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Rule 12b-1 Reform Climbs Back Up Priority List

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Recent changes to the financial terrain could have a bearing on the course of Rule 12b-1 reform, which appears to have crawled back up the SEC's priority list.

Reform to the rule, which governs fund expenses for distribution, had been put on hold while the commission crafted proposed changes to money market funds.

"One of the core issues certainly from a board perspective... is the 12b-1 considerations that a board undertakes every time it ratifies a plan or approves a plan each year, and I think everyone agreed those are painfully antiquated and at this juncture, as soon as feasible, need to be caught up to the current day," says Jeff Keil, principal member of **Keil Fiduciary Strategies**.

The rule allows mutual funds to use fund assets to pay broker-dealers and other intermediaries for distribution and servicing expenses. The fees, initially designed for distribution models that existed in the early 1980s, have been criticized over the years for becoming a replacement for a sales load that flowed to the fund.

In recent congressional testimony, SEC chairman Mary Schapiro said she had asked the staff to prepare a recommendation on Rule 12b-1.

"These fees, with their bureaucratic-sounding name and sometimes unclear purpose, are not well understood by investors," she said, according to a transcript.

"Despite this, in 2008, aggregate Rule 12b-1 fees amounted to more than \$13 billion. It is essential, therefore, that the SEC engage in a comprehensive reexamination of Rule 12b-1 and the fees collected pursuant to the rule."

As for boards, Keil says they generally dismiss the outdated and inapplicable 12b-1 factors, and base plan renewal on the need for marketplace competition over a more strict cost/benefit analysis.

"With updated factors that presumably include more stipulations on benefits derived, I feel this will generally prompt more data requests by boards, more examination of plan effectiveness, and basically more decision-making power in the hands of trustees," Keil says in an e-mail.

The reform could mean a higher level of due diligence, he says, which could come in the form of raw information, analytics, distribution personnel presentation or closer scrutiny of distribution arrangements, depending on the board.

Niels Holch, executive director of the **Coalition of Mutual Fund Investors**, says that given all that's happened financially, 12b-1 reform still needs to be high on the priority list, especially since investors who do not benefit from 12b-1 services continue to finance them.

He says he wouldn't be surprised to see something from the commission before the end of the year.

"First and foremost, I think it'll be changes in transparency: Boards will have more information; investors will have more information," he says.

"I do think there will be an attempt by the commission to make sure that any kind of asset-based fee benefits most, if not all, the shareholders and not a small subset

of the shareholder base. I'm hoping that they'll deal with some omnibus account issues as well."

Melody Hobson, president of **Ariel Investments**, says that the accelerated pace of consolidation during the financial crisis also could impact the course of reform.

Hobson has more than once made the argument that 12b-1 fees serve a vital role for smaller fund families, particularly no-load funds such as hers. Without such fees, Ariel could be sitting on the sidelines, and a trend of merging companies has made that argument even more salient, she says.

Recent consolidation has led to a meaningful decrease in shelf space with organizations bringing together third-party distribution centers.

"If you're bringing one organization with another and they both have a select list or they both have certain types of products, they're obviously not going to double that inventory," she says.

"For smaller firms, it makes the barriers to entry become greater and it makes being able to compete on a level playing field all the more important in terms of a 12b-1 fee."

Hobson supports modernizing and tightening the rule, without diminishing its significance.

Brad Barber, a finance professor at the University of California-Davis Graduate School of Management, says that there is little research to indicate why investors opt for one share class over another.

"One of the issues in these multiple class shares is, do investors end up picking the class that's appropriate for them or do they end up in a class that results in the highest compensation for the fund provider?" he says.

While the industry says the investors end up in the right share class, he says, it appears there are incentives for them to end up in the one that has the highest compensation.

Complexities are inherent in the sale of funds because mutual funds are offered under multiple platforms, explains Thomas Poehling, president of **Poehling Capital Management**, a registered investment advisory firm that does not work on commission.

For example, he says, the **Nakoma** fund is offered on multiple platforms, and it's not the job of the fund to police the registered representatives that meet with investors.

"The representatives are working for somebody else, they happen to be representing Nakoma," says Poehling, who is an independent director of the Nakoma fund.

Poehling says reform aimed at broker-dealers is a mistake because the broker-dealers aren't the ones meeting with the end client. Parent companies of registered representatives should be forced to better police their reps, he says, by providing disclosure documents for the reps to give to clients as to what the potential inherent conflicts of interest are, how representatives may be compensated at a greater rate if they sell an annuity product rather than an investment product, and how it may impact the rep's benefits with his employer.

In an e-mailed statement, the Investment Company Institute would not elaborate on what it anticipates with 12b-1 reform, saying that it supports the basic framework of the rule and changes should be limited to refinements or enhancements.

"In particular, we would support changes to clarify the role of the fund board under the rule and provide investors with better disclosure of 12b-1 fees," ICI spokesman

Rachel McTague states.

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