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# Will 12b-1 Fees Cave Under Pressure? and Related Questions in a Time of Change

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The pricing structure of mutual fund share classes that was familiar to many for over three decades has been severely disrupted, and the new normal is a work in progress still being shaped by market and regulatory forces. Though they were once ubiquitous among mutual funds, so-called "12b-1 fees" paid by shareholders to cover fund distribution costs pursuant to Rule 12b-1 under the Investment Company Act of 1940 (Investment Company Act) have fallen out of favor as investors in all channels migrate to less-expensive options and the costs of investing are further externalized from the fund expense ratio. An exploration of the current market and regulatory landscape and the historic evolution of Securities and Exchange Commission (SEC) Staff thinking on Rule 12b-1 suggests that a phase out of 12b-1 fees could be possible and raises important business and legal questions for the asset management industry.

## Market Pressure

The now defunct fiduciary rule adopted by the US Department of Labor (DOL) in April 2016 intensified existing downward pressure on actively-managed mutual fund fees,[1] and there is no doubt that investors are paying less today than they did in the past.[2] The Investment Company Institute (ICI) reports that fees and expenses "paid by mutual fund investors have fallen substantially over time," with average expense ratios for equity mutual funds declining 40% from 0.99% in 2000 to 0.59% in 2017 on an asset-weighted basis.[3] According to Morningstar, Inc.,[4] open-end mutual fund and exchange-traded fund (ETF) investors paid less in 2017, with an asset-weighted average total expense ratio of 0.52% and aggregate asset-weighted costs for actively-managed funds dropping 8% in 2017 versus 2016, the largest one-year decline ever.[5]

Institutional mutual fund share classes with no loads and no 12b-1 fees that qualify as "clean shares,"[6] which retail investors can readily access through omnibus accounts sponsored by financial intermediary distribution platforms, are the primary sellers today, with even sales of load-waived Class A shares in decline.[7] ICI data shows that at 2017 year end, 72% of actively-managed equity mutual fund assets were in funds with expense ratios in the lowest quartile and that 78% of index, or passively-managed, equity mutual fund assets were also in lower-cost funds.[8]

As can be seen across the industry in regulatory filings and press materials, firms have responded creatively to the pressure on fund fees and expenses, taking a variety of approaches from performance-based "fulcrum" fees bottoming at 0.00% for a year's or more worth of underperformance to "triple zero"

clean shares with nominal transaction fees and no loads, no 12b-1 fees and no sub-transfer agency or sub-administration (sub-TA) fees. Financial intermediaries are also increasingly offering wrap and flat fee programs that charge advisory fees instead of point-of-sale commission-based fees such as 12b-1 fees.

In addition, mutual fund firms are looking outside the fund expense ratio, to sources such as securities lending, for income. Industry commenters have observed while there are limits on the demand for securities lending, "growth in that market [could] allow an increasing number of funds to offset some or all of their expenses through loan income."[9] Firms are also looking to generate cost savings internally through the use of cloud, blockchain and other technology, as well as through more traditional means. For example, in 2017 Ameriprise reportedly "scrapped 12b-1 fees…on advisory accounts, costing it $54 million in the second quarter. But net annual revenue per advisor climbed 7%, to $541,000, year over year," due to what the firm's CEO called exceptionally high productivity "at the top of the charts for regional and independent brokerages."[10]

Some believe that fees for passively-managed mutual funds and ETFs are in fact nearing 0.00%, including the academic author of an early 2018 article suggesting that "zero-fee ETFs" are nascent in the United States.[11] The author argues that "between the low overhead costs possible through economies of scale, and the additional income that fund managers can generate by lending securities to short-term borrowers, the barrier could be broken in the next year or two. Even a negative-fee ETF—where the fund pays investors to invest—might be possible."[12] Indeed, later in 2018 "Fidelity Investments launched its first-ever free index funds – that is, funds with a stated expense ratio of zero," available to select Fidelity clients.[13]

It bears mentioning that outliers in the mutual fund space have not conceded to the tides of disruption, with $1.3 trillion, or more than 8% of industry assets remaining in "the two priciest quintiles of annual fees, according to Morningstar Direct," Morningstar's wealth management arm.[14] Evidence shows that some investors are willing to pay higher fees for strong performance and other benefits. The Baron Funds, for example, include 13 mutual funds with fees 54% higher than the industry average, which the firm founder argues is justified by the fact that "since inception, 98 percent of our funds have beaten their benchmark."[15]

Still, the commercial viability of 12b-1 fees and the share classes that carry them is uncertain. With Class B shares all but extinct,[16] and recent SEC filings from multiple fund families announcing the conversion of Class C to Class A shares generally within ten years of purchase, Class A shares could relatively soon be the only remaining 12b-1 share class.[17] The results of an online poll conducted by a mutual fund industry publication show that many anticipate perhaps even Class A shares dying out, with over 70% of participants indicating they believe that 12b-1 fees will eventually become obsolete.[18]

## Regulatory Pressure

In recent years the Staff of the SEC has focused fairly heavily on mutual fund distribution issues, contributing to the uprooting of the once routine use of 12b-1 fees.

*Distribution-in-Guise.* The "distribution-in-guise" sweep exam that began in 2013 ushered in a new era of board oversight and SEC enforcement with respect to Section 12(b) of and Rule 12b-1 under the Investment Company Act.[19] As the articulated priorities of the SEC's Office of Compliance Inspections and Examinations (OCIE) National Examination Program (NEP) at that time explained, the sweep exam was intended to evaluate the extent to which sub-TA fee payments were being made for actual shareholder services or whether, in violation of Rule 12b-1, they were "instead payments for distribution and preferential treatment."[20]

An IM Guidance Update published by the Staff of the SEC's Division of Investment Management (IM) in January 2016 discussed specific indicia of

distribution-in-guise observed by the Staff, adding to the factors discussed in a 1998 letter regarding "fund supermarket" fees that fund boards should consider in evaluating whether or not a fund payment is for distribution or non-distribution purposes.[21] Enforcement actions followed in which fund firms and boards were charged with, among other things, negligently allowing fund assets (typically in the form of sub-TA fees) to be used outside of a written board-approved Rule 12b-1 plan to cover "shelf space" fees and similar distribution costs charged by third-party intermediary platforms.[22]

By now, most mutual fund boards and service providers have settled into a new Section 12(b)/Rule 12b-1 reporting and oversight framework. But OCIE Staff have maintained that the distribution-in-guise enforcement phase is ongoing.[23]

*Share Class Selection Initiative and Amnesty Program.* Like the regulatory insistence of the distribution-in-guise regulatory initiative on transparency into the fees paid by mutual funds, OCIE's more recent investment share class selection initiative and amnesty program under the Investment Advisers Act of 1940 (Advisers Act) has also kept 12b-1 fees in the regulatory spotlight.

Launched in July 2016, OCIE's share class selection sweep exam (the Share Class Selection Initiative) was an undertaking of the SEC Staff "to address the risk that advisers may be making certain conflicted investment recommendations to their clients…specifically…conflicts of interest tied to advisers' compensation or financial incentives for recommending mutual fund…share classes that have substantial loads or distribution fees" without sufficient disclosure.[24] Examples of such conflicts of interest cited in the NEP Risk Alert announcing the Share Class Selection Initiative include "situations where the adviser is also a broker-dealer or affiliated with a broker-dealer that receives fees from sales of certain share classes, and situations where the adviser recommends that clients purchase more expensive share classes of funds for which an affiliate of the adviser receives more fees."[25]

Noting that the SEC had previously found advisers to have failed to meet their fiduciary duties when they caused "a client to purchase a more expensive share class of a fund when a less expensive class of that fund [was] available"[26] and that "as a fiduciary, an adviser has an obligation to act in its client's best interest and to disclose material conflicts of interest such as the receipt of compensation for selecting or recommending mutual fund share classes," the NEP Risk Alert advised that SEC Staff would be conducting "focused, risk-based examinations of high-risk areas" including advisers' fiduciary obligations to:

- act in clients' best interests and to seek best execution for client transactions — "(i.e., "to seek the most favorable terms reasonably available under the circumstances")"[27] — including "when recommending or selecting mutual fund…investments to clients;" and
- fully and fairly disclose to clients "all material facts, including all material conflicts of interest that could affect the advisory relationship,"[28] which by extension includes information regarding "whether the adviser or its supervised persons accepts compensation for the sale of securities or other investment products, including asset-based sales charges or service fees from the sale of mutual funds" and an explanation of "the conflict of interest such compensation creates and how the adviser addresses the conflict, including the adviser's procedures for disclosing the conflict to its clients."[29]

The NEP Risk Alert also described a March 2016 enforcement action in which the Staff emphasized "the need for advisers making mutual fund share class selections to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act, including those that govern their selection process."[30] In releasing the Share Class Selection Initiative, OCIE stated that it was encouraging advisers to "reflect upon

their own practices, policies, and procedures in these areas and to make improvements in their advisory compliance programs where necessary."[31]

In February 2018, the SEC announced an amnesty program in connection with the Share Class Selection Initiative "to encourage self-reporting and the prompt return of funds to investors" (the Amnesty Program).[32] Noting recent enforcement activity that "included significant penalties against the investment advisers, and collectively returned millions of dollars to clients,"[33] as well as OCIE's efforts to "repeatedly caution. . .investment advisers and other market participants to examine their share class selection policies and procedures and disclosure practices," the Amnesty Program press release stated that the SEC's Enforcement Division would

> recommend standardized, favorable settlement terms to investment advisers that self-report that they failed to disclose conflicts of interest associated with the receipt of 12b-1 fees by the adviser, its affiliates, or its supervised persons for investing advisory clients in a 12b-1 fee paying share class when a lower-cost share class of the same mutual fund was available for the advisory clients. Among other things, for eligible advisers that participate. . .the Division will recommend settlements that will require the adviser to disgorge its ill-gotten gains and pay those amounts to harmed clients, but not impose a civil monetary penalty. The Division warns that it expects to recommend stronger sanctions in any future actions against investment advisers that engaged in the misconduct but failed to take advantage of this initiative.[34]

The detailed announcement on the Amnesty Program from the Division of Enforcement provided some guidance on meeting the Staff's expectations around conflicts of interest disclosure in an adviser's Form ADV, indicating that disclosure would *not* be sufficient if it related that the adviser's supervised persons "may" or "might" receive 12b-1 fees from the sale of mutual fund shares and that such fees "may" or "might" create a conflict of interest; rather the adviser should have affirmatively stated that it had an actual conflict of interest and was, "in fact, receiving 12b-1 fees due to the mutual fund shares they bought for or recommended to their clients."[35]

And, a settlement order published by the SEC along with two others in the Spring of 2018 includes the following statement:

> Many mutual funds also offer other shares classes that do not charge 12b-1 fees (*e.g.,* "Institutional class" or "Class I" shares). Some of these share classes are available only to investors who meet certain criteria (*e.g.*, minimum investment amount or eligible investment program), which vary from fund to fund. For many of the Class I shares that have higher initial investment minimums as compared to Class A shares, the funds waive or substantially reduce these thresholds for client purchases, particularly in advisory accounts. . .A client who holds Class I shares of a mutual fund will pay lower fees over time - and earn higher returns - than a client who holds Class A shares of the same fund. Therefore, if a mutual fund offers Class I shares, and a client is eligible to own it, it is almost invariably in the client's best interest to purchase or hold the Class I share.[36]

Further, in FAQs addressing questions related to the Amnesty Program, the SEC Staff provided a non-exhaustive list of circumstances in which it "would likely conclude that a lower-cost share class was "available" for the same fund."[37] Noting that "the availability of a lower-cost share class is [a] fund specific" issue, the FAQs explained that for purposes of the Share Class Selection Initiative and the Amnesty Program, a lower-cost share class would be deemed "available" when:

- the investor meets the applicable investment minimum and can purchase a lower-cost share class;
- per its prospectus language, the fund will waive the investment minimum for a lower-cost share class of the same fund for clients of investment advisers;
- per its prospectus language, the fund may waive the investment minimum for a lower-cost share class of the same fund for clients of investment advisers, and the adviser has no reasonable basis to believe the fund would not waive the investment minimum for a lower-cost share class for its advisory clients; and/or
- the adviser has purchased a lower-cost share class of the same fund for other similarly-situated clients.[38]

*2018 SEC Exam Priorities and Regulatory Agenda*. Alongside its efforts that specifically relate to mutual fund share classes and 12b-1 fees, the SEC's 2018 NEP Priorities (Exam Priorities) are generally targeted at protecting the retail investors to whom such share classes were traditionally offered directly (Class A and C shares, and to the extent they still exist, Class B shares) and through retirement channels (Class R shares), as well as protecting elderly investors who may very well be long-term shareholders of older style Class A, B, and C share classes.

In 2018, the Exam Priorities explain, OCIE Staff are continuing to "prioritize [the] commitment to protect retail investors, including seniors and those saving for retirement…looking closely at products and services offered to retail investors, as well as the disclosures they receive about those investments," and targeting in examinations investment recommendations made to seniors to ensure that "financial service professionals have met their legal obligations."[39] Similarly, the Exam Priorities make clear that OCIE is focused on

> firms that have practices or business models that may create increased risks that investors will pay inadequately disclosed fees, expenses, or other charges. These practices or business models include…personnel that may receive financial incentives to recommend that investors invest, or remain invested, in particular share classes of mutual funds where the investors may pay higher sales loads or distribution fees and the conflict of interest may not be disclosed to investors.[40]

Related topics such as "Fund Retail Investor Experience and Disclosure Request for Comment" and "Investment Company Advertising, Target Date Retirement Fund Name and Marketing" are, respectively, on the SEC's short-term (pre-rule stage) and long-term (long-term action stage) regulatory agenda, updated as of March 14, 2018.[41]

*SEC Fiduciary Proposals*. The fiduciary rulemaking proposed by the SEC in April of this year stands to further impact whether in the future 12b-1 fees will be included in the expense ratio of any mutual fund share class. On April 18, 2018, the SEC proposed two new rulemakings and one new interpretation regarding the fiduciary standards for investment advisers and broker/dealers, the language of which in some ways echoed Staff guidance around the Share Class Selection Initiative and the Amnesty Program. The combined proposal is more than 1,000 pages long and is still being digested by the asset management industry. In summary:

- The "Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers" would, without defining the term, confirm that investment advisers' fiduciary duties of care and loyalty require them to act in clients' "best interests" specifically by providing advice that is in clients' "best interests," seeking the most favorable transaction costs under the circumstances (best execution), providing appropriately tailored and current advice and monitoring over the course of the client

relationship, putting client interests first, and not "unfairly" favoring one client over another.[42] The proposing release notes that some conflicts may not be cured by disclosure, and that an adviser cannot "disclose or negotiate away, and the investor cannot waive," the adviser's duty to place the client's interest ahead of its own.[43]

- "Regulation Best Interest," also without defining the term, would require broker-dealers to act in and prioritize customers' "best interests" in making recommendations to retail investors and would provide a safe harbor for brokers-dealers disclosing all material conflicts of interest and other key facts, exercising the "reasonable diligence, care, skill, and prudence" necessary to form a belief that a recommended product is in the customer's "best interest" and enforcing policies and procedures designed to mitigate material conflicts of interest arising from financial incentives.[44]
- On new Form CRS (Customer/Client Relationship Summary), investment advisers, broker-dealers, and dual-registered firms would be required to provide retail investors with four pages of standardized disclosure regarding the services offered by the firm, the legal standards of conduct applicable to the firm, the fees a customer might pay and the existence of certain conflicts of interest.[45] Mock-ups of Form CRS provided by the SEC Staff suggest that firms would be required to make statements along the following lines, among others:

  Investment Advisers: "Our interests can conflict with your interests. We must eliminate these conflicts or tell you about them in a way you can understand, so that you can decide whether or not to agree to them…We can make extra money by advising you to invest in certain investments, such as [__], because they are managed by someone related to our firm. Your financial professional also receives more money if you buy these investments. We have an incentive to advise you to invest in certain investments, such as [__], because the manager or sponsor of those investments shares with us revenue it earns on those investments."[46]

  Broker-Dealers: "Our interests can conflict with your interests. When we provide recommendations, we must eliminate these conflicts or tell you about them and in some cases reduce them…We can make extra money by selling you certain investments, such as [__], either because they are managed by someone related to our firm or because they are offered by companies that pay our firm to sell their investments. Your financial professional also receives more money if you buy these investments. We have an incentive to offer or recommend certain investments, such as [__], because the manager or sponsor of those investments shares with us revenue it earns on those investments."[47]

  Investment Advisers and Broker/Dealers: "You may prefer paying: an asset-based fee if you want continuing advice or want someone to make investment decisions for you, even though it may cost more than a transaction-based fee; a transaction-based fee from a cost perspective, if you do not trade often or if you plan to buy and hold investments for longer periods of time."[48]

Comments on the proposals were due to the SEC by July 8, 2018, though the comment period was extended through August 7, 2018. Public comments as of July 31, 2018 include a suggestion from the Investment Adviser Association that the SEC publicize the results of its investor testing on the efficacy on the proposed Form CRS and extend the comment period on the proposals,[49] and challenges from the New York City Bar Association's Committee on Investment Management Regulation that the proposals are overly broad and vague in the context of existing case law.[50]

## Historical Views on Rule 12b-1 and Fund Distribution Costs

Prior to the adoption of Rule 12b-1 in 1980, it was generally impermissible for mutual fund assets to be used to cover the costs of marketing and selling fund shares, except through an underwriter.[51] Those costs were instead typically paid either by investors as front-end sales loads or absorbed by investment advisers. The SEC Staff had granted narrow no-action and exemptive relief to a few fund families,[52] but it was not until the publication of the adopting release for Rule 12b-1 that the SEC affirmed that, under a written plan adopted by its independent trustees, a mutual fund's assets could be used to pay for "sales activities primarily intended to result in the sale of shares."[53]

The distribution-related costs borne by shareholders have generally come down since Rule 12b-1 was adopted, in part due to rulemaking efforts by the SEC. Initial attempts at reforming Rule 12b-1 targeted transparency around the ongoing nature of 12b-1 fees relative to one-time contingent deferred sales charges (CDSCs) that could at that time be charged only with exemptive relief. Rules adopted by the SEC under the Securities Exchange Act of 1934 (Securities Exchange Act) and the National Association of Securities Dealers (NASD), now the Financial Industry Regulatory Authority (FINRA), limited annual "asset-based fees," including sales charges and 12b-1 fees to 6.25% of a fund's average annual net assets plus interest for funds with service fees and 7.25% for funds with no service fees, and established a 0.25% annual cap on asset-based service fees and a 0.75% annual cap on total asset-based fees.[54] Prospectus rules were amended to include disclosure about 12b-1 fees in the mutual fund fee table.[55]

In 2004, a financial economist in the SEC's Office of Economic Analysis argued in a comment paper that "while funds with 12b-1 plans do, in fact, grow faster than funds without them, shareholders are not obtaining benefits in the form of lower average expenses or lower flow volatility. Fund shareholders are paying the costs to grow the fund, while the fund adviser is the primary beneficiary of the fund's growth."[56]

The SEC attempted to reform Rule 12b-1 in 2010 with a rule proposal that sought to upend the status quo by, among other things, replacing Rule 12b-1 with a new Rule 12b-2 that would allow only a 0.25% annual "marketing and service fee" and by amending Rule 6c-10 to promote the "unbundling" or "externalization" of distribution costs from the fund expense ratio.[57] In proposing the reform, the SEC characterized existing rules as outdated, divorced from marketplace realities and out of alignment with investors' best interests.[58] Interestingly, opposition to the 12b-1 reform package voiced by the ICI argued that, as the ill-fated DOL fiduciary rule seems now to have actually done, the SEC's Rule 12b-1 reform package "could fundamentally alter the way intermediaries use funds in various distribution channels, significantly affect the lineup of share class options currently available to investors, necessitate major systems changes, and require the renegotiation of thousands of dealer agreements."[59]

As issues associated with 12b-1 fees remain under regulatory scrutiny, it is worth noting the SEC Staff's original position on the burdens of selling mutual fund shares. Before thinking at the SEC evolved to conceive of circumstances in which a mutual fund's independent trustees could deem it beneficial for shareholders to pay fund distribution costs, the SEC Staff reasoned in its February 1972 Statement on the Future Structure of the Securities Markets that any use of an investment company's assets for the purpose of financing the distribution of its shares would be improper because a fiduciary duty was owed to each shareholder and it would be improper for one shareholder's assets to be used to pay for marketing to another shareholder since the first shareholder would get little if any benefit from his or her assets being used in that way.

## Questions Looking Forward

These current and historic market and regulatory factors raise myriad business and legal questions for the mutual fund industry as it seeks to maintain profitable and compliant mutual fund operations.

- Will Class A shares carrying 0.25% 12b-1 fees remain a uniquely appropriate pricing choice for some investors? Or could recent SEC enforcement efforts drive a de facto return to the SEC's pre-1980 policy stance on 12b-1 fees? In other words, as mutual fund groups must offer non-12b-1 share classes to keep up with investor demand, will advisers continue to recommend share classes with 12b-1 fees if share classes without them are "available?" How will broker-dealers potentially governed by proposed Regulation Best Interest recommend investments carrying 12b-1 fees? What will the impact be, if any, on the mutual fund board's annual renewal of the Rule 12b-1 plan?
- Do prevailing trends such as transaction-based and advice-for-fee models imply a belief among investors that individual shareholders should be responsible for paying fees only where there is a clear and direct benefit to them, and not where the benefit is indirect such as with increased assets under management and realization of economies of scale?[60] What would such a shift — to a model where performance and substantive advice is potentially available only through higher-end fees—imply about access for the retail and senior investors that the SEC aims to protect?
- Will the "drive to zero" fees experienced within "clean share" classes and ETFs migrate to retail classes? Will the costs of selling mutual funds become wholly external to the mutual fund expense ratio, borne directly by fund investors on one hand, or service providers on the other? If so, how will fund service providers compensate for the lost 12b-1 revenue and how will boards ensure that fund advisers have adequate resources and fund shareholders are not improperly footing any bills?
- How will the reconsideration of the mutual fund board oversight responsibility framework that has been much discussed by the Director of the SEC's Division of Investment Management, Dalia Blass, intersect with the market and other regulatory forces currently surrounding 12b-1 fees?[61]
- With Class A shares emerging as the only standard 12b-1 share class (now uniformly charging 0.25% in 12b-1 fees), in line with the SEC's 2010 Rule 12b-1 reform attempt, could other aspects of the 2010 proposal manifest in the markets?
- If Form CRS is adopted as proposed, will advisers and broker-dealers be willing to make the required disclosures regarding conflicts of interest associated with 12b-1 fees, or will they abandon them in favor of some less-complicated pricing options?

The ultimate question, of course, is whether 12b-1 fees will remain a viable pricing alternative in an environment in which "expense ratios are the financial version of…calorie counts"?[62] As we wait to learn the answer, fund boards and their service providers should be on alert, working with counsel to conduct increasingly thorough and analytical due diligence regarding the various aspects of fund distribution costs.

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**Ms. Williamson** is a partner in the Investment Management Practice Group at Perkins Coie LLP. She thanks Matthew S. Williams, an associate in the Investment Management Pratice Group at Perkins Coie, for his contributions to this article. Certain information regarding the evolution of Rule 12b-1 under the Investment Company Act of 1940 included in this article has previously appeared in a different format in Martin E. Lybecker and Gwendolyn A. Williamson, "The

Administrative History of Rule 12b-1," PLI Basics of Mutual Funds and Other Registered Investment Companies 2013, New York, New York, April 24, 2013. In addition, certain information regarding the SEC's April 2018 fiduciary proposals has previously appeared in a different format in Gwendolyn A. Williamson and Matthew S. Williams, "Fiduciary Investment Advice: Emerging Legislation and Regulations" PLI Fiduciary Investment Advice 2018, New York, New York, May 10, 2018.

## NOTES

1 *See* the 2018 Investment Company Institute (ICI) Factbook at p.121 (describing "downward pressure on expense ratios—from competition among existing mutual fund sponsors, new mutual fund sponsors entering the industry, competition from products such as exchange-traded funds…and economies of scale resulting from the growth in fund assets"). The 2018 ICI Factbook is *available at https://www.ici.org/pdf/2018_factbook.pdf.*

2 *See* William A. Birdthistle and Daniel J. Hemel, "Next Stop for Mutual-Fund Fees: Zero," *Wall St. J.* (June 10, 2018) (noting that "since 2000 the average annual mutual-fund fee has fallen by more than a third"). In addition to exerting pressure on fund fees generally, the DOL fiduciary rule also drove a re-construction of mutual fund share classes that generated a more uniform share class structure with greater consistency in pricing and nomenclature across fund groups than was offered even just two years ago. For example, fund groups' most expensive institutional share classes (with no 12b-1 fees) are now typically referred to as "Institutional" or "I" shares, with cheaper classes designated in succession (Institutional 2 (I2), Institutional 3 (I3), etc.).

3 2018 ICI Factbook, *supra* n.1, at p.119 (reporting that the average hybrid mutual fund expense ratio fell from 0.89% in 2000 to 0.70% in 2017, a reduction of 21%, and the average bond mutual fund expense ratio fell from 0.76% in 2000 to 0.48% in 2017, a decline of 37%).

4 Morningstar, Inc., (Morningstar) is an investment research, analysis, and ratings firm.

5 *See* Morningstar U.S. Fund Fee Study (Apr. 28, 2018), *available at https://www.morningstar.com/blog/2018/05/11/fund-fee-study.html*.

6 Through a January 11, 2017, no-action letter to Capital Research and Management Company, the Staff of the SEC's Division of Investment Management said it would not recommend enforcement action against brokers setting their own commission rates for sales of so-called "clean shares" of mutual funds with no fund-imposed sales loads or distribution fees, despite Section 22(d) of and Rule 22d-1 under the Investment Company Act which otherwise would require such commission schedules to be fixed by share class at the sales load rates established in the fund prospectus (the Clean Shares Letter). The Clean Shares Letter allowed for the de-coupling of commissions paid by shareholders from sales loads paid by shareholders to funds. The Clean Shares Letter is *available at https://www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm.*

7 *See* 2018 ICI Factbook *supra* n.1, at Fig. 6.10 -6.12 and p.120 (explaining that a "factor contributing to the decline of the average expense ratios of long-term mutual funds is the shift toward no-load share classes … particularly institutional no-load share classes, which tend to have below-average expense ratios. In part, this shift reflects a change in how investors pay for services from brokers and other financial professionals").

8 2018 ICI Factbook *supra* n.1, at p.122.

9 Birdthistle and Hemel *supra* n.2.

10 "Ameriprise Loses 12b-1 Fees But Boosts Productivity," *Barron's* (July 27, 2017), *available at www.barrons.com/articles/ameriprise-loses-12b-1-fees-but-boosts-productivity-1501179544.*

11 Derek Horstmeyer, "Zero-Fee ETFs (or Even Negative) Are on the Horizon," *Wall St. J.* (Feb. 4, 2018), *available at https://www.wsj.com/articles/zero-fee-etfs-or-even-negative-are-on-the-horizon-1517800320.*

12 *Id*.

13 Birdthistle and Hemel *supra* n.2.

14 Reshma Kapadia, "The Great Fund Fee Divide," *Barron's* (Jan. 6, 2018), *available at https://www.barrons.com/articles/the-great-fund-fee-divide-1515214360.*

15 Landon Thomas, Jr., "Why Are Mutual Fund Fees So High? This Billionaire Knows," *N.Y. Times* (Dec. 30, 2017), *available at https://www.nytimes.com/2017/12/30/business/why-are-mutual-fund-fees-so-high-this-billionaire-knows.html.* Other factors may also contribute to investors' willingness to pay the Baron Funds' fees, including an annual shareholder conference held at the Metropolitan Opera House at Lincoln Center in New York City and has boasted entertainment such as performances by Barbara Streisand and Paul McCartney. *Id.*

16 *See* Corrie Driebusch, "The New ABCs of Mutual Funds*," Wall St. J.* (June 2, 2013).

17 Class C shares still account for $719 billion in investor assets. S*ee,* Kapadia *supra* n.14.

18 "Will 12b-1 Fees Ever Disappear?" *Ignites!* poll results, accessed July 17, 2018.

19 *See* IM Guidance Update No. 2016-01, "Mutual Fund Distribution and Sub-Accounting Fees," (Jan. 2016) *available at https://www.sec.gov/investment/im-guidance-2016-01.pdf* (describing SEC Staff expectations of mutual fund boards overseeing the use sub-TA fees and Rule 12b-1 plan compliance, and of fund service providers informing boards' oversight, and making clear that Rule 38a-1 under the Investment Company Act requires "policies and procedures reasonably designed to prevent violations of Section 12(b) and Rule 12b-1," that include policies and procedures to identify payments for distribution-related services outside of the 12b-1 plan).

20 *See* SEC Press Release, "SEC Announces 2013 Examination Priorities," (Feb. 21, 2013) *available at http://www.sec.gov/news/press/2013/2013-26.htm*.

21 *See* IM Guidance Update No. 2016-01 *supra* n.19 (citing Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, Securities and Exchange Commission, to Craig S. Tyle, General Counsel, Investment Company Institute (Oct. 30, 1998)).

22 *See, e.g.*, In the Matter of First Eagle Investment Management, Investment Company Act Rel. No. 31832 (Sept. 21, 2015); In the Matter of William Blair & Company, L.L.C., Investment Company Act Rel. No. 32621 (May 1, 2017); In the Matter of Calvert Investment Distributors, Inc., Investment Company Act Rel. No. 32624 (May 2, 2017).

23 *See, e.g.*, Remarks of Jane Jarcho, Deputy Director of OCIE, at the ICI Securities Law Developments Conference, Washington, DC (Dec. 7, 2017).

24 *See* NEP Risk Alert, "OCIE's 2016 Share Class Initiative," (July 13, 2016), *available at* https://www.sec.gov/files/ocie-risk-alert-2016-share-class-initiative.pdf.

25 *Id.*

26 NEP Risk Alert*, supra* n.24, citing Advisers Act Release No. 3686 (Oct. 2, 2013).

27 NEP Risk Alert*, supra* n.24, citing Advisers Act Release No. 2713 (Mar. 5, 2008).

28 NEP Risk Alert*, supra* n.24, citing *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180 (1963).

29 NEP Risk Alert*, supra* n.24.

30 *Id.,* citing Advisers Act Release No. 4351 (Mar. 14, 2016).

31 NEP Risk Alert*, supra* n.24.

32 SEC Press Release, "SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors" (Feb. 12, 2018) *available at https://www.sec.gov/news/press-release/2018-15.*

33 *See, e.g., SEC v. Westport Capital Markets, LLC*, Civil Action No. 3:17-cv-02064 (Dec 11, 2017) (adviser charged with, among other things, breaching it fiduciary duty by failing to disclose the existence of 12b-1 fees to its clients and investing "clients in mutual fund share classes that charged a 12b-1 fee when a share class of the same fund was available without a 12b-1 fee" for which the clients were eligible), and *In the Matter of PNC Investments LLC* (Investment Advisers Act Release No. 4878 (Apr. 6, 2018) (total disgorgement and prejudgment interest imposed in

settlement order totaled over $6 million, with an additional civil penalty of $900,000, where among other things defendant adviser allegedly "breached its fiduciary duty to seek best execution for its clients by investing them in mutual fund share classes with 12b-1 fees rather than lower-cost share classes" and had multiple disclosure shortcomings with respect to its conflict of interest in recommending fund share classes that would generate financial benefits for the adviser and its associates).

34 SEC Press Release *supra* n.32. Applications to participate in the Amnesty Program were due to the SEC by June 12, 2018.

35 SEC Announcement, "Share Class Selection Disclosure Initiative," *available at https://www.sec.gov/enforce/announcement/scsd-initiative.*

36 In the Matter of Geneos Wealth Management, Inc., Advisers Act Release No. 4877 (Apr. 6, 2018) (total disgorgement and prejudgment interest imposed totaled approximately $2 million, with an additional civil penalty of $250,000, for charges involving 12b-1 share class recommendations). *See also, In the Matter of Securities America Advisors, Inc.*, Advisers Act Release No. 4876 (Apr. 6, 2018) (adviser charged with improperly placing clients in share classes with 12b-1 fees imposed total disgorgement and prejudgment interest of more than $5.8 million).

37 SEC Share Class Selection Initiative FAQs, at Item 11 (May 1, 2018) *available at https://www.sec.gov/enforce/educationhelpguidesfaqs/share-class-selection-disclosure-initiative-faqs.*

38 *Id.*

39 The Exam Priorities are *available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf.*

40 *Id.*

41 *See* Advisers Act Release No. 33-10470; Investment Company Act Release No. 33045; Office of Information and Regulatory Affairs, Office of Management and Budget, Executive Office of the President, Agency Rule List—Spring 2018, Securities and Exchange Commission, *available at reginfo.gov* (accessed July 31, 2018).

42 Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Advisers Act Release No. 4889 (Apr. 18, 2018), *available at https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.*

43 *Id.*

44 Regulation Best Interest, Securities Exchange Act Release No. 83062 (Apr. 18, 2018), *available at https://www.sec.gov/rules/proposed/2018/34-83062.pdf.*

45 Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Securities Exchange Act Release No. 83063, Advisers Act Release No. 4888 (Apr. 18, 2018), *available at https://www.sec.gov/rules/proposed/2018/34-83063.pdf.*

46 "Hypothetical Relationship Summary for a Registered Investment Adviser Prepared By SEC Staff —For Illustrative Purposes Only: Is An Investment Advisory Account Right For You?," *available at https://www.sec.gov/rules/proposed/2018/34-83063-appendix-e.pdf.*

47 "Hypothetical Relationship Summary for a Registered Broker-Dealer Prepared By SEC Staff —For Illustrative Purposes Only: Is A Brokerage Account Right For You?," *available at https://www.sec.gov/rules/proposed/2018/34-83063-appendix-d.pdf.*

48 "Hypothetical Relationship Summary for a Dually Registered Investment Adviser and Broker-Dealer Prepared By SEC Staff – For Illustrative Purposes Only: Which Type of Account is Right for You—Brokerage, Investment Advisory or Both?," *available at https://www.sec.gov/rules/proposed/2018/34-83063-appendix-c.pdf.*

49 *See* Comment Letter from Investment Adviser Association, *available at* https://www.sec.gov/comments/s7-09-18/s70918-3713511-162482.pdf.

50 *See* Comment Letter from New York City Bar, Committee on Investment Management Regulation, *available at https://www.sec.gov/comments/s7-09-18/s70918-3937033-167034.pdf.*

51 Section 12(b) of the 1940 Act is not self-executing; rulemaking by SEC Staff was necessary to implement its purpose.

[52] *See, e.g.,* In the Matter of Broad Street Investing Corp. (Mar. 1972).

[53] Investment Company Act Release No. 11414 (Oct. 1980). Many of the dominant features of today's mutual fund share class structures were determined by SEC rulemaking in the years following the adoption of Rule 12b-1. Rule 22d-1 under the Investment Company Act was adopted in 1985, allowing funds to establish scheduled variations, or breakpoints, in front-send sales charges (Investment Company Act Release No. 14390 (Feb. 22, 1985)); Rule 6c-10 under the Investment Company Act was adopted in 1995, allowing funds to charge CDSCs without exemptive relief and with established breakpoints (Investment Company Act Release No. 20916 (Feb. 23, 1995); *see also,* Investment Company Act Release No. 16619 (Nov. 2, 1988) (original Rule 6c-10 proposal) and Rule 18f-3 under the Investment Company Act (adopted in 1995 to permit funds to offer multiple share classes with different expense structures without exemptive relief (Investment Company Act Release No. 20915 (Feb. 23, 1995)).

[54] Securities Exchange Act Release No. 30897 (July 7, 1992); NASD (now FINRA) Conduct Rule 2830(d); *see also* Proposed Rule Change by NASD (now FINRA) 10-11 (Dec. 28, 1990).

[55] Investment Company Act Release No. 16244 (Feb. 1, 1988).

[56] Lori Walsh, "The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns," *available at https://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf.*

[57] Investment Company Act Release No. 29367 (July 21, 2010).

[58] Investment Company Act Release No. 29367 (July 21, 2010).

[59] *See* Letter from ICI to SEC, "Mutual Fund Distribution Fees; Confirmations," File No. S7-15-10 (Nov. 5, 2010).

[60] *See, e.g.*, SEC Statement on the Future Structure of the Securities Markets (Feb. 1972).

[61] *See, e.g.*, Remarks of Dalia Blass, Director of the SEC's Division of Investment Management, Keynote Address: ICI Securities Law Developments Conference, Washington, DC (Dec. 7, 2017), *available at https://www.sec.gov/news/speech/blass-keynote-ici-securities-law-developments-conference-2017.*

[62] Kapadia *supra* n.14, quoting a third party.