Unraveling the 12b-1 Debate
By Robert Huebscher
September 28, 2010

The SEC has proposed sweeping changes to the way commission-based advisors will be compensated for the services they provide. Those changes will rename and modify the 12b-1 fees that many mutual funds now charge.

The evolution of 12b-1 fees since their inception 30 years ago has led to many problems, accurately documented in Michael Edesess’ article two weeks ago. The core cause for concern is that the opaque nature of 12b-1 fees makes it likely that most fund purchasers will be unaware of their existence or, if they are aware, will be unable to accurately assess the extent to which advisors are being compensated through those fees for the services they provide.

Does the SEC’s 12b-2 proposal solve those problems? Does it create additional problems? To answer those questions, I spoke with Avi Nachmany, the co-founder and director of research at Strategic Insights, a NY-based consulting firm and data provider that serves over 300 major mutual funds.

Nachmany believes the existing 12b-1 fees serve an important and valuable purpose, and he worries that the SEC’s new proposals could cause many fees to be “externalized” – charged directly by advisors, and not deducted from a fund’s assets – causing the cost of advice to increase.

We’ll take a close look at Nachmany’s claims and I’ll offer my own thoughts, but first let’s quickly review how 12b-1 fees work and the changes that the SEC has proposed.

**The SEC’s proposal**

Approximately 40% of assets across mutual funds are subject to 12b-1 fees; approximately 33% of the fund assets has 12b-1 fees less or equal to than 0.25% of assets. The remainder has fees greater than that. In 2009, funds charged $9.5 billion in 12b-1 fees.

Rule 12b-1 allows fund companies to take those fees from fund assets and pass them on to broker-dealer firms for the services they provide. A portion is kept by the broker-dealer firm, and the remainder is paid to individual advisors.

Advisors and their broker-dealer firms are paid 12b-1 fees for services such as the investment advice by the advisor, and marketing, recordkeeping and account servicing by the broker-dealer.
Rule 12b-2 would limit ongoing fees based on assets. Funds would still be allowed to charge up to 0.25% of assets for the same purposes as they currently levy 12b-1 fees: marketing, recordkeeping, and other advisory services. Beyond such fees up to 0.25%, additional fees paid for advice out of the fund’s assets would be limited in duration. Specifically, such fees could not exceed, on a cumulative basis, the maximum up-front sales load charged on other share classes that have no such ongoing asset-based fees.

Sales charges and ongoing service fees would have to be more clearly disclosed, according to the 12b-2 proposal. In addition to being listed in the prospectus, as 12b-1 fees already are, they would also be disclosed on transaction confirmations and client statements.

Broker-dealers, under 12b-2, would be allowed to impose their own sales charges, in addition to whatever fees are charged by the fund. These fees would be competitively determined in the marketplace.

The greatest impact of the new rules would be for funds with 12b-1 fees greater than 0.25% (approximately 7% of all fund assets). These funds would need to track such fees and terminate them at some point. All funds that continued to pay such fees (titled “ongoing sales charges”) would need to track the amount paid on a cumulative basis, at the tax lot level, to ensure it does not exceed the allowable maximum.

The pros and cons of 12b-2

Nachmany was one of the panelists at the SEC Public Hearing on Rule 12b-1 held in June 2007, the last time 12b-1 reform was discussed. His sentiment then was summarized in a 2007 study his firm wrote:

Eliminating Rule 12b-1 and externalizing fees charged for advice would result, over time, in a significant increase in what the average mutual fund investor would pay for advice. It could end up doubling the out-of-pocket costs, when also accounting for the tax benefits lost as compared to charging 12b-1 fees through the mutual fund. Furthermore, many lower income and wealth investors using mutual funds would be shut out completely from access to affordable personal advice.

Now, he said, the proposed Rule 12b-2 “preserves many benefits to investors and financial advisors that were enabled via Rule 12b-1.”

In coming to his conclusion, Nachmany reviewed the context in which 12b-1 are imposed. He said that 80% of funds are sold through a financial advisor – an RIA, financial planner, or traditional broker. Those advisors provide important services, and investors seeking their counsel come to them, willing to pay a fee. Both 12b-1 and how they are modified in Rule 12b-2 are reasonable ways for those fees to be paid.
Nachmany’s next point was one that he said is rarely articulated or even understood. When you pay for advice through a fee that is part of fund expenses (such as a 12b-1 fee), you are paying for it in pre-tax dollars; you are automatically deducting the cost of that advice out of the fund’s return.

In contrast, if you pay for advice through a separate fee outside of fund expenses (the way most RIAs are compensated, or how fees are charged in mutual fund wraps, in UMAs or SMAs, etc.), the fees are paid in after-tax dollars and are rarely shown as a deductible expense in one’s tax filing.

Thus, for a high tax-rate investor, paying for advice through 12b-1 fees is ultimately cheaper than a payment to their RIA, as the after-tax advice cost in RIA relationships could be roughly twice as high as through 12b-1, Nachmany said.

Third, according to Nachmany, many financial advisors are quite concerned about the 12b-1 0.25% service fee, which is the foundation of their ability to continue to serve and guide many of their smaller customers. Rule 12b-2 preserves that fee and maintains the economic incentive to continue to service small investors.

Nachmany said it is too early to gauge the reaction of his clients to the proposed 12b-2 changes. He said there are many operational, technical and legal considerations to fine-tune.

He noted a number of areas of concerns that are often expressed in his discussions with clients. “First,” he said, “by itself Rule 12b-2 will not dramatically change how mutual funds are sold and advised. But 12b-2 is just one of many regulatory developments underway.”

Among the other questions yet to be resolved are how new fiduciary standards will affect mutual fund sales by financial advisors and brokers. What are the mutual-fund-related details of new point-of-sales disclosure standards? What areas related to mutual fund distribution by financial advisors does the Wall Street Reform and Protection Act affect?

“At this point, these regulatory changes are not set to be harmonized or aligned with each other, or planned to be decided and implemented simultaneously,” Nachmany said. “Should the SEC collect input on all of these rule changes, but finalize them simultaneously once all the interdependencies are fully considered?”

Small retirement plans

Another concern not addressed in the 12b-2 proposal, Nachmany said, is how to pay for the costs of small retirement plans. Defined contribution (DC) plan investments in mutual funds total over $2 trillion. Most plans use low-fee share classes having no 12b-1 fees or classes with up to 0.25% 12b-1 fees to compensate for some of the plan’s costs. Only
about 4% of DC-plan assets are invested in mutual fund share classes that charge more than 0.25% in 12b-1 fees (mostly retirement plan-dedicated R shares).

The rule 12b-2 proposal requires that currently charged 12b-1 fees over 0.25% will have to be tracked post-purchase for each investment and stopped after a certain number of months. Nachmany said this raises two critical issues for small retirement plans currently dependent on 12b-1 fees: one, their costs need to be paid for and do not stop after month “X.” Secondly, some such plans do not track each investment tax lot (unlike taxable accounts where you need to know the cost basis of each investment and thus you track it through its life).

Without the technology to track each tax lot, such retirement plans cannot monitor individual contributions and determine when to terminate “ongoing sales charges.” Unless these plans develop such tax-lot tracking capability, Nachmany said, they would not be able to use certain type of high-fee share classes in a few years.

Nachmany sees one possible solution, which is to offer an exemption from 12b-2 to small retirement plans, to relieve them of the burden to track each tax lot and determine when to terminate ongoing sales charges.

The future of externalized fees

I asked Nachmany whether he foresees a world where more and more fees are externalized, with a greater number of advisors operating in a fee-only model. He’s not convinced this will happen, nor is he convinced that it should. There is “little transparency across organizations as to the level of such [externalized] fees,” Nachmany said, “and no easy way to compare the depth and quality of services they pay for, such as investment selection and asset allocation, but also financial planning, guidance, real estate and mortgages, and estate planning."

“When fees for advice are paid through 12b-1, you have transparency,” Nachmany said, “In a world of externalized, uncapped fees for advice, my hunch is that such fees will not trend to be significantly lower than they are today.”

Nachmany does not suggest that externalization of fees will lead to higher costs for advice. Yet, he said that, on an after-tax basis, the fees charged by many RIAs are higher than 12b-1 fees paid by investors, at times for not dissimilar services.

After listening to Nachmany, I admit that he is clearly right about the after-tax benefits of paying for advice through internalized fees, and his concerns about small retirement plans are entirely justified. The benefits of externalized fees are equally clear, though. Investors are better able to identify and assess the value of externalized fees than the value of fees that are bundled into a fund’s expense ratio.
With proper disclosure of external fees, I believe the cost of advisory services would be competitively determined in the marketplace. Those competitive forces are much more likely to work in a world of external fees than when those fees are internalized. That was surely the SEC’s motivation for capping 12b-2 fees at 0.25% of assets.

Perhaps part of the solution would be to make advisory fees tax-deductible, to remove the tax advantage of internalized fees. For now, the SEC’s 12b-2 proposal is a reasonable step forward, but the best long-term solution would be to externalize all advisory fees.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit: http://www.advisorperspectives.com/subscribers/subscribe.php