

Financial Services and Products ADVISORY

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SEC Proposes New Regulatory Framework Governing Mutual Fund Distribution Fees to Replace Rule 12b-1

On July 21, 2010, the Securities and Exchange Commission (SEC) voted unanimously to propose new rule and rule and form amendments under the Investment Company Act of 1940 (the "1940 Act"), the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), each as amended, regarding the regulation of distribution fees paid by registered open-end management investment companies, or mutual funds (the "Proposal"). The Proposal would replace Rule 12b-1 under the Investment Company Act in its entirety with a new regulatory framework that would impose limits on the promotional costs that funds would be permitted to bear and the cumulative sales charges that investors would pay, and would require clearer disclosure about all sales charges in fund prospectuses, annual and semi-annual reports to shareholders, and in investor confirmation statements. Among other things, the Proposal would break out the types of fees currently paid under Rule 12b-1 into two new categories: marketing and service fees and ongoing asset-based sales charges. The Proposal is intended to achieve the following objectives:

- Protect investors by limiting fund sales charges;
- Improve transparency of fees to promote investor understanding;
- Encourage retail price competition among funds and intermediaries in setting sales loads and distribution fees; and
- Revise fund director oversight duties.

Comments on the Proposal must be received by the SEC on or before **November 5, 2010**.

Background

Currently, Rule 12b-1 directs the manner in which a mutual fund may use fund assets to market and sell fund shares to investors, as well as how a broker-dealer can be compensated from the fund for its sales efforts. The SEC adopted Rule 12b-1 in 1980 in response to significant developments occurring in the mutual fund market in the 1970s, including a prolonged period of net redemptions experienced by many funds resulting in lower fund asset levels and an increase in the number of money market funds and no-load fund groups that did not charge sales loads but needed a source of revenue to support direct selling efforts. The SEC adopted Rule 12b-1 with the intent that using fund assets to support the sale of fund shares could benefit fund shareholders by increasing economies of scale, reducing fund expense ratios and introducing greater price competition in the sale of mutual funds, thereby lowering sales loads for all investors.

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However, following the adoption of Rule 12b-1, funds began to adopt Rule 12b-1 plans with higher fees, using the revenue to compensate fund intermediaries for their sales efforts instead of simply to defray promotional costs. In the view of many industry participants, Rule 12b-1 fees have evolved into a fee that is used to an extent and in ways that are different than originally envisioned. Accordingly, to protect individual investors from paying disproportionate amounts of sales charges in certain share classes, promote investor understanding of mutual fund distribution fees, provide a more appropriate role for fund directors and enhance clarity, fairness and competition in the sale of mutual fund shares, the SEC has put forward the Proposal for comment.

The SEC's Proposal

Asset-Based Distribution Fee Changes

The Proposal would rescind Rule 12b-1 in its entirety and break out the types of fees currently paid under the rule into the following two categories:

1. Marketing and Service Fees

The Proposal would adopt new Rule 12b-2, which would permit funds to deduct a “marketing and service fee” with respect to any class of fund shares of up to 25 basis points (0.25 percent) annually from fund assets to pay for distribution activities. The marketing and service fee would be permitted to pay for any type of distribution costs; however, the SEC anticipates the fee to be primarily used to pay for servicing fees currently permitted under FINRA rules, trail commissions to broker-dealers selling fund shares and fees paid to fund supermarkets. Additionally, funds (including no-load funds) would be able to use the marketing and service fee to pay for services provided by retirement plan administrators, shareholder call centers, compensation of underwriters, advertising, printing and mailing of prospectuses to prospective shareholders, and other traditional distribution activities. A fund could also use the marketing and service fee to pay for certain non-distribution expenses, like sub-transfer agency fees, as is currently permitted under Rule 12b-1.

Guidance for Fund Directors. Fund board directors would not be required to adopt or renew a “plan” or make any special findings under proposed Rule 12b-2 (unlike under Rule 12b-1). Instead, fund boards would have the ability to authorize the use of fund assets to finance distribution activities consistent with the parameters set forth under the rule and their fiduciary obligations to the fund and fund shareholders. The fund board would be expected to oversee the amount and uses of the marketing and service fees in the same manner that it oversees the use of fund assets to pay any other fund operating expenses. Finally, a fund would be required to specifically identify and fully disclose the marketing and service fee in the fund prospectus fee table as a type of operating expense.

Shareholder Approval. In order to institute or increase the rate of a marketing or service fee on an existing class of fund shares, a fund would be required to obtain the approval of a majority of its shareholders under proposed Rule 12b-2. With respect to a new class of fund shares, however, shareholder approval would not be required for a fund to institute a marketing and service fee.

2. Ongoing Sales Charges

Under the Proposal, Rule 6c-10 of the 1940 Act would be amended to permit funds to deduct asset-based distribution fees in excess of the 25 basis points annually permitted under Rule 12b-2, provided that the excess amount is considered an “ongoing sales charge” subject to certain sales charge restrictions and an automatic conversion feature. The proposed rule would treat the ongoing sales charge as another form of deferred sales load. Specifically, the cumulative amount of any ongoing sales charge (determined as a percentage of net asset value) for any share class could not exceed the amount of the highest front-end load an investor would have paid if the investor had invested in another class of shares of the same fund (the “reference load”). For funds that do not have any shares with a front-end sales load, the reference load would be the maximum sales charge permitted under NASD Rule 2830(d)(2) for funds with an asset-based sales charge and a service fee, which currently is set at 6.25 percent of the amount invested. In the proposing release, the SEC notes that “by setting the maximum front-end load, the fund, its board, and the principal underwriter would also establish the maximum amount of the cumulative ongoing sales charge.” A fund could impose a contingent deferred sales charge (CDSL) together with an ongoing sales charge, but the total sales charges could not exceed the proposed limit.

Automatic Conversion. Under the proposed amendments, a fund could comply with the maximum sales charge limitation by requiring that the purchased shares that have an ongoing sales charge automatically convert to another class of shares without an ongoing sales charge once the cap has been reached. The shares would be required to convert “no later than the end of the month during which the fund would have paid on behalf of the investor the maximum amount of permitted sales load based on the cumulative rates charged each year.”

The maximum number of months a shareholder could remain invested in a class of shares paying an ongoing sales charge would depend both on the maximum sales load and the rate of the ongoing sales charge, making it easy to determine the conversion period at the time of an investor’s purchase.

The maximum sales charge limit would be a shareholder account-level cap based on the cumulative amount of sales charges that an individual investor pays in any form, effectively replacing the current fund-level cap under NASD rules that limits the amount that FINRA members can collect in asset-based sales charges.

Funds would be required to track investor purchases as each purchase, or “lot,” would have its own conversion period at the end of which the shares of each lot would be programmed to automatically convert, and the maximum length of the conversion period would be unaffected by any subsequent increase or decrease in the value of shares purchased. When fund shares are transferred from one fund intermediary to another, the Proposal would require the receiving fund intermediary to continue to track the shares for purposes of calculating the length of the conversion period.

Quantity Discounts. The proposed amendments would permit (but not require) funds to apply quantity discounts or scheduled variations in the front-end load for which investors may qualify when determining the reference load for an ongoing sales charge.

Reinvestment of Dividends and Other Distributions. Dividends and other distributions reinvested in the same class of shares would be given the same conversion date as the shares on which they were declared.

Guidance for Fund Directors. As under proposed Rule 12b-2, the proposed amendments to Rule 6c-10 would not require fund boards to adopt a plan or approve asset-based sales charges or make any special findings related to these charges. However, fund directors would continue to have fiduciary obligations under the 1940 Act and state law in determining whether the use of the fund's assets to pay ongoing sales charges is in the best interests of a fund and fund investors.

Shareholder Approval. Under the proposed amendments to Rule 6c-10, a fund would be prohibited from instituting or increasing the rate of an ongoing sales charge, or lengthening the period before shares automatically convert, after any public offering or sale of the fund's voting shares to investors other than the fund's organizers, regardless of shareholder approval. A new fund that has not made any public offering or an existing fund with respect to a new class of shares would not be required to obtain shareholder approval before instituting an ongoing sales charge.

Application to Funds of Funds. With respect to funds of funds arrangements, proposed Rule 12b-2 would permit an acquiring fund and acquired fund to charge a marketing and service fee, as long as the aggregate fee charged by the funds together does not exceed the NASD service fee limit of 25 basis points. Furthermore, under the proposed amendments to Rule 6c-10, an acquiring fund and acquired fund could not both impose an ongoing sales charge.

Application to Funds Underlying Separate Accounts. The proposed rule and rule amendments would apply to funds serving as investment vehicles for insurance company separate accounts offering variable annuities or life insurance contracts. Typically, these separate accounts are organized as unit investment trusts, which invest in the proceeds of premium payments made by contract owners in one or more mutual funds (underlying funds) that manage assets supporting insurance contracts. Under the proposed rule changes, an underlying fund would be treated like other mutual funds, and therefore, it could charge a marketing and service fee up to the NASD sales charge limit on service fees. Any asset-based distribution fees charged in excess of the marketing and service fee would be deemed ongoing sales charges and subject to the requirements of proposed Rule 6c-10 (which would require the underlying fund or insurance company sponsor to keep track of share lots attributable to contract owner purchase payments, and provide for the automatic conversion of shares by the end of the conversion period).

Retail Price Competition: Account-Level Sales Charges

As proposed, Rule 6c-10 would also be amended to provide an exemption from Section 22(d) of the 1940 Act, which prohibits mutual funds, their principal underwriters and dealers from selling mutual fund shares to the public except at a current offering price as described in their prospectus. Section 22(d) effectively prevents price competition with respect to the selling price of mutual fund shares because the funds set their own sales load schedules, and all dealers in a fund's shares must sell the shares at the same sales load disclosed in the fund's prospectus. Under the proposed elective account-level sales charge alternative, a fund (or class of the fund) could elect to issue shares without a sales load at net asset value, and broker-dealers would be able to set their own commissions or other types of sales charges to pay for the distribution of the fund's shares. Theoretically, the fee could be paid directly by an investor to the broker-dealer or could be charged to the investor's brokerage account, depending on the arrangement between the broker-dealer and investor, and the fee could be charged at the time of sale, over time or upon redemption. Because the exemption would effectively permit the unbundling of the sales charge components of distribution from the price of fund shares,

the SEC intends that this alternative “would expand the range of distribution models available to mutual funds, enhance transparency of cost to investors, promote greater price competition, and provide a new alternative means for investors to purchase fund shares at potentially lower costs.”

In order to take advantage of the Section 22(d) exemption for any share class, a fund would be required to meet two conditions. First, the fund would not be permitted to charge any front-end sales load or ongoing sales charge with respect to the share class (though the fund would still be permitted to charge a marketing and service fee under proposed Rule 12b-2). Second, the fund would be required to disclose in its registration statement that it has elected to rely on the exemption. A fund seeking to use this alternative distribution model would be required to amend its selling agreements or enter into new agreements to grant their selling broker-dealers the authority to set their own compensation.

Disclosure Changes

1. Transaction Confirmations

The SEC is proposing to amend Rule 10b-10 under the Exchange Act, which currently requires broker-dealers to disclose specific information to their customers about securities transactions, including transaction price, remuneration paid by the customer to the broker-dealer, and in certain circumstances, remuneration received by the broker-dealer from third parties such as a mutual fund.¹ As proposed, amended Rule 10b-10 would require transaction confirmations to disclose additional information, including front-end and deferred sales charges, as well as ongoing sales charges and marketing and service fees.

Specifically, transaction confirmations would be required to disclose the following information:

- Amount of any sales charge that a customer incurred at the time of purchase (both in percentage and dollar terms), in addition to the net dollar amount invested in the security and the amount of any applicable breakpoint or threshold used to calculate the sales charge;
- Maximum amount of any deferred sales charge that a customer may pay in the future, if the customer may pay a deferred sales charge upon redemption of the shares;
- If the customer will incur any ongoing sales charge or marketing or service fee following the purchase:
 - Annual amount of the charge or fee (as a percentage of net asset value);
 - Aggregate amount of the ongoing sales charge that may be incurred over time (as a percentage of net asset value); and
 - Maximum number of months or years that the customer will incur the ongoing sales charge;
- Following statement (which may be modified to reflect the charge or fee at issue): “In addition to ongoing sales charges and marketing and service fees, you will also incur additional fees and expenses in connection with owning this mutual fund, as set forth in the fee table in the mutual fund prospectus; these typically will include management fees and other expenses. Such fees and expenses are generally paid from the assets of the mutual fund in which you are investing. Therefore, these costs are indirectly paid by you.”

¹ Currently, information related to the remuneration received by a broker-dealer from third parties is not required to be included in a transaction confirmation if the customer receives a prospectus that adequately discloses this information.

In the Proposal, the SEC acknowledges that the utility of improving confirmation disclosure to promote investor understanding of fees may be limited, since customers do not receive transaction confirmations until after completing their purchases. However, the SEC indicates that it may consider requiring improved disclosure of cost information prior to the sale of mutual fund shares.

2. Form N-1A

Form N-1A, which is the registration statement used by mutual funds to register with the SEC under the Securities Act and the 1940 Act, would be amended in various ways with the intent of facilitating greater investor understanding of the fees being paid.

Item 3. The prospectus “fee table,” which lists all fund expenses and requires disclosure regarding 12b-1 fees, would be amended to replace such disclosure with disclosure of asset-based distribution fees separated into line items for ongoing sales charges and marketing and service fees.

Item 12(b). The requirement that funds that have adopted Rule 12b-1 plans disclose information about the operation of the plan in the prospectus would be eliminated (because funds would no longer be required to have a “plan”). Instead, funds would be required to disclose whether they charge a marketing and service fee or an ongoing sales charge (and if so, the rates of the fees and the purposes for which they are used). Any fund that imposes an ongoing sales charge would be required to disclose the number of months (or years) when the shares will automatically convert to another class without the charge and after which the shareholder would cease paying such a charge. Additionally, if the fund deducts an asset-based distribution fee for services provided to investors, it would need to describe the nature and extent of the services provided.

Any fund offering multiple classes of shares in a single prospectus (each with its own method of paying distribution expenses) must generally describe the circumstances under which an investment in one class may be more advantageous than an investment in another class.

Item 19(g). The requirement that funds describe in detail the material aspects of its Rule 12b-1 plans and related agreements in the Statement of Additional Information (SAI) would largely be eliminated, because funds would no longer be required to have written “plans” that are approved by their boards of directors under the proposed rules.

Item 25. Funds electing to rely on the exemption to Section 22(d) of the 1940 Act provided by proposed Rule 6c-10(c) must state that they have made this election.

Item 28(m). The requirement that a registered fund attach its Rule 12b-1 plan and any related agreements as an exhibit to the registration statement would be eliminated.

Related Rule Amendments

1. Rule 11a-3 under the 1940 Act

Rule 11a-3 currently permits fund and fund underwriters to charge a sales load on shares acquired in certain exchanges between funds within the same fund group, and is designed to provide shareholders with credit for all sales loads paid (on either the exchanged or acquired shares) in connection with a purchase of fund shares. The SEC is proposing to amend Rule 11a-3 to require funds to also provide shareholders with

credit for the payment of ongoing sales charges in terms of the cumulative rate of the ongoing sales charge previously paid (instead of the amount of fees paid). Rule 11a-3 would further be amended to permit funds to provide credit to shareholders only for the ongoing sales charge portion of the asset-based distribution fee (and not the marketing and service fee) in determining the amount of deferred sales load due upon ultimate redemption of fund shares.

2. Rules 17a-8, 17d-3 and 18f-3 under the 1940 Act

The substance of Rules 17a-8, 17d-3 and 18f-3 under the 1940 Act would be preserved, with proposed amendments to these rules replacing all references to Rule 12b-1 with references to Rule 12b-2 or Rule 6c-10, as appropriate.

Transition Periods

1. Effective Date and Compliance Period

If the proposed amendments are adopted, the SEC is proposing that the amendments become effective within 60 days following the issuance of the adopting release, thereby allowing funds to take advantage of the new rules quickly. However, funds would have 18 months from the effective date within which to comply with new Rule 12b-2, amended Rule 6c-10 and other conforming amendments in connection with any new fund shares sold. Following this 18-month period, funds would be required to comply with the new regulatory framework.

2. Grandfathering

For fund share classes sold prior to the end of the 18-month period, the SEC is proposing to provide a five-year grandfathering period. Within this five-year grandfathering period, qualified share classes may continue to charge Rule 12b-1 fees at the same or lower rate as approved by the fund's Rule 12b-1 plan. During this period, however, fund directors could eliminate mandatory provisions of Rule 12b-1 plans that require board annual approval and quarterly reports, and allow for board or shareholder termination of plans. Fund directors would continue to exercise responsibility over the Rule 12b-1 plan in accordance with their general oversight responsibilities. Following the grandfathering period, these shares would be required to be converted or exchanged into a class that does not deduct an ongoing sales charge.

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