



## **A Modest Proposal to the SEC**

By Michael Edesess

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The SEC is now considering reforming how 12b-1 fees are set and disclosed. These proposals are likely to face intense lobbying efforts by industry groups who wish to maintain the status quo.

Perhaps the best way to combat that pressure is to offer a yet more radical proposal. For example, why not a Surgeon General-like warning, slapped on the client agreement in giant, boldface letters, as on a cigarette pack.

If it were written in typical detailed, full-disclosure mode, it might look something like this:

*This fund charges a 12b-1 fee of up to 1.0% of its value. This fee will be deducted each year from your account regardless of how well (or poorly) the fund performs. The fee, which is in addition to any front-end, deferred or other sales load charge, is for the stated purpose of covering marketing, distribution, and other shareholder services (though many funds choose not to market and some funds are closed to new investors). Even if this fund is classified as a "no-load" fund, it may still charge a 12b-1 fee of up to 0.25%. Even if you bought this fund from a discount broker or "fund supermarket," you may still be paying a 12b-1 fee. If you hold this fund in your 401(k) or other retirement account, you may be charged a 12b-1 fee, which will be used to pay for the administrative costs of your plan. In some instances, you may be able to purchase other share classes of this same fund that do not carry 12b-1 fees. According to a 2005 study by the Investment Company Institute (ICI), the trade organization that represents fund companies, 40% of 12b-1 fees went to pay advisors for the initial sales of funds, even though the fee is assessed annually in perpetuity. Your advisor's compensation through 12b-1 fees may be higher than for other funds that you might have bought. The ICI also found that 52% of 12b-1 fees went to pay advisors for ongoing support to clients; this, of course, is in addition to any fee your advisor may charge you for his or her support. The support provided by the fund company may consist of prospectuses, disclosures and other regulatory information, which must be prepared and mailed (or provided electronically) to you. The cost of preparing these materials is generally the same, regardless of the amount of the fund you own; however, the 12b-1 fee you pay will increase along with the amount of the fund you own. Your fund manager may have to take on extra risk in the fund's holdings in order to outperform his or her benchmark after the 12b-1 fees have been deducted.*



If a client asked, “Tell me all about 12b-1 fees,” your answer would have to include the above facts. In fairness, you would also explain that 12b-1 fees, which are part of a fund’s expense ratio, allow clients to pay for advisory fees on a pre-tax basis, whereas advisory fees are paid on an after-tax basis.

But why muddle the answer with all that folderol? What client is going to read through all that, however large the lettering?

The Surgeon General knew how to cut through the muddle of claims and counter-claims when it came to smoking. A prospective client – and every other investor – deserves a clearer, quickly digestible explanation of 12b-1 fees. Therefore, a shorter form of the above warning would be better.

Hence, in the spirit of the brief, forceful warnings (“SMOKING KILLS”) used by the Surgeon General – and based on sound statistical evidence, and on the manner in which 12b-1 fees are currently charged and disclosed – I propose a summary warning as follows:

#### *12b-1 FEES: YOU LOSE*

I subscribe to the principle of *caveat emptor*, provided the buyer is well-informed. If smokers want to smoke, let them smoke, but be adequately warned – strongly if necessary; and if buyers of mutual funds want to pay 12b-1 fees, let them do so, but let them be warned in a transparent manner.

Surgeon General C. Everett Koop showed us how to break the back of a concerted, deliberate misinformation campaign. He saved the lives of hundreds of thousands of people who would otherwise have died of lung cancer. A similar campaign can save the future retirement incomes of millions of people who could otherwise lose as much as half their wealth to unproductive fees.

Let’s put an end to the era of opaque fees. Most clients will only be aware of 12b-1 fees if they take the time to carefully read a fund’s prospectus or Statement of Additional Information. Very few do this; most clients have no idea what 12b-1 fees they are paying.

Let the sun shine in.

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