

Financial Services and Products ALERT

July 22, 2010

SEC Proposes New Rules Governing Mutual Fund Distribution Fees Replacing Rule 12b-1

On July 21, 2010, the Securities and Exchange Commission (SEC) voted unanimously to propose a new rule and rule and form amendments under the Investment Company Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934, each as amended, regarding the regulation of distribution fees paid by registered open-end management investment companies, or mutual funds (the "Proposal"). To address concerns of lack of investor understanding with respect to mutual fund distribution fees, or "12b-1 fees," and to enhance clarity, fairness and competition in the sale of mutual fund shares, the SEC proposed new Rule 12b-2 under the 1940 Act to replace existing Rule 12b-1. Currently, Rule 12b-1 directs the way in which a mutual fund may use fund assets to market and sell the fund to investors and how a broker-dealer can be compensated from the fund for its sales efforts.

The Proposal would:

- **Protect Investors by Limiting Fund Sales Charges.** The Proposal would limit the cumulative sales load or charge that an investor could pay overtime, whereby:
 - Sales loads paid over time could not exceed, on a percentage basis, the maximum upfront sales load an investor would have paid if the load had been paid upfront at the time of purchase. For example, if one class of a fund charges a four percent front-end sales charge, another class could not charge more than four percent in total to investors over time. If a fund does not have a class of shares with an upfront sales load, sales loads paid over time could not exceed the maximum permissible sales load under FINRA rules.
 - Payments for ongoing sales loads would be limited to a specific number of years, which would be set forth in written confirmation statements.
- **Improve Transparency of Fees for Investors.** The Proposal would improve disclosure provided in a mutual fund's:
 - Prospectus regarding the fees that are deducted from the fund's assets to pay for sales loads and distribution expenses by:
 - Eliminating the term "12b-1 fee"; and
 - Replacing the 12b-1 fee in the fund's fee schedule with two separate fees: "ongoing sales charges" and "marketing and service fees." "Ongoing sales charges" would reflect the

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percentage of fund assets paid to fund intermediaries for distribution, while “marketing and service fees” would reflect the percentage of fund assets paid to third parties for providing ongoing services to fund investors (marketing and service fees would be limited to 25 basis points per year).

- Confirmation statements by requiring clear disclosure:
 - That certain fees will be deducted from the fund annually to compensate the fund intermediary selling the fund, and that management and other fees will also be deducted;
 - The total sales charge rate that an investor will have to pay; and
 - The amount of sales and marketing fees expected to be paid.
- **Encourage Retail Price Competition.** The Proposal would permit mutual funds to sell through broker-dealers who determine their own sales compensation, subject to market competition. This would allow broker-dealers to sell funds at sales loads they set, instead of having the sales load be set by the fund itself. A broker-dealer could tailor sales charges to different levels of service and to charge shareholders directly. Funds relying on this particular exemption would not be permitted to deduct other sales charges from fund assets for the particular class of shares offered in this manner to prevent double-charging.
- **Revise Fund Director Oversight Duties.** The Proposal would eliminate the need for fund directors to explicitly approve and re-approve fund distribution plans by setting automatic limits on fund fees and charges.

The full text of the proposed rules on mutual fund distribution fees were only made available last night, so the descriptions provided in this special alert are based on the SEC’s press release and statements made by the Commissioners and the staff at the open meeting. A more detailed advisory will follow shortly.

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