June 10, 2004

Office of Senator Richard C. Shelby
534 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20510

Dear Senator Shelby:

The purpose of this letter is to thank you, as a member of the Senate Banking Committee, for your objective, measured approach with respect to the issue of mutual fund reform, and to respectfully request that the Committee continue to consider *all* perspectives in the debate over the Mutual Fund Reform Act of 2004. Although the Mutual Fund Reform Act of 2004 and, in particular, the provisions of the Act which call for the repeal of SEC Rule 12b-1, have been presented by certain political figures and the media as a populist cause worthy of broad-based political support, I maintain that the facts on which this platform has been built have been badly distorted.

As detailed in hundreds of letters submitted to the SEC during the public comment period for SEC Proposed Rule "*Prohibition on the Use of Brokerage Commissions to Finance Distribution*", the repeal of SEC Rule 12b-1 would likely be disastrous for millions of investors who value and rely upon professional financial planning guidance. Secondarily, the repeal of SEC Rule 12b-1 would also almost certainly lead to massive job loss among financial planners, full-service investment firms, and advisor-distributed mutual fund companies. Unfortunately, because of the highly politicized manner in which the 12b-1 fee debate has been framed, and because of the recent brokerage and mutual fund scandals in general, the legitimate opposing perspective has received almost no attention or consideration.

For your reference, this opposing point of view is articulated in the two PDF files submitted with this e-mail. The first is a white paper submitted to the Journal of Financial Planning entitled *Share Class Warfare: A Counter Perspective on 12b-1 Fees*. The second is a letter submitted to SEC Chairman Donaldson's office in response to SEC staff economist Lori Walsh's highly publicized (and severely flawed) white paper questioning the value of 12b-1 fees. In addition, following this letter are a series of informal comments on a number of issues that are germane to the 12b-1fee debate.

Again, I express my tremendous gratitude and respect for the objectivity you have shown in considering the issue of Congressional involvement in the mutual fund reform process. Your consideration of the alternative perspective presented herein is sincerely appreciated as well.

Regards,
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Comments Expressing the Views of Members of the Financial Planning Community

- The SEC received hundreds of letters during its request for public comment period for its Proposed Rule "*Prohibition on the Use of Brokerage Commissions to Finance Distribution*". A majority of these were submitted by individual financial planners and advisers who receive 12b-1 fees in return for the guidance they provide their clients. Although the perspectives of these individuals is obviously not without bias, since the repeal of Rule 12b-1 would likely displace thousands of advisers (and their clients), their point of view should at least be considered by lawmakers.

- The American Bar Association Section of Business Law's Committee on Federal Regulation of Securities submitted a letter during the public comment period for SEC Proposed Rule "*Prohibition on the Use of Brokerage Commissions to Finance Distribution*". This letter, which is posted on the SEC website, makes a compelling case for the continuation of SEC Rule 12b-1. Although hundreds of letters were submitted on both sides of the 12b-1fee debate, the ABA letter is noteworthy in that it is academically thorough and uniquely objective.

- Although all mutual funds are governed by the provisions of the Investment Company Act of 1940 and are regulated by the SEC, the industry is broadly and unofficially divided into two distinct and competing categories based upon how their shares are distributed. In one category are "no-load" mutual funds whose shares are marketed directly to the public through media advertising and through marketing agreements with discount brokerage firms such as E*trade and Charles Schwab. In the competing category are advisor-distributed mutual funds whose shares are marketed primarily through a wide range of brokerage houses, insurance companies, and banks. Since investors usually acquire advisor-distributed mutual funds with the assistance and advice of a financial professional, the fees associated with these funds (i.e., sales charges and/or 12b-1 fees) tend to be higher than the fees associated with acquiring and owning no-load mutual funds. Simply put, while no-load mutual funds offer a legitimate alternative for cost-conscious, do-it-yourself investors, other investors value carefully conceived financial planning and asset allocation advice, and are willing to pay higher fees associated with advisor-distributed mutual funds to obtain such guidance.

- The NASD currently requires all fees and expenses associated with the purchase of mutual funds to be disclosed to investors orally and in writing via delivery of the mutual fund prospectus. Failure to execute either of these mandates represents a violation of existing securities law. Assertions by critics of SEC Rule 12b-1 that 12b-1 fees are not disclosed to investors who purchase retail advisor-distributed (Class A, B, or C) mutual fund shares are therefore misguided.

- Many financial planners and advisors agree that written disclosure of mutual fund expenses, including 12b-1 fees should be improved. Although these expenses are clearly delineated in the first few pages of mutual fund prospectuses, it is a simple fact that many investors do not take the time to carefully read the prospectus before investing and/or are intimidated by the "legalese" of document.

- Improved disclosure of the amount and purpose of all fees associated with the purchase and ongoing ownership of mutual fund funds could be achieved in a single, easy-to-read one page document that could be given to prospective investors to read and sign prior to purchasing fund shares. It might also be productive to require mutual fund companies to deliver updated versions of the fee disclosure document to all shareholders on an annual, semi-annual, or quarterly basis. This common sense solution to the 12b-1 fee disclosure issue would be far simpler and far less disruptive than the complete elimination of 12b-1 fees.

- Contrary to the assertions of some outspoken 12b-1 fee critics, the financial planning community unequivocally supports mutual fund reforms that improve transparency and eliminate conflicts of interest as long as such reforms are carefully conceived. However, Section 310 of the Mutual Fund Reform Act of 2004, which calls for the repeal of SEC Rule 12b-1, is not carefully conceived because it fails to recognize the harm and disruption that will be caused to millions of investors who value professional planning advice. A better solution, or at least one that should be tried first, is to improve transparency and disclosure of 12b-1 fees.

- There are valid reasons why many investment industry representatives believe the SEC is better qualified to enact mutual fund reforms than Congress. While the financial planning community generally supports the majority of the initiatives outlined in the Mutual Fund Reform Act, it should be noted that the SEC is already actively addressing almost all of the provisions in the Act. Section 310 of the Mutual Fund Reform Act provides a clear example of why the financial planning community believes the SEC is better qualified to address the issue of mutual fund reform than Congress. Simply calling for the repeal of SEC Rule 12b-1 without offering any alternative means of compensating advisors for ongoing mutual fund guidance suggests that the sponsors of the bill have not considered the effect that the elimination of Rule 12b-1 would have on millions of investors who value this guidance or on the thousands of financial advisors who may be displaced if their primary source of compensation is eliminated.

- The SEC is currently considering replacing 12b-1 fees paid to financial advisors with an alternative system in which mutual fund investors would be directly and transparently billed on a quarterly basis. Under this proposed system, investors would pay for these charges by liquidating fund shares. Most financial planners and advisors oppose this proposal because it would add tax complexity and would likely result in higher income and capital gains taxes to mutual fund investors. Improved disclosure is a far simpler solution and is undeniably better for shareholders.

- The primary argument made by financial planners and advisors in favor of 12b-1 fees is that the purpose of the fees is to compensate advisors for the planning advice they give their clients. This guidance includes not only assistance with mutual fund selection and monitoring, but also "big picture" planning assistance such as asset allocation planning and educating clients on topics such as education planning, estate planning, life and long term care insurance, retirement planning, IRAs and qualified plans, and much more.

- Some critics of 12b-1 fees entirely discount the value of the financial advisory relationship, and believe that all investors should self-direct their investments using no-load mutual funds. While these individuals are entitled to their opinions, millions of investors value professional financial guidance and are willing to pay for it. As referenced above, investors currently have the ability to choose to avoid or minimize 12b-1 fees by self-directing with no-load funds, or to pay for the services of a financial advisor by purchasing advisor-distributed mutual funds (Class A, B, or C shares). The elimination of SEC Rule 12b-1 would severely limit the latter option.

- Some critics of SEC Rule 12b-1 argue that 12b-1 fees of .25%-1% per year are excessive and that the primary reason investors pay them is because they are hidden costs. Although the disclosure issue has been addressed in earlier comments, the assertion that a 1%

ongoing fee for fund monitoring and guidance is excessive is without merit. In recent years, mutual fund wrap programs and managed accounts have been among the fastest growing segments of full-service brokerage industry. In these programs, all fees are clearly disclosed to the client in the form of a contract and the client is billed quarterly. The advisor compensation portion of these fees for retail accounts under $1 million usually ranges between 1%-2%. Clearly millions of Americans believe they are receiving economic value in return for these fees. It should be noted that some financial advisors actually use Class C share mutual funds (1% 12b-1 fee) for their clients because this option is often less expensive for their clients than wrap fee alternatives.

- Some critics of 12b-1 fees argue that they represent a conflict of interest. In reality, the opposite is true. Using the retail share class with the highest 12b-1 fee as an example, Class C-shares, the advisor's interests and those of his client are completely aligned (i.e. both parties benefit if the assets grow, and both parties suffer if the fund portfolio declines). Further, with Class C-shares, the financial advisor has an incentive to monitor his clients' mutual funds, and can objectively recommend changes as needed, since his compensation will be no greater by switching to a new fund (see *Share Class Warfare* white paper). In contrast, eliminating 12b-1 fees would give financial advisors little incentive to monitor client mutual fund portfolios after the initial purchase. In fact, if 12b-1 fees are eliminated, financial advisors will actually have an incentive to recommend fund changes for the sake of earning a commission. A major positive development in the investment world over the past decade has been the movement away from commission-based product sales and toward objective, fee-based financial planning. Eliminating 12b-1 fees would reverse this progress to the detriment of millions of investors.

- Some critics of 12b-1 fees argue that the fees are superfluous because, in reality, financial advisors do not provide much ongoing guidance after the initial fund purchase is made. While this criticism may apply to some financial advisors, the financial planning community in general understands its obligation to its clients and also realizes that servicing one's clients leads to more business and to referrals. It should also be noted that, at some level, the individual investor should be accountable for decisions they make as well. If an investor is not receiving ongoing guidance from his advisor or feels that the advice he is receiving is inadequate, he should consider finding a new one.

- The comments above pertain to 12b-1 fees as they apply to retail advisor-distributed share classes (Class A, B, and C shares). Other applications of 12b-1 fees may indeed merit criticism and even elimination. For instance, many no-load mutual fund companies pay 12b-1 fees to discount brokerage firms, such as E*trade and Charles Schwab, to distribute their funds. The fact that these funds are marketed to the public as having no fees is clearly misleading. Further, it can be argued that these fees are indeed superfluous, since investors who purchase funds through this platform are generally self-directing and do not receive any guidance in return for the fees they are paying. As a separate matter, 12b-1 fees paid to 401(k) sponsors and to sponsors of mutual fund wrap fee programs can justifiably be criticized for "double-dipping", since they are receiving these fees in addition to the wrap fee charged directly to the participants/clients.

Comments Addressing Well-Known Critics of 12b-1 Fees

- Jack Bogle, director of Bogle Financial Markets Research Center and founder of The Vanguard Group has been among the most vocal critics of 12b-1 fees. He has testified before Congress on numerous occasions, and Senator Peter Fitzgerald has even cited Mr. Bogle's influence in the development of the Mutual Fund Reform Act. It should be noted that Mr. Bogle is a lobbyist for the no-load mutual fund industry. This special interest group will gain a huge competitive edge over advisor-distributed mutual funds if SEC Rule 12b-1 is repealed. If the Mutual Fund Reform Act is implemented in its present form, it will almost certainly reap millions of dollars in new revenue for the no-load mutual fund industry. The notion that Mr. Bogle is an objective advocate for the individual investor is pure fiction.

- One of Mr. Bogle's primary and most widely touted arguments against 12b-1 fees is a simple illustration of the power of compounding. Specifically, Mr. Bogle regularly likes to demonstrate how a 1% difference in expenses can lead to significant differences in wealth accumulation over long periods of time. However, there are two flaws in Mr. Bogle's reasoning that he neglects to mention. First, Mr. Bogle does not acknowledge that investors who pay higher fees are receiving value in the form of financial planning guidance. Second, Mr. Bogle fails to mention that the average holding period for mutual fund investors is less than three years, and that the average holding period for investors who self-direct using no-load mutual funds is significantly shorter than investors who purchase mutual funds with the help of financial advisors.

- Mr. Bogle also claims that lack of disclosure is a major reason to eliminate 12b-1 fees. One of his most common media soundbites is "sunlight is the best disinfectant". However, it should be noted that Mr. Bogle is not advocating for improved disclosure of 12b-1 fees. Instead, he is lobbying for the complete elimination of 12b-1 fees – a move which would clearly benefit the no-load mutual fund industry at the expense of millions of individual investors who value full-service investment guidance.

- Consumer Federation of America has also been among the most vocal critics of 12b-1 fees. Barbara Roper is the organization's highly articulate and effective spokesperson on this issue. Like Mr. Bogle, she too has testified before Congress on the subject of mutual fund reform. Although CFA does not have a direct financial interest in the 12b-1 fee issue, it is a defacto lobbying group for the no-load fund industry. As presented in CFA's joint letter to the SEC (signed by Ms. Roper), the organization actively favors no-load mutual fund investing and does not hide the fact that it discounts the value of financial advisory relationships.

- Although its name suggests that it represents the interests and views of millions of American consumers, according to Consumer Federation of America's director of membership, Mr. Steve Brobeck, the organization has just 300 members and is primarily comprised of other organizations and advocacy groups. According to Mr. Brobeck, some of the organization's members may specifically be other no-load fund advocacy groups. The general perception that Consumer Federation of America represents the broad views of American consumers is clearly inaccurate. Ironically, although CFA has blasted the mutual fund industry over disclosure issues, it makes no attempt to dispel misconceptions about its membership base, and, according to Mr. Brobeck, CFA will not disclose its membership list to the public for scrutiny of possible conflicts of interest. In fairness, Mr. Brobeck maintains that CFA does not receive funding directly or indirectly from any no-load mutual fund companies.

- Fund Democracy founder Mercer Bullard is another vocal critic of SEC Rule 12b-1. Mr. Bullard formerly worked for the SEC and is currently a law professor. He is highly intelligent and articulate and has also testified before Congress as an advocate for mutual fund reform and for the repeal of SEC Rule 12b-1. As the director of Fund Democracy, he co-signed the letter submitted to the SEC with Consumer Federation of America. A review of his website and public comments reveals that he is a no-load fund investor and a staunch proponent of no-load investing. The inflammatory nature of his rhetoric also seems to suggest that he has a rather low opinion of financial planners and advisors. While Mr. Bullard is certainly entitled to his opinions, it should be noted that millions of Americans value and are willing to pay for professional investment guidance. It should also be noted that Fund Democracy does not appear to have a broad membership base. Despite the all-encompassing implications of its name, to suggest that Fund Democracy or Mr. Bullard's views represent those of a majority of American investors is again inaccurate.

- Mr. Bullard claims to advocate greater disclosure and supports the SEC's proposal to replace 12b-1 fees with a system in which advisor-related expenses are directly billed to shareholders and paid through the liquidation of fund shares. Although the problems with this solution have been addressed in earlier comments, it should be noted that Mr. Bullard dismisses the far simpler solution of simplified, improved disclosure as being "too complex". In making this assertion, Mr. Bullard fails to acknowledge the enormous complexity and disruption that would occur in eliminating 12b-1 fees and implementing an entirely new system. Mr. Bullard is undoubtedly aware that the elimination of 12b-1 fees would make it more difficult and expensive for investors to obtain guidance through financial advisors. Mr. Bullard's strong personal bias in favor of no-load fund investing should be weighed in considering his public comments on behalf of Fund Democracy.

- New York State Attorney General Eliot Spitzer and Massachusetts Attorney General William Galvin have been outspoken critics of 12b-1 fees and of mutual fund fees in general. Their public comments suggest that they do not understand that fees are only an issue in the absence of value and that millions of investors receive economic value in the form of financial planning guidance in return for 12b-1 fees. Although both gentleman claim to advocate improved disclosure, both favor the complete elimination of 12b-1 fees without any consideration of improved disclosure as a viable alternative. Both men cite Jack Bogle's influence in the formation of their opinions and both have used Mr. Bogle's example of the effects of fees on wealth accumulation over time as a primary reason to eliminate SEC Rule 12b-1. AG Spitzer has even publicly referred to Mr. Bogle as his "good friend".

- While there is no direct evidence to suggest that Mr. Spitzer or Mr. Galvin are motivated by anything other than a desire to serve the public interest, Congress should at least be aware that the populist appeal of their highly publicized demands for lower fees for mutual fund shareholders could potentially serve as a convenient political springboard. As supported by other comments provided herein, it should also be noted that such populist outcries vastly oversimplify the issue, and could actually cause considerable harm to millions of investors who value financial planning advice.

- The North American Securities Administrators Association, Inc., a Washington D.C. based group representing state securities regulators, has also been vocal in seeking the elimination of 12b-1 fees. The organization's President and director of Connecticut's securities division, Ralph Lambiase, has been quoted as saying, "Financial advisers are generally paid a percentage of what money that have under management. If I sell a product to someone, I get a fee. If you buy a car, do you owe the dealer a percentage of the car fee for your life… I've had a mutual fund for 10 years. I have never gotten a phone call from the agent, yet their getting ongoing compensation for the sale of that fund. That's unfair." This series of statements, which appeared in a recent article in the publication *Investment News,* reflects a startling lack of understanding of the financial planning process and of the mechanics of advisor-distributed share classes. Most financial planners would also suggest that Mr. Lambiase take responsibility for his financial affairs by firing his "agent".

- As the co-sponsors of the Mutual Fund Reform Act of 2004, Senators Fitzgerald, Levin, and Collins are, by definition, vocal proponents of the complete repeal of SEC Rule 12b-1. A reading of Senator Fitzgerald's white paper discussion of the Act suggests that he is a loyal disciple of Jack Bogle and that he is completely oblivious to the fact that Mr. Bogle represents a powerful special interest group that will benefit from the elimination of 12b-1 fees. In his paper, Senator Fitzgerald says, "Vanguard Founder and ***industry savant*** John Bogle calls the Mutual Fund Reform Act of 2004 "the gold standard in putting mutual fund shareholders back in the driver's seat." He also notes that his views were influenced in part by Barbara Roper and Consumer Federation of America. His discussion of the provisions of the Act calling for the elimination of 12b-1 fees also feature Mr. Bogle's patented compound interest illustration – "[12b-1 fees] can cost investors up to 1% of their investment every year. Over the life of a retirement plan, that 1% can cost an investor 35% to 40% of his or her retirement income." Such naiveté and oversimplification of the 12b-1fee issue suggests that the SEC, rather than Congress, is better qualified to develop mutual fund reform policies.

Comments Addressing Academic Criticism of 12b-1 Fees

- There is currently a vast disconnect between the academic community and the financial planning community with respect to the value of 12b-1 fees. The conclusions of a wide body of academic research on the issue of 12b-1 fees are based on severely flawed assumptions arising from a lack of practical understanding of the financial planning process in general, a lack of understanding of the difference between no-load and advisor-distributed mutual funds, and a lack of understanding of the economic value differences between the three main advisor-distributed share classes (Class A, B, and C).

- A common theme among many academic papers (e.g. Walsh 2004, Barber, Odean & Zheng 2003) is that 12b-1 fees represent a superfluous deadweight expense to investors. Surprisingly, the authors of many of these papers do not seem to understand the difference between no-load and advisor-directed mutual funds. As a recent highly publicized example, Lori Walsh's paper fails to even acknowledge the existence of the ongoing financial advisory relationship, much less the fact that such relationships might have real economic value.

- The authors of many academic papers fail to understand that 12b-1 fees are paid to brokerage firms and advisers that distribute them. 12b-1 fees are not part of the fund companies' revenue or profits. As described in great detail in every mutual fund prospectus, 12b-1 fees are entirely separate from the operating expenses of the funds and serve an entirely different purpose. With respect to the retail classes of mutual fund shares (Class A, B, and C), the purpose of this fee is compensate financial advisors for providing ongoing guidance to their clients (fund selection, asset allocation, financial planning, etc.). Criticism of mutual fund companies for failing to lower shareholder expenses as assets under management have grown is completely separate from and irrelevant to the 12b-1 fee debate.

- Another common assertion among academic papers on 12b-1 fees is that investors who purchase advisor-distributed mutual funds are making irrational economic decisions due to inadequate disclosure and a lack of sophistication (e.g., Barber, Odean & Zheng, July 2002). If one accepts the premise that there is a correlation between net worth and investor acumen, empirical data suggests that the opposite is true. It is widely known that the median net worth of investors who self-direct through no-load mutual funds and discount brokerage firms is considerably lower than that of full-service investors. Further, such assertions are directly contrary to the most basic principle of economics - that individuals are extremely adept at making rational decisions in order to maximize their financial well-being. It is well documented that even "unsophisticated", socio-economically disadvantaged groups, such as drug dealers and welfare recipients, are remarkably adroit at developing complex economic systems to maximize their own utility. In this light, it seems particularly absurd that investors who utilize the services of a financial advisor to guide their investments are oblivious to the fact that they are paying more than if they invested in no-load funds on their own. This is also supported by the fact that, in instances where advisory fees of 1-2% per year are entirely transparent (e.g., mutual fund wrap fee and managed account programs) millions of investors are perfectly willing to pay for the guidance and service they receive.

- Conflicts of interest are also a common academic criticism levied at 12b-1 fees (Walsh, May 2004, Freeman & Brown, December, 2003). Objectively speaking, a credible case can indeed be made that potential conflicts of interest do indeed exist with respect to the two commission-based retail mutual fund classes (Class A & B shares). However, one of the arguments in support of the .25% 12b-1 fees that are usually associated with class A and B shares is that they mitigate the incentive for unnecessary transactions by giving the financial advisers an incentive to avoid switching funds and to monitor client portfolios. Ironically, as presented in the accompanying white paper, the share class with the highest 12b-1 fees, Class C shares, was created in response to demand for a more objective *fee-based* share class option. The trend in the financial services industry away from commission-based products and toward fee-based planning alternatives is widely regarded as being beneficial to investors. It is extremely difficult to argue that conflicts of interest exist with Class C shares as long as the 1% annual 12b-1 fee is properly disclosed. The inability to recognize this benefit or to recognize that the three advisor-distributed mutual fund share classes have different economic values represents a failing of the academic community.

- Another reason for the divide between the academic community and the financial planning community is the academic community's almost blind devotion to Efficient Market Theory and indexing. This theory, which was developed in the early 1970's, continues to be taught in economics classes and in business schools as if it was an established fact. So strong is the belief in this theory that it seems difficult for the academic community accept that financial advisors provide any economic value because, in their view, the only investment the individual investor needs is a low cost S&P 500 Index fund (Barber, Odean, & Zheng, July 2002). Although the "founder" of efficient market theory, Burton Malkiel, is widely regarded as a candidate for the Nobel Prize in economics, the financial planning community broadly rejects most forms of this theory. On a purely intuitive level, it seems patently absurd that the entire mutual fund industry and brokerage industry are utterly superfluous. Although there is a mountain of empirical evidence to refute all three forms of the Efficient Market Hypothesis, many financial planners and investment advisors simply point to the poor down market performance of the S&P 500 from 2000-2002 relative to more broadly diversified and balanced fund portfolios as convincing evidence of the shortcomings indexing. Financial planners understand that avoiding down market volatility is critical, particularly as investors approach or enter retirement. Planners recognize that a major flaw of indexing is that it can lead to high portfolio failure rates during bear markets. This dose of economic reality is lost on many academicians who do not have the responsibility of protecting the hard-earned savings of individual investors on a daily basis.