

It's time to shed some light on 12(b)-1 fees

Clients should be armed with as much data as possible when making investment decisions

By Jim Pavia

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To borrow a line from Supreme Court Justice Louis Brandeis, it's time we let some sunlight in on 12(b)-1 fees.

The trailing mutual fund expenses are a contentious issue among advisers, with one camp vigorously defending them as a way to cover the expense of continuing work on a client's behalf, while other advisers criticize them as a needless drag on performance.

Because of the importance of the issue, Securities and Exchange Commission Chairman Mary Schapiro's recent request that agency staff come up with possible recommended changes to 12(b)-1 fees is a step in the right direction.

She said she wants to take time to assess 12(b)-1 fees to ensure that investors are supplied with "relevant, simple and comparable information at the point of sale [rather than] only after the sale has occurred, if at all."

I would challenge any financial professional who believes that a client should not be armed with as much data as possible when making an investment decision. The investor's interests come first, right?


With that said, I am going to be an optimist and believe that the SEC will find ways to provide investors with more clarity when it comes to 12(b)-1 fees.

Financial advisers and planners should embrace anything that creates less confusion for their clients. It should be their primary goal.

After all, investors have a right to understand what the 12(b)-1 fees are being used for and the exact amount that they're paying.

If an investor decides not to purchase a fund that has a 12(b)-1 fee, as some have argued,

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so be it. While it probably doesn't make sense to use the fees alone as a tool to screen out funds, there are certainly plenty of other funds to choose from that do not carry a 12(b)-1 fee.

As for the SEC, the agency should take its time and fairly scrutinize 12(b)-1 fees so that it can develop a way to offer meaningful disclosure to the investor.

Let's be honest, though. The real problem with 12(b)-1 fees is that investors have no idea what the fees are, how they are deducted, how they are used or who ultimately is receiving them.

Any credible adviser should have no problem sending clients a detailed invoice with a transparent explanation of how much was actually charged, by whom and for what, exactly.

The SEC adopted 12(b)-1 fees in 1980 so that a fund company could attract more investors through marketing and advertising, generating economies of scale that would bring cost savings and lower asset management fees.

In theory, investors who paid the 12(b)-1 fee would eventually reap the benefits in the form of lower overall costs.

The fact is that nowadays, 12(b)-1 charges are rarely used to pay for advertising. Instead, they mainly pay for commissions to financial advisers and for a fund's administrative costs.

What's more, some funds that have been closed to new investors continue to charge 12(b)-1 fees; to whom are they marketing if only current fund owners can invest?

Proponents argue that the fee serves as a substitute for a front-end load, and that over time, investors do better with a high 12(b)-1 fee than with a high front-end load.

Additionally, it has been argued that 12(b)-1 fees help to discourage the churning of a client's account by compensating the salesperson for the hand-holding, resolving administrative glitches and giving investment advice after the sale.

It's obvious that there are good arguments on both sides.

However, after 30 years of growth and change in the mutual fund market, I think it's fair to say that it's time at least to reassess the need for, and effectiveness of, 12(b)-1 fees.

The SEC has been pondering scrapping the fees for a very long time. I am not convinced that 12(b)-1 fees need to be eliminated, but a name change and a thorough re-evaluation of how to enhance clarity for investors would certainly be an improvement.

Without true transparency, consumers cannot make educated investment decisions. And if that's the case, no one wins.

[Jim Pavia is the editor of *InvestmentNews*.]



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