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Will '12b-1' Fees Ever Stop Bugging Investors?

By JASON ZWEIG



Could the little fee that eats away at mutual funds finally disappear?

Earlier this month, Securities and Exchange Commission Chairman Mary Schapiro declared that "we must critically rethink how 12b-1 fees are used and whether they continue to be appropriate."

Roughly 70% of funds charge 12b-1 fees, named after the SEC rule that permits them. These charges help defray marketing and distribution costs, which might include commissions to financial advisors, processing and record-keeping in a 401(k) plan, mailing prospectuses, even advertising in *The Wall Street Journal*.

A 12b-1 fee also covers the costs of getting new investors to buy the fund, which is somewhat like paying a \$100 surcharge on a Chevy so General Motors can keep selling Chevys to other drivers.

Typically running \$1.50 to \$3 a year on each \$1,000 you've invested, 12b-1 fees sound tiny. But 12b-1s add up, big-time. Since 1990, based on data from Lipper Inc. and the Investment Company Institute, investors have paid more than \$140 billion in 12b-1s.

What has that \$140 billion bought? Back in 1980, when 12b-1 fees were born, mutual funds were weathering a long winter. Stock and bond funds held less money than they had in 1971, and almost a third of all accounts had been closed.

So the SEC broke with legal tradition and permitted managers to charge shareholders a new fee. In theory, that would help retain existing investors and attract others, enabling funds to grow again and to achieve "economies of scale." Fund investors would pay lower fees, while fund companies would have more money to manage.

In practice, however, fund companies began using 12b-1 fees to pay brokers a continuing stream of smaller fees instead of the traditional "sales load," or one-time upfront charge, which in those days ran up to 8.5%. Funds got bigger, fund managers' profits got fatter and investors got more confused.

Like Dr. Frankenstein haunted by his monster, the SEC has long seemed tormented by self-doubt over whether creating 12b-1 was a mistake. Reports by SEC economists in 1990 and again in 2004 found no evidence that 12b-1s were worth what they cost investors.

Will the agency seriously consider banning 12b-1s outright? Andrew Donohue, the SEC's head of mutual-fund regulation, won't say. "We want to make sure investors are treated appropriately, not just at the macro level of the fund but also at the individual level," he says. "When something is the functional equivalent of a sales load, maybe it should be disclosed and regulated that way."

Keep in mind, brokers have to get paid somehow. "It's not as if you can wave a magic wand and eliminate 12b-1 fees and then those expenses will be retained by investors in their own pockets," says Paul Schott Stevens, president of the Investment Company Institute, the mutual-fund trade group.

Mr. Stevens argues that since 12b-1 fees are deducted out of the fund's income, they should be viewed as a "highly tax-efficient" way to pay brokers. Of course, if fees ate up 100% of your return, you wouldn't owe any taxes at all. Tax efficiency shouldn't be the goal of 12b-1 reform.

Here are a few ideas.

Industry analyst Jeffrey Keil of Keil Fiduciary Strategies in Littleton, Colo., says the best way to "achieve the proper transparency" is to make individual shareholders, rather than the fund itself, pay the costs of marketing and distribution. Your statement would show, in dollars, how much you paid for your broker's services.

Don Phillips, managing director at Morningstar Inc., the fund researcher, argues that 12b-1 fees "are a farce, because they don't capture all the distribution costs." Some fund managers pay for marketing out of their management fees, for example. Mr. Phillips suggests that funds should overhaul their financial statements by sorting all expenses into three main buckets: "investment management," or what it costs to research and run the portfolio; "sales and marketing," or what it costs to distribute the fund; and "operations," or overhead like accounting and legal expenses.

The SEC—or Congress—also could loosen the 69-year-old requirement that mutual funds must have fixed sales charges. Purchase 100 shares of **Microsoft** stock, and you will pay different commissions for an online trade, a purchase at a discount brokerage office or a transaction through a full-service broker.

Why not treat mutual funds the same way? You and your financial advisor should be free to negotiate how much you pay, rather than being locked into a rigid fee that munches everyone's money at the same relentless rate.

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