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Mutual Fund Fee Reform: A Multibillion-Dollar Sleight of Hand?

Would 12b-1 reform truly make fund ownership cheaper?

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As the Securities and Exchange Commission looks to push through its reform of mutual funds' 12b-1 fees, one nagging question looms large: Will billions of dollars simply disappear from the mutual fund industry?

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Last year alone, 12b-1 fees, which cover everything from advertising to broker compensation, drained \$9.5 billion from investors' accounts. In 2007, that number was an eye-popping \$13.3 billion. While some of this money went toward funds' marketing and services needs, the vast majority was funneled to brokers. But earlier this month, the SEC voted in favor of an overhaul that would do away with the term "12b-1" and impose limits on funds' ability to charge ongoing sales commissions.

While this proposed change, which is still tentative until a 90-day comment period passes and the SEC can take into account public reactions, was drafted in the hopes of easing fund investors' financial burden, it's far from clear whether or not it can actually accomplish that goal. Simply put, brokers are unlikely to let billions of dollars slip through their fingers. Even if the SEC's proposal ultimately becomes the law of the land, brokers will find new ways to generate the revenue that once flowed from 12b-1 fees. That much we've known all along. What remains to be seen is how they will go about doing that—and whether the new fee structures will be any more favorable to investors than the old ones.

First, a bit of background. The SEC established 12b-1 fees in 1980 to help the mutual fund industry attract assets. In the early years, fund companies used the money they collected largely to fund advertising and distribution costs. Back then, the fund industry was struggling and asset levels were low. In the intervening years, though, funds ballooned in size, to the point where many have stopped accepting new investors. But even as their initial purpose became less relevant, 12b-1 fees continued to catch on. In a 2007 report, the Investment Company Institute said that roughly 70 percent of funds had 12b-1 fees for at least one of their share classes. Over time, these fees have gone from paying for printing and advertising to providing the brokers who sell funds with sales commissions.

Under regulations approved by the Financial Industry Regulatory Authority, funds can charge up to 1 percent (100 basis points) per year in 12b-1 fees. Of that, up to 25 basis points can be used for nuts and bolts "marketing and services" expenses. Meanwhile, up to 75 basis points can be used for asset-based sales charges, which are primarily code for ongoing sales commissions paid out to brokers.

Investors who pay the fees encapsulated in these 75 basis points are often invested in class C shares. Unlike A shares, which often have a front-end load, C shares allow investors to put their money to work immediately. But there's a tradeoff. Instead of paying one upfront sales charge, investors in C shares will often have their commissions spread out over time. Here's the catch: Investors who pay up to 75 basis points per year on their assets under management will, over the course of many years, often end up dishing out more than they would have had they elected to pay one lump sum upfront.

That's where the SEC's proposal comes in. It looks to prevent investors from paying more in continuing sales charges than they would have had they paid the maximum front-end load. In the case of investors in C shares, their investments would essentially convert to A shares after a set amount of time. Take, for instance, a fund that has its maximum front-end load set at 5 percent. Under the proposed regime, investors in C shares could, depending on the specific arrangements made by various fund companies, pay 1 percent per year for five years. After that period elapses, the investor's holdings would be converted into A shares with no continuing commission. This, of course, won't be an exact science. If the investor's holdings appreciate each year over the course of the five years, paying 1 percent per year would cost more than paying 5 percent upfront on the initial investment. Still, it's a relatively close approximation. Separately, funds would still be allowed to charge the 25 basis point "marketing and services" fee in perpetuity.

[See [What 12b-1 Reform Means for Investors](#).]

While this all looks fairly clean on paper, its implementation could cause a number of changes in the brokerage industry. Here are some possibilities:

More 'churning.' Brokers sell mutual funds to investors. Currently, when brokers put investors in class C shares, they can count on receiving commissions in perpetuity. Under the proposal, though, they'd be cut off after a set number of years. As a result, some worry that brokers could, right before the ongoing fees expire, move their clients into new mutual funds and have the commission clock start over.

This commission-based trading is known as portfolio churning, and it could essentially transform the supposed reform into a multibillion-dollar sleight of hand, with fees that were supposed to disappear magically re-emerging. "If the [brokers aren't] getting paid that much anymore,

maybe they'll just churn the portfolios more so they can collect more commissions," says Russel Kinnel, Morningstar's director of mutual fund research. "One would hope they wouldn't do that, but it's a possibility."

Currently, brokers can churn portfolios without fear of lawsuits. That's because, unlike registered investment advisors, brokers aren't held to a fiduciary standard. In other words, they only need to find suitable investments—as opposed to the best investments available—for their clients. Under the newly minted financial reform bill, though, the SEC is authorized to study and make changes to the standards to which brokers are held.

More competition. As part of the SEC's proposal, new share classes would be allowed to emerge in which brokers set the loads. Currently, brokers have their commissions dictated to them by fund companies. In other words, every broker who sells shares of a given fund receives the same percentage commission. By letting brokers set their own commissions, the SEC hopes that they will compete for clients by offering to undercut one another, thereby putting downward pressure on loads.

"The brokers could institute different loads," says Susan Ferris Wyderko, the executive director of the Mutual Fund Directors Forum, a group that provides outreach and education for the independent directors of U.S. mutual funds. "They would presumably advertise their rates along with explanations of what benefits the shareholders would get."

A middle ground. A lot about the new fee structure remains speculative. What's clear, though, is that even if the SEC gives the final nod to its proposal, brokers won't part easily with the billions in fees that they're used to collecting. Now that they won't be bringing in as much from loads set by fund companies, they'll have to find ways to generate them themselves. With the new share classes that allow them to set commissions, they have that opportunity. Competition will likely drive some loads down, but that could be offset at least partially by an increase in churning.

Bottom line: Smart investors know how much they're paying and where the money is going. Under the new rules, they'll be allowed to shop around for the cheapest loads and, if they put money in C shares, insist on keeping it there after the conversions kick in. Billions of dollars won't simply disappear into thin air, but overall, mutual fund investing could get a bit more affordable.

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