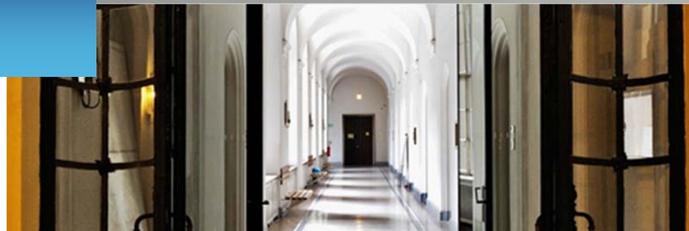


Mutual Funds in the Spotlight Is a paradigm shift necessary or desirable?



Recently, the Securities and Exchange Commission (SEC) proposed a series of sweeping changes to mutual fund distribution fees that, if approved, could result in a paradigm shift for the industry. This comes at a time when several other major regulatory initiatives also are being debated by the Department of Labor (DoL) and other bodies. BlackRock is carefully assessing the potential impact that these proposals could have on retail and institutional investors, mutual funds and their boards of directors, fund distributors and fund managers.

In this paper, we review several of the policy proposals currently on the table. While the various regulatory bodies may be looking at each of the proposals separately, we believe it is important to evaluate the potential impact of the many regulatory changes collectively. We fully support the ideals of transparency and protection of investors. However, taken together, we believe these proposals could significantly change the manner in which fund products are distributed and negatively impact the products and services available to investors. In addition, we are concerned that these proposals have the potential to be harmful to smaller investors and may reduce choice for investors.

SEC Proposals for Fund Distribution Fees and Related Disclosure

The SEC has proposed changes for fund distribution fees (i.e., 12b-1 fees) and disclosure. The stated objectives of the proposals are to:

- ▶ Protect investors by limiting fund sales charges;
- ▶ Improve transparency of fees for investors;
- ▶ Encourage retail price competition; and
- ▶ Revise fund director oversight duties.

SEC Chairman Mary Schapiro has stated that the proposals “are intended to provide clarity and fairness to a mutual fund distribution system that has become confusing and potentially anti-competitive. At the same time, they are designed to preserve investor choice in selecting distribution methods and to minimize operational disruptions and expensive system changes.”

Despite these good intentions, we are concerned that the proposals may inadvertently reduce choice and increase costs without providing clear benefits to investors or more effective or efficient oversight by fund boards.

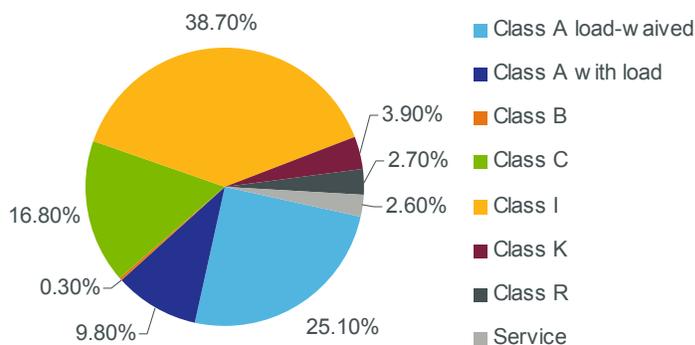
Current Marketplace: Choice Abounds

Today, investors have numerous choices when purchasing funds. A typical individual investor can buy a mutual fund from a broker-dealer, an adviser, a mutual fund supermarket or directly from some mutual fund companies. Investors also indirectly invest in mutual funds through wrap accounts, 401(k) plans, 529 plans and similar vehicles.

When buying mutual funds from a broker-dealer, the investor often may purchase Class A shares with a front-end load, Class B shares with a back-end load, Class C shares with a level load, or load-waived Class A shares or Class I shares in a wrap account (asset-based fee) portfolio. Likewise, institutional investors may purchase Class R shares or Class C shares, which charge fees that are used to offset administrative costs of 401(k) and similar plans, or they may buy institutional shares if the plan is large enough. BlackRock’s share class structure, which is fairly typical for the industry, enables clients to access BlackRock’s diverse set of equity and fixed income mutual funds with a variety of pricing options. As highlighted in Figure 1 below, actual sales reflect the different preferences of various investors for purchasing BlackRock’s mutual funds. In addition to traditional mutual funds, investors can buy exchange-traded funds (ETFs), which offer yet another fee structuring option.

These varied pricing options reflect the decades-long evolution of mutual funds as important investment vehicles for a diverse group of investors. The industry has successfully been able

Figure 1: BlackRock Mutual Fund Sales* (Gross) by Share Class (YTD through July 2010)



Source: BlackRock; data as of 31 July 2010.

* Includes sales via intermediaries and direct sales of institutional class shares.

Background: Mutual Fund Fees and Expenses

Mutual funds offer investors the advantages of professional management and portfolio diversification. Smaller investors enjoy funds' low investment minimums and the opportunity to pool their assets with other investors, affording them access to opportunities that may otherwise be unavailable to them. All funds come with fees, which can fall into two primary categories — sales charges and ongoing operating expenses (including investment management fees).

Sales Charges

Funds that impose a sales charge are known as load funds and are sold through intermediaries such as broker-dealers or financial advisers. The sales charge or commission paid directly by the investor compensates the intermediary for his or her services to the investor. The load can be paid at the time of purchase (front-end load), at the time shares are sold (back-end load), or for as long as the investor holds the fund (level load). Under FINRA regulations, total front-end and back-end loads cannot exceed 8.5% of the initial investment. The Investment Company Institute (ICI) reports that most funds charge far less than the maximum.

No-load funds are distributed directly by some investment companies and, therefore, do not charge a commission or sales charge (although they may charge a distribution or service fee of up to 25 basis points and still be considered "no load"). Similarly, load-waived funds do not require investors to pay a load, but are often available only to certain types of investors that make substantial investments (e.g., investors in wrap accounts, defined contribution plans or institutional investors).

Ongoing Operating Expenses

Generally speaking, most funds, load and no-load, require investors to pay ongoing expenses. These expenses are paid from total fund assets and, as such, are indirect expenses to the shareholder. A fund's ongoing operating expenses cover portfolio management, shareholder services, recordkeeping, administration and compliance, distribution (12b-1 fees) and other operating costs. "12b-1 fees" are named for the rule under the Investment Company Act of 1940 that authorizes them. One element of the SEC proposals is to rename "Rule 12b-1 fee;" we support this change.

Mutual funds offer a variety of pricing options, each with a different combination of sales charges, ongoing expenses and other features (such as different account minimums and service levels). The different pricing options are expressed as share classes. Most fund families offer Class A, Class B and Class C shares, and many offer R shares for retirement plans or I shares for institutional investors. The multiple pricing options available under the different share classes allow investors to choose the combination of expenses and services that suits their needs.

to offer innovative pricing structures tailored to the needs and preferences of different investors, effectively expanding the choices available and, where appropriate, instituting the common market practice of offering volume discounts in the form of lower-cost/higher-minimum-investment share classes, rights of accumulation and other means.

SEC Proposal 1: Limit Fund Sales Charges

The SEC's first proposal seeks to limit fund sales charges by restricting cumulative ongoing sales charges to an amount equal to the maximum front-end load charged by any class of the relevant fund. A typical mutual fund's Class C share (level load) carries a 25-basis-point (bp) ongoing fee for shareholder services and a 75-bp ongoing distribution and sales support (12b-1) fee (applicable to both equity and fixed income funds). These fees compensate brokers for their ongoing client service. As an example, under the proposals, if these equity and fixed income funds also offer Class A shares with respective loads of 5.25% and 4.0%, the Class C shares for the equity fund could charge the 75 bps for 7 years, and would then convert to load-waived Class A shares. Likewise, the Class C shares for the fixed income fund could charge 75 bps for 5.3 years, and then convert to load-waived Class A shares. (The 25-bp marketing and service fee applicable to Class C shares would also remain in affect.) For investors with a shorter investment horizon, this may not present an issue, as they will redeem their shares before the cap is met. However, for longer-term investors, brokers will no longer earn the ongoing 75 bps of revenue, which may impact service levels for Class C investors.

The elimination of these fees would result in revenue losses for broker-dealers, which they would likely seek to replace through other sources. In the most likely scenario, many clients would move to advisory programs ("wrap accounts"), which charge ongoing "wrap" fees that encompass both investment advisory fees and sales compensation on purchases and sales of wrap account investments, including mutual funds and ETFs. Alternatively, some broker-dealers may require increased revenue sharing from fund sponsors, which will result in distribution costs becoming less transparent to investors. This is directly counter to one of the stated objectives of the rule proposals. In addition, the shift to increased revenue sharing will eliminate some of the board oversight relief that was one of the other stated goals of the proposals, as boards will need to spend additional time reviewing revenue-sharing arrangements in the overall context of adviser profitability.

Wrap accounts typically are designed for investors seeking discretionary investment advice from their financial intermediary. In our experience, wrap account investors tend to have larger account balances than typical fund investors and appear to be more willing to pay for professional investment advice. Investors who enter into wrap accounts would be faced with fees that are typically 1% or more based on the assets under management for as long as the investment is in the account.

Smaller investors will be especially harmed by this shift from commission-based fees to asset-based fees, as their wrap account fees will likely exceed the 12b-1 fees they are now paying, both annually and over the life of their investment.

According to Cerulli Associates, the average annual wrap advisory fee is 1.14%, though listed prices can be as much as 1.5% and higher (not counting underlying fund fees). See Figure 2 below. This compares to the typical Class C share aggregate service and 12b-1 fee of 1%. In addition, unless they are in a nondiscretionary wrap program, these investors may no longer retain discretion over their portfolios, as the terms of the wrap agreement may delegate discretion to the broker. As a result, investors who seek advice, but do not want to grant discretion to the broker via a wrap account, will face reduced choice. At the extreme, smaller investors may find themselves shut out of an advice model, as wrap accounts typically have a minimum investment requirement that is higher than A or C shares. Statistics gathered by Cerulli Associates show that minimums for mutual fund advisory and rep-as-adviser platforms range from \$10,000 to \$50,000, with most minimums around \$25,000 and an average of roughly \$39,000 (see Figure 3). By contrast, most mutual funds in a general brokerage arrangement offer initial investment minimums of \$1,000. Ultimately, small investors may be left to do their own fund research and manage their portfolios without the benefit of professional advice. It is also worth noting that, when investing via a mutual fund supermarket, an individual investor would, in some cases, incur transaction costs of up to \$75 on both the purchase and the sale of fund shares, in addition to any applicable fund sales charges.

In the current retail marketplace, investor choice abounds. Investors willing to pay for discretionary investment advice, and able to meet the higher minimums that typically apply, often

Figure 2: Average Wrap Fees Exceed Average Class C 12b-1 Fee

Advisory Platform Fees, Q2 2009	
Average Annual Wrap Advisory Fee	1.14%
Average "All In" Wrap Advisory Client Fee	2.06%
Average Annual Rep-as-Adviser Fee	1.03%

Source: Cerulli Associates

Figure 3: Wrap Account Minimums Difficult for Small Investors

MF Advisory Minimums, Q2 2009	
Lowest Reported	\$5,000
Average	\$38,902
Highest Reported	\$150,000

Source: Cerulli Associates

choose to invest in funds through wrap accounts. Smaller investors who want assistance from financial intermediaries, but who cannot afford to invest through a wrap account, are still able to access financial intermediaries using C shares. If the proposed rules take effect, we fear that this model will disappear, and smaller investors will either be driven to wrap account programs that are more expensive than C shares, or may be forced to forego professional investment assistance entirely if C-share programs are phased out.

Participants in defined contribution [401(k)], deferred compensation (457) and college savings (529) plans will feel the affects of the fee changes as well. Smaller plans (under \$10 million) will be impacted the most. Today, mutual funds are the vehicle of choice within the 401(k) marketplace, especially within the micro, small and mid-sized plans. This model reflects the need for smaller firms to minimize the administrative work and operational costs of offering retirement plans.

As with direct sales of mutual funds, the varying share class structures and their differing expense ratios provide plan sponsors with flexibility in how and how much they pay for services provided to their plan and its participants. According to Strategic Insight, about 50% of funds in retirement plans charge 12b-1 fees of 25 bps or more (some as high as 1%), while the remaining funds charge fees of 25 bps or less. In aggregate, Strategic Insight estimates that \$100 billion of participant assets will be affected by the proposed fee changes.

Under the current fee structure, plan sponsors can offer 401(k) plans without incurring costs, as the costs of servicing participants are passed on to the participants in the form of 12b-1 and service fee payments. We anticipate that the proposed changes designed to limit the maximum sales charge paid by investors would require substantial operational and back-office retooling — costs incurred by service providers that ultimately would be recouped from plan sponsors.

As highlighted in Figure 4 on the following page, the largest plans tend to use Class I shares (with no 12b-1 fee) and the smallest plans tend to use Class C shares, which enables them to offset the costs of administering their plans. These costs are continual and need to be covered year after year; therefore, any change that caps fees or curtails fees after a certain period of time will impact the ability of plan sponsors to offer these plans. Given the increased work and the inability to pass through costs to participants, plan sponsors may decide not to offer defined contribution plans to employees.

SEC Proposal 2: Increased Transparency

The second proposal focuses on improving transparency for investors by renaming 12b-1 fees and adding sales charge disclosure to transaction confirmations. We fully support renaming 12b-1 fees, as the current name is not inherently

meaningful nor is it descriptive for the investor. A new name, such as “ongoing marketing and service fees,” would be more intuitive, and should be combined with additional disclosure in the prospectus to help investors understand the ongoing services they are to be receiving in exchange for such fees.

While we support the concept of providing additional sales charge information to mutual fund investors, the implementation of a requirement to add this information to transaction

confirmations will present many challenges and may be impractical and costly. First, the only source for this information is the fund prospectus and statement of additional information (SAI). Unfortunately, there is no systematic way for broker-dealers or other financial intermediaries to update fee changes and sales charge breakpoints in many different databases. Second, there is the question of precisely what fee must be disclosed on the confirmations. Without the benefit of a

Figure 4: Current Fee Structure Provides Flexibility for 401(k) Plans of All Sizes

			C Shares 100 bps	R Shares 50 bps	A Shares 25 bps	I Shares 0 bps
\$500,000 Plan AUM	TOTAL FEE		\$5,000	\$2,500	\$1,250	- 0 -
	Per Participant	33 @ \$15K per	\$151.52	\$75.76	\$37.88	- 0 -
		20 @ \$25K per	\$250.00	\$125.00	\$62.50	- 0 -
		13 @ \$40K per	\$384.62	\$192.31	\$96.16	- 0 -
\$1 Million Plan AUM	TOTAL FEE		\$10,000	\$5,000	\$2,500	- 0 -
	Per Participant	67 @ \$15K per	\$149.25	\$74.63	\$37.31	- 0 -
		40 @ \$25K per	\$250.00	\$125.00	\$62.50	- 0 -
		25 @ \$40K per	\$400.00	\$200.00	\$100.00	- 0 -
\$5 Million Plan AUM	TOTAL FEE		\$50,000	\$25,000	\$12,500	- 0 -
	Per Participant	333 @ \$15K per	\$150.15	\$75.08	\$37.54	- 0 -
		200 @ \$25K per	\$250.00	\$125.00	\$62.50	- 0 -
		125 @ \$40K per	\$400.00	\$200.00	\$100.00	- 0 -
\$10 Million Plan AUM	TOTAL FEE		\$100,000	\$50,000	\$25,000	- 0 -
	Per Participant	667 @ \$15K per	\$149.92	\$75.76	\$32.88	- 0 -
		400 @ \$25K per	\$250.00	\$125.00	\$62.50	- 0 -
		250 @ \$40K per	\$384.62	\$192.31	\$96.16	- 0 -
\$50 Million Plan AUM	TOTAL FEE		\$500,000	\$250,000	\$125,000	- 0 -
	Per Participant	3,333 @ \$15K per	\$151.52	\$75.76	\$32.88	- 0 -
		2,000 @ \$25K per	\$250.00	\$125.00	\$62.50	- 0 -
		1,250 @ \$40K per	\$384.62	\$192.31	\$96.16	- 0 -
\$100 Million Plan AUM	TOTAL FEE		\$1,000,000	\$500,000	\$250,000	- 0 -
	Per Participant	6,667 @ \$15K per	\$151.52	\$75.76	\$32.88	- 0 -
		4,000 @ \$25K per	\$250.00	\$125.00	\$62.50	- 0 -
		2,500 @ \$40K per	\$384.62	\$192.31	\$96.16	- 0 -

The above table depicts the various share classes used within the defined contribution industry, the service and distribution fees available within each share class, and how much revenue those fees generate to service providers at different plan levels. Boxes highlighted in yellow represent the fee that would be generated by a plan of median assets under management (AUM) where that share class is typically used, while boxes highlighted in green represent plans at the high AUM size for that range. The table summarizes this data on both a plan level and a per-participant level.

To us, the key points to this data are: (a) The current share class structures provide flexibility and portability of retirement plan assets between share classes, fund families, types of plans and plan sponsors; (b) at present, service provider compensation is flexible, disclosed and is transparent to all interested parties, as per the prospectus; and (c) changing or capping the available fees would most likely impact the smallest plans where the biggest reduction in total revenue would occur. This could have the potential affect of reducing service, passing hard-dollar fees onto the plan sponsor and/or passing hard-dollar fees onto the plan participants.

prospectus-type explanation, a simple number in basis points or dollars will be more confusing than helpful. How would an investor interpret a 4% front-end load and compare it to a C-share fee arrangement? Additionally, under the proposals, the confirmation would disclose the maximum sales charge the investor could incur, although the actual sales charge paid will vary depending on how long the investor holds the funds. This approach may confuse investors rather than help them to make more-informed decisions since the confirmations are designed to be post-sale documents that enable investors to confirm the details of a completed transaction. Under the current rules, broker-dealers send the prospectus to the client within three days of the trade. This system affords investors more complete information than could be provided on a transaction confirmation.

SEC Proposal 3: Competitive Pricing

The third proposal introduces a new type of pricing designed to encourage price competition among broker-dealers. Under this proposal, mutual fund companies would be able to sell shares through broker-dealers at commission rates established by the broker-dealers rather than being subject to a sales charge at the fund level. We would argue that, in today's marketplace, price competition already exists in that investors can buy mutual funds through supermarkets, broker-dealers or financial advisers, or even directly from some fund companies. Investors willing to pay for discretionary investment advice also can access funds through wrap accounts.

While this new provision may be interesting to some distributors, implementation of this proposal is likely to require significant and costly operational changes for distributors and for mutual fund companies. Due to the costs involved, this proposal is likely to favor scale players that can bear the infrastructure costs this proposal will entail over smaller firms that have fewer resources available to them, once again resulting in reduced choice for some investors. In addition, it will be cumbersome to apply a different sales charge rate to each purchase and is likely to substantially drive up costs of subaccounting and transfer agent services, especially where omnibus accountholders currently enjoy the benefits of scale. Moreover, with different firms charging different sales charges for the same funds, recordkeeping will be complicated in instances where financial advisers and/or clients leave one firm for another. The industry will need to develop mechanisms to track not just share purchase dates, but also historical sales charge rates charged during the life of the investment (which may include different rates applied by different firms at different times of the investment's life). The systems to track these amounts do not currently exist and, as such, the cost of implementing these changes is unknown. The cost uncertainty alone is likely to dissuade many firms from offering fund shares at their own sales charge rates. Coupled with the broker and investor confusion likely to result during any transition period from the current

pricing scheme to any new scheme, BlackRock believes these factors are not likely to result in the desired price competition.

Given the existing competition in the market and the array of pricing choices described earlier, combined with the potential administrative costs associated with this proposal, the value of yet another fee structure is unclear. Ultimately, this proposal is likely to expand the number of available share classes (particularly during the grandfather period), leading to confusion for both shareholders and brokers. Finally, as with the first proposal, this proposal is likely to lead smaller investors into wrap accounts that are designed primarily for investors willing and able to pay for discretionary advice, thus reducing their flexibility and possibly increasing their total costs. In our view, the costs of implementing this pricing proposal appear to outweigh the benefits of any increased competition that may result.

SEC Proposal 4: Revised Duties for Directors

The fourth proposal would revise mutual fund directors' duties by proscribing limits on sales charges and eliminating the need for directors to spend time reviewing detailed data about 12b-1 fees. Theoretically, this would allow mutual fund directors more time to focus on oversight of other aspects of mutual fund operations. Under current rules, boards spend a significant amount of time reviewing and approving 12b-1 arrangements and related payments, even though the boards play only a limited role in setting distribution and related fees.

As the SEC noted in the Proposing Release, the current operation of Rule 12b-1 no longer reflects the realities of today's fund marketplace. Therefore, we believe there is a need to provide clear guidelines for ongoing fees and services, which would eliminate the uncertainty regarding the standards to be applied to the board's oversight of distribution payments, as well as the need for extensive and repetitive 12b-1 reviews. Regardless of whether the other proposals move forward, this aspect of the proposals would improve oversight by mutual fund boards. Unfortunately, however, several aspects of the proposals may have the unintended effect of shifting fund director focus from 12b-1 fees to overall distribution costs, particularly as it relates to the oversight of ongoing sales charges and the annual Section 15(c) profitability review process performed by fund boards. This will certainly be the case if the current economic model of how mutual fund distribution is financed is overturned, and broker-dealers and other financial intermediaries insist on pursuing revenue sharing arrangements as a way to make up for lost 12b-1 fee revenue. Even with clearer guidance from the SEC on what factors the boards should weigh in considering distribution expenses and revenue sharing arrangements, it is unclear that the boards will realize significant benefits in terms of their required oversight of fund expenses. In our view, directors will always exercise their business judgment in considering these matters, and it is unclear that the proposals, in aggregate, will measurably improve director oversight of funds.

DoL Regulations for Defined Contribution Plans

Over the past few years, the Department of Labor (DoL) has developed new regulations on disclosure of service provider compensation in connection with services provided to employee-benefit plans and certain products in which they invest, starting with the new Form 5500 Schedule C reporting requirements (effective starting with 2009 plan years), followed by the new Interim Final 408b-2 regulations (Interim Final Regulations) released on July 15, 2010. The objective of these disclosure initiatives is to provide information that will enable plan fiduciaries to assess the reasonableness of contracts and other arrangements for services by requiring more detailed disclosure of direct and indirect compensation, highlighting any potential conflicts of interest that may affect the service providers' performance. The Interim Final Regulations are expected to be effective as of July 16, 2011.

There is no proscribed format for the new disclosures required under the Interim Final Regulations. However, they will need to detail the services provided to, and the compensation (direct and indirect) received in connection with, plans and certain investment products, including brokerage services, recordkeeping and compensation among related parties. Since many 401(k) plans offer mutual funds as investment options, these regulations will require mutual fund-related service providers, such as plan recordkeepers, to respond.

On October 20, 2010, the DoL issued new requirements for disclosures to participants in 401(k) and other participant-directed plans. The information must be furnished in a chart or similar format that compares the investment fees, benchmarks and performance of each available investment option. Importantly, defined contribution providers face uncertainty as to how best to respond to these varying disclosure requirements, particularly given both the continuing discussions on 12b-1 fees and the ongoing efforts in Congress. Many industry participants are concerned that the uncertainty will continue as Congressman George Miller (D-CA), chairman of the House Committee on Education and Labor, has proposed yet a different set of fee disclosure rules that go much further than the Form 5500 Schedule C disclosure requirements and the Interim Final Regulations. Congressman Miller's alternate proposals even suggest a bias toward low-fee index products, regardless of other characteristics of the fund. These proposals seem well beyond the scope of improved disclosure and exacerbate the uncertainty for 401(k) plan providers related to mutual fund distribution and 12b-1 fees.

We continue to support increased disclosure that enables plan fiduciaries to compare service providers and make informed decisions on behalf of their plan participants. We agree with DoL's distinction between those disclosures necessary for plan fiduciaries to meet their obligations as contrasted with those

disclosures necessary for plan participants to make informed investment choices from among the designated investment alternatives under their plan. We are also sensitive to the challenges presented to plan fiduciaries when large amounts of information are presented in multiple contexts (e.g., before entering into a contract and at the close of a plan's year) and in varying formats, which may not necessarily facilitate a plan fiduciary's understanding of service provider arrangements or comparison among service providers. Given the growing uncertainty around mutual fund distribution models and the existing disclosure regime for mutual funds alongside an enhanced DoL framework of disclosure for retirement plans, it is imperative to finalize a set of rules, as operational changes are expensive and time-consuming to implement. Without such agreement from Congress, the DoL and the SEC, market participants run the risk of not meeting implementation deadlines, and some may need to reduce other client services as they scramble to keep up.

DoL and SEC Proposals for Target Date Funds

Background

Target date funds were introduced to the defined contribution marketplace in 1993 to afford plan participants the opportunity to invest in professionally managed, diversified portfolios consisting of stocks and bonds. The Pension Protection Act (PPA) of 2006 included guidance for plan fiduciaries on allowable default options, called Qualified Default Investment Alternatives (QDIA). These rules explicitly encouraged plan sponsors to use "asset allocation" products as the default investment option for participants who did not choose to select their own investment options. Not surprisingly, the use of target date funds accelerated. An analysis by the Employee Benefit Research Institute (EBRI) found that, at year-end 2008, 75% of 401(k) plans included target date funds in their investment lineup and 31% of 401(k) participants held these products.

In the financial crisis of 2008, target date funds declined in value as the equity markets declined. Unfortunately, some investors did not understand the equity holdings underlying the target date funds, and some of these investors were surprised by the sharp declines in value. Most participants who remained invested in their target date funds recouped their losses in 2009; however, legislators and regulators had already begun to scrutinize the product.

Actions and Proposals

There is little dispute that target date funds are an innovative solution for the average 401(k) investor who does not have the expertise, interest and/or time to manage his or her own portfolio. However, not all target date funds are the same. Each provider brings a different investment philosophy and approach, which can significantly impact the risk profile of funds with similar

names. Some of the key factors are: the glidepath of the asset allocation through the retirement date (i.e., what portion of fund assets is invested in equity, fixed income or cash), the use of active versus passive strategies, the number and types of underlying funds, and the management of the post-retirement longevity risk. In May 2010, the SEC and DoL recognized these differences and jointly issued guidance to investors. In addition, the DoL is developing a due diligence checklist for plan fiduciaries to use in evaluating and selecting target date funds.

In June 2010, the SEC issued a proposal on marketing materials, including recommendations around the naming convention for target date funds and improved disclosure. The objective of this proposal is to increase investors' awareness of the risks involved with the funds. Per the SEC, "We are proposing to require a target date fund that includes the target date in its name to disclose, together with the first use of the fund's name, the asset allocation of the fund at the target date." Many industry leaders believe that adding the asset allocation to the name of a fund will confuse investors rather than provide insight for investment decisions.

The Defined Contribution Institutional Investment Association (DCIIA) recently filed a detailed letter highlighting the industry's concerns with this proposal. Some of the key issues discussed in this letter include information overload for investors, the risk of confusion around the meaning of the disclosure of the equity landing point, and the importance of the role of plan fiduciaries when target date funds are made available through tax-qualified employer-sponsored plans. Rather than focusing on the name of the fund or adding confusing language when the fund name is first used, we recommend requiring clear disclosure on the investment philosophy of the fund — including passive/active glidepath, passive/active underlying funds, asset allocation through the target date, single versus multiple manager and diversification within asset classes — and addressing the topics highlighted in the DoL guidance noted above.

Dodd-Frank Bill Follow-On Study of Fiduciary Standards

The Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) requires the SEC to study the effectiveness of existing standards of care for broker-dealers and investment advisers, with the objective of developing a "harmonized" standard of conduct for these professionals when providing personalized investment advice to retail customers. To aid in this effort, the SEC solicited investor and industry views on the topic.

As Chairman Schapiro noted, "Comments that recognize the primary and central importance of investor protection, but offer suggestions on implementing fair and flexible regulation, will help us craft rules that increase investor confidence while preserving brokers' ability to offer a full spectrum of services." Under the Dodd-Frank Act, the study is due in January 2011, and the SEC is expected to promulgate regulations soon thereafter.

This review arises from concerns that retail investors are confused about the potential variation in standards of care between broker-dealers (who operate under a "suitability" standard) and investment advisers (who have a duty established by case law to act in the best interest of their clients). BlackRock agrees that these inconsistent standards may be confusing to some retail investors. However, a recent RAND study concluded that clients do not differentiate between the two models and that most clients are satisfied with their provider.*

Wisely, the Dodd-Frank Act authorizes the SEC, should it decide to adopt rules providing for a uniform standard of care, to also include in those rules that potential conflicts of interest of broker-dealers (acting as principal in filling orders from inventory and selling only proprietary or other limited range of products) may be handled through notice to and consent by the retail customer. In addition, we support the requirement that the rules should be designed to facilitate the provision of simple and clear disclosure to investors regarding their relationships with broker-dealers and investment advisers, including disclosure of compensation methods and material conflicts of interest.

In our view, this balanced approach recognizes the important goals of increasing investor confidence and strengthening investor protection, while preserving consumer choice both in the selection of an investment professional and in the means for compensating this professional. We believe it is important to recognize the validity of different business models, from "execution- or distribution-only" services to full-scope investment advice. When providing advice, both broker-dealers and investment advisers should be required to disclose their fees and/or sources of compensation. At the same time, the retail investor also should be able to decide how he or she wishes to pay for advice (via a one-time fee, wrap or ongoing advisory fees, or commissions on trade activity), provided that clear and relevant disclosure is made available by the investment professional so the choice is an informed one.

Recommendations and Conclusion

We are concerned that the current package of regulatory changes will fundamentally impact investors' ability to choose the products they want and to pay for mutual funds as they wish. In addition, we fear the increased operational costs that would result from the proposed changes will either be passed along to consumers in the form of higher fees, will result in a lowering of service levels, or both. Smaller investors and smaller retirement plans will be especially harmed as distributors assess and adjust the revenues and expenses of their business models. Finally, such a comprehensive change will have unknown implications for jobs at distributors and asset management companies. Attrition in the industry resulting from revenue-driven cost

* "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers," issued by the LRN-RAND Center for Corporate Ethics, Law, and Governance within the RAND Institute for Civil Justice, as commissioned by the US Securities and Exchange Commission (SEC) in 2008.

reductions could lead to reduced services and inferior results for clients, all of which is directly counter to the objective of enhancing investor protection.

BlackRock supports financial regulatory reform that increases transparency, protects investors and facilitates responsible growth of capital markets, while preserving customer choice and assessing benefits versus implementation costs.

Holistic Approach

While some of the proposals discussed in the preceding pages may have elements of merit in and of themselves, we believe these proposals need to be reviewed holistically, weighing the impact that all reforms collectively would have on the industry. Ultimately, the goal should be to avoid the unintended consequences of reducing investor choice and/or increasing costs to shareholders. We recommend providing clear guidelines around policies and fees, making it possible to simplify board approval processes and thereby free up directors' time for other discussions pertinent to shareholders. Clear direction also is needed in terms of 401(k) plan sponsor and plan participant disclosure. This requires coordination across regulators in order for recordkeepers and others to meet implementation deadlines.

Improve Disclosure

We believe in full and fair disclosure. However, inundating plan sponsors or investors with voluminous data can be a source of confusion rather than a help. We favor adding meaningful disclosure, with an emphasis on "plain English" verbiage over legalese. This is particularly true as it relates to terms such as the more precise "ongoing marketing and service fees" versus the more nebulous "12b-1 fees." Similarly, to the extent the overhaul of fund distribution results in expanded revenue sharing arrangements, it is likely that fee disclosure will be even more opaque unless additional guidance is forthcoming. With respect to the proposed fee disclosures to investors, if additional, helpful information can be supplied without requiring excessive systems implementation costs and fundamental changes to the way funds and broker-dealers make fee and other information available to

investors, we are fully supportive. However, the costs and burdens imposed by any new disclosure requirements should not outweigh the intended benefits of the disclosure enhancements.

In terms of target date funds, plain English disclosure of the investment philosophy and risks, rather than a change in the naming convention, will make it easier to understand the product and compare funds. Finally, we would discourage disclosure guidelines that would have the effect of disadvantaging mutual funds versus competing products. For those products available in 401(k) and similar tax-qualified employer-provided plans, consistent disclosure guidelines from the SEC and DoL would be appreciated by employers and the industry. Investors today can choose among many products. This type of competition is healthy, in our view, and mutual funds should not be subject to rules that would disadvantage them relative to other products.

Preserve Choice

Investor choice has been at the heart of the mutual fund industry since its earliest days. The current multi-share class, multi-fee system allows investors to choose among an array of options suited to their needs. We are concerned that the proposed changes will reduce product choice, especially for smaller investors and smaller defined contribution plans. Equally important is investor choice when it comes to investment advice and services, and how to pay for each. Assuming robust and fair standards of disclosure, we believe investors should be free to choose their investment intermediary and how to compensate them for their services.

Overall, we recommend an approach that emphasizes clear guidelines for allowable fees and improved disclosure for investors. Only in this way can we as an industry make change that ensures investor protection without undermining the solid foundation on which mutual funds have been distributed and thrived over the many decades since their introduction.

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