fund families and receiving individual statements from each fund are long gone. Most fund shares are now sold through intermediaries, such as fund supermarkets, broker-dealers, investment advisers, retirement plans and insurance companies. The mutual fund distribution system has evolved in a manner that has been very helpful to the growth of the industry, but there are aspects of the current sales and distribution structure that are overly expensive and not in the best interests of fund investors.

If directors evaluate the fees being charged to finance the current fund distribution system, they will find payments to broker-dealers for account maintenance and record-keeping activities. These broker-dealers want to be paid for holding fund share positions for their customers in an omnibus sub-accounting structure. Directors will also find sales charges and "shareholder servicing" payments to various financial intermediaries from Rule 12b-1 plans. And there are revenue-sharing payments being made directly by fund advisers, as a part of their distribution relationships with certain third parties. Finally, directors will find payments being made to distribute shares through various fund supermarkets.

Some of these payments come from fund assets, and some of these

payments, such as revenue-sharing, come directly from the profits of a fund adviser. A number of these payments are being made as a substitute for an upfront sales load. Other payments are made to keep a broker-dealer (or other intermediary) interested in distributing a fund's shares.

There does not appear to be a consistent approach to structure these fund distribution arrangements in a manner that looks after the interests of long-term investors. From the perspective of individual investors, many do not make sense. Broker-dealers are already required to perform "account maintenance" and "shareholder servicing" activities under existing SEC and Finra rules. And the issuers of other types of investment offerings – such as corporate equities, municipal bonds, and exchange-traded funds – do not make similar payments to intermediaries for holding these investment positions in a customer-level account.

These sales and marketing arrangements are expensive. A recent study by the Coalition of Mutual Fund Investors estimated that these payments – excluding the fund supermarket fees – may be adding as much as \$8.47 billion each year to the cost of distributing fund shares. It is hard to argue that the individual investor is benefiting from these additional distribution costs. And the payments to broker-dealers for omnibus sub-accounting are causing a number of prospectus and regulatory compliance problems – partly caused by the lack of transparency that is associated with omnibus accounts. These developments cause investor-level record-keeping to become more fragmented, less transparent and non-uniform across distribution channels.

Within the context of these trends, directors can see how overseeing key aspects of fund distribution will remain a complicated task despite the elimination of Rule 12b-1. Fund directors have a greater incentive than ever to evaluate fund distribution arrangements in a more holistic manner – and one in which the interests of the individual shareholders are placed ahead of other interests.

Unnecessary fees should be eliminated, more disclosure of distribution arrangements should be required, and prospectus policies should be enforced uniformly for all shareholders. Payments made to intermediaries should be disclosed in an easy-to-understand manner, and investors should be told that these payments are not being made to all intermediaries distributing a fund's shares.

While the SEC's Rule 12b-1 reforms may result in a reduced workload, the director's role is likely to become more challenging.

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