



All that's hot in the mutual fund industry

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Study: 12b-1 Fees Up Tenfold in 10 Years

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The 12b-1 fees funds charge investors to support their sales and marketing efforts have increased tenfold in the past decade. That's according to a new [study](#)¹ on 12b-1 fee usage put out by the Investment Company Institute.

According to the ICI, 12b-1 fees have risen from \$1.1 billion in 1990 to \$10.4 billion in 2004. The study found that 40% of fees collected in 2004 were used to compensate financial advisors for initial assistance they provided to clients.

That included meeting with investors, identifying financial goals, analyzing investments, determining asset allocations and recommending mutual funds.

Another 52% was used for services rendered to existing shareholders. That comprised payments to financial advisors for ongoing services, such as responding to customer inquiries and providing information on investments.

An additional 6% was paid to fund underwriters and the remaining 2% was used for fund advertising and promotion. That's a decline since 2000, when a similar ICI study showed that 5% of 12b-1 fees were used for advertising and sales promotion activities.

The change in how the fees are used over the past decade is a key issue in the debate surrounding perceived gaps between the charges' original purpose and their current use.

"There's a lot of misunderstanding about how 12b-1 fees are used," says ICI chief economist Brian Reid. "Many people believe that shareholders don't receive any benefit from them. This survey demonstrates that current shareholders are the primary recipients of 12b-1 fee benefits."

Many believe that when the SEC adopted rule 12b-1 in 1980, it intended for the fees to be used to pay for funds' distribution expenses.

But their current use for other purposes, the lack of disclosure of those purposes to investors and the charges' meteoric growth have caused both the SEC and the NASD to take harder look at them.

The NASD has formed a task force to consider 12b-1 fee issues. And the SEC is reviewing the charges with a view to potential revisions of the rule.

Stephanie Monaco, a partner in the securities regulation and enforcement group of law firm **Crowell & Moring**, says most 12b-1 plans are written broadly, so she does not believe that most firms' payments violate the rule.

Indeed, in its 1980 adopting release, the commission emphasized that the rule does not restrict the kinds or amounts of payments that could be made, indicating that the rule was developed to be flexible enough to address new distribution arrangements that might arise.

Reid also notes that over the years, the SEC has issued hundreds of exemptive orders permitting funds to impose spread loads, consisting of a 12b-1 fee plus a contingent deferred sales charge. A spread load effectively finances a front-end sales load.

Front-end sales loads have declined from an average of 8% in 1980 to 5% in 2004, due in part to the growing use of 12b-1s.

However, others point out some inherent problems with the charges.

"When you spend your own money instead of your clients' money you always spent it more wisely," says Niels Holch, a partner with Washington, D.C.-based firm McGuinness & Holch.

Holch says he'd like to see some of those expenses being paid by the management company instead of fund

shareholders. He also favors more disclosure of what those 12b-1 fees are being used for.

At the National Investment Company Service Association 23rd Annual Conference & Expo this week, ICI president Paul Schott Stevens maintained that the SEC will probably stipulate that the industry provide more disclosure on how 12b-1 revenues are spent.

Stevens added that he thinks fund boards should be given more guidelines from regulators for use when evaluating if they should renew 12b-1 plans. Furthermore, the name 12b-1 is somewhat cryptic.

"It's an uninformative name," he said. "Certainly we can do better than that."

Another attorney says that because of the payments' ambiguity, he counsels his advisor clients to obtain dual registration as broker-dealers.

"You can dress up a 12b-1 fee all you want, but it was intended to be a fund-authorized distribution payment," he says. "If an unaffiliated advisor receives 12b-1 revenue, you have to look behind the curtain and see what they're really doing. It's better to be safe than sorry."

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