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# Webinar Held on Rule 12b-1 Fees: Past, Present and Future

*By Michael R. Rosella, Mitchell Nichter, Domenick Pugliese, Bill Sullivan, Grace Carter and Joshua Hamilton*

Perhaps no aspect of mutual fund regulation is currently undergoing closer scrutiny than Rule 12b-1 under the Investment Company Act of 1940. The Securities and Exchange Commission (the "**Commission**") has publicly announced that it is undertaking a complete review of Rule 12b-1, and most industry observers anticipate a Commission pronouncement regarding the Rule in 2007. In anticipation of this pronouncement, on October 11, 2007, Paul Hastings hosted a webinar on Rule 12b-1 featuring Matthew Fink, former President of the Investment Company Institute. Participants from Paul Hastings included Mike Rosella (moderator), Domenick Pugliese and Mitch Nichter from our Investment Management Practice Group, and Bill Sullivan, Grace Carter and Joshua Hamilton from our Securities Litigation Group. The participants reviewed the history of Rule 12b-1, the way in which 12b-1 fees are currently used, the duties of fund Boards of Directors, and current developments in the regulatory and litigation arenas. The participants also discussed their thoughts on what pronouncements the Commission may make in the area in both the short term and over the long term.

## HISTORICAL CONTEXT OF RULE 12B-1

Matthew Fink provided the historical context for the Rule and focused on distinguishing the myths from the realities as to why Rule 12b-1 was adopted. He acknowledged that while the Rule was adopted during a period when the fund industry was suffering from extended net redemptions, a further impetus in the adoption of the Rule was the belief by certain senior members of the Commission staff that the staff's historical position that it was impermissible for a fund to act as a distributor for its own shares was not tenable. He believed that the Commission staff had come to the realization that without a rule, it had no ability to prevent or regulate the activities of a fund when the fund was acting as a distributor of its own shares. He also reviewed industry developments that led to the adoption of the Rule and the development of spread load plans.

Mr. Fink then addressed certain of the criticisms that have been leveled against Rule 12b-1. He noted that if the Rule were repealed, the Commission would find itself in the same legal position that existed immediately prior to the Rule's adoption, *i.e.*, the Commission would have no ability to regulate the activities of a fund acting as a distributor of its own shares. He also addressed, and rebutted, criticisms that the Rule has been used for purposes not contemplated at the time of its adoption. In this regard, Mr. Fink noted that the Rule itself permits the use of Rule 12b-1 fees to compensate brokers. Finally, he noted that the Rule has been very successful and that the fund industry has grown dramatically since the Rule's adoption. He further noted that the Rule has allowed funds to develop multiple options for a shareholder to choose how he/she wishes to pay for shareholder servicing and distribution. He urged the Commission to proceed cautiously and emphasized that any regulatory changes in this area should be based upon events that have actually taken place, not upon myths.

## CURRENT USES OF RULE 12B-1 FEES

Domenick Pugliese then discussed the current ways in which Rule 12b-1 fees are used. He highlighted four primary applications of the Rule: (i) for payment of shareholder servicing costs and maintenance of fund accounts, (ii) as sales compensation to brokers within a spread load plan, (iii) in payment of fund supermarket fees, and (iv) for payment of retirement plan record keepers and similar entities. He discussed the inherent conflicts that exist when fund assets are used for

distribution purposes and certain of the criticisms that have been leveled against each of these uses.

With respect to the use of 12b-1 fees to compensate brokers for shareholder servicing, Mr. Pugliese noted that NASD Rule 2830 permits funds that limit such fees to .25% to maintain a "no-load" designation. He discussed whether the NASD Rule inadvertently had the effect of setting a "floor" for the level of service fees, possibly resulting in overpayment by a fund for such services. With respect to the use of 12b-1 fees as compensation to brokers for sale of fund shares, Mr. Pugliese discussed criticisms that such fees were not readily transparent to shareholders. He noted the conflict that may be created for the broker-dealer when advising a client to invest in a fund where the broker is to receive compensation from the fund for such sale. He stated that fund disclosure documents, such as prospectuses, are not always the most effective means to disclose this conflict to shareholders and addressed certain point-of-sale disclosure documents that might achieve this disclosure more effectively. With respect to the use of Rule 12b-1 fees to participate in "no-load" fund supermarket distribution systems, he noted the difficulties for a fund's board in determining whether the various services provided by the supermarket were reasonable. He noted that critics have argued that fund supermarket providers may be receiving a windfall in scenarios in which a client may own multiple funds within the supermarket platform, with each fund assessing a separate 12b-1 fee.

## DIRECTORS' DUTIES IN REVIEWING RULE 12B-1 FEES

Mitchell Nichter then led a discussion addressing how boards should review 12b-1 fees. He discussed the "nine factors" contained in the Rule 12b-1 adopting release and noted that some of these factors may not be applicable to the ways in which Rule 12b-1 is used today. Mr. Nichter encouraged directors to focus only on the factors applicable to a plan presented to them, and also pointed to additional factors a board may consider. For example, Mr. Nichter stated that fund directors may wish to consider the extent to which a plan may help a fund to maintain or increase its assets, and may also consider the effects upon the fund should a plan be discontinued. Ultimately, the board's primary analysis should be to determine whether continuance of a Rule 12b-1 plan would be in the best interests of fund shareholders. In agreement with prior comments made by Mr. Fink, Mr. Nichter emphasized that no rigid set of factors should control this evaluation, but rather directors should focus on applying their business judgment.

## CURRENT REGULATORY DEVELOPMENTS AND A LOOK TO THE FUTURE

Mr. Pugliese and Mr. Nichter then discussed various proposals for "fixing" Rule 12b-1 submitted by interested industry participants, such as the Investment Company Institute and the Mutual Fund Directors Forum, and offered their own views in this regard. Mr. Fink added several thoughts regarding the future. He discussed the idea of a unitary fund fee, but noted that this outcome might be unlikely since this would require an act of Congress. He stated that in the short term, the Commission is likely to put out a comment release, followed by several proposals before the Commission begins to take things in a new direction.

## TRENDS IN 12B-1 FEE LITIGATION AND POTENTIAL FUTURE ISSUES

The Paul Hastings litigation attorneys participating in the webinar emphasized that, for suits seeking recovery of allegedly unlawful Rule 12b-1 fees, the standards of pleading and proof are relatively high. Bill Sullivan noted that most suits are brought under Section 36(b) of the Investment Company Act of 1940 (the "**ICA**"), which creates a private cause of action against investment advisers for breaches of fiduciary duty. 15 U.S.C. § 80a-47.[1] The majority of courts have held that these claims must be brought derivatively and only against defendants who actually received the challenged fees.

Mr. Sullivan explained that Rule 12b-1 fees are actionable under Section 36(b) when the fee is so disproportionately large that it bears no reasonable relationship to the value of the services rendered. In determining whether Rule 12b-1 fees are excessive, courts apply a balancing test, considering the "*Gartenberg*" factors such as the nature and quality of the services provided; the profitability of the mutual fund to the adviser-manager; "fall-out" benefits; economies of scale; how the fee structure compares with those of other similar funds; and the independence and conscientiousness of the fund's independent directors. *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923 (2d Cir. 1982).

Grace Carter explained that, in addition to excessiveness, plaintiffs have advanced numerous other theories of liability. For example, plaintiffs have alleged that the structure of the fees—allegedly improper revenue-sharing agreements between funds and brokers—should have been disclosed but were not, in violation of Section 36(b). Plaintiffs have also attacked the practice of charging Rule 12b-1 fees for closed funds, alleging that there is no need for marketing and promotional fees in such a fund. Ms. Carter noted that the viability of this theory, however, is called into question when one considers that NASD Rule 2830(d)(2) allows a closed fund to continue charging Rule 12b-1 fees within a specified cap, and that 12b-1 fees are not limited to *current* marketing and distribution expenses but can be charged in order to recover sales-related expenses *previously* paid out when distributing the fund's shares.

Joshua Hamilton noted that plaintiffs have also used the Securities Exchange Act of 1934 as a vehicle for challenging Rule 12b-1 fees, alleging that brokers stated in marketing materials that financial advisers were unbiased even though brokers were receiving 12b-1 fees from the funds in exchange for steering investors into the funds. Mr. Hamilton said that courts are split on whether, where the total fees are disclosed, the failure to disclose how the fees are used amounts to a material misrepresentation.

Mr. Hamilton pointed out that, in the most recent fee-related decision, *In re Smith Barney Fund Transfer Agent Litigation,* 2007 WL 2809600 (S.D.N.Y. September 26, 2007), the court foreshadowed the difficulties plaintiffs may have in pursuing viable claims in the future. The plaintiffs claimed that fees paid for transfer agent services were excessive and that the allocation of fees among affiliated entities was not properly disclosed in the fund prospectuses. The court granted the motion to dismiss, holding that since total fees were disclosed, the omission of other information about allocation of fees or "the transfer agent's profit margin" was not material to the price and value of the funds. *Cf. Siemers v. Wells Fargo & Co.*, 2006 WL 2355411 (N.D. Cal. Aug. 14, 2006) (allowing claim based on "kickback" payments which tainted the investment advice provided to investors). The *Smith Barney* court also dismissed the state law claims because they were not pleaded as derivative claims, but allowed plaintiffs to re-plead them. The participants noted that, although plaintiffs routinely include a supplemental state law claim for breach of fiduciary duty, some courts have held these claims to be preempted by the Securities Litigation Uniform Standards Act ("**SLUSA**"). *See, e.g., In re Salomon Smith Barney Mut. Fund Fees Litig.*, 441 F. Supp. 2d 579 (S.D.N.Y. 2006).

Mr. Sullivan and Mr. Hamilton indicated that courts have also been unsympathetic to the argument that a complaint alleging excessive Rule 12b-1 fees should not be required to allege specific facts of disproportionality when such facts are not publicly known or otherwise available. For example, in *Amron v. Morgan Stanley Inv. Advisors, Inc.*, 464 F.3d 338 (2d Cir. 2006), the plaintiffs argued they should essentially be excused from pleading with specificity because the profitability of the Rule 12b-1 fees charged, and hence the fees' disproportionality under the *Gartenberg* standard, could only be obtained through discovery. The Second Circuit nevertheless affirmed dismissal of the complaint in its entirety without leave to amend, noting that a mere prayer for discovery was not enough to defeat the defense motion. *Id.* at 344-45.[2]

Ms. Carter noted that other potential future issues include whether there is insurance coverage for excessive fee claims, the scope of state law breach of fiduciary claims for excessive or improper fees where a federal claim is preempted by SLUSA, and whether courts will permit claims alleging breaches of fiduciary duty under ERISA to proceed.[3]

***If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:***

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[1] Under the standards set out by the Supreme Court in *Alexander v. Sandoval*, 532 U.S. 275 (2001), the trend in cases challenging 12b-1 fees and other mutual fund-related fees is to find no implied private right of action under the ICA absent clear Congressional intent to the contrary. Consistent with this line of cases, the Second Circuit recently held that no private right of action exists for violations of Sections 34(b), 36(a), and 48(a) of the ICA. *Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110, 116 (2d Cir. 2007) (*per curiam*).

[2] This is consistent with the increased tightening of general pleading standards under the Federal Rules of Civil Procedure, as exemplified by the Supreme Court's recent decision in *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955 (2007). Of particular concern in *Twombly* was the prospect of subjecting defendants to costly discovery on the basis of broad, speculative allegations that did not plausibly suggest any illegal conduct. *Twombly*, 127 S. Ct. at 1966-67.

[3] A recent string of class action lawsuits brought under the Employee Retirement Income Security Act of 1974 ("ERISA") have attempted to hold employers/sponsors, plan administrators, plan trustees and service providers liable for breach of fiduciary duty for permitting the plan to charge excessive and unreasonable fees, or by failing to adequately disclose certain fee-sharing arrangements. Court decisions to date have varied as to whether these suits state valid claims. *Compare Hecker v. Deere & Co.*, 496 F. Supp. 2d 967 (W.D. Wisc. June 21, 2007) *with Loomis v. Exelon Corp.*, Case No. 06 CV 4900 (N.D. Ill. June 26, 2007).