Why the 12b-1 fee era must end

By Michael Kitces *Financial Planning* Magazine 4/3/17

From its start in 1980, the 12b-1 fee was controversial. Here was a distribution charge assessed against current mutual fund investors that the fund company could then use to market the fund to *new* investors. In other words, the mutual fund used investor dollars rather than its own money to grow the fund's assets under management.

In theory, using the fund investor's own money to market the fund company's products was supposed to benefit the investor. Several decades of subsequent analysis, however, show that while mutual funds that charge 12b-1 fees are successful at incentivizing salespeople to bring in more AUM, the 12b-1 fee isn't living up to its promise of helping scale up and bring down the expense ratio as the mutual fund grows.

Combined with investors' own shifting strategies, the relevance of the 12b-1 is today in marked decline. Is it time to create a more appropriate pricing structure for the realities of today's investment marketplace?

ORIGINS

Rule 12b-1 of the Investment Company Act of 1940 authorizes mutual funds to pay for marketing and distribution expenses directly from the investment assets of shareholders, effectively treating those sales expenses as akin to other operating expenses of the mutual fund.

Because the 12b-1 fee is paid directly by fund investors, the fund's board of directors must approve a 12b-1 plan before such fees can be assessed. The board also has a responsibility to monitor the use of the 12b-1 fee over time.

Technically, the 12b-1 fee is comprised of two pieces: a distribution and marketing fee that can be up to 0.75% per year, and a service fee of up to 0.25% per year, for a combined maximum annual total of 1%. Class A share mutual funds, which pay a separate upfront sales commission for distribution and marketing, accordingly have just a 0.25% annual 12b-1 service fee, while C share mutual funds that don't otherwise pay an upfront commission rely on the 0.75% distribution fee + 0.25% service fee = 1% total 12b-1 fee to compensate their salespeople.

At its core, it imposes an obligation on current investors to pay for the cost for the fund company to market to other people who are not yet investors. In other words, current fund investors pay for the fund company's salespeople and marketing efforts to get new investors, rather than having the fund company itself pay to grow its business.

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This is an important contrast to traditional upfront commissions, because those payments come directly from the fund company — and/or the investor's own dollars directly — not the aggregate of other mutual fund investors. Notably, B share mutual funds allowed broker-dealers to pay brokers an upfront commission, and then recover it over time through the 12b-1 fee, though use of B shares has been in decline.

In fact, the Investment Company Act of 1940 itself originally banned the use of investor assets to pay for a mutual fund's marketing and distribution. However, when Rule 12b-1 was first adopted in 1980 under Investment Company Act Release No. 11414, the justification for taking the mutual fund's marketing expenses directly from shareholders themselves — even though those marketing expenses to grow the fund would enrich the fund company — was that given the underlying fixed costs to run a mutual fund in the first place, adding more investors would allow the fixed costs to be amortized over more investors, bringing the average cost down for everyone, and thus actually benefiting the investors in the long run.

The opportunity to assess a 12b-1 fee to help grow the fund was viewed as especially important for smaller/newer mutual funds that might not have had the capital to invest in marketing and distribution themselves, but could use 12b-1 fees assessed on investor assets to grow the fund — which would ultimately benefit both the fund company and the investors themselves.

THE PROBLEM

Unfortunately, while in the decades since the 12b-1 fee was first adopted the mutual fund complex overall has grown larger and mutual fund expenses on average have declined, researchers haven't been able to find much of a link between the existence and use of 12b-1 fees and a subsequent decline in the operating expense ratios of those particular mutual funds.

In other words, if 12b-1 fees worked, funds that use a 0.25% 12b-1 fee to grow would eventually see their expense ratios fall by 25bps or more, and overall mutual funds that use 12b-1 fees would end up either being cheaper — given the expense ratio drops by even more than the 0.25% fee as the fund scales its operating expenses — or at least find other cost efficiencies, such as amortizing trading costs over more investor dollars. Both developments would in turn help improve the funds' returns.

Instead, an SEC study found that mutual funds with 12b-1 fees are becoming much larger, but not cheaper. in the end, they're just larger funds that are more expensive — by almost the entire cost of the 12b-1 — as existing investors continue to pay the marketing costs to reach new investors. This may enrich the mutual fund company, but not the current fund investors who are paying for it.

The net result? The 12b-1 fees investors actually pay are effective at incentivizing salespeople to distribute mutual funds and grow their assets under management, but there are no operational economies of scale coming back to benefit the investor themselves — despite the fact that the investor is paying for it.

Furthermore, even though 12b-1 fees were supposed to help mutual funds grow, in recent years the greatest growth is actually flowing specifically to no-load mutual funds that don't have a 12b-1 fee anyway (e.g., Vanguard).

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This seems driven in part by the growing recognition that investment costs have a sizeable impact on long-term performance. Consequently, the best funds to choose are the ones with the lowest expenses — which disproportionately are funds with no 12b-1 fees. But it's also simply driven by the fact that as investors get more tools to implement their own portfolios, they are effectively cutting out the middleman, pursuing fund-share classes that don't pay sales commissions and [Office1] assess distribution expenses.

At the same time, there's a shift among advisers toward independent RIAs — which charge AUM fees but can't accept 12b-1 fees, and instead pursue cheaper institutional share classes on behalf of their clients. This may only be further accelerated if/when the Department of Labor's fiduciary rule comes to pass, further winnowing the number of higher-cost share classes with 12b-1 fees anyway.

Thus, as the chart below from Investment Company Institute (ICI) data shows for the last decade that fund data was available, retail no-load funds with either no 12b-1 fee or only a 0.25% 12b-1 servicing fee have dramatically outgrown the net flows to all loaded funds combined. It's even more dramatic when you include all no-load funds, both retail and institutional. And notably, the data would be even more dramatic if the rapid growth of ETFs, which also have no 12b-1 fees, were included as well.

The situation is further complicated by the fact that paying distribution costs is more complex in the modern investment world. For instance, while 12b-1 fees are paid to brokers who sell a mutual fund, they are also paid to many online investment platforms dealing in[Office1] No Transaction Fee (NTF) mutual fund offerings.

In other words, rather than having new investors pay the transaction fee to buy the fund — i.e., the mutual fund ticket charge — current investors subsidize the new investor's cost to purchase by paying the 12b-1 fee to the brokerage firm to make the fund available as an NTF fund.

Ultimately, this is a form of distribution cost to incentivize new investors to invest into the mutual fund. But again, it appears to be more effective at bringing in new investors than actually scaling up the mutual fund to bring down operating expense ratios for existing investors.

On the other hand, some mutual funds today use 12b-1 fees to cover more nondistribution administrative services that third-party investment platforms help facilitate, including record-keeping and tracking shareholders' purchases and redemptions — given those transactions are happening on the third-party platform instead of directly with the mutual fund. This form of 12b-1 fee arguably is at least less of a distortion, as it's paid by existing investors to fulfill the record-keeping needs for those existing investors.

Still, the fact that some investment companies cover these costs from 12b-1 fees, while others pay the costs directly from the fund company — or simply let the investor pay their platform directly in the form of transactional, custodial or wrap fees — means that the uneven use of 12b-1 fees can potentially distort the cost of mutual funds in the marketplace.

ARE ADVISERS DISTRIBUTORS?

From the adviser perspective, a huge number of us work in a broker-dealer environment, where our advice is compensated partially or entirely by 12b-1 fees paid out from the investments we recommend for our clients. As a result, the ability to get paid for what we do, through the mechanism of the 12b-1 fee, is a major pillar of how many advisers receive compensation. This is particularly true for those who rely on C-share mutual fund trails to generate the typical 1% AUM fee as an adviser.

Of course, a huge swath of advisers also work as registered investment advisers, where the RIA generates the exact same net 1% AUM fee from clients. It's simply paid as a fee collected from the client directly, rather than a 12b-1 distribution charge paid from the fund investor assets. In fact, many in the adviser community have suggested there's little reason to adjust the 12b-1 fee at all, given it's simply a means of maintaining adviser compensation parity across channels — i.e., brokers get a 1% AUM fee from 12b-1 fees, while RIAs get a 1% AUM fee from advisory accounts, so it's about the same.

The caveat is that a 1% AUM fee paid to an RIA and a 1% 12b-1 fee paid to a broker are substantively different from a legal and regulatory perspective. A 1% AUM fee is paid by the client for services rendered to that client. A 1% 12b-1 fee is paid by all the investors to compensate the broker to get new investors.

More generally, a 1% AUM fee paid to an RIA is a payment for investment advice. A 1% 12b-1 fee is therefore technically still just a distribution charge paid by the mutual fund — or rather, its current investors — to incentivize the broker to sell the product. In other words: A 1% 12b-1 fee is not, and was not ever, intended to pay for advice.

For most advisers, the impact of elimination could actually be neutral.

In fact, it's a requirement under the Investment Advisers Act of 1940 that any advice a broker provides to earn a 12b-1 fee must be "solely incidental" to what is primarily just the sale of a product. Otherwise, the broker actually would have to register as an investment adviser, and be paid an actual AUM fee for investment advice instead.

This ultimately means that if advisers really are moving away from being salespeople who get 1% annual commissions into actual advisers who get 1% AUM fees for investment advice, the shift from 12b-1 fees to AUM fees paid to an RIA may be inevitable anyway. The fact that the DoL fiduciary rule only permits advisers to be "level fee fiduciaries" if they receive level AUM fees — but not level 12b-1 commissions — further emphasizes the adviser and regulatory shift away from 12b-1 fees toward direct, client-paid AUM fees instead, therefore making the 12b-1 fee less relevant.

IMPLICATIONS OF ELIMINATION

Given the declining relevance of the 12b-1 fee — combined with the fact that it was never intended to pay for advice and potentially distorts payments between existing and new fund investors — what are the implications if the fee is eliminated altogether?

For most advisers, the impact could actually be neutral. Those who rely on 12b-1 trails for their business model can simply charge an equivalent AUM fee to clients, while doing an internal exchange to convert from a share class of the mutual fund with a 12b-1 fee to an institutional share class instead.

Of course, it's important to recognize that such a conversion would also shift the adviser from being a commission-based broker to an investment adviser representative (IAR) of an RIA — whether their own or a corporate RIA affiliated with their broker-dealer. Nonetheless, given the overwhelming number of advisers who are already at least hybrids with both a B/D and RIA affiliation, the transition would be manageable for most.

Ironically, the potential elimination of a 12b-1 fee would likely be more disruptive for the platforms that support advisers than for advisers themselves.

Most broker-dealers share in the 12b-1 compensation for both administrative costs and through their share of GDC grid payouts to brokers. Many annuity providers rely on 12b-1 fees from their subaccounts to help supplement the revenue they get from their Mortality and Expense (M&E) costs. And a number of RIA custodians rely on 12b-1 fees to generate a material portion of their revenue —again through either revenue-sharing for administrative costs with the fund provider directly, or by offering NTF platforms that use the 12b-1 share classes to get paid.

Of course, as long as broker-dealers, RIA custodians and annuity products exist and must generate revenue, the cost must ultimately be borne somehow by the end investor. Eliminating 12b-1 fees from annuities will just increase their M&E charges, while limiting their payments to broker-dealers will just drive those firms to have advisers charge AUM fees and share in the take from their corporate RIA instead. Meanwhile, if RIA custodians and direct-to-consumer investing websites can't get 12b-1 fees for NTF funds, they may simply charge an equivalent wrap or custodial fee to the end consumer instead.

Such a shift would arguably still help align costs for consumers. Investors would pay their own expenses, rather than the expenses of fund companies to grow their own profits, and the fund companies themselves can make their own decisions about the benefits of paying for marketing and distribution.

And increasing the saliency of the costs — that is, making consumers more aware of what they're paying by charging outright AUM or platform fees — helps consumers better assess whether they're really getting their money's worth. Indeed, research has shown that 12b-1 fees are less salient and may be distorting mutual fund buying decisions.

That does put more pressure on everyone — from advisers to the platforms that serve them — to better justify that their cost is worth the value that it provides. But that's already true for most independent RIAs and other fiduciaries, who have been growing rapidly in the past decade despite being unable to earn back-end 12b-1 fees.

The bottom line, though, is simply to recognize that as investors increasingly buy their investments direct, and advisers shift from being salespeople who distribute mutual funds to actual advisers who get paid for dispensing advice — which might happen to include recommendations on how to implement a portfolio — the relevance of the 12b-1 fee itself is declining, and the causes couldn't be clearer: In its 30-plus years of its existence, the fee has failed to prove it can accomplish its original purpose of helping grow mutual funds in a manner that brings their operating expense ratios down by more than their 12b-1 fees.

Eliminating the 12b-1 fee wouldn't necessarily make investing cheaper in the aggregate, as companies and advisers must still be paid for what they do. But it's time to at least consider a payment mechanism that is more salient, more transparent and better aligned between who pays the cost and who enjoys the benefits.