



MUTUAL FUND DIRECTORS FORUM

The FORUM for FUND INDEPENDENT DIRECTORS

REPORT

of the

MUTUAL FUND DIRECTORS FORUM

BEST PRACTICES AND PRACTICAL GUIDANCE FOR DIRECTORS UNDER RULE 12b-1

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TABLE OF CONTENTS

	<u>Page</u>
I. Introduction	1
II. Background	3
III. Practical Guidance for Independent Directors Regarding Their Review of 12b-1 Plans	8
A. Developing an Understanding of the Fund’s System of Distribution and the Role of the Fund’s 12b-1 Plan in that System.....	8
1. All fund directors should have a general familiarity with the ways in which any fund for which they are responsible is distributed, irrespective of whether the distribution arrangements include a 12b-1 plan.	8
2. Fund directors should understand how a fund’s 12b-1 plan fits into the fund’s overall distribution plan.	8
3. Fund directors should request and obtain from management the materials and information necessary to evaluate the fund’s 12b-1 plan, including a breakdown of how 12b-1 fees are being used.....	9
B. Basic Steps in Evaluating the Fund’s 12b-1 Plan.....	10
4. Fund directors need to judge whether continued distribution through the fund’s existing intermediate channels is in the best interests of the fund’s shareholders.	10
5. The factors and considerations that fund directors use to analyze the value and efficacy of the fund’s 12b-1 plan should be related to the purposes of the plan.	11

6.	As part of their review of the fund’s plan, fund directors should be aware of the factors identified in the SEC’s initial adopting release for Rule 12b-1. However, they need consider only those factors relevant to their fund’s circumstances, and should assign those factors an appropriate weight as part of their analysis of whether to continue, alter or eliminate their fund’s 12b-1 plan.	12
C.	Basic Considerations that May Warrant Use of Fund Assets in Support of Distribution.....	12
7.	Directors should consider the ways in which continued distribution of fund shares, and, in particular, the use of fund assets to pay for distribution, will potentially benefit fund shareholders.	12
D.	Evaluating those Parts of the Fund’s 12b-1 Plan that Substitute for a Load.....	14
8.	Directors may consider the need of the fund to penetrate particular distribution channels in the marketplace, as well as the competitive conditions within those channels, as part of their analysis of the fund’s 12b-1 plan.	14
9.	In appropriate circumstances, fund directors may wish to consider whether fund shareholders (or shareholders of a particular class) have effectively agreed to pay specific amounts to support distribution of the fund to them.	14
10.	Although fund directors should review carefully the need for a 12b-1 plan when a fund is closed to new investors, the need to repay amounts already spent distributing the fund can warrant continuance of the plan.	15
E.	Evaluating those Parts of a 12b-1 Plan that Pay for Administrative and Shareholder Support Services.....	16

11.	With respect to each of the services being funded through a 12b-1 plan, directors should examine whether the cost of the service is reasonable in light of the nature of the service generally and the quality of the specific service being obtained.	16
IV.	Conclusion.....	17

Report of the Mutual Fund Directors Forum: Best Practices and Practical Guidance for Directors under Rule 12b-1

I. Introduction

Over 25 years ago, the Securities and Exchange Commission (“Commission” or “SEC”) reversed a long-held position and adopted Rule 12b-1¹ to permit, under certain circumstances, mutual funds to use fund assets to pay for the distribution of fund shares.² The rule, among other things, requires fund boards to approve annually the plans that govern distribution payments. In adopting Rule 12b-1, the Commission contemplated that the plans would be used by a fund for limited periods of time and, in that context, provided directors with guidance on what factors they should consider in reviewing and approving 12b-1 plans.³ Accordingly, the guidance that was given was largely limited to situations where a fund was facing net redemptions or other temporary difficulty.

In fact, 12b-1 plans have been rarely used for that purpose. Instead, they have achieved widespread popularity because of their use for two very different purposes. First, they compensate brokers and sellers of fund shares for shareholder accounting and other services provided to fund shareholders; and second, and most important, they offer purchasers of fund shares the alternative of paying for the services of a broker or other intermediary through a continuing 12b-1 fee rather than through the traditional front-end load – a use never contemplated by the Commission when Rule 12b-1 was adopted.

Moreover, the competitive landscape in which 12b-1 fees are used has become significantly more complex since the adoption of 12b-1. Today, 12b-1 fees cover only one portion of the elaborate and highly competitive range of distribution payments to intermediaries. Because the SEC has provided fund directors with little formal guidance regarding Rule 12b-1 since its original adoption, there essentially is none that addresses the competitive landscape in which Rule 12b-1 is used today – a landscape in which funds are distributed through numerous intermediary channels not controlled by the funds, the sales and other charges for using those channels are largely nonnegotiable, and access to those channels is increasingly viewed as a necessity for even traditional no-load funds to remain viable. In addition, many directors have found that the avid market competition for inflows (and the costs associated with that competition) makes altering existing 12b-1 plans virtually impossible in the absence of regulatory change.

Perhaps in recognition of the absence of guidance relevant to today’s mutual fund distribution systems, when then-SEC Chairman William Donaldson requested that the Forum develop best practices for the governance of mutual funds in 2003, he also asked

¹ See 17 CFR 270.12b-1.

² See *Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Release No. 11414 (October 28, 1980) [45 FR 73898 (November 7, 1980)] (“Rule 12b-1 Adopting Release”)

³ See *id.*

that the Forum draft best practices for the review of 12b-1 plans.⁴ Subsequently, in 2004, the Forum released its best practices report containing recommendations on, among other things, fund governance and director oversight of soft dollars, directed brokerage, revenue sharing arrangements and valuation and pricing. However, the Forum deferred addressing 12b-1 with the expectation that the SEC or its staff would provide further guidance on what direction it was going to take.⁵

Although neither the staff nor the Commission has since released additional guidance on Rule 12b-1, recently, there has been an acknowledgement that the uses of 12b-1 have changed substantially since the adoption of the Rule. Both Chairman Christopher Cox and Division Director Andrew Donohue have stated that the Commission will begin to reexamine Rule 12b-1 (and the financing of distribution generally) by the end of 2007.⁶ We welcome this comprehensive reexamination of Rule 12b-1 – and of the issues associated with distribution generally. As a follow-up to this report, the Forum intends to continue studying potential avenues for reforming the regulatory structure that governs distribution payments and will work with the Commission with respect to any proposed regulatory reforms.

Fund boards, however, cannot wait for thoroughgoing regulatory reform. In spite of the problems inherent in the Rule as currently written, directors must still abide by it. More specifically, the Rule requires the independent directors of a fund initially to approve adoption of a Rule 12b-1 plan,⁷ to review quarterly reports of the expenditures made pursuant to the fund's 12b-1 plan,⁸ and finally to approve continuation of the plan annually based on findings that the plan continues to benefit the fund and its shareholders.⁹ While fund directors often receive voluminous material in connection with the annual approval process, there is little meaningful guidance from the SEC or elsewhere on the issues that are relevant to the continuance of the plan. Indeed, the factors that the Commission suggested in 1980 should guide directors in their review of 12b-1 plans are today, in the context of current systems of distribution, largely irrelevant.¹⁰ Therefore, to assist fund directors as they struggle to evaluate plans fairly,

⁴ See Letter from William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, to David S. Ruder, Chairman, and Allan S. Mostoff, President, Mutual Fund Directors Forum (November 17, 2003), http://www.mfdf.com/UserFiles/File/best_pra.pdf.

⁵ The expectation was based on the fact that, at the time that the Commission banned directed brokerage in early 2004, it also sought comment on how to reform Rule 12b-1.

⁶ See Speech by the SEC Chairman: Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference by Chairman Christopher Cox in Washington, D.C., April 13, 2007 (available at www.sec.gov/news/speech/2007/spch041207cc.htm). See also Speech by SEC Staff: Keynote Address at 2007 Mutual Funds and Investment Management Conference by Andrew J. Donohue, Director, Division of Investment Management, Palm Desert, California, March 26, 2007 (available at www.sec.gov/news/speech/2007/spch032607ajd.htm).

⁷ Rule 12b-1(b)(2).

⁸ Rule 12b-1(b)(3)(ii).

⁹ Rule 12b-1(b)(3)(i); Rule 12b-1(e).

¹⁰ Although directors are not required to consider any particular factors, the Rule 12b-1 Adopting Release suggests that the following factors “may provide helpful guidance to directors” when

the Forum is now publishing “practical guidance” for directors under Rule 12b-1. This guidance was developed with significant input from leaders in the independent director community, who not only have thought deeply about these issues, but also have faced them on a regular basis as directors of both large and small funds.¹¹ While these guidelines necessarily reflect the imperfections of the current regulatory structure, they nonetheless should provide a basis for fund directors who must make crucial decisions about their funds’ distribution plans.¹²

II. Background

In 1940, Congress was concerned with the potential conflicts of interest if mutual funds paid for distribution costs out of the assets of the fund. Section 12(b) of the Investment Company Act of 1940, as amended (the “1940 Act”), therefore makes it unlawful for mutual funds to distribute their own securities, but grants the SEC authority to regulate the use of fund assets to pay for the distribution of fund shares.¹³ The SEC

considering Rule 12b-1 plans: (1) consider the need for independent counsel or experts in reaching a determination; (2) consider the nature of the problem or circumstance which purportedly makes implementation or continuation of such a plan necessary or appropriate; (3) consider the causes of such problems or circumstances; (4) consider the way in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including the nature and approximate amount of the expenditures; the relationship of such expenditures to the overall cost structure of the fund; the nature of the anticipated benefits, and the time it would take for those benefits to be achieved; (5) consider the merits of possible alternative plans; (6) consider the interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company’s shares, including whether any payments by the company to such other person are made in such a manner as to constitute the indirect financing of distribution by the company; (7) consider the possible benefits of the plan to any other person relative to those expected to inure to the company; (8) consider the effect of the plan on existing shareholders; and (9) consider, in the case of a decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the company and its shareholders.

¹¹ To prepare this Report, the Forum organized a working group that consisted of members of the Forum and the Forum’s Advisory Board. Members of the working group participated in this effort in their individual capacities, and not as representatives of their organizations, the fund boards on which they serve, or the funds themselves. Drafts of this Report were reviewed by the Forum’s Steering Committee and Board of Directors, and their comments have been integrated into this document. The Report does not necessarily represent the views of all Forum members in every respect.

¹² In recommending these best practices, the Forum recognizes that each fund and fund family is unique, that fund directors need to assess whether a particular practice makes sense for a particular fund, and that in some circumstances the independent directors of a fund may reasonably conclude that the recommended practice may not be in the best interests of their fund’s shareholders. The Forum’s recommendations are not intended to be legally mandated, nor should they carry any implication that current or prior practices not consistent with the recommendations involve a breach of fiduciary duty or a violation of law. Finally, this Report is not intended, nor should it be relied upon, as a substitute for appropriate professional advice with respect to the applicability of laws and regulations in particular circumstances, nor is it intended to express any legal opinion or conclusion concerning any specific policy, procedure, practice or activity.

¹³ See Section 12(b) of the 1940 Act. The legislative history characterizes the section as one that “protects the open-end company against excessive sales, promotion expenses, and so forth.”

adopted Rule 12b-1 in 1980, following a prolonged period of net redemptions for the mutual fund industry as a whole in the latter half of the 1970s. Rule 12b-1 reflected the culmination of industry efforts in the 1970s urging the SEC to reexamine its position that fund assets may not be used for distribution of fund shares.¹⁴ It sought to address the argument of mutual fund sponsors that it would be in the interest of fund shareholders to permit the use of fund assets as a supplemental source of financial support for the distribution of mutual fund shares as a way of addressing the problems created by industry-wide net redemptions.¹⁵ Accordingly, Rule 12b-1 reversed the historic SEC position that fund assets should not be used for distribution.¹⁶ In so doing, the rule recognizes the “serious conflict of interest that may exist between a fund and its investment adviser when fund assets are used to finance distribution.”¹⁷ The rule relies heavily on a fund’s directors, particularly its independent directors, to manage that conflict. It reflects the view that, with appropriate safeguards, the independent directors of mutual funds should be permitted to make a business judgment that the use of fund assets to finance distribution, under some circumstances, would be in the best interest of the fund and its shareholders.

At the time of the adoption of Rule 12b-1, the SEC believed that distribution expenditures paid by a fund would actually benefit the fund and its shareholders only in limited circumstances. Accordingly, the Rule contains significant procedural and substantive standards.¹⁸ A fund may make distribution-related payments only in accordance with a written plan, and any agreements relating to implementation of the plan also must be in writing. The plan initially must be approved by the fund’s board of directors, including a majority of the independent directors, at an in-person meeting. The plan, if adopted after the fund’s initial public offering, also must be approved by a

Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcommittee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 112 (1940) (Statement of David Schenker).

¹⁴ *See Bearing of Distribution Expenses by Mutual Funds Investment Company Act* Release No. 10862 (September 7, 1979) [44 FR 54014 (September 17, 1979)] (“Rule 12b-1 Proposing Release”)

¹⁵ Supporters argued that increased sales: (1) could lead to economies of scale reflected in a decline of a fund’s overall expense ratio as its size increases, (2) could permit a fund to employ a greater variety of portfolio management techniques and strategies, (3) generally permit a fund to obtain better, and lower cost, portfolio execution services, and (4) attract and retain higher quality investment and other personnel. *See Memorandum for Staff Use in Responding to Public Inquiries Regarding Disclosure and Other Issues Raised by Certain Types of 12b-1 Plans* (May 21, 1986) (pub. avail. June 4, 1986) (“Staff Memorandum”).

¹⁶ The SEC’s historic position was based on a concern that, if the expenditures were paid by the fund, a fund’s adviser (who is typically compensated based on the size of the fund) might encourage the fund to pay excessive amounts for distribution in an attempt to increase the size of the fund and therefore the adviser’s compensation. *See Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Inv. Co. Act Rel. No. 16431* (June 13, 1988) (the “1988 Release”).

¹⁷ Staff Memorandum.

¹⁸ *See Rule 12b-1. See also Staff Memorandum* (observing that the procedural and substantive standards of Rule 12b-1 were intended to be more stringent than those that apply to the approval or renewal of an advisory contract).

majority of fund shares. Any material changes to the plan must be approved by both the board and shareholders. The board, including a majority of the independent directors, also must approve continuation of the plan annually based on findings that it continues to benefit the fund and its shareholders. The board must review, at least quarterly, reports of expenditures paid under the plan and their purposes. Rule 12b-1 also obligates parties (*i.e.*, the fund's distributor) to furnish the fund's board with all information reasonably necessary for the directors to make an informed decision to adopt or continue a plan. Further, the fund's board of directors must satisfy the fund governance standards contained in SEC rules. By the time the SEC finally approved Rule 12b-1 in 1980, the fund industry had emerged from net redemption status and started experiencing significant growth. Consequently, the Rule at first was seldom used and then only by no-load funds on a temporary basis. By the mid-eighties, however, an increasing number of intermediary-distributed funds began to use Rule 12b-1 as an alternative to the front-end sales load. Under these alternative arrangements, funds effectively allowed purchasers of shares to defer payment for the services of their intermediary by investing in a class of shares which paid an annual asset-based distribution fee instead of a front-end sales load. Often the distribution fee amounted to one percent of net assets annually, but some fees were higher.

By 1988, over 1,100 funds (approximately 52 percent of funds at the time) had adopted 12b-1 plans that provided an asset-based fee alternative to the front-end sales load.¹⁹ Through the mid-eighties, the Division of Investment Management became increasingly concerned that Rule 12b-1 was being used for a purpose never intended or even anticipated by the SEC in 1980, and that potential abuses might arise from that use. Accordingly, in 1988, following the publication of the Staff Memorandum in 1986 and subsequent input from a number of sources, the Division recommended to the SEC, and the SEC issued, proposed revisions to Rule 12b-1.²⁰ The proposed revisions, although characterized as a "midcourse correction," essentially would have abolished the use of Rule 12b-1 as an alternative to the front-end sales load.²¹

The mutual fund industry vigorously opposed the SEC's 1988 proposal. It contended, among other things, that Rule 12b-1 provided a useful alternative to the front-end sales load for fund investors because it allowed the full amount of their investment to work for them immediately and that any abuses (and the industry contended that there was no evidence of abuse) could effectively be addressed by disclosure and regulatory initiatives.²² To this end, the ICI suggested, among other things, that the level of 12b-1 fees be regulated by the National Association of Securities Dealers, Inc. (the "NASD")

¹⁹ See 1988 Release.

²⁰ See *id.*

²¹ The proposed revisions would have virtually eliminated "spread-load" plans by prohibiting 12b-1 payments for expenses incurred more than one year prior to payment, preventing underwriters from recouping, over time, distribution expenses fronted at the time of sale. See *id.*

²² See *id.*, citing the Statement of the Investment Company Institute Regarding the Operation of Rule 12b-1 Plans, submitted by the Investment Company Institute (the "ICI") in August 1986 in response to the Staff Memorandum.

with limitations that would be the “economic equivalent” of the limitations on front-end sales loads contained in NASD Conduct Rule 2830.²³ That limit was 8.5% of the public offering price, which amounted to 9.2% of the amount invested.²⁴

At the behest of the SEC and the ICI, the NASD undertook a study to determine limits on asset-based sales charges that would be the economic equivalent of its front-end sales load limits. The study examined many factors, including the average holding period for fund investments and appropriate measurements for the time value of money. It found that the economic equivalency test would support an annual distribution fee of 75 basis points and that, in addition, an annual service fee of not more than 25 basis points would be appropriate to incentivize brokers and other intermediaries to provide their fund customers with continuing service.²⁵ Ultimately, with industry support, the SEC approved amendments to NASD Conduct Rule 2830 to impose these limitations on 12b-1 fees.²⁶ Over the years, front-end sales loads have declined from the 8.0% - 8.5% level that prevailed for equity funds at the time of the NASD study; they now hover around 5.25% - 5.75% of the public offering price (but they now often include a 25 basis point 12b-1 fee or service fee).²⁷ The NASD limits, however, have not been changed.

Today, 12b-1 fees are widely used in the fund industry. Virtually all intermediary-distributed funds, as well as an increasing number of funds which are primarily no-load funds but have intermediary-distributed share classes, have adopted 12b-1 plans. As noted above, when Rule 12b-1 was adopted, the SEC contemplated that fund assets to support distribution would be used for relatively short periods of time or to deal with particular distribution problems. In fact, they are seldom used in this way today. Instead, 12b-1 plans are used on a continuing basis for different purposes. First and foremost, they are used to provide shareholders with an alternative to the front-end sales load for compensating intermediaries. Second, 12b-1 plans are used to protect payments for administrative and shareholder services performed by distributors of fund shares against an attack that the distribution relationships might preclude fund managers from negotiating such service fees on an arm’s-length basis. According to the ICI, over 95% of the 12b-1 plans are used for these two purposes.²⁸ In addition, some fund

²³ Although the NASD Conduct Rules only apply to fund distributors and not the funds themselves, by prohibiting distributors to sell fund shares with sales loads in excess of the proscribed amounts, the rules effectively regulate mutual fund sales charges.

²⁴ See Sec. Exch. Act Rel. No. 30897 (July 7, 1992).

²⁵ These limits are embodied in NASD Conduct Rule 2830(d)(2)(E), which prohibits the offer or sale of fund shares with an asset-based sales charge in excess of 75 basis points and NASD Conduct Rule 2830(d)(5), which prohibits the offer or sale of fund shares with a service fee (*i.e.*, payments by a fund for personal service and/or maintenance of shareholder accounts) in excess of 25 basis points.

²⁶ The amendments revised, among other things, the definition of the term “sales charge” for purposes of the rule to include all “charges or fees that are paid to finance sales or sales promotion expenses, including ... asset-based sales charges” (*i.e.*, 12b-1 fees).

²⁷ In addition, share classes sold without front end loads have grown in popularity in recent years.

²⁸ See Use of 12b-1 Fees by Mutual Funds in 1999, *Fundamentals*, Vol. 9. No. 1 (April 2000) available at www.ici.org/pdf/fm-v9n1.pdf.

complexes, most notably the Fidelity Funds, have adopted so-called “defensive” 12b-1 plans which are designed to permit directors to consider the sponsors’ distribution expenses in evaluating the reasonableness of management fees.²⁹

The widespread use of 12b-1 fees has led mutual funds to establish multiple classes of fund shares in order to accommodate shares purchased under front-end sales load arrangements and under different types and levels of asset-based fee arrangements. The most common fund share classes are Class A, which charge a front-end sales load and often a small annual 12b-1 fee, Class B, which charge an annual 12b-1 fee and impose a contingent deferred sales load (“CDSL”) and typically convert automatically to Class A after a period of six to eight years, and Class C, which charge an annual 12b-1 fee and impose a CDSL. Class B and C usually charge the highest 12b-1 fees and impose a sales charge on those shareholders who redeem their shares within specified periods. The CDSL consists of a percentage of redemption proceeds and may decline over the period of investment.

Other share classes commonly provide for reduced levels of 12b-1 fees for shares purchased by participant-directed retirement plans or to pay only for the administrative and servicing expenses in amounts usually not in excess of 25 basis points per year. The development of multiple share classes to accommodate these various 12b-1 plans has served to complicate what otherwise would be a relatively simple corporate or trust structure for investment of a pool of money contributed by a multitude of investors who seek professional management of a diversified portfolio of securities.

Within this context, we now recommend “best practices” for evaluating, and ultimately passing upon, a fund’s 12b-1 plan in light of the current strictures of Rule 12b-1. These guidelines are not intended to be obligatory. Instead, because every fund faces different circumstances, directors will need to adapt and apply these guidelines sensitively and flexibly to the issues faced by the individual funds they oversee. Finally, these guidelines are not formulaic, and thus are not designed so that their correct application will somehow produce the “right” answer. Rather, they are designed to assist directors in more effectively applying their judgment to the complex distribution choices faced by funds.

²⁹ By acknowledging that the fund sponsor may make payments to support the distribution of fund shares, “defensive” 12b-1 plans seek to protect the fund’s adviser from allegations that its management contract is merely a conduit for distribution spending.

III. Practical Guidance for Independent Directors Regarding Their Review of 12b-1 Plans

Developing an Understanding of the Fund's System of Distribution and the Role of the Fund's 12b-1 Plan in that System

- 1. All fund directors should have a general familiarity with the ways in which any fund for which they are responsible is distributed, irrespective of whether the distribution arrangements include a 12b-1 plan.**

Along with good investment performance, effective distribution is key to the long-term success of virtually all mutual funds. Among other things, effective distribution of fund shares could reduce costs incurred by fund shareholders by smoothing out cash flows, enhancing and simplifying portfolio management, attracting (and retaining) talented investment professionals, and allowing the realization of economies of scale achievable with larger fund asset size.

In the current marketplace, provision of services to fund shareholders is often part of the distribution system. In particular, the payments that intermediaries receive for the sale of fund shares often includes a variety of components, including compensation for services ranging from the initial sale to the ongoing servicing of shareholder accounts to the provision of individually tailored advice to fund shareholders.

A fund's approach to distributing fund shares – including its use of a 12b-1 plan to finance that distribution -- is generally developed by the fund's adviser and underwriter and then presented to the fund's Board of Directors. Distribution may be paid for in any number of ways, including through front- or back-end loads, through 12b-1 plans, or by revenue sharing or other payments made by the fund's adviser or its affiliates. Because of the importance of distribution to the overall success of the fund, of which a 12b-1 plan is just one piece, directors should both understand the role of and oversee the performance of the fund's primary underwriter. While directors are not responsible for either the design or the day-to-day management of a fund's distribution system, their general oversight responsibilities include an understanding of the arrangements in place for distribution of fund shares.

- 2. Fund directors should understand how a fund's 12b-1 plan fits into the fund's overall distribution plan.**

Accordingly, rather than considering the 12b-1 plan in isolation, directors should first seek to understand the manner in which fund shares are distributed, the economics of the distribution system, and the competitive environment within which their funds operate. By initially undertaking this broader task, directors will be better able to understand the role of the fund's 12b-1 plan in the context of the fund's distribution system.

As part of understanding the role of a fund's 12b-1 plan, directors should identify the types of distribution expenses that the plan is expected to fund. By doing so, directors will be in a better position to determine whether the expenses incurred are appropriate,

what (if any) impact they can have on the amount of the expense, and, where there is any flexibility, whether the amount of the expense is reasonable.

Most broadly, 12b-1 plans are often used as a substitute for front-end loads and to pay for other direct expenses associated with the distribution of fund shares. Somewhat more specifically, the key categories of distribution expenses covered by 12b-1 plans are:

- Payments to brokers and other financial advisers for the sale of fund shares;
- Ongoing shareholder services;
- Reimbursements and other payments to fund underwriters; and
- Advertising and other promotional expenses.

In order to understand their fund's 12b-1 plan fully, including the specific types of payments made under the plan, directors should seek to understand how the categories of 12b-1 payments relate to other payments made to intermediaries and the competitive environment within which such compensation is paid.

3. Fund directors should request and obtain from management the materials and information necessary to evaluate the fund's 12b-1 plan, including a breakdown of how 12b-1 fees are being used.

Developing an understanding of the goals and underpinnings of a fund's 12b-1 plan is, by itself, not sufficient to permit fund directors effectively to analyze the plan. Rather, at least with respect to an existing 12b-1 plan, directors need to understand how the plan is, in fact, being used. In order to accomplish this, directors should obtain and review materials regarding the fund's 12b-1 plan, including detailed information regarding how payments are being made pursuant to the plan.

Rule 12b-1 explicitly states that directors have a right (indeed, a duty) to obtain materials related to the plan, including a requirement that directors be provided, on a quarterly basis, "a written report of the amounts so expended and the purposes for which such expenditures were made."³⁰ Directors need to exercise this authority thoughtfully, and should seek to ensure that they are receiving full and meaningful information about their fund's 12b-1 plan and that that information is sufficiently detailed to permit them to see the purposes for which expenditures are being made, who is the recipient of those expenditures and especially the amount, if any, of 12b-1 fees that are being retained by affiliates of the fund. Obtaining this type of information will place the Board in a better position to evaluate the overall efficacy of the fund's 12b-1 plan.

Directors may also employ other resources as part of their attempt to understand how a 12b-1 plan is functioning. Most notably, directors may wish to seek the assistance

³⁰ Rule 12b-1(b)(3)(ii).

of the fund's chief compliance officer as well as their independent counsel in developing a more comprehensive understanding of the operations of the fund's 12b-1 plan. In addition, in more unusual circumstances, directors may consider hiring a consultant or other outside expert to help them understand or analyze particular aspects of a fund's 12b-1 plan.

Basic Steps in Evaluating the Fund's 12b-1 Plan

4. Fund directors need to judge whether continued distribution through the fund's existing intermediate channels is in the best interests of the fund's shareholders.

In analyzing a fund's 12b-1 plan, directors, in the broadest sense, must determine whether the 12b-1 plan is in the best interests of fund shareholders. As developed further below, the process of making this determination depends in large part on the purpose or purposes that underlie the plan, including the distribution channels that the plan is intended to permit the fund to access.

The task, at least on its face, appears most straightforward in situations in which the 12b-1 plan is used exclusively to pay for shareholder, accounting and other services – under these circumstances, directors presumably can focus on the nature, quality and cost of the services that are paid for out of the 12b-1 plan. Nevertheless, directors face the reality that their ability to influence the price paid for services provided by distributors of fund shares is limited and that their ability to influence precisely which services are obtained in return for participating in specific distribution channels is also likely to be restricted.

With respect to a plan that is used partly to pay for services and partly to pay for distribution, the analysis of the expenditures for services should be analogous. However, the analysis may not be simple, as rarely are the costs of the non-distribution services received readily separable from the cost of the distribution services and, in any event, are dictated by competitive conditions. The more that services are wrapped into distribution arrangements – that is, the more that services and distribution are provided to the fund from a single source in a bundled fashion – the more difficult the task becomes to evaluate the nature, quality and cost of the services or to effect changes in the arrangements without affecting the distribution relationship. For example, the services being provided in these circumstances may or may not be of value, and directors will likely not be in a good position to evaluate the value and quality of the services being provided or to influence the cost of the services. Directors may also discover that, as a result of the manner in which services are provided, their ability to evaluate and affect the quality of services is highly circumscribed. To the extent feasible, directors nonetheless should request information concerning the nature, quality and cost of services paid for out of 12b-1 plans.

As a general matter, fund shares must be distributed – assets are likely to decline if the fund is eliminated from significant distribution channels and fund expense ratios may likewise increase, perhaps significantly. Moreover, in the current environment,

distribution must be paid for at prices that are set by the marketplace. Faced with these harsh realities, directors may sometimes, as a practical matter, be limited to doing little more than determining whether continued distribution of fund shares is in the best interests of shareholders; to the extent that directors believe that it is, and that the management company cannot fully defray distribution expenses, they may well have few options other than to approve the continuance of the fund's existing 12b-1 plan.

However, directors may find some bases on which they can further explore this analysis. For example, directors may examine the extent to which payments are made out of the fund to affiliates of the management company and to what extent they are made to non-affiliates (*e.g.*, selling brokers). While directors may have a very limited ability to assess and effect payments made to third parties, in some circumstances where competitive factors do not operate they may well consider whether to subject payments made to fund affiliates to additional scrutiny -- particularly if, due to the nature of these payments, they feel they have a greater ability to influence them.

5. The factors and considerations that fund directors use to analyze the value and efficacy of the fund's 12b-1 plan should be related to the purposes of the plan.

For many directors, the annual and quarterly reviews of a fund's 12b-1 plan can seem frustrating or pointless. Because most intermediaries demand a specific asset-based payment for their services (and will simply refuse to distribute a fund's shares absent such payments), most 12b-1 fees are effectively fixed by competitive forces. As a result, directors often feel that they have little control over the level of most 12b-1 expenditures -- notably, 12b-1 fees paid in lieu of a sales load to cover payments to selling intermediaries are generally set by the marketplace and, in some sense, are specifically agreed to by shareholders as a result of their choices regarding which share class they purchase.

As a result of this frustration, directors may feel tempted to look at a standardized list of factors, such as those previously identified by the SEC, and adopt a "check the box" approach to evaluating the fund's 12b-1 plan. As described in more detail below, however, in order to successfully fulfill their obligations, directors need to resist this temptation. Instead, through careful analysis of the purposes of their fund's 12b-1 plan and of the expenditures it is actually making, directors should seek to identify a set of factors (whether or not those factors were on the SEC's original list) that is relevant to the plan they are evaluating, and use those factors to determine what action they should take with respect to the plan. Set forth below are factors that may be relevant in evaluating plans that, at least partially, substitute for a front-end load, and factors that may be relevant in evaluating plans that, at least partially, pay for administrative and shareholder support services received, in most instances, from distributors of fund shares. Many plans serve both of these purposes, and some plans may have other purposes. Whatever the circumstances, the evaluation is most effective when it is tailored to the actual purposes of a fund's 12b-1 plan.

6. **As part of their review of the fund’s plan, fund directors should be aware of the factors identified in the SEC’s initial adopting release for Rule 12b-1. However, they need consider only those factors relevant to their fund’s circumstances, and should assign those factors an appropriate weight as part of their analysis of whether to continue, alter or eliminate their fund’s 12b-1 plan.**

The SEC has identified factors that directors may wish to consider in their review of their fund’s 12b-1 plans. Most prominently, in the Rule 12b-1 Adopting Release, the Commission identified nine factors, ranging from the consideration of alternative plans of distribution to the benefits that the plan would provide to persons other than the fund and its shareholders, that it believed were likely relevant to directors’ consideration of 12b-1 plans.³¹

The SEC was very clear, however, that it was not mandating that “directors ... consider any particular factors.”³² Thus, directors are neither legally obligated specifically to consider each of the enumerated factors nor prohibited from considering other factors that they identify as relevant. Given the complexity of the environment within which funds are distributed, this type of discretion is appropriate – review of a 12b-1 plan should not be a pro forma process in which a static list of factors is dutifully considered, but rather should be the result of an analysis by directors of how their fund is distributed and how the fund’s 12b-1 plan is used to facilitate that process. As a result of this analysis, directors are likely to identify some factors that are important, some that are less important and some that are clearly irrelevant. While directors may well determine that few of these factors are ultimately relevant to their fund’s specific circumstances, they nonetheless should review and consider the relevancy of the Commission’s list of factors as part of their overall analysis.

Basic Considerations that May Warrant Use of Fund Assets in Support of Distribution

7. **Directors should consider the ways in which continued distribution of fund shares, and, in particular, the use of fund assets to pay for distribution, will potentially benefit fund shareholders.**

One might view the point of using fund assets to pay for distribution as little more than an attempt to increase a fund’s size so that shareholders can more easily obtain, through reduced expense ratios, the benefits of any economies of scale realized by the adviser. This view, however, may seem overly simplistic from the perspective of directors required to review the benefits, in the context of current competitive fund industry, of continuing to pay for the distribution of fund shares and the potential impact on their fund of not doing so.

³¹ For a list of the factors, see *supra* note 10.

³² Rule 12b-1 Adopting Release.

- For example, directors should consider whether continuance of a fund's 12b-1 plan will minimize the disruption to portfolio management that otherwise might be caused by the need to sell portfolio securities to satisfy ongoing redemption requests. A fund that experiences a prolonged period of net redemptions or even a fund that experiences uneven cash flows will likely be more difficult and expensive to manage than a fund with stable assets or a fund with steadily growing assets. In particular, every time that a portfolio manager is forced to sell securities solely to meet redemptions, the costs of doing so will be passed on to shareholders who remain in the fund. These costs may include everything from opportunity costs to transaction costs to the tax impact of engaging in unnecessary transactions. To the extent that continuing to distribute fund shares and supporting that distribution through a 12b-1 plan minimizes the need to engage in unnecessary transactions, directors may conclude that using a 12b-1 plan to support distribution is in the best interests of fund shareholders.
- Directors should also consider whether continuance of a fund's 12b-1 plan will lead to a greater stability of (or a more predictable change in) fund assets that, if achieved, will allow shareholders to obtain benefits that otherwise would not be realized. Directors examine economies of scale in a number of contexts, most notably as part of the annual 15(c) process. Review of the fund's system of distribution and its 12b-1 plan provides another context within which directors may consider this issue. In particular, to the extent that economies of scale exist, they cannot be realized unless the fund grows in size. One key variable affecting a fund's potential growth is the success of its distribution efforts. If directors believe that the fund can obtain further economies of scale by growing, and that the fund's 12b-1 plan reasonably contributes to the fund's growth and that growth will benefit shareholders, it is clearly appropriate for them to consider this possibility in evaluating the fund's 12b-1 plan.
- Directors may also wish to consider whether continuance of the fund's 12b-1 plan will permit fund shareholders to obtain other benefits from growth in assets (such as increased investment by the adviser in its compliance functions, its asset management capabilities, including portfolio management personnel, and back-office functions). Likewise, directors may conclude that asset growth (or at least asset stability) is necessary to motivate existing investment staff and to recruit new talent. While these benefits may not be as obvious as those produced by predictable cash flows and a growing asset base, they are nonetheless benefits that can have a significant positive impact on fund shareholders, and thus should appropriately be considered by directors as part of the 12b-1 process.

Evaluating those Parts of the Fund's 12b-1 Plan that Substitute for a Load

- 8. Directors may consider the need of the fund to penetrate particular distribution channels in the marketplace, as well as the competitive conditions within those channels, as part of their analysis of the fund's 12b-1 plan.**

In the current market environment, many different distribution channels are available to funds and advisers. Because successful distribution of fund shares depends upon reaching as many potential shareholders as possible, most funds seek to use all or virtually all of the available channels. In most cases, the costs of using a particular distribution channel (such as distributing fund shares through a variety of prominent fund supermarkets) will not be negotiable. Hence, once a channel is selected, there is generally little choice but to pay the costs associated with the channel, whether through a load, fees paid by the management company or by the fund through a 12b-1 plan, or otherwise.

Because a major part of the costs of many of the channels are paid out of 12b-1 plans, directors need to understand how use of these channels fits in with the fund's overall plan of distribution. While the selection of a particular channel is best left to the business judgment of the fund's adviser, the directors' should seek to assure themselves that the costs associated with particular distribution channels are justified by competitive conditions and thus are not clearly unreasonable. In order to do so – as well as to better understand the fund's overall system of distribution – directors should seek to familiarize themselves, to the extent possible, with the competitive environment within which the various distribution channels operate.

- 9. In appropriate circumstances, fund directors may wish to consider whether fund shareholders (or shareholders of a particular class) have effectively agreed to pay specific amounts to support distribution of the fund to them.**

For those funds that use 12b-1 fees as a substitute for loads, a significant portion of the expenditures made pursuant to a 12b-1 plan will be payments to brokers and other financial advisers who advise their clients whether to purchase the fund's shares and whether to continue to hold the fund's shares. These intermediaries require compensation for the services that they provide to fund shareholders, and their compensation is often financed through a fund's 12b-1 plan.

As discussed further below, the appropriateness of these payments likely depends less on the actions and review of fund directors and more on whether selling intermediaries provide their clients with full disclosure and engage in suitable selling practices. The compensation that intermediaries receive is generally fixed by the marketplace (and, to the extent it is negotiated, it is not negotiated by the shareholder, but rather results from negotiations between the adviser and the intermediary). These compensation arrangements also can be viewed as representing the shareholder's implicit

agreement to compensate the intermediary upon whom he or she relies for advice. In addition, as a result of the growth in the number of funds that have multiple share classes with differing levels of 12b-1 fees, individual shareholders have some ability to choose the manner in which their representatives will be compensated. In these circumstances, it is appropriate for fund directors to be reluctant to upset what reasonably can be viewed as financial arrangements agreed upon by shareholders and intermediaries.

The success and fairness of distributing through intermediaries in this manner depends on whether the intermediaries that sell fund shares comply with their own legal obligations – that is, whether those intermediaries appropriately disclose the structure of their compensation arrangements, fully advise their clients on the impact of investing in different share classes and recommend the purchases of share classes that are appropriate for their individual clients. Funds and directors have a limited ability to monitor whether intermediaries are satisfying these obligations and, indeed, are not primarily responsible for ensuring that they do so. However, directors should be prepared to address their fund’s share class structure carefully if it becomes apparent that that structure encourages unsuitable sales. In addition, although directors do not have an independent obligation to seek to identify abusive sales practices, they nonetheless should inquire whether the fund’s adviser has processes in place to monitor distribution issues such as suitability, seek to understand how these processes function and take appropriate action if they become aware of widespread abuses. In the end, however, ensuring that sales are suitable and that appropriate disclosure is given to shareholders remains the primary responsibility of the intermediaries who sell fund shares.

10. Although fund directors should review carefully the need for a 12b-1 plan when a fund is closed to new investors, the need to repay amounts already spent distributing the fund can warrant continuance of the plan.

On the face of it, it may seem unnecessary for a fund that is closed to new investors to have a 12b-1 plan – after all, a fund that is not seeking to sell additional shares may seem not to need to pay for the distribution of shares.³³ However, as is true

³³ The question of whether to close a fund to new investors (or to all new investment) may well arise as part of the directors’ review of a fund’s 12b-1 plan. It can arise in many other areas as well, including as part of the annual 15(c) process or as part of the Board’s review of the fund’s performance.

While a full delineation of the factors that directors should consider in determining whether to close a fund is far beyond the scope of this paper, we nonetheless note the following. Under certain circumstances, closing a fund may benefit existing fund shareholders. For example, if the fund has grown quickly or invests in small or illiquid markets, continued growth in the fund’s assets – and hence, continued distribution efforts – may no longer be in the best interests of fund shareholders. Needless to say, the issue of whether continued growth in fund assets benefits or harms shareholders involves a delicate balancing of many factors, including the potential benefits of achieving further economies of scale against the constraints potentially applicable to a larger fund – a balance that is rarely easily quantifiable. Further, the decision to close a fund raises numerous other issues -- including when to close it, whether to close it to all new investment or just new investors, and how to monitor the effectiveness of the closure – factors that, as noted above, are beyond the scope of this analysis of the role of directors in approving and monitoring 12b-1 plans.

of a fund that remains open to new investors, a closed fund may still need to reimburse other parties for funds that have already been advanced to compensate selling intermediaries, in effect continuing the agreed upon financial arrangements reached between shareholders and intermediaries. If directors would have approved this use of the fund's 12b-1 plan had the fund remained open, they may approve use of a closed fund's 12b-1 plan for the same purposes.

More specifically, in many cases (as is discussed more fully above in point 9), the fund may have an ongoing responsibility to compensate intermediaries who have sold fund shares in the past (and may be continuing to provide services to find shareholders) or may need to reimburse the fund's sponsor or adviser for distribution-related costs that it has incurred. In cases such as this, directors may conclude that there are valid reasons for a closed fund to continue to have a 12b-1 plan. Again, as noted above, the decision to continue a 12b-1 plan under these circumstances depends upon a full understanding of the purposes of the plan within the fund's overall distribution system.

Evaluating those Parts of a 12b-1 Plan that Pay for Administrative and Shareholder Support Services

- 11. With respect to each of the services being funded through a 12b-1 plan, directors should examine whether the cost of the service is reasonable in light of the nature of the service generally and the quality of the specific service being obtained.**

Evaluation of the services provided via a 12b-1 plan is, for directors, potentially similar to the evaluation of other services the purchase of which by the fund is overseen by directors. In particular, directors should attempt to evaluate the cost and quality of the service being purchased and should, if the appropriate data is available, compare the price and quality of the service being acquired with what is offered by other providers.

In many cases, however, this analysis will not be this simple. The services being analyzed – for example, sub-transfer agency services – often are packaged together with distribution services or come as part of a distribution platform. In circumstances like this, it may be difficult to determine accurately the true cost of the service being provided or accurately ascertain its quality. Moreover, if the service comes as part of a distribution channel or distribution platform that the fund desires or needs to use, acquisition of the service from the distribution partner may be, effectively, mandatory. Further, it is often difficult for directors, who are removed from day-to-day shareholder servicing activities, to evaluate fully the quality of services provided. In cases like this, analysis of the cost and quality of the service will quickly collapse into an inquiry into whether continued use of the distribution channel is in the best interests of fund shareholders, and all the difficulties involved in this type of analysis (as outlined above) will continue to exist.

IV. Conclusion

In sum, the requirements of Rule 12b-1 that provide for initial and ongoing review of 12b-1 plans put independent directors in an almost impossible position. Fund management companies face a conflict in administering 12b-1 funds, as they have an incentive to use fund assets to promote distribution of fund shares in order to increase the rate of growth in fund assets and thereby increase their own profitability. Doing so may also benefit fund shareholders, as increasing (or just stabilizing) inflows to the fund can have the effect of reducing the percentage level of fund expenses, but it will not necessarily do so – or, more importantly, different levels of spending on distribution may have very different impacts on how fund assets change and equally different impacts on the level of expenses.

However, the rule asks directors to engage in this almost impossible task. Directors are thus, in some ways, being asked to predict before the fact whether paying distribution costs will increase fund assets and thereby allow shareholders to reap the benefits of lower expense ratios. Even after the fact, it will be difficult – if not impossible – for directors to know the extent to which the 12b-1 plan has enhanced the distribution of a particular fund's shares. And, even if directors could determine conclusively that it did not, in considering whether to eliminate a 12b-1 plan in today's market environment, they would be faced with the possibility of halting distribution of shares, potentially seeing fund assets drop sharply, and potentially incurring an equally sharp jump in fund expenses.

In short, Rule 12b-1, as currently structured, simply does not reflect the current marketplace. Directors, who are required to evaluate 12b-1 plans to determine whether they are in the best interests of fund shareholders, are thus asked to take on a task that, in the present environment, they are not well-positioned to perform. Rule 12b-1 thus cries out for serious review and ultimately significant reform.

Nonetheless, fund directors must comply with existing law and, in the exercise of their fiduciary duties, should do as much as possible to ensure that the manner in which a fund's shares are distributed is consistent with the best interests of fund shareholders. The Forum remains committed both to the reform of Rule 12b-1 and its role in the fund distribution process on behalf of fund directors (and, ultimately, fund shareholders) and thus intends to continue studying potential alternative approaches to the existing system governing the payment of fund distribution costs. In addition, the Forum remains committed to producing papers such as these guidelines, as part of its mission of helping fund directors meet their obligations under existing law as effectively as possible.