



The SEC's 12b-1 Proposal is Based on Misguided History, Flawed Economics

By John H. Robinson
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In recent years, the SEC has been apologetic for its lax oversight in the wake of numerous high-profile regulatory shortcomings. Ironically, though, since 2003 the agency has been dogged in its pursuit of 12b-1 reform with SEC officials repeatedly referencing it as a “top priority.”

While the SEC's stated aims of increasing transparency, reducing investor fees, and increasing competition among mutual funds are laudable, my review of its 278-page proposal found major flaws, including a misinformed historical pretext and naïve economic analysis.

I will review the SEC's proposed changes and then explain why its plan is both misguided and would harm consumers.

On July 21, 2010, the agency released its proposal to entirely rescind Rule 12b-1 and replace it with a new “Rule 12b-2” to govern the use of fund revenue to pay for distribution expenses. The new rule effectively requires the conversion of class C shares to A shares at the time when the total cumulative 12b-1 fees paid equal the upfront sales charge the investor would have paid, including breakpoints, if he had originally purchased A shares. Rule 12b-2 also introduces an entirely new class of funds with no 12b-1 fees that would allow dealers to charge an ongoing “sales charge” as a separate externalized fee in a manner not dissimilar to the now vanquished fee-based brokerage accounts. The new set of rules also provides for clearer disclosure of fees and expenses in retail share classes – an improvement that is generally supported by both sides of the 12b-1 debate.

The basis for the SEC's reform proposal is outlined in a video preamble by SEC Chairman Schapiro and in the introduction of the proposal. Specifically, the SEC posits that Rule 12b-1 was adopted in 1980 as short term measure to help the mutual fund industry stem net outflows. At that time, the proposal contends, the SEC believed that using a portion of revenue to pay for marketing and advertising would help fund companies attract assets and that investors would eventually benefit from economies of scale. The proposal also suggests that the SEC never envisioned the use of 12b-1 fees dealer compensation and that such applications evolved under the SEC's radar. This historical perspective is surprisingly misinformed. The entire administrative history of Rule 12b-1 was delivered to



the SEC in a 2004 public comment letter from the American Bar Association's Section of Business Law and was echoed in the first panel discussion of the SEC 12b-1 Roundtable on June 19, 2007. The primary source documents referenced in the ABA letter reveal that state of the mutual fund industry had nothing to do with the adoption of Rule 12b-1 and that the SEC in 1980 had not been persuaded by the economies of scale arguments put forth by fund companies in the 1970's. Instead, the record shows that the SEC adopted Rule 12b-1 to promote competition and innovation in the mutual fund industry and that its true aim was the reduction of the prevailing 8.5% up-front sales loads. Contrary to the 2010 revisionist retrospective, insofar as Rule 12b-1 gave rise to the no-load fund industry, led to competition that spelled the end of 8.5% sales loads, and dramatically increased fund choices, 12b-1 was remarkably forward-thinking and has unquestionably benefited individual investors.

The SEC's economic basis for reform stems from a concern that investors are paying too much of their hard-earned savings in the form of 12b-1 fees. As noted by Chairman Schapiro, ***"These fees amounted to \$9.5 billion in 2009, nearly \$12 billion in 2008 and exceeded \$13 billion in 2007—compared to just a few million dollars in 1980 when they were first permitted."*** Of course, in 1980 there were barely 600 mutual funds with total assets under \$100 billion. Today, there are more than 9,000 funds with assets in the trillions of dollars. To determine whether the SEC's proposal will actually benefit investors requires more sophisticated analysis than simply saying investors are paying too much. The case presented by the SEC is that the drag of higher expenses on long term class C shareholders hurts performance relative to investors who elect to pay up front sales charges. If two funds hold exactly the same investments, the SEC reasons, the one with higher cumulative expenses over time will suffer inferior performance. In reality, however, this model is overly simplistic and does not accurately reflect the economics of mutual fund choice.

To begin, the SEC's model errantly assumes that performance, adjusted for expense ratio differences, is the same across all share classes. In fact, it is not, and the reason it is not is that investor behavior differs depending upon the share class purchased. For instance, [research](#) has shown that, while investors in both A and C share funds tend to underperform the funds in which they invest due to timing decisions, investors in class C mutual funds actually experience significantly better net performance than class A share investors. Additionally, the SEC's economic model overlooks the influence of advisor incentives in mutual fund selection decisions. As noted in the SEC Roundtable testimony of former SEC Chairman Katherine Bradley McGrath, the acceptance of class C shares during her tenure reflected a consensus view that prevails today - that ongoing fee-based compensation better aligns advisor and investor interests than commission-based sales. Of course, investors could still purchase C shares under the SEC's 12b-2 proposal. However, to the extent that brokers who steer their clients to class C shares will experience a dramatic reduction in compensation upon the A share conversion date, the SEC fails to consider the possibility that C share investors may be adversely impacted by either neglect after the 12b-1 fee is reduced or by a recommendation to switch to an



alternative form of investment that will once again provide compensation to the advisor. Similarly, the SEC's economic analysis fails to fully consider the potential impact of substitutes. For example, it is reasonable to assume that a fair number of advisors may recommend switching away from C shares to potentially more expensive alternatives, such as wrap fee advisory accounts and variable annuity contracts.

In closing, the SEC's current 12b-1 reform proposal is inscrutable. To its credit, the SEC has clearly devoted an enormous amount of thought and resources into preparing a 278-page proposal replete with 575 footnotes. However, why the agency is using a distorted historical perspective to advance its position, why it has not seriously analyzed whether investors will actually benefit from the reform, and why it has narrowly focused on C shares, which, according to Morningstar, represent just 5% of the mutual fund market, are difficult to postulate. Equally puzzling is the apparent contradiction in the SEC's disdain for 1% ongoing 12b-1 fees and its apparent acceptance of "2 and 20" hedge funds, undisclosed bond mark-ups, and exorbitant opaque commissions and fees in variable insurance products. Perhaps most perplexing, however, is the SEC's failure to acknowledge a central issue – the use of 12b-1 fees to compensate plan sponsors in 401(k) plans with limited disclosure to participants. These fees are by far the largest contributor to the billions of dollars of annual 12b-1 fees referenced in Chairman Schapiro's remarks and they have been the subject of numerous highly publicized media exposes. This is one aspect of Rule 12b-1 that is truly ripe for reform. On this score, the SEC proposal summarily dismisses the notion of such reform in footnote #459 by stating that these measures might be too disruptive to "existing distribution systems."

To the extent that the SEC is truly motivated to protect the interests of individual investors, the current proposal to rescind and replace Rule 12b-1 seems hopelessly flawed and entirely off target. Unfortunately, judging from the forceful tenor of the SEC's recent commentary, it seems likely that, to paraphrase a line from a classic western, Rule 12b-1 will be given a proper public hearing, after which it will be properly hung.



Supporting literature

- (1) [Transcript of SEC 12b-1 Roundtable, June 19, 2007, Panel 1 Discussion.](#)
 - (2) [American Bar Association Section of Business Law, Public Comment Letter to SEC, May 14, 2004.](#)
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