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## *SEC Proposes Reform of Mutual Fund Distribution Framework*

BY THE INVESTMENT MANAGEMENT PRACTICE

### Summary

On July 21, 2010, after a multi-year review, the Securities and Exchange Commission ("SEC") proposed significant changes to the current mutual fund distribution framework, including the proposed rescission of Rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act").<sup>1</sup> In its place, the SEC proposed a new rule, Rule 12b-2 ("Rule 12b-2"), and amendments to other rules which would allow registered open-end investment companies ("funds") to charge a limited "marketing and service fee" (currently up to .25% of the fund's net assets) to finance the marketing and distribution of fund shares. In a significant departure from the structure of current Rule 12b-1, under proposed Rule 12b-2 fund directors would not be required to adopt or annually approve any distribution "plan" nor would they be required to make any "special findings" in order for a fund to pay the proposed marketing and service fee. Under the proposals, any distribution related fee in excess of the marketing and service fee would be considered an asset-based sales charge and would be limited so that, over time, an investor would pay no more in asset-based sales charges than he/she would have paid if he/she had purchased a class of shares with a front-end sales load.

The proposals would also for the first time provide for retail price competition in the distribution of fund shares by allow distributing broker/dealers to establish sales charges on funds they sell, rather than requiring that sales charges be set by the funds, as is currently the case. Finally, the SEC also proposed various disclosure rule amendments, including changes to mutual fund confirmation statements.

In their totality, the proposals if adopted have the potential to significantly change the fund distribution landscape. The proposals are complex (the Proposing Release is 278 pages) and detailed. Because Rule 12b-1 is so ingrained in the structure of funds, their operation and administration, the proposals necessarily touch on a multitude of other ancillary matters, including the potential impact on a fund's investment in another fund, dividend reinvestment, exchanges and share class conversions, wrap fees and fund supermarkets, multiple share class structures including the potential negative impact on Class R shares, prospectus and proxy disclosure and the use of revenue sharing. Comments to the Proposing Release are due to the SEC by November 5, 2010 and the SEC will no doubt receive significant reaction and comment regarding these proposals. We discuss below the highlights of the proposals. We will keep you informed as the proposals develop.

## A. Rescission of Rule 12b-1; the Marketing and Service Fee and the Asset-Based Sales Charge

*The "Marketing and Service Fee"* - The SEC has proposed to rescind Rule 12b-1 in its entirety. In its place, the SEC has proposed to adopt a new rule, Rule 12b-2, which would allow funds, with respect to any class of shares, to charge a "marketing and service fee" ("MSF") in an amount up to the current FINRA prescribed limit with respect to "service fees" (currently 0.25% of net assets<sup>2</sup>). The MSF would be used for the payment of any distribution related expenses<sup>3</sup> and would not be subject to the limitations on sales loads discussed below in connection with asset based sales charges. The Proposing Release notes that the SEC expects that the MSF would be used for any range of distribution or distribution-related/mixed use activity, including: fees to participate on fund supermarket platforms, the payment of trail commissions to broker-dealers in recognition of the ongoing services they provide to fund shareholders, payments to retirement plan administrators for the services they provide participants (which relieve the fund from providing such service), payments for the operation of call centers, as well as other traditional distribution or marketing-related activities such as compensation of underwriters, advertising, printing and mailing of prospectuses to other than current shareholders<sup>4</sup>. In order to help investors better understand the costs associated with their investment in fund shares, the Proposing Release requires a fund to clearly disclose in its prospectus whether it charges a MSF, the amount of such fee<sup>5</sup>, and the purpose(s) for which it is used.

Under proposed Rule 12b-2, all existing Rule 12b-1 plans would be eliminated and fund directors would not be required to adopt or renew any distribution-related "plan". The directors would also not be required to make any special findings with regard to the use of the MSF, as the MSF would be treated in the same category of other uses of fund assets to pay operating expenses.

*The Asset Based Sales Charge* – The Proposing Release states that any distribution related fee in excess of the permitted MSF would be considered an asset-based sales charge ("ABSC")<sup>6</sup>. In this regard, the SEC has proposed amendments to Rule 6c-10 under the 1940 Act ("Rule 6c-10") that would allow funds to deduct ABSCs subject to certain restrictions, including the eventual conversion of an ABSC class to a non-ABSC class as described below. In particular, the proposed amendments to Rule 6c-10 would permit a fund to deduct an ABSC as long as the cumulative amount of sales charges the investor pays on any purchase of fund shares over the life of his/her investment in the fund does not exceed:

- for funds that have a class of shares with a front-end sales charge (typically, Class A), the amount of the maximum front-end sales charge that the investor would have paid if it had invested in the front-end load class, or
- for funds that do not have a class of shares with a front-end load, the maximum sales charge permitted under applicable FINRA rules for funds with an asset-based sales charge and a service fee, currently 6.25%.<sup>7</sup>

For example, if the Class A shares of Fund X have a 6.00% front-end sales load, the Class B shares of Fund X could charge up to 6.00% in ABSC over the life of an investor's investment in Class B. That ABSC may be comprised of a .75% annual level load and a contingent deferred sales charge ("CDSC") that, when combined with the level load, would not exceed the maximum 6% rate over the life of the investment. By way of another example, Fund X could also have another share class with a 2.00% front-end sales load, but in this case, the maximum ABSC is limited to 4.00%, or it could have a level load (Class C share) where it could charge a .75% annual fee until such time as the cumulative fee paid by the investor since purchase reaches 6%.

Each class that charges an ABSC must have a conversion feature, such that an investor's shares would automatically convert to another class of shares which does not have an ABSC no later than the end of the month during which the investor would have paid the maximum amount of permitted ABSC (the "Conversion Date"). The proposed amendments to Rule 6c-10 would not require a fund or financial intermediaries to track the actual dollar amount of ongoing sales charges that each investor has paid, although they may choose to do so.<sup>8</sup> Instead, shares would be tracked in "share lots" by identifying all shares acquired in the same month (the "Purchase Month") and calculating the Conversion Date from the end of the Purchase Month.<sup>9</sup> So, for example, if a fund has a maximum Class A front-end sales load of 3.00%, the ongoing sales charge on a class of shares that does not have a CDSC, such as Class C shares, could be 0.50% annually for six years, 0.25% annually for 12 years, 1.00% annually for 3 years, or any other combination totaling 3.00%. At the end of the period, the Class C shares would automatically convert to Class A shares.<sup>10</sup>

As with the MSF, a fund must clearly disclose in its prospectus whether it charges an ABSC, the amount of such charge, and the purpose(s) for which it is used. Additionally, funds charging an ABSC would need to disclose the number of months or years before fund shares will convert to another class without an ABSC. If a fund offers multiples classes in a single prospectus, the fund would need to generally describe the circumstances under which one class may be more advantageous to investors than another.

Under the proposals, shares acquired through reinvestment of dividends or distributions would be placed in the same "share lot" as the shares which paid the dividend or distribution. As a result, they would convert at the same time as those shares. If adopted, the current "aggregate sales charge" limitations imposed by the NASD under Conduct Rule 2830(D)(2) would be rescinded.

The Proposing Release also discusses the consequences of transfers and exchanges to the Conversion Date, noting that all share lot history must move with the transfer or exchange and that the maximum load will continue to be calculated based on the maximum front end load charged by the original fund purchased.

Like the MSF, fund directors would not be required to make any special findings with regard to the use of the ABSC, as such charges would be considered as another form of deferred sales load<sup>11</sup>. The Proposing Release notes that it expects to provide guidance to directors to assist them in satisfying their fiduciary duties in overseeing the MSF and ABSC in the adopting release to the final rules.<sup>12</sup>

## **B. Application to Investments in Other Funds**

Proposed Rule 12b-2 would permit a fund (the "acquiring fund") investing in another fund (the "acquired fund") to have a MSF, as long as the total of the acquiring fund's and acquired fund's marketing and service fees do not exceed 0.25%.<sup>13</sup> In addition, under the proposed amendments to Rule 6c-10, the acquiring fund and acquired fund may not both charge an ABSC. Therefore, if an acquiring fund does charge an ABSC, then it may only invest in other mutual funds that do not charge an ABSC. This restriction would apply to any fund investing in another fund, not just "fund of funds." The Proposing Release notes that most acquiring funds do not invest in acquired funds that charge a 12b-1 fee, and if they do, such fee is usually less than 0.25%. The Proposing Release further notes that most acquiring funds do not purchase acquired funds with sales loads, and if they do, they do not charge one themselves.

### C. Shareholder Approval

As proposed, a new fund or an existing fund that offers a new share class would not be required to seek shareholder approval before implementing a MSF or ABSC as there would be no current shareholders affected by the implementation of such charges. Once a fund or new share class has been publicly offered, however, a fund would be required to obtain shareholder approval before it could charge or increase a MSF, similar to the current requirements of Rule 12b-1. On the other hand, no ABSC could be increased or instituted on an existing fund, irrespective of shareholder approval.

### D. Transaction Confirmations

In connection with the proposals regarding new Rule 12b-2 and amendments to Rule 6c-10, the SEC has proposed amendments to Rule 10b-10 under the 1934 Act ("Rule 10b-10") which would require that transaction confirmations sent to investors who purchased fund shares contain disclosure relating to the amount of sales charges that the investor incurred at the time of purchase, expressed both as a percentage and in dollar terms, as well as the net dollar amount invested in the fund and the amount of any applicable breakpoint used to calculate the sales charge.<sup>14</sup> In addition, if a fund's shares have a deferred sales charge upon redemption, the transaction confirmation sent to the investor at the time of purchase would be required to show the maximum amount of deferred sales charge that the investor may pay in the future, and this amount should be shown as a percentage of the net asset value at the time of purchase, or at the time of redemption, as applicable.

Furthermore, if an investor purchases shares that have an ABSC or a MSF, then the purchase confirmation must disclose: the annual amount of that charge or fee, expressed as a percentage of net asset value; the aggregate amount of the ABSC that may be incurred over time, expressed as a percentage of net asset value; and the maximum number of months or years that the investor will incur the ABSC.<sup>15</sup> Transaction confirmations would also include the following disclosure, amended to reflect the specific fees or charges of the fund: "In addition to ongoing sales charges and marketing and service fees, you will also incur additional fees and expenses in connection with owning this mutual fund, as set forth in the fee table in the mutual fund prospectus; these typically will include management fees and other expenses. Such fees and expenses are generally paid from the assets of the mutual fund in which you are investing. Therefore, these costs are indirectly paid by you."

Lastly, when an investor redeems fund shares, it is proposed that the investor will receive a transaction confirmation disclosing the amount of any deferred sales charge that the investor has incurred, expressed both in dollars and as a percentage of net asset value at the time of purchase, or at the time of redemption, as applicable.

### E. Alternative Distribution Model, Retail Price Competition in the Distribution of Fund Shares

The Proposing Release also provides funds with an alternative model in which to distribute their shares through financial intermediaries. If a fund elects to use this new model, the fund, or a class thereof, would issue its shares at net asset value, without any ABSC, and then a financial intermediary would impose its own sales charge(s) based upon the services that it offers to its clients. The fund could charge an MSF. This provision would exempt funds from the requirements of Section 22(d) under the 1940 Act, which currently prohibits competition in sales loads on fund shares at the retail level. The amount of sales charges and the method by which they are imposed would not be governed under the 1940 Act; rather they would be subject to the applicable FINRA limits. The SEC notes that this proposed distribution model may reduce conflicts for financial intermediaries and, therefore, reduce the risk that an investor may be placed in a fund that is not suitable for his or her needs. The SEC

further notes that the use of this alternative model is voluntary and a fund may choose whether it wishes to externalize its distribution expenses in this manner. Funds that elect to adopt this alternative distribution model, however, will need to disclose such election in their statement of additional information (SAI).

## F. Compliance Date; Grandfather Provisions

Given the operational complexities associated with the implementation of Rule 12b-2 and the various other rule amendments, the SEC expects that the compliance date would likely be at least 18 months after the effective date of the final rule (the "Compliance Date"). The effective date will likely be 60 days from the date the adopting release is published. For funds that offer share classes prior to the Compliance Date that have a Rule 12b-1 plan, the Proposing Release contemplates a five-year "grandfathering" period during which funds may continue to charge 12b-1 fees. After the grandfathering period such fund shares would have to convert or be exchanged into a class that does not charge an ABSC and that has a MSF no higher than the fund's 12b-1 fee. New sales would not be allowed in grandfathered share classes after the Compliance Date. For funds that currently charge fees pursuant to a Rule 12b-1 plan, the SEC has determined that no investor protection purpose would be served by continuing to require such funds to maintain formal 12b-1 plans or continue with annual board approval and quarterly reporting, as such funds would not be allowed to increase the amount of any Rule 12b-1 fee they charge.

If a fund currently charging a Rule 12b-1 fee wishes to conform to the new Rule 12b-2, instead of taking advantage of the five-year "grandfathering" period, such fund would not need to obtain shareholder approval if (i) the fund currently charges a Rule 12b-1 fee of 0.25% or less and does not increase the rate of such fee or (ii) the fund reduces the amount of the current 12b-1 fee to 0.25% or less and renames it as a "marketing and service fee."

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<sup>1</sup> SEC Release 33-9128; 34-62544; IC-29367, July 21, 2010 (the "Proposing Release").

<sup>2</sup> See NASD Conduct Rule 2830 (d)(5).

<sup>3</sup> "Distribution activities" are defined as any activity which is primarily intended to result in the sale of shares issued by a fund, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature.

<sup>4</sup> With respect to "mixed-use" activities, funds would not be required to determine which portion of the fee is primarily used for distribution and which portion is primarily for administrative.

<sup>5</sup> The marketing and service fee would be required to be clearly identified and fully disclosed in a fund's prospectus fee table as an operating expense.

<sup>6</sup> It appears from the Proposing Release that a fund may determine that a fee, such as a portion of a fund supermarket fee, is purely related to a non-distribution activity, such as administration or sub-transfer agency services. In this event, the Fund could enter into separate administration or sub-transfer agency agreements with these third parties and the fees associated with such agreements would fall outside both the MSF and the ABSC. Footnote 153 in the Proposing Release notes that to the extent a fund does not rely on Rule 12b-2 to bear those costs that clearly have no relation to a fund's distribution (e.g., sub-transfer agency fees), such fund could instead properly characterize those costs as administrative in nature and thus keep its total asset-based distribution fees within the 25 basis point cap of the new marketing and servicing fee. However, footnote 153 also cautions that merely characterizing an activity as "administrative" would not permit a fund to pay such fee outside of Rule 12b-2 if all "or a portion" of the fee is distribution related.

<sup>7</sup> See NASD Conduct Rule 2830(d)(2).

<sup>8</sup> The proposed amendments to Rule 6c-10 would allow for conversion periods to be computed as of the end of the calendar month because this calculation conforms to the way in which most funds presently compute conversion periods for their class B shares.

<sup>9</sup> As a result, changes in the value of an investment since inception will not impact the Conversion Date. This is different than the current requirements in Rule 6c-10 with respect to deferred sales loads, where the rule limits the amount of the load to the specified percentage at the time of investment, so that no CDSC is paid on share appreciation.

<sup>10</sup> The Proposing Release states that the Conversion Date will be easily determinable at the time of investment and therefore the fund or financial intermediary will be able to provide this information to the investor at the time of purchase.

<sup>11</sup> The Proposing Release notes that as a form of deferred sales load, intermediaries receiving ABSC compensation would need to be registered as broker-dealers under Section 15 of the Securities Exchange Act of 1934. The Proposing Release notes that the recipient of MSF may also be required to be registered under Section 15, depending on the nature of services provided in exchange for such fee.

<sup>12</sup> The Proposing Release sets forth proposed guidance in this regard, which equates the duties of directors in providing oversight of ABSC with a 15(c) process which includes an annual review of the nature, scope and quality of the underwriting services, the fairness and reasonableness of the underwriting compensation, economies of scale, and fee breakpoints.

<sup>13</sup> For example, acquiring fund X, which charges a marketing and service fee of 0.10%, may only invest in an acquired fund that charges a marketing and service fee of 0.15% or less.

<sup>14</sup> In the amendments to Rule 10b-10, the term "sales charge" has the same meaning as "sales load" in the 1940 Act and refers to the difference between the public offering price of the fund and the portion that is actually invested (less deductions for certain fees).

<sup>15</sup> The Proposing Release suggests the following disclosure: "You will pay a maximum total ongoing sales charge of X%, deducted from the assets of the fund in which you are investing at an annual rate of Y% over the next Z years. You will also pay marketing and service fees of 0.25% for as long as you own the fund."