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July 19, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: SEC Request for Comments Regarding Rule 12b-1 (File No. 4-538)

Dear Ms. Morris:

The Investment Company Institute[1] is pleased to submit comments in connection with the Securities and Exchange Commission's review of Rule 12b-1 under the Investment Company Act of 1940.[2] Periodic reassessment of longstanding rules and regulations is good regulatory policy and we commend the SEC for carefully considering whether any changes to Rule 12b-1 are necessary.

Mutual funds currently have over $11 trillion in assets on behalf of more than 90 million shareholders with nearly 290 million accounts. They play a particularly important role in helping millions of Americans prepare for a financially secure retirement. Rule 12b-1 is an integral part of the structure and success of the mutual fund industry. The rule and its associated fees allow investors the option of paying distribution costs over time, give investors access to funds that otherwise might not be available to them, and compensate financial intermediaries, on whom so many fund investors depend.

Recognizing these important contributions to the vitality of mutual funds, the Institute supports retaining the basic framework of Rule 12b-1. Any regulatory changes should be limited instead to those that refine or enhance the rule, such as changes that would clarify the role of the board

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[1] The Investment Company Institute is the national association of U.S. investment companies. More information about the Institute is included at the end of this letter.

[2] On June 19, 2007, the SEC held a roundtable ("Roundtable") on Rule 12b-1 that addressed the history of the rule, the current uses of 12b-1 fees, the costs and benefits of 12b-1 plans, and the options for reform or rescission of the rule. In connection with the press release announcing the panelists and final agenda for the Roundtable, the SEC encouraged all interested persons to comment on the topics discussed at the Roundtable and on any other issue relating to the use of fund assets to pay for the sale of fund shares. The press release can be found on the SEC's website at http://sec.gov/news/press/2007/2007-112.htm.

under the rule and provide better disclosure of 12b-1 fees. We urge the SEC to refrain from making changes that would fundamentally alter the way Rule 12b-1 operates or that would fully or partially rescind the rule. In general, these changes would limit investor choices, increase barriers to entry to the industry, cause shareholders to pay higher taxes on their funds, and impose significant operational and transitional costs on funds, intermediaries, and investors.

I. Importance of Economic Analysis in Rulemaking

Any regulatory action requires a thorough economic analysis of the impact of the action on the affected markets and their participants. As the SEC's chief economist recently stated:

> [W]hile a cost-benefit analysis cannot be finalized until the form of a proposed rule is determined, in fact consideration of the cost-benefit also is integral to making appropriate regulatory judgments among alternatives. The economic analysis of a rule should reflect not just why a proposed rule is better than the status quo, but also why the proposal would be an improvement over the relevant alternatives.[3]

These principles apply equally to the consideration of changes to an existing rule. Thus, in reviewing Rule 12b-1, the SEC should identify the need for any changes and should assess the economic costs and benefits of any proposed changes and relevant alternatives. A full, thoughtful, and careful economic analysis is especially critical given the significant benefits Rule 12b-1 has provided to fund investors. A majority of funds today use 12b-1 fees to defray distribution-related costs and the fees are deeply embedded within the fund distribution infrastructure. Hasty or ill-designed changes to the rule risk confusing or displacing investors, disturbing the vast market for mutual funds, and impairing market efficiency and competition.

II. Importance of Rule 12b-1 to Mutual Funds and Their Shareholders

Section 12(b) of the Investment Company Act provides that, in general, it is unlawful for a mutual fund to act as a distributor of its securities in contravention of any rules or regulations the SEC may prescribe. Although the statutory language of Section 12(b) does not prohibit funds from imposing asset-based charges to pay for the distribution of their shares, before Rule 12b-1 was adopted the SEC and its staff generally took the position that it was improper for mutual funds to finance the distribution of their shares. Following public hearings and solicitations of written comments, the SEC adopted Rule 12b-1 in 1980 permitting funds to pay directly distribution-related costs.[4]

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[3] Speech by SEC Staff: "Economic Analysis and Cost-Benefit Analysis: Substitutes or Complements?" by Chester S. Spatt, Chief Economist and Director, Office of Economic Analysis, Securities and Exchange Commission, Washington, D.C. (March 15, 2007) at 2.

[4] *See* Bearing of Distribution Expenses by Mutual Funds, SEC Release No. IC-11414 (November 7, 1980) ("Rule 12b-1 Adopting Release"). For an historical overview of Rule 12b-1, *see* Report of the Working Group on Rule 12b-1, Submitted

The regulatory history of Rule 12b-1 has been the subject of recent discussion by regulators, the media, and industry participants. Some have argued that Rule 12b-1 was intended to address net redemptions in the industry, that 12b-1 plans were meant to be temporary, and that the rule was intended to cover payments for advertising but not intermediary compensation. Participants on the first panel of the Roundtable who were involved in the rule's adoption strongly refuted these and other misconceptions. These panelists asserted that the SEC was seeking a permanent solution to the issues raised in certain no-action letters in the mid-1970s that involved funds using a portion of their advisory fees to pay intermediaries for the sale of fund shares.[5]

As the Roundtable participants noted, Rule 12b-1 does not restrict the kinds or amounts of payments that a fund may make and was intended to be flexible enough to allow funds to develop new distribution practices.[6] The SEC determined that within the framework of the rule, discretion would lie with fund boards, and particularly independent directors, regarding the fund's distribution-related activities. In fact, shortly following the adoption of Rule 12b-1, increased competition from no-load funds and negative attitudes among mutual fund investors toward products that charge front-end sales loads prompted load funds to develop alternative methods of distribution financing. The SEC helped to foster these innovations in fund distribution by creating the infrastructure to support the fund industry's development of a wide variety of methods for compensating broker-dealers and other intermediaries that sell fund shares.[7]

Innovations in the marketplace since the adoption of Rule 12b-1 have given investors significant choice about how and where they purchase mutual fund shares. Today, over 70 percent of all funds have 12b-1 plans.[8] While some investors prefer to make their own investment decisions, most investors

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to Investment Company Institute Board of Governors (May 2007) ("Working Group Report") at 1-4 and Appendices I and II, available at http://www.ici.org/new/rpt_07_12b-1.pdf.

[5] *See, e.g.,* Armstrong Associates, SEC No-Action Letter (pub. avail. August 19, 1975); Mutual Liquid Assets, Inc., SEC No-Action Letter (pub. avail. July 15, 1976).

[6] The adopting release for Rule 12b-1 states that "[s]ome commentators suggested the definition of distribution expenses recite precisely all activities that would be deemed distribution expenses. Recognizing that new distribution activities may continuously evolve in the future, and in the view of the impracticability of developing an all-inclusive list, the SEC maintains that the better approach is to define distribution expenses in general terms (*e.g.*, financing activities primarily intended to result in the sale of fund shares)." Rule 12b-1 Adopting Release, *supra* note 4.

[7] For example, soon after Rule 12b-1 was adopted the SEC permitted funds to adopt "spread load" arrangements and issue multiple classes of securities. *See* Working Group Report, *supra* note 4, at 3-4.

[8] According to the Institute's research using data from Lipper and internal data collected by the Institute, as of May 2007, 5,151 funds (out of 7,032) or 73 percent of all mutual funds including variable insurance products were paying 12b-1 fees to intermediaries. More detailed information regarding 12b-1 fees paid by mutual funds is included in Appendix I.

seek professional help and advice from financial intermediaries.[9] These investors purchase, hold, and redeem shares through financial intermediaries at securities firms, banks, insurance agencies, and financial planning firms. Investors also can buy and redeem shares of many funds through "fund supermarkets"[10] or retirement plan platforms[11] sponsored by broker-dealers, retirement plan administrators and other institutional intermediaries. In those programs, the supermarket or platform sponsor provides administrative and/or distribution services to its customers who purchase shares of a fund participating in the program.

The primary use of 12b-1 fees is to compensate financial intermediaries for advice and other services to their clients. Many funds, including no-load funds,[12] money market funds, and front-end sales load funds, also have established 12b-1 plans to pay service fees to compensate sales personnel and others for providing ongoing advice, administrative, recordkeeping, and transfer agent services to investors. [13]

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[9] As of 2003, more than 80 percent of all shareholders owning fund shares outside a 401(k) or other employer-sponsored pension plan owned fund shares through financial intermediaries. *See* "Ownership of Mutual Funds Through Professional Financial Advisers," *Fundamentals*, Vol. 14, No. 3, Investment Company Institute, April 2005, available at http://www.ici.org/pdf/fm-v14n3.pdf.

[10] Fund supermarkets are programs sponsored by financial institutions through which their customers may purchase and redeem a variety of funds, with or without paying transaction fees. Many funds that offer shares through fund supermarkets adopt 12b-1 plans to help finance the payment of fees that are charged by the sponsors of the fund supermarkets. *See* Division of Investment Management, Securities and Exchange Commission, *Report on Mutual Fund Fees and Expenses* (December 2000) at 39, available on the SEC's website at http://www.sec.gov/news/studies/feestudy.htm.

[11] Retirement plan service providers provide plan participants with a variety of services, such as distributing educational materials and organizing seminars that explain the retirement plan and investment options, answering investors' questions through telephone call centers and automated voice-response systems, and maintaining websites with information specific to the retirement plan. Employers may choose a variety of ways to pay for these services to plan participants. The costs may be covered through a combination of employer subsidies, direct charges to employees, and/or fees included in mutual fund expenses, such as 12b-1 fees and other service fees. *See* Brian K. Reid and John D. Rea, "Mutual Fund Distribution Channels and Distribution Costs," *Perspective*, Vol. 9, No. 3, Investment Company Institute, July 2003, at 5-6 ("July 2003 Perspective"), available at http://www.ici.org/pdf/per09-03.pdf. *See also* "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses," *Fundamentals*, Vol. 15, No. 7, Investment Company Institute, November 2006, available at http://www.ici.org/pdf/fm-v15n7.pdf.

[12] NASD rules prohibit any fund with a front-end load, contingent deferred sales load ("CDSL"), or 12b-1 fee from being referred to as "no-load," except for a fund with a 12b-1 fee that does not exceed 25 basis points. *See* NASD Conduct Rule 2830(d).

[13] In 2004, for example, virtually all (98 percent) of the 12b-1 fees paid by mutual funds were used to pay for ongoing advice, administrative and shareholder services and/or as a substitute for front-end sales loads. According to a survey conducted by the Institute, 52 percent of the 12b-1 fees paid in 2004 were used to compensate financial advisers for ongoing services, such as responding to customer inquiries and providing information on fund investments. Forty percent of the 12b-1 fees collected in that year were used to compensate financial advisers and other financial intermediaries for assisting fund investors before they make an initial fund purchase. Another six percent of the 12b-1 fees collected in 2004 were used to

Many funds sold through intermediaries use 12b-1 fees to offer investors alternative sales charge arrangements that combine different structures (multi-class and/or master-feeder) and/or sales charge methods (front-end and CDSLs). Funds also use different combinations of service fees and distribution fees. The different arrangements are reflected in different classes of shares, with the three most common being Class A, Class B, and Class C.[14]

III. Considerations Regarding Suggested Changes to Rule 12b-1

The changes to Rule 12b-1 that have been offered by various commentators, including participants at the Roundtable, generally fall into four categories: (i) revisiting board oversight under Rule 12b-1; (ii) improving disclosure and transparency of 12b-1 fees; (iii) externalizing distribution and servicing fees that are currently levied under Rule 12b-1 by requiring funds to assess them on individual shareholder accounts; and (iv) fully or partially rescinding Rule 12b-1. Each of these is discussed below.

A. Board Oversight

Many commentators, including several Roundtable participants, have suggested revisiting the board's responsibilities in approving 12b-1 plans. We agree that the existing guidance concerning the board's responsibilities under Rule 12b-1 has long been outdated and is not consistent with the current uses and marketplace realities of 12b-1 fees. As a result, we believe the SEC should consider modifying the role of directors to reflect current uses of 12b-1 fees, updating or eliminating the board factors originally suggested by the SEC, and/or eliminating Rule 12b-1's quarterly reporting requirements.[15]

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compensate mutual fund underwriters to cover some of their costs. The remaining two percent of the 12b-1 fees paid by fund shareholders were used for advertising and other sales promotion activities. *See* "How Mutual Funds Use 12b-1 Fees," *Fundamentals*, Vol. 14, No. 2, Investment Company Institute, February 2005, available at http://www.ici.org/pdf/fm-v14n2.pdf. Survey respondents accounted for three-quarters of the assets of mutual funds with 12b-1 fees.

[14] Class A shares have front-end sales loads and often small 12b-1 fees; Class B shares have annual 12b-1 fees and CDSLs that decline in each year the investment is held and convert to Class A shares after a period of time (*e.g.*, six to eight years); and Class C shares typically have annual 12b-1 fees as well as CDSLs of one percent for the first year of the investment. *See* July 2003 Perspective, *supra* note 11, at 8-11.

[15] *See generally* Letter from Amy B.R. Lancellotta, Acting General Counsel, Investment Company Institute to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated May 10, 2004. *See also* Letter from Robert W. Uek, Chair, IDC Governing Council to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated July 19, 2007; Working Group Report, *supra* note 4.

B. Disclosure and Transparency

Many commentators, including some Roundtable participants, questioned the extent to which investors are aware of the nature and purpose of 12b-1 fees and suggested that disclosure of the fees and other distribution-related costs can and should be improved. We agree. Investors benefit from the wide range of choices of how to pay for the advice and services they receive in connection with fund investments. This variety and range of choices, however, present disclosure challenges that ought to be addressed.

To improve investor awareness and understanding of 12b-1 fees and other fund fees and expenses, the SEC should consider improving the disclosure provided to investors both by the fund in its disclosure documents and by the intermediary at the point of sale. Several Roundtable participants also supported better disclosure as a way to improve the transparency of 12b-1 fees and other distribution-related costs. Like some of these participants, we recommend that 12b-1 fees be identified in a manner that describes their purpose(s) rather than being identified by reference to an SEC rule.[16]

The SEC's anticipated broader efforts to improve fund disclosure also would improve the transparency of 12b-1 fees. The SEC intends to consider allowing funds to use a short-form disclosure document that provides key information about a fund, including its fees.[17] A simplified disclosure document is likely to significantly enhance the transparency of not only 12b-1 fees, but all fund fees and expenses.

An additional way to promote investor awareness and understanding of 12b-1 fees would be to require financial intermediaries to provide investors with information about 12b-1 fees and other intermediary compensation at or before the point of sale. The SEC should take care to ensure, however, that any such disclosure requirements do not discourage intermediaries from selling mutual funds. In particular, these requirements should not create competitive disadvantages by imposing regulatory obligations only relating to funds. Singling out funds from other investment products that

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[16] *See also* Working Group Report, *supra* note 4, at 8-9; Report of the Mutual Fund Task Force: Mutual Fund Distribution, NASD (April 2005) at 17, available at http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_013690.pdf. The Mutual Fund Task Force was formed by NASD in 2004 and issued a report on fund distribution arrangements in early 2005.

[17] *See* Testimony Concerning "A Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission," by Christopher Cox, Chairman, Paul S. Atkins, Commissioner, Roel C. Campos, Commissioner, Annette L. Nazareth, Commissioner, and Kathleen L. Casey, Commissioner, Securities and Exchange Commission, Before House Committee on Financial Services Full Committee Meeting, June 26, 2007 ("[W]e are hard at work on a simplified, plain English disclosure for mutual funds that gives investors what they need to know, in a form they can use. We are focused on a new, streamlined disclosure document for investors that will provide better information about investment objectives, strategies, risks, and costs."), available on the SEC's website at http://sec.gov/news/testimony/2007/ts062607sec.htm.

intermediaries sell likely would encourage intermediaries to steer customers to alternative investments that do not offer the same level of regulatory protection and other benefits (*e.g*., diversification and liquidity) as mutual funds. Any disclosure requirements along these lines also need to recognize and accommodate the typical ways that investors interact with intermediaries (*i.e.,* by phone or email rather than in face-to-face meetings).

The SEC should carefully consider the costs and complexity of any disclosure improvements. For example, one approach mentioned at the Roundtable would require individualized mutual fund fee calculations on monthly or quarterly brokerage statements. We note that the SEC considered and decided against taking such an approach just three years ago, based on several reasons including the substantial costs and logistical complexity involved.[18]

C. Account-Level Distribution and Servicing Fees

Some commentators have suggested refashioning Rule 12b-1 so that funds would deduct distribution and servicing fees directly from shareholder accounts rather than from fund assets. These commentators assert that account-level fees would provide a more transparent way of paying for advice and other services. There are significant tax and operational disadvantages to imposing 12b-1 fees at the account level that likely would outweigh the benefits of this approach. As a result, we believe that the disclosure modifications described above are a more reasonable way to enhance investors' understanding of fees associated with a fund purchase.

1. Tax Considerations

Deducting distribution and servicing fees at the account level would increase investors' tax costs and decrease the tax efficiencies of mutual funds. Account-level fees also would require overly burdensome additional recordkeeping. Today, 12b-1 fees are netted at the fund level against the fund's investment income (before distributions are made and taxes are assessed on the distributed amounts); shareholders have no 12b-1 fee recordkeeping responsibilities. If account-based treatment were mandated, portions of the fee most likely would be subject to different tax rules based upon each portion's purpose. Funds would need to inform shareholders about how 12b-1 fees should be allocated between various purposes; shareholders then would be responsible for applying the relevant tax rules to each portion.

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[18] *See* Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, SEC Release No. IC-26372 (February 27, 2004) at 6-7, 69 FR 11244 (March 9, 2004) at 11247. The SEC also stated that providing investors with expense information in a standardized rather than a personalized manner facilitates comparison of ongoing costs among funds.

While the tax treatment of 12b-1 fees paid at the account level is not certain, account-level fees most likely would be deemed to serve multiple purposes subject to different tax considerations. The fee might be treated partly as a commission (for the broker's services in effecting the share purchase (*e.g.,* B shares)), partly as interest income (to compensate the adviser for making up-front payments to brokers and recovering these amounts over time through 12b-1 fees), and partly as compensation for ongoing services (such as administrative services or advice).

In applying a cost-benefit analysis to the tax consequences of account-level fees, three tax-related factors should be considered. First, would the tax rules allow, in all circumstances, a tax benefit in the form of lower shareholder taxable income? Second, what type of income would be reduced by the fee and at what rate would that income have been taxed? Third, when would the reduction in taxes occur?

- *Tax Benefits:* Fund-level fee treatment generally is more favorable because the fees reduce fund distributions (and shareholders' taxable income) on a dollar-for-dollar basis. The extent to which account-level fees would reduce taxable income depends on their characterization.

    - Interest expenses are deductible, but only to the extent of investment income.

    - Commission payments are not deductible, but are added to the taxpayer's cost basis.

    - Compensation for ongoing services, such as service charges or wrap fees, are treated as investment expenses that are deductible as miscellaneous itemized deductions, but only to the extent that miscellaneous deductions exceed two percent of adjusted gross income (AGI); this limitation is known as the "two-percent floor." Most mutual fund shareholders do not have miscellaneous deductions above this floor and therefore would lose any tax benefit of account-level fees treated as investment expenses.[19]

- *Tax Rates:* Fund-level fee treatment generally is more favorable because the fees are netted first against income (*i.e.,* interest income, non-qualified dividends, and short-term gains) taxable at ordinary rates (of up to 35 percent); any excess fees are netted against qualified dividends taxable at more favorable rates (generally 15 percent). Account-level fees most likely would offset ordinary income or qualified dividends (in part) and capital gains (in part). For example, fees for ongoing services most likely would offset ordinary income, but only to the extent that relevant limitations (*e.g.,* the two-percent floor) were satisfied. Commissions, in contrast, would offset capital gain income (taxable at a 15 percent maximum rate on shares held for more than one year).

[19] Using 2002 tax return data from the Internal Revenue Service Statistics of Income Division (the latest year for which return level data is available), the Institute estimates that only 12 percent of mutual fund shareholders with assets in non-tax-deferred accounts currently have miscellaneous deductions above the two-percent floor.

- *Timing:* Fund-level fee treatment generally is more favorable because the fees, in all cases, reduce taxable interest in the year they are incurred. While some account-level fees would reduce income in the year incurred (subject to applicable limits), others would not. Amounts treated as commissions, for example, would be added to the cost basis of the shares, but would provide no tax benefit until the shares were sold.

Thus, the loss of tax benefits to the shareholder resulting from a change to account-level 12b-1 fees would vary depending on the amount of 12b-1 fees incurred, the shareholder's ordinary income tax rate, the fund shares' rate of return, the type of investment income generated by the fund,[20] and the shares' holding period. In many cases, the tax cost of account-level fees would be substantial and would decrease account balances by up to 3.5 percent after ten years due solely to the change in tax treatment.[21] We would therefore urge the SEC to carefully consider the tax impact on fund investors from any proposed changes to Rule 12b-1. Indeed, the SEC has recognized the magnitude of tax costs and how they affect mutual fund performance. Specifically, in the release adopting the requirement that funds disclose after-tax returns, the SEC stated:

> While the tax-efficiency of a mutual fund is of little consequence to investors in 401(k) plans or other tax-deferred vehicles, it can be very important to an investor in a taxable account, particularly a long-term investor whose tax position may be significantly enhanced by minimizing current distributions of income and capital gains.[22]

2. *Operational Issues*

Switching from fund-level to account-level deductions of distribution and servicing fees also has very significant operational implications.[23] Account-level fees would be a departure from current practice and would require costly systems changes at all distribution levels by fund distributors, transfer agents, and other intermediaries. Specifically, to track and assess accrued 12b-1 fees daily against individual accounts, new transfer agent, bookkeeping, and accounting systems would need to be created. Mutual fund investor recordkeeping typically is conducted at multiple levels, including the funds' primary transfer agent as well as broker-dealers, banks, trust companies, and retirement plan

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[20] The analysis described above is somewhat different if the fund invests only in state and local bonds.

[21] Examples demonstrating the tax consequences of account-level fees are included in Appendix II.

[22] Disclosure of Mutual Fund After-Tax Returns, SEC Release No. IC-24832 (January 18, 2001) at 4, 66 FR 9002 (February 5, 2001) at 9003.

[23] For a detailed discussion of the operational implications associated with charging 12b-1 fees at the account level, *see* Working Group Report, *supra* note 4, at Appendix V.

recordkeepers operating sub-accounting systems (*e.g*., omnibus accounts, such as retirement plans). As a result, new systems and the required programming would need to be implemented and replicated at each level.

Account-level fees also presumably would be collected through periodic redemption of fund shares. Systems would need to address how to ensure that account balances are not reduced (by redemptions, exchanges, and/or market-related reductions) to levels below which collection of the 12b-1 fees would be at risk. The redemption of shares to pay the fees, often involving relatively small amounts, likely would result in higher transfer agent fees.

D. Full or Partial Rescission

Some commentators have suggested that Rule 12b-1 be fully or partially rescinded. One suggestion along these lines is to lower the cap on 12b-1 fees to, for example, 25 basis points, in an effort to effectively externalize or "demutualize" most distribution-related fees. Under this alternative, most payments for distribution and servicing fees would no longer be set or paid by funds (unlike the approach described above where funds continue to set these fees through 12b-1 plans).[24] Instead, investors would pay and negotiate with intermediaries directly for the package of advice and services that intermediaries provide. Many intermediaries currently offer investors externalized fees as a payment option,[25] but the need for radical change to Rule 12b-1 to require *all* mutual fund investors to use this form of payment with their intermediaries is not apparent.

Forcing all funds and their investors to externalize distribution-related fees, assuming that a set of distribution services could be defined, would disadvantage investors who prefer to use fund assets to pay for distribution and likely lead to higher distribution costs for many investors. Rule proposals that limit choice and thereby dictate market outcomes should have demonstrable benefits for investors that outweigh the attendant costs. Imposing an artificially low limit on 12b-1 fees—or eliminating 12b-1 fees altogether—would disserve the interests of many mutual fund investors and negatively impact all aspects of the mutual fund industry.[26] These changes would limit investor choices, increase barriers to

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[24] As we understand it, other aspects of Rule 12b-1 would be eliminated under this approach; thus, 12b-1 plans would no longer be necessary, and fund directors would no longer have any special oversight role.

[25] Examples of externalized payment options include advisory programs that directly charge investors asset-based fees, such as wrap programs, and fee-for-service programs that directly charge investors for the services rendered on an hourly or flat-rate basis.

[26] *See* "Rule 12b-1: A Vital Concept That Requires Reshaping," Lipper Inc. (2004) at vii ("[t]horoughly dismantling or severely modifying [Rule 12b-1] would undoubtedly wreak havoc on fund company operations, distribution networks, asset flows, broker-dealer relations, securitized 12b-1 flows, shareholder service levels, and recoupment of commission payments.").

entry to the industry, cause shareholders to pay higher taxes on their funds, and impose significant operational and transitional costs on funds, intermediaries, and investors.

1. *Impact on Investor Choice*

Rule 12b-1 has broadened the payment options available to investors for distribution and shareholder services. Many funds have responded by creating share classes with fees that reflect the different services investors receive through a particular distribution channel. By choosing a particular class of shares or sales charge arrangement, investors may elect the particular method for paying their intermediary. Some commentators have argued that the proliferation of share classes confuses shareholders and provides incentives for intermediaries to sell funds based on the compensation they receive rather than the needs of the investor. To the contrary, we believe the current flexibility of multiple share classes and various payment arrangements has enabled investors to select the pricing option that best suits their needs and, at the same time, has retained the benefits of paying for these services with fund assets. As discussed below, this flexibility has facilitated the creation of share classes designed to help investors meet their goals of saving for retirement and paying for college. Full or partial rescission of Rule 12b-1 would have serious consequences on the availability of these share classes.

- *Retirement shares*: As of year-end 2006, about $520 billion in 401(k) assets were held in mutual fund share classes with a 12b-1 fee, and a little over $140 billion of those assets were held in mutual fund share classes with 12b-1 fees greater than 25 basis points.[27] While many retirement platforms use load-waived Class A shares (with a 25 basis point 12b-1 fee), some platforms offer share classes that have been specially designed for retirement plan platforms (often referred to as "R shares").[28] Generally, 12b-1 fees on R shares can range from 25 basis points to 100 basis points. This allows tailoring to the economics of a specific plan and the needs of an employer-sponsor, with the range reflecting differing levels of "cost-sharing" to defray costs of administering a plan. R share classes, a relatively new innovation, are beneficial to defined contribution plan participants because they allow plan sponsors who might otherwise be unable to afford a defined contribution plan to offer one to their employees. Full or partial rescission could limit the options some smaller employers would have in offering such plans to their employees.

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[27] ICI calculations based on data from Lipper; © CRSP University of Chicago, Strategic Insight Simfund, and confidential data submitted to the Institute for its annual retirement survey.

[28] Fund companies generally do not assess front-end loads for group retirement plan platforms due to the scale of the platforms. Classes B and C shares usually are not used by group retirement plan platforms because the assessment of CDSLs and back-end loads complicates recordkeeping.

- *529 plans*: Some 529 plans, tax-advantaged savings plans intended to encourage saving for future college costs, are sold through financial intermediaries who help investors choose a 529 plan and an investment strategy to meet their needs. Similar to R shares, 12b-1 fees on mutual fund shares in 529 plans range from 25 to 100 basis points. The Institute has identified a little over 35 percent of assets in mutual fund share classes specifically designed for 529 plans that have 12b-1 fees greater than 25 basis points.

The effects of "demutualizing" intermediary fees would not be borne uniformly. For example, alternative fee-based products offered by broker-dealers and other investment professionals, such as separately managed accounts ("SMAs") or mutual fund advisory "wrap" programs ("wrap accounts"), are not available to investors with more modest amounts to invest.[29] The costs of these products tend to be higher than the costs of payment options using fund assets.[30]

2. *Impact on Small Funds*

Fully or partially rescinding Rule 12b-1 likely would have serious negative consequences for smaller funds and, consequently, for competition. As noted by several participants at the Roundtable, financial intermediaries have significant market power in distribution channels and the vast majority of mutual funds are "price takers" because they do not determine the market for distribution. Currently, the market price for intermediaries' services often is greater than payments under a fund's 12b-1 plan.[31]

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[29] As of the first quarter of 2007, the average SMA size is $336,000. *See* "Rule 12b-1: Looking Back, Looking Forward, in the Context of a $12 Trillion Mutual Fund Industry," *Strategic Insight Overview*, Issue 4 (2007) at 2 ("2007 SIO Issue"). For wrap accounts, investment minimums can be as low as $5,000 and $10,000 at some firms. *See* "In the Comfort Zone: Shining While Remaining Out of the Spotlight," Managed Accounts Edition, *The Cerulli Edge*, Cerulli Associates, First Quarter 2005 at 6. The current average account size, however, is $143,000. 2007 SIO Issue at 2. In contrast, account-level data collected by the Institute indicate that the typical balance in a long-term retail mutual fund, as indicated by the median account balance, is about $5,000. *See* "Mutual Funds and Institutional Accounts: A Comparison," Investment Company Institute (2006). In addition, fund investment minimums can be as low as $50 per month for investors participating in automatic investment plans.

[30] Fees charged for smaller SMAs are generally 2.5 to 3.0 percent of assets. For all SMAs, large and small, the average effective fee (asset-weighted) is 1.69 percent. Fees charged for wrap accounts average 1.17 percent in addition to the underlying mutual funds' expenses. *See* 2007 SIO Issue at 2. In contrast, NASD limits 12b-1 fees (including service fees) to 1.00 percent. NASD rules impose a limit on annual asset-based sales charges of 0.75 percent of a fund's assets. An additional 0.25 percent "service fee" may be paid to brokers or other sales professionals for providing ongoing information and assistance. There also is an overall cap on 12b-1 fees (other than service fees) that is based on a percentage of fund sales. The cap is calculated at 6.25 percent of new sales (plus interest) for funds that pay a service fee, and 7.25 percent plus interest for funds that do not pay a service fee. *See* NASD Conduct Rule 2830(d). These limits are designed to achieve "approximate economic equivalency" in the amounts that may be charged in 12b-1 fees and front-end or deferred sales loads.

[31] Some proponents of full or partial rescission suggest that the tendency for 12b-1 fees to cluster around the NASD limits is evidence that 12b-1 fees inhibit price competition. This suggestion, however, fails to recognize that the market price for distribution and shareholder servicing frequently exceeds these limits.

As a result, intermediaries seek additional payments for the services provided to funds and their shareholders through other sources, such as sub-transfer agent fees from funds and revenue-sharing payments from fund advisers.

Rescinding or restricting the authority provided under Rule 12b-1 to pay for distribution and servicing costs would not remove this market pressure and therefore likely would favor larger established fund firms with greater market power, brand recognition, and broader distribution networks at the expense of newer or smaller fund firms. Our small fund members report that without asset-based distribution fees, they would be at a competitive disadvantage. They explain that the ability of small funds to assess asset-based distribution fees has enabled these funds to remain competitive by allowing them to gain access to a wider array of distribution channels, such as fund supermarkets, than they otherwise would have through traditional front-end sales load structures.[32] Indeed, Mellody Hobson, President of Ariel Capital Management, stated at the Roundtable:

> We would argue we could not exist without the existence of the 12b-1 fee to grow the funds ultimately. We would also argue that we believe the entrepreneurial spirit that has led to such a competitive marketplace in the mutual fund business would be very significantly affected should 12b-1 fees not create an opportunity for small entrepreneurial mutual fund companies to exist.

Small funds represent an important segment of the mutual fund industry. In addition to providing choices for investors and encouraging competition, they have historically been prolific sources of innovation and purveyors of highly specialized investment products.[33] Small fund complexes also popularized many other common investment products, including socially responsible and leveraged funds. In fact, some specialized products, such as municipal bond funds for particular states, are available only from small fund advisers.

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[32] *See, e.g.,* Statements of Mellody Hobson, President, Ariel Capital Management, LLC/Ariel Mutual Funds, and Thomas O. Putnam, Founder and Chairman, Fenimore Asset Management, Inc./FAM Funds ("Thomas Statement"), on "Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Costs and Distribution Practices," Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 26, 2004 and March 31, 2004, respectively (discussing the importance of 12b-1 fees to small fund complexes).

[33] *See* Thomas Statement, *supra* note 32, at 4-7 (describing the important role of small funds in the mutual fund industry, including providing choices for investors, fostering competition, developing specialized and niche products and offering shareholders individual service and attention that cannot be matched by large funds). Also, money market funds, which now hold $2.573 trillion in assets, were first offered in 1971 by the Reserve Fund, at the time a small fund complex.

3. Adverse Tax Considerations

Full rescission of Rule 12b-1 generally would have tax consequences similar to those explained above in Section III.C.1. (discussing the tax impact of charging 12b-1 fees at the account level), assuming intermediaries charge the same total amount of distribution and servicing fees after full rescission. A partial rescission of the rule would increase taxes to a lesser extent because a portion of distribution and servicing fees (*e.g.*, 25 basis points) would continue to be charged at the fund level.[34]

4. Significant Operational Changes

Fully or partially rescinding Rule 12b-1 likely would require that significant operational changes be made to IT, recordkeeping, and compliance systems at all distribution levels, including principal underwriters, selling broker-dealers, transfer agents, administrators, and third-party administrators. Externalizing distribution costs likely would force intermediaries to shift to a different and more expensive compensation model for ongoing investment planning assistance for many fund clients. Each intermediary would need to incur substantial additional costs to develop, operate, and maintain a proprietary compensation model, losing the efficiencies of the current "mutualized" model. These costs likely would be passed on to investors in the form of higher distribution costs.

5. Changes to Fund Selling and Service Agreements

Externalizing distribution costs likely would require extensive and costly changes to current fund selling and service agreements. These costs can be substantial, as evidenced by the recent implementation of Rule 22c-2 under the Investment Company Act, which required the addition of specific provisions to intermediary agreements.

6. Reimbursement/Recoupment/Securitization

Fund underwriters typically use the revenues from 12b-1 fees to recoup commissions fronted to financial intermediaries selling Class B or C shares. Likewise, they sometimes use anticipated future revenue streams from 12b-1 fees as collateral to obtain loans that allow them to advance sales commissions to financial intermediaries. Other underwriters sell the expected future cash flows from 12b-1 fees to investment banks that issue debt securities backed by the underwriters' contractual right to receive the future fees.[35] Any SEC rulemaking that would consider the elimination of these share classes would need to address the effect of such elimination on these obligations.

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[34] Examples demonstrating the tax consequences of partial rescission of Rule 12b-1 are included in Appendix II.

[35] Moody's Investors Services reported 37 rated issues of securitized 12b-1 fees for a total of approximately $3.2 billion as of year-end 2005. *See* "Default and Loss Rates of Structured Finance Securities 1993-2006" (April 2007).

* * * * *

We commend the SEC for holding the Roundtable and soliciting public comment from all interested persons relating to Rule 12b-1 prior to proposing specific changes to the rule. Considering the vital role that 12b-1 fees play in the fund industry, it is both necessary and appropriate for the SEC to fully understand the effect on mutual funds and their shareholders of any proposed course of action with respect to Rule 12b-1. Changes to the rule that have unclear benefits and high economic costs will make funds and their shareholders worse off by hampering efficiency and diminishing competition in the fund industry.

The Institute appreciates the SEC's consideration of our comments. If you have any questions or need additional information, please contact me at 202-326-5826 or our Chief Economist, Brian Reid at 202-326-5917.

Sincerely,

/s/ Mary S. Podesta

Mary S. Podesta
Acting General Counsel

cc: The Honorable Christopher Cox
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth
The Honorable Kathleen L. Casey

Andrew J. Donohue, Director
Robert E. Plaze, Associate Director
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About the Investment Company Institute

ICI members include 8,766 open-end investment companies (mutual funds), 670 closed-end investment companies, 440 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $11.242 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

12b-1 Fees Paid by Mutual Funds
2006

	Total Net Assets (year end)	Net New Cash Flow	Total 12b-1 Fees	12b-1 Fees Asset-Weighted Average	12b-1 Fees Simple Average	12b-1 Fees Median
	(billions of dollars)			(basis points)		
All Mutual Funds	10,414	474	14.2	16	38	25
Long-Term Funds	6,835	203	11.8	17	41	25
Front-end Load[1]	2,034	51	4.9	24	24	25
Back-end Load[2]	250	-49	2.4	96	93	100
Level Load[3]	350	22	3.3	93	91	100
Other Load[4]	77	12	0.4	50	51	50
No-Load[5]	4,124	166	0.8	2	4	0
Variable Annuities[6]	1,267	30	1.1	15	21	25
Money Market[7]	2,312	241	1.3	13	33	25

[1] Front load > 1 percent. Primarily includes Class A shares; includes sales where front loads are waived.

[2] Front load = 0 percent and CDSL > 2 percent. Primarily includes Class B shares.

[3] Front load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fees > 0.25 percent. Primarily includes Class C shares; excludes institutional share classes.

[4] All other load share classes not classified as front load, back-end load, or level load. Primarily includes retirement share classes (R shares).

[5] Front load = 0 percent, CDSL = 0 percent, and 12b-1 fees ≤ 0.25 percent.

[6] Includes variable annuity money market funds.

[7] Excludes variable annuities.

Note: Components may not add to total because of rounding.

Sources: Investment Company Institute; Lipper; and Strategic Insight Simfund

Illustrative Examples: Tax Consequences of Account-Level Distribution Fees

I. Tax Consequences of Account-Level 12b-1 Fees or Full Rescission of Rule 12b-1

The calculations below illustrate the tax effect on a long-term investor under various scenarios involving account-level distribution and servicing fees, either by amending Rule 12b-1 to require that 12b-1 fees be charged at the account level or fully rescinding Rule 12b-1. In either case, it is assumed for purposes of this illustration that changes to the rule would not affect the total amount of distribution and servicing fees; the fees would simply no longer be charged at the fund level.

Summary of Loss of Tax Benefits (in the Illustrative Examples)

The shareholder tax cost of account-level fees would vary depending on the amount of fees incurred, the shareholder's ordinary income tax rate, the fund shares' rate of return, the type of investment income generated by the fund, and the shares' holding period. For Class B shares, account-level fees would result in an account balance as much as 3 percent lower after 10 years and as much as 6 percent lower after 40 years. For Class C shares, account-level fees would result in an account balance as much as 3-1/2 percent lower after 10 years and as much as 13 percent lower after 40 years.

Description of Model Assumptions

- Two types of investments are simulated.
  - A one-time "lump-sum" purchase of shares with all distributions reinvested after netting out taxes and fees.
  - An annual investment, with all distributions reinvested after netting out taxes and fees. The total purchase price of the new shares purchased annually is assumed to be constant in real (inflation-adjusted) dollars, with annual inflation assumed to be 2.5 percent.

- The amount of time from opening the account to selling all shares ranges from 10 to 40 years. In the case of annual investments, new shares are purchased in every year the account is open.

- Two types of assets are held.
  - A stock mutual fund, which yields 9.75 percent a year, consisting of
    - 2.75 percentage points of dividend distributions, of which 2.0 percentage points are in the form of qualified dividend income taxed at the preferential dividend rate and 0.75 percentage points in the form of short-term capital gain income taxed at ordinary rates;
    - 3.0 percentage points of long-term capital gain distributions taxed at the preferential capital gains rate; and

        - 4.0 percentage points of unrealized capital gain, which will be taxed at the preferential capital gains rate when the shares are sold.
    - A bond mutual fund, which yields 6.0 percent a year, all in the form of interest income taxed at ordinary income tax rates.

- Three portfolios are held.
    - 100 percent stock mutual fund shares.
    - 50 percent stock mutual fund shares and 50 percent bond mutual fund shares with the portfolio rebalanced annually.
    - 100 percent bond mutual fund shares.

- Two types of shares are purchased.
    - Class B shares, which have a 75 basis-point distribution fee and a 25 basis-point service fee; these shares convert after eight years to Class A shares, which have an ongoing 25 basis-point service fee.
        - The 75 basis-point distribution fee in the first eight years can be further broken into a 60 basis-point payment of commission (for the broker's services in effecting the share purchase) and a 15 basis-point payment of interest (to compensate the advisor for making up-front payments to brokers and recovering these amounts over time through 12b-1 fees).
    - Class C shares, which have an ongoing 100 basis point annual fee.

- Tax treatment of the fees.
    - Fund-level 12b-1 fees are netted against fund income before distribution (and taxation) of income to the shareholder.
    - Account-level fees that are characterized as ongoing expenses (the 25 basis-point service fee on the Class B shares and the 100 basis-point annual fee on the Class C shares) are treated as miscellaneous itemized deductions, and are only deductible to the extent that total miscellaneous deductions exceed 2.0 percent of the taxpayer's AGI.
    - Account-level fees that are characterized as interest (the 15 basis-point charge attributed to interest on Class B shares) are deductible to the extent of investment income.
    - Account-level fees that are characterized as commission (the 60 basis-point charge attributed to commission on Class B shares) are added to the shareholder's basis in the shares.

- It is assumed that the shareholder does not have sufficient miscellaneous itemized deductions to benefit from deducting ongoing expenses (that is, the 25 basis-point service fee on the Class B shares and the 100 basis-point annual fee on the Class C shares).
    - Using 2002 tax return data from the Internal Revenue Service Statistics of Income Division (the latest year for which return level data is available), the Institute

estimates that only 12 percent of mutual fund shareholders with assets in non-tax-deferred accounts currently have miscellaneous deductions above the 2 percent floor.

- All long-term capital gains and qualified dividends are taxed at 15 percent; ordinary income is taxed at either 25 percent or 35 percent.

- The results below compare the proceeds derived from selling the shares at the end of the holding period, net of all taxes, including tax on capital gains realized at the time of the sale.

Discussion of Model Results

In general, the shareholder tax cost of account-level fees increases with the amount of fees incurred, the shareholder's ordinary income tax rate, the fund shares' rate of return, the proportion of fund distributions taxed at ordinary tax rates, and the shares' holding period. The shareholder tax cost declines with the proportion of account-level fees that are deductible against income.

The tax costs associated with account-level fees on Class B shares ranges from 0.6 percent to 3.1 percent of accumulated assets for a holding period of ten years and ranges from 2.4 percent to 6.0 percent for a holding period of 40 years. Relative to the portfolio invested solely in stocks, the tax cost of account-level fees is higher for portfolios that invest solely in bonds. Fund-level 12b-1 fees in a bond fund offset ordinary income taxed at rates of up to 35 percent, whereas fund-level 12b-1 fees in a stock fund offset both ordinary income (short-term gains) and qualified dividend income that would be taxed at rates of up to 15 percent. The cost of account-level fees is nearly as high for a mixed stock/bond portfolio as it is for a straight bond portfolio because the tax costs incurred are compounded over time at a higher overall rate of return. The tax costs are lower for shareholders with a lower tax rate on ordinary income.

For accounts that are open for the same amount of time, the tax cost of account-level fees is higher as a percentage of assets for an account with a single lump-sum investment than for an account with additional shares purchased each year. This is because the tax cost increases with the amount of time the shares are held. The holding period for a lump-sum investment is the amount of time the account has been open. With annual investments, only a portion of the shares in the account has been held for the entire time period. Thus, the effective holding period, on an asset-weighted basis, of all shares in the account for an investor who purchases new shares each year is much lower than the amount of time the account has been open (*i.e.*, much lower than the holding period of a lump-sum investment).

The tax costs associated with account-level fees on Class C shares ranges from 1.3 percent to 3.4 percent of accumulated assets for a holding period of ten years and ranges from 5.3 percent to 13.1 percent for a holding period of 40 years. The tax costs are higher for Class C shares than Class B shares for two reasons. First, Class C shares have higher fees: the 12b-1 fees for Class C shares remain at 100

basis points for the entire holding period of the shares; the 12b-1 fees for Class B shares are reduced to 25 basis points after eight years. Second, the entire 100 basis point fee is considered an investment expense, which is a miscellaneous deduction subject to the 2.0 percent AGI floor, and it is assumed that the shareholder does not have enough miscellaneous deductions to claim a tax benefit.

Tax Treatment of Fund-Level 12b-1 Fees versus Account-Level Fees: The Case of B Shares

Model Assumptions	
Rates of Return	
Stocks	9.75%
Dividends	2.00%
Short-term gains	0.75%
Bonds (all interest)	6.00%
Fees[1]	
Total fees (first 8 years)	1.00%
Service	0.25%
Commission	0.60%
Interest	0.15%
Total fees (after 8 years)	0.25%
Tax Rates	
Ordinary	25% or 35%
Dividends & gains	15%

Model Results

Scenario Number	**1**	**2**	**3**	**4**	**5**	**6**
Type of Investment	Lump-Sum	Lump-Sum	Lump-Sum	Annual[2]	Annual[2]	Annual[2]
Portfolio Allocation						
Bonds	0%	50%	100%	0%	50%	100%
Stocks	100	50	0	100	50	0
Percent Reduction in After Tax Balance with Account-Level Fees						
Amount of Time Account Open	**Ordinary income taxed at 35 percent**					
10 years	-1.6%	-2.9%	-3.1%	-0.9%	-1.7%	-1.8%
20 years	-2.7	-4.0	-4.1	-1.8	-2.8	-2.8
30 years	-3.6	-4.9	-5.1	-2.6	-3.6	-3.5
40 years	-4.5	-5.8	-6.0	-3.3	-4.3	-4.1
Amount of Time Account Open	**Ordinary income taxed at 25 percent**					
10 years	-1.1%	-2.3%	-2.4%	-0.6%	-1.3%	-1.4%
20 years	-2.0	-3.1	-3.2	-1.3	-2.2	-2.2
30 years	-2.7	-3.9	-3.9	-1.9	-2.8	-2.7
40 years	-3.3	-4.5	-4.6	-2.4	-3.4	-3.2

[1] Fund level 12b-1 fees charged first against interest income, then non-qualified dividends, then short-term gains, then qualified dividends; fund level 12b-1 fees cannot be charged against long-term gains. Taxpayer assumed to be unable to deduct account-level service fee due to 2.0 percent AGI floor. Account-level interest charge deductible against investment income. Account-level commission charge is added to basis. Capital loss upon sale of bond funds assumed to reduce long-term capital gain income.

[2] Investor makes annual investment (purchase of shares) for the account. Annual investment is constant in real dollars with inflation assumed to be 2.5 percent.

Source: ICI calculations

Tax Treatment of Fund Level 12b-1 Fees versus Account-Level Fees: The Case of C Shares

Model Assumptions	
Rates of Return	
Stocks	9.75%
Dividends	2.00%
Short-term gains	0.75%
Bonds (all interest)	6.00%
Fees[1]	
Total fees	1.00%
Tax Rates	
Ordinary	25% or 35%
Dividends & gains	15%

Model Results

Scenario Number	1	2	3	4	5	6
Type of Investment	Lump-Sum	Lump-Sum	Lump-Sum	Annual[2]	Annual[2]	Annual[2]
Portfolio Allocation						
Bonds	0%	50%	100%	0%	50%	100%
Stocks	100	50	0	100	50	0
Percent Reduction in After Tax Balance with Account -Level Fees						
Amount of Time Account Open	**Ordinary income taxed at 35 percent**					
10 years	-2.9%	-3.2%	-3.4%	-1.7%	-1.8%	-1.9%
20 years	-5.7	-6.2	-6.8	-3.5	-3.6	-3.7
30 years	-8.4	-9.2	-10.0	-5.4	-5.5	-5.4
40 years	-11.0	-12.1	-13.1	-7.5	-7.5	-7.2
Amount of Time Account Open	**Ordinary income taxed at 25 percent**					
10 years	-2.2%	-2.3%	-2.5%	-1.3%	-1.3%	-1.4%
20 years	-4.3	-4.6	-4.8	-2.6	-2.7	-2.7
30 years	-6.4	-6.8	-7.2	-4.1	-4.1	-4.0
40 years	-8.4	-9.0	-9.5	-5.7	-5.6	-5.3

[1] Fund-level 12b-1 fees charged first against interest income, then non-qualified dividends, then short-term gains, then qualified dividends; fund-level 12b-1 fees cannot be charged against long-term gains. Taxpayer assumed to be unable to deduct account-level fees due to 2.0 percent AGI floor.
[2] Investor makes annual investment (purchase of shares) for the account. Annual investment is constant in real dollars with inflation assumed to be 2.5 percent.
Source: ICI calculations

II. Tax Consequences of Partial Rescission of Rule 12b-1

A partial rescission of Rule 12b-1 also would increase taxes but to a lesser extent than either full rescission of the rule or requiring account-level 12b-1 fees because a portion of fees would continue to be charged at the fund level. The examples below make the same assumptions as used above to simulate the tax effects of account-level fees; however, for brevity, only the examples with a lump-sum investment are presented.

Compared to full rescission or account-level 12b-1 fees, retaining a 25-basis-point fund-level 12b-1 fee on Class B shares would reduce the tax cost by approximately 25 percent for bond mutual funds after 10 years. For example, the tax cost for an individual in the 35 percent tax bracket is reduced from 3.1 percent of assets with full rescission to 2.2 percent with partial rescission. For equity funds, partial rescission would reduce the tax cost by slightly more than 50 percent after ten years. For example, the tax cost for an individual in the 35 percent tax bracket falls from 1.6 percent of assets with full rescission to 0.7 percent with partial rescission. Because Class B shares are assumed to convert to Class A shares after eight years and partial rescission essentially allows for all Class A share 12b-1 fees to be collected at the fund level, the tax cost expressed as a percent of assets increases more slowly as the holding period increases. For example, after 40 years the tax cost for an individual in the 35 percent tax bracket increases to 2.6 percent of assets for a bond-fund investor and to 1.2 percent of assets for an equity-fund investor. Thus, compared to full rescission or account level 12b-1 fees, the tax cost of partial rescission is proportionately lower for longer holding periods.

The relative costs of partial rescission are much more straightforward in the case of Class C shares: Compared to full rescission or account-level 12b-1 fees, retaining a 25-basis-point fund-level 12b-1 fee on Class C shares would reduce the tax cost by approximately 25 percent for all asset allocations and holding periods. For example, the tax cost for an individual in the 35 percent tax bracket investing in split stock/bond portfolio is reduced 27 percent after 10 years (from 3.2 percent of assets with full rescission to 2.3 percent of assets with partial rescission) and reduced by 26 percent after 40 years (from 12.1 percent of assets with full rescission to 9.0 percent with partial rescission).

Tax Costs of Partial Rescission of Rule 12b-1

Model Assumptions

Rates of Return	
Stocks	9.75%
Dividends	2.00%
Short-term gains	0.75%
Bonds (all interest)	6.00%
Fees[1]	
Total fees	1.00%
Service (B shares)	0.25%
Commission (B shares)	0.60%
Interest (B shares)	0.15%
12b-1 fees after partial rescission	0.25%
Tax Rates	
Ordinary	25% or 35%
Dividends & gains	15%

Model Results

Scenario Number	**1**	**2**	**3**	**4**	**5**	**6**
Type of Investment	Lump-Sum	Lump-Sum	Lump-Sum	Lump-Sum	Lump-Sum	Lump-Sum
Type of Shares	Class B	Class B	Class B	Class C	Class C	Class C
Portfolio Allocation						
Bonds	0%	50%	100%	0%	50%	100%
Stocks	100	50	0	100	50	0
Percent Reduction in After Tax Balance with Partial Rescission of Rule 12b-1						
Amount of Time Account Open	**Ordinary income taxed at 35 percent**					
10 years	-0.7%	-2.1%	-2.2%	-2.0%	-2.3%	-2.6%
20 years	-1.0	-2.3	-2.4	-4.1	-4.6	-5.1
30 years	-1.1	-2.4	-2.6	-6.0	-6.8	-7.6
40 years	-1.2	-2.5	-2.6	-7.9	-9.0	-9.9
Amount of Time Account Open	**Ordinary income taxed at 25 percent**					
10 years	-0.5%	-1.7%	-1.8%	-1.6%	-1.7%	-1.8%
20 years	-0.7	-1.9	-2.0	-3.1	-3.4	-3.7
30 years	-0.9	-2.1	-2.1	-4.7	-5.1	-5.4
40 years	-0.9	-2.1	-2.2	-6.2	-6.7	-7.2

[1] Fund-level 12b-1 fees charged first against interest income, then non-qualified dividends, then short-term gains, then qualified dividends; fund-level 12b-1 fees cannot be charged against long term gains. Class B shares pay annual fund-level service charge; deduct account-level interest charge against investment income; and add to basis account-level commission charge. Capital loss upon sale of Class B share bond funds assumed to reduce long-term capital gain income. For Class C shares, taxpayer assumed to be unable to deduct all account-level fees due to 2.0 percent AGI floor.

Source: ICI calculations