DONOR–ADVISED FUNDS:
THE APPLICABILITY OF RULE 12B-1 FEES AND TRAIL COMMISSIONS

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Introduction

In the financial services marketplace, it is a widely-used and well-accepted business practice of long standing for a mutual fund to pay distribution and servicing expenses to brokers, dealers and other third-party financial advisors who sell or recommend any particular mutual fund to their clients and customers.

In the context of charities soliciting and accepting contributions maintained in donor-advised funds, similar practices have arisen in the marketplace. The same brokers, dealers and financial advisors who sell or recommend mutual funds to investors may also refer those same persons to charities as prospective donors who wish to establish donor-advised fund accounts. As a result, it is important to understand how these brokers, dealers and financial advisors may be compensated for their referrals. In particular, attention has begun to focus on the use of "12b-1 fees" or "trail" commissions as a form of compensation for the referral of donors. But what are 12b-1 fees and trail commissions and how are they being applied in the donor-advised fund context? This article seeks to answer that question.

Donor Advised Funds

Donor-advised funds have existed for many years, but have grown explosively in recent years. In summary, donor-advised funds are separate accounts maintained by a charitable organization (the "sponsoring charity"). A donor to the sponsoring charity makes an irrevocable gift to the sponsoring charity, and the sponsoring charity obtains full legal control and ownership of the property contributed. In a donor-advised fund, the sponsoring charity undertakes to maintain a separate account with respect to that donor's contributions, and the donor is permitted to retain the privilege to recommend grants to be made by the sponsoring charity from funds maintained in the donor-advised fund. The sponsoring charity reviews grant recommendations, and, if approved, makes a grant to the intended recipient.

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In addition to the grant recommendation privilege retained by the donor, the donor may have limited privileges to designate how the funds held in the donor-advised fund should be invested up until the time a grant is made. In a common arrangement, a donor is permitted to recommend at the time of contribution and at periodic intervals how the sponsoring charity should invest the funds maintained in that donor-advised fund, from a choice among a limited range of "pools," each investment pool being made up of one or more open-end investment companies (commonly referred to as "mutual funds") registered with the Securities and Exchange Commission (the "Commission") pursuant to the Investment Company Act of 1940, as amended (the "Investment Company Act").

Under this arrangement, the balance in a donor-advised fund account varies according to the fluctuation in the value of the underlying mutual fund shares in which the assets of the account are invested. The value of shares held in the mutual funds, in turn, is determined according to their respective net asset values. The net asset value of a share in a mutual fund reflects that share's proportionate interest in the underlying investments of the fund, and also reflects the expenses incurred by the mutual fund in the course of its operations.

Compensation for Sales of Shares of Registered Open-end Investment Companies

Given that a sponsoring charity may invest donor-advised fund assets in mutual funds, it is important to understand how a mutual fund conducts business in offering its shares. The manner in which a mutual fund offers its shares to the public differs significantly from the manner in which other companies offer their shares. Mutual fund shares are purchased from and redeemed by the mutual fund directly and are not traded on a national securities exchange, such as the New York Stock Exchange or NASDAQ. In other words, whereas other companies that make public offerings of their shares offer a set number of shares to the public that trade on an exchange, a mutual fund offers an indefinite number of shares that do not trade on an exchange but rather are sold and redeemed by or through the fund's "principal underwriter"[2] or, as more commonly referred to, the "distributor." In turn, the distributor enters into selling agreements with brokers, dealers and/or financial advisors who undertake to offer shares of the mutual fund to their customers.[3]

How are these brokers compensated? Until 1980, mutual funds were sold only in one of two ways: either as "load" funds or as "no load" funds. Investors purchasing shares of a "load" fund pay a sales charge to the fund upon the purchase of shares. This payment is commonly referred to as a "front-end sales charge." The front-end sales charge is deducted

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[2] Investment Company Act Section 2(a)(29). The principal underwriter may either purchase the securities from the mutual fund directly with a view to further distribution to the public, or as agent for the mutual fund has the right to sell the securities on the fund's behalf. While it is possible for a mutual fund to distribute its shares without the use of a distributor and brokers, the more common arrangement is for a mutual fund to use a distributor and brokers.

[3] For the remainder of this article, references to "brokers" shall include brokers, dealers and other financial advisors.

from the investor's initial investment. In other words, if a fund charges a 4% front-end sales charge and the investor makes a $100,000 initial investment, only $96,000 is actually invested in the fund. The fund pays the $4,000 sales charge to the distributor and the distributor remits all or a portion of the sales charge to the broker who recommended the fund to its customer.[4]

Prior to 1980 a mutual fund could not use its own assets to pay for distribution expenses (i.e., to compensate the brokers for recommending the fund to its customers). The broker was compensated either from the proceeds of the investor's investment or by the investment manager out of its own pocket. The Commission's view was that the cost of selling and purchasing mutual fund shares should be borne by each investor upon purchasing the shares and not spread amongst all of the existing shareholders over time.[5] But in 1980 the Commission adopted Rule 12b-1 under the Investment Company Act, which authorizes the use of mutual fund assets to pay for and finance distribution expenses. Under Rule 12b-1, those distribution expenses include expenses incurred in connection with any activities which are "primarily intended to result in the sale of shares . . . including . . . advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature."[6] Proponents of Rule 12b-1 were of the view that to permit a mutual fund to finance the distribution of its shares would increase the size of the fund, yielding several benefits to all of the fund's shareholders — the achievement of economies of scale because of a decline in the overall expenses per share, the ability to maintain significant portfolio diversification and the ability to obtain better and cheaper portfolio brokerage services.[7]

Rule 12b-1 has several requirements intended to protect against abuses. In order for a mutual fund to use its assets to pay for or finance the distribution of its shares, the fund must adopt a written plan that describes "all material aspects of the proposed financing of the distribution."[8] The Rule also requires the Board and, under certain circumstances, the fund's shareholders, to approve the adoption of the plan and material amendments.[9] The Board must conclude that there is a "reasonable likelihood" that the fund and its shareholders will benefit from payments made under the 12b-1 plan.[10] The Board of Directors must also approve the continuation of the plan on an annual basis and the Board must receive written reports on a

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4 In some "no-load" funds, brokers were compensated by the investment manger of the fund out of the investment manger's own funds.

5 See The Colonial Group, Incorporated, SEC No-Action Letter, 1986 WL 66886 (S.E.C.) (publicly available June 4, 1986) ("Colonial") at 1-2.

6 Investment Company Act Section 12b-1(a)(2).

7 See Colonial at 3.

8 Investment Company Act Section 12b-1(b).

9 *Id.*

10 Investment Company Act Rule 12b-1(e).

quarterly basis of amounts expended under the plan and the purposes for which they were expended. The prospectus and statement of additional information for a mutual fund, which must be updated annually, are required to disclose the details of a mutual fund's 12b-1 plan and payments made under the plan during the prior year.[11]

As a result of the adoption of Rule 12b-1, different methods developed in the financial services marketplace for financing the distribution of mutual funds shares, including the transformation of the old distinction between load and no-load funds into a variety of structures and permutations. For example, as an alternative to a front-end sales charge, or in conjunction with a lower front-end sales charge, a shareholder could be offered shares with respect to which the fund's assets could be used to pay an annual "12b-1 fee" to the distributor (generally at an annual rate ranging from .25% to 1.00% of the net asset value of the shares). The benefit of this arrangement to the investor is that a greater portion of the purchase price, perhaps even 100%, is invested. Rather than bearing a front-end sales charge, the shareholders as a group bear this expense. The net asset value of the fund's shares will reflect the payment of this fee.

Actually, there are two types of 12b-1 fees: a "12b-1 distribution fee," in an amount up to 0.75% of the net asset value of the shares, and a "12b-1 service fee," in an amount up to 0.25% of the net asset value of the shares. The 12b-1 distribution fee serves to compensate brokers for assistance in the sale and distribution of mutual fund shares, which can include compensation for services that will result in the distribution of fund shares, and the 12b-1 service fee serves to compensate brokers for personal service and/or maintenance of accounts. The bifurcation of these fees into the categories of "distribution" and "service", and the caps of 0.75% and 0.25%, respectively, reflect rules promulgated by the National Association of Securities Dealers ("NASD"), the self-regulatory agency for brokers and dealers. The NASD Code of Conduct Rules provide that an NASD member may not offer to sell shares of a mutual fund that charges distribution and service fees in excess of an annual rate of 0.75% and 0.25%, respectively.[12]

Even though the 12b-1 fee is an annual fee paid from the fund's assets, the typical arrangement is nevertheless for the broker to receive a sizable portion of his or her compensation up-front out of the distributor's own pocket. Over time, the distributor recoups the advanced commission from the 12b-1 fee. The broker may also receive a "trail" commission paid over time, which is intended to reflect compensation to the broker for providing on-going services. The amount and length of time over which trail commissions are paid varies and is discussed in more detail below.

Finally, in some arrangements, shares are subject to the opposite of a front-end sales charge — a "back-end" sales charge imposed upon the redemption of shares, referred to as a "contingent deferred sales charges" or "CDSC." The purpose of a CDSC is to reimburse the

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[11] See Form N-1A, Registration Statement of Open-End Management Investment Companies.

[12] See NASD Code of Conduct Rule 2830.

distributor if a shareholder redeems its shares before the distributor recoups the advanced sales commission paid by the distributor to the broker. The CDSC is deducted from the investor's redemption proceeds and therefore, like the front-end sales charge, is paid out of the investor's funds and not out of the fund's assets.

It is now quite common for a single mutual fund to offer investors the option to invest in one of several different classes of shares.[13] Each class of shares has a common undivided interest in the portfolio of securities held by the fund, but each class is subject to a different set of fees and expenses.[14] Each class of shares may charge a different combination of front-end sales charges, Rule 12b-1 fees and contingent deferred sales charges. The reason a single mutual fund will offer different classes of shares is to attract investors with different needs and characteristics. The particular class of shares best suited for an investor will primarily depend upon the anticipated size of the investor's investment and on that investor's investment horizon (e.g., long-term vs. short term), as well as services provided to the investor by his or her broker.

While there are numerous permutations, to illustrate the concept the following is a hypothetical multiple class structure:[15]

	Class A	Class B[16]	Class C
Front-End Sales Charge (deducted from the investor's initial investment)	5.75% (distributor pays all to the broker) (decreases as purchases get larger)[17]	None (distributor pays broker an up-front commission, e.g. 4.00%)	None (distributor pays broker a commission, e.g. 1.00%)

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13 In 1995, the Securities and Exchange Commission adopted Rule 18f-3, pursuant to which a mutual fund may issue multiple classes of shares. Prior to the adoption of this rule, mutual funds were required to obtain specific exemptive relief from the Commission in order to issue multiple classes.

14 The fee paid to the fund's investment adviser may not vary by class. Investment Company Act Rule 18f-3(a)(1)(ii).

15 The features of multiple class structures and 12b-1 plans implemented by mutual fund complexes vary significantly.

16 Class B shares convert to Class A shares after six years. After six years of charging a 12b-1 distribution fee, the distributor will have recouped its advance to the broker. Similarly, the CDSC has declined to zero as well. The CDSC serves as a mechanism to compensate the distributor because no front-end sales charge was imposed, in case the shareholder redeems the shares before the 12b-1 fees have compensated the distributor. As each year passes, the distributor earns more money, and the need for the CDSC declines proportionately. So, after six years the Class B shares convert because the fees paid are economically comparable to Class A shares at that point.

17 Some mutual funds waive the Class A front-end sales charge and/or the Class B and Class C CDSCs for certain classes of investors, such as participants in 401(k) programs or investors who purchase shares through "asset allocation" programs sponsored by financial institutions who may charge their own fees.

	Class A	Class B[16]	Class C
Contingent Deferred Sales Charge ("CDSC") (deducted from the investor's redemption proceeds)	None	5.00% (declines to zero over six years)	1.00% (only if redeemed within one year of purchase)
Annual 12b-1 distribution and service fees (deducted from each class' assets)	.25% (may be paid to the broker)	1.00% (.25% paid to broker)	1.00% (all paid to broker after 1st year of investment) (distribution and service)

What is the logic behind these various permutations? In the hypothetical above, an investor with a relatively short-term horizon (e.g., less than six years) should consider Class A or Class C as opposed to Class B because of the combined effect of the Class B 12b-1 fee and the CDSC. Furthermore, if the investment is under a certain amount, Class C is preferable to Class A because there is no front-end sales charge on Class C and the Class C CDSC does not apply if the shares are held for more than one year. But as the size of the investment gets larger, Class A starts to become preferable to Class C because the Class A sales charge declines as the size of the investment increases and may not apply at all for large investments over a particular amount (e.g., $1,000,000). At a certain level of investment, the reduced Class A sales charge will have a lesser impact than the Class C 12b-1 fee. Class B makes most sense for long-term investments under a certain amount. The CDSC will decline to zero, the 12b-1 fee will decrease from 1.00% to 0.25% because the shares will convert to Class A after six years (which makes it a better investment than Class C at that point) and no front-end sales charge is paid upon investment (which makes it a better investment than Class A). Class A will make most sense for large investments that qualify for a reduced sales charge or no sales charge. For the benefit of potential investors, a mutual fund that offers multiple classes will disclose the foregoing fee arrangements of the various classes.

What do these different permutations mean for the brokers? It is important to remember that front-end sales charges, contingent deferred sales charges, and 12b-1 fees have a common underlying purpose: to compensate the distributor and the brokers for offering and recommending the shares to their customers and providing related customer service. The amount of compensation received by a broker may differ to some extent based upon the class in which its customers invest. However, at least from a theoretical perspective, a 12b-1 plan should <u>not</u> provide the broker with an inappropriate financial incentive to recommend one class over another class to an investor if that class does not make sense for that investor. Critically,

the broker has an affirmative obligation to discuss the options with his or her client, and to ensure that he or she is invested in a suitable share class.[18]

Applicability of 12b-1 Fees and Trail Commissions in the Context of Donor-Advised Funds

How do 12b-1 fees and trail commissions apply in the donor-advised fund context? When the assets in a donor-advised fund are invested by the sponsoring charity in shares of mutual funds, the sponsoring charity must make an investment decision as to whether the shares will be invested in a fund or class of shares of a fund that charges 12b-1 fees and/or front-end or contingent deferred sales charges, through which the fund pays up-front and trail commissions to brokers. A sponsoring charity might invest its assets in a fund or in a class of shares that makes such payments in order to induce brokers to refer donors to the sponsoring charity and to compensate brokers for ongoing services provided to the donor-advised fund accounts. However, it is important to remember that these payments are not deducted at the donor-advised fund account level, but rather are deducted at the mutual fund level. Nonetheless, the donor-advised fund account indirectly bears these expenses through its interest in the sponsoring charity's underlying mutual funds.

An example of the application of Rule 12b-1 fees and trail commissions in the donor-advised fund context is illustrated by the recent Form 1023 Application for Recognition of Exemption submitted on behalf of OppenheimerFunds® Legacy Program (the "Program" or the "Oppenheimer Program").[19] The Program received its recognition of exemption letter on November 8, 2000. The Form 1023 disclosed that the Oppenheimer funds in which the assets of a donor-advised fund account would be invested were parties to standard agreements. While the Form 1023 noted that the Program is not a party to these agreements, it nonetheless contained detailed disclosure regarding these agreements. In particular, the Form 1023 stated that each Oppenheimer fund is a party to an agreement and plan under Rule 12b-1 with OppenheimerFunds® Distributors, Inc., the distributor of the funds. For its distribution and shareholder services, the distributor would receive distribution and shareholder servicing fees, equal to 1.00% annually of the asset value of the class of shares in which the donor-advised fund accounts were invested (Class C). The fees would be deducted from the Class C assets. The Form 1023 proceeded to disclose as follows:

> "[OppenheimerFunds Distributors], in turn, will contract with financial advisors to perform a range of services that include making potential donors aware of the Program and acting as a liaison between donors and the Program. [OppenheimerFunds Distributors] will compensate financial advisors in the form of distribution assistance fees and service fees totaling [1.00%] in their first year of the contracts and up to [1.00%] in

[18] See NASD Code of Conduct Rule 2310.

[19] The Program's Form 1023 Application was reprinted in Paul Streckfus' EO Tax Journal, (Volume 6, No. 2, February 2001).

years 2-5 of their contracts of the aggregate net asset value of the Oppenheimer funds shares allocated to the donor sub-accounts."

The Form 1023 also contained a copy of the form of "financial advisors service agreement" between the distributor and the financial advisors. This contract is very similar to the type of selling agreement a distributor would enter into with a broker, dealer or financial advisor. The contract indicated that the financial advisors were to be compensated for two types of services: program participation assistance and account service. Program participation assistance includes (i) making customers aware of the Program, (ii) arranging and holding meetings with customers concerning the Program, (iii) assisting customers in completing documentation required to participate in the Program, (iv) obtaining and transmitting information regarding prospective donors to the Program, (v) referring to the Program questions relating to the operation of the Program and (vi) otherwise acting as a liaison between prospective donors and the Program. Account service includes (i) maintaining regular contact with participants and assisting in referring to the Program inquiries concerning the Program, including the performance of investments, (ii) assisting in effecting and maintaining accurate donor accounts and records, (iii) assisting participants in effecting administrative changes, and (iv) providing other information and services as requested. The fee structure replicates the typical fee structure for an agreement adopted under a 12b-1 plan: 0.75% of the value of the relevant participants' shares for participation assistance and 0.25% of the value of the relevant participants' shares for account service. Furthermore, and importantly, the form contract indicates that these fees are payable only for the first five years that the service agreement is in effect.

The draft guidebook for donors submitted with the Form 1023 also disclosed the fees that would be earned by financial advisors under the Program. In addition, the Program's website (www.opplegacy.org) discloses that the distributor will "pass on 12b-1 service and distribution fees to the broker-dealer of record for providing educational materials and services to clients on the benefits of charitable giving."

Why did the Program choose Class C as the class to invest the assets of the Program? Although the fee and expense arrangement for the Class C shares of the Oppenheimer funds is not necessarily identical to that of "Class C" in the hypothetical set forth above, the hypothetical is nonetheless instructive. Using the hypothetical as a guide, Class C arguably makes sense in this context. Class C is an appropriate choice for *relatively* smaller investments (i.e., investments that do not qualify for a reduced front-end sales charge) and shorter-term investment horizons. Donor-advised funds encourage, expect and/or require a certain minimum level of grantmaking, and in that context, a relatively shorter-term investment horizon is to be expected. Class A charges a front-end sales charge, which would be an immediate up-front charge against the initial contribution.[20] Class B shares are subject to a CDSC and the imposition of a CDSC in

[20] Using the hypothetical as a guide, Class A shares, with a waiver of the front-end sales charge, would be the most appropriate choice in cases where brokers and financial advisors are not used as a source of referrals for the sponsoring charity.

the donor-advised fund context was not appropriate for the Program.[21] A CDSC could potentially discourage donors from recommending grants until the CDSC has declined to zero (e.g., six years) because of the charge upon the shares redeemed in order to provide funds to make grants. Class C shares do pay a larger 12b-1 fee than Class A shares and unlike Class B, do not convert to Class A shares, and thus continue to pay that larger 12b-1 fee indefinitely. This is the reason Class C shares are not appropriate for longer-term investment horizons. However, as stated above, the expectation is that Class C shares will not be held for a protracted length of time, but will be redeemed in order to provide funds to pay grants. In addition, as discussed in more detail below, although the Class C 12b-1 fee may be indefinite, the Form 1023 for the Program indicates that the financial advisors are compensated for the first five years only.[22] Therefore, after a consideration of the facts and circumstances, including the 12b-1 fees associated with Class C shares and the fact that the donor-advised fund accounts would indirectly bear these expenses, the Board of Directors of the Program presumably determined that Class C was the appropriate class of shares in which the Program should invest.

The Form 1023 Application for Recognition of Exemption submitted on behalf of the American Gift Fund ("AGF") also contained disclosure regarding compensation of financial advisors.[23] However, in this case AGF's trustee, and not AGF, compensates the planners, brokers and agents who solicit donations and refer donors to AGF. The Form 1023 does not indicate whether the assets of donor accounts are invested in mutual funds that charge 12b-1 fees. Presumably, however, if AGF itself is compensating financial advisors, the assets are not invested in funds that charge 12b-1 fees. Otherwise, planners, brokers and agents would be compensated twice for the same services.

Legal Implications

Case Law. The courts have addressed the payment by charitable organizations of commission-based compensation on several occasions. In National Foundation, Inc. v. United States (13 Cl. Ct. 486, U.S. Claims Court 1987), National Foundation, Inc. ("NFI"), an organization whose operations were similar to those of a sponsoring charity, successfully defeated an IRS challenge to its exemption. NFI's major purposes were "(1) to raise and distribute funds to other nonprofit organizations and (2) to initiate, fund, and administer a wide variety of charitable, educational, religious, scientific and literary projects, most of which are recommended by donors."[24] NFI made contact with donors through "Charitable Development Officers (CDOs), who are typically professionals such as accountants, attorneys, trust officers,

[21] Note that the hypothetical discussed earlier included a 1.00% CSDC on Class C shares if redeemed within one year of purchase. If the Class C shares of the underlying funds in which the Program invests also charge such a CDSC, the prudent course of action would be for the Program to waive this CDSC.

[22] It is not clear how the 12b-1 fee is applied after the fifth year.

[23] AGF's Form 1023 Application was reprinted in Paul Streckfus' EO Tax Journal, (Volume 3, No. 7, June 1998).

[24] National Foundation, 13 Cl. Ct at 488.

stockbrokers, life underwriters, ministers and CDOs from universities, hospitals, and churches."[25] CDOs were paid a percentage, ranging from three to six percent, of the donations they generated, varying with the size of the donation. The CDOs also received $50 from the application fee paid by donors to NFI.[26] NFI's exemption was challenged by the Internal Revenue Service on several grounds, including that the commissions paid to CDOs represented private inurement.[27] The Court rejected the argument that the CDO's were co-venturers with NFI, as opposed to independent contractors.[28] Thus, the Court focused solely on whether the compensation was reasonable and in that regard stated the following:

> [T]here is nothing insidious or evil about a commission-based compensation system. . . . [T]he existence of a contingent compensation arrangement does not preclude tax-exempt status if the arrangement is reasonable. This court finds that a commission of no more than six percent is reasonable. (emphasis added)[29]

The Claims Court in National Foundation cited two other cases in support of its finding that the six-percent compensation to the CDOs was reasonable. In People of God Community v. Commissioner of Internal Revenue, the Tax Court affirmed the Service's denial of tax exemption to an organization based on a finding of private inurement to the organization's founder and controlling person.[30] Among other things, the founder was compensated based on a percentage of the overall gross tithes and offerings received by the organization.[31] It is noteworthy that the Tax Court emphasized that there was no upper limit on the percentage of the organization's gross receipts that could be potentially passed on to the founder.[32] Although it denied exemption, the Tax Court made the following statement, quoted by the Claims Court in National Foundation:

> We do not, however mean to imply that all contingent compensation arrangements made by charitable organizations will preclude tax-exempt status. Such arrangements are a part of business life and must

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[25] *Id.* at 489.

[26] *Id.*

[27] *Id.* at 494.

[28] *Id.*

[29] *Id.*

[30] 75 T.C. 127 (U.S. Tax Court 1980) at 129.

[31] *Id.*

[32] *Id.* at 132.

> occasionally be paid by a charity to salesmen, publishers, support groups, and even fund raisers.[33]

The Claims Court in National Foundation also cited to World Family Corporation v. Commissioner of Internal Revenue, where again commission-based compensation was challenged.[34] World Family Corporation ("World Family"), in an effort to attract fundraisers, planned to offer commissions of up to twenty percent. Again, the Tax Court stated that the question at hand was whether the commissions were reasonable, a question of fact to be determined in light of all the circumstances.[35] In its analysis, the Tax Court noted that state statutes expressly regulate contingent fee payments to fundraisers, and "endorse commissions higher than the 20-percent ceiling" proposed by World Family.[36] The Tax Court found the commission arrangement to be reasonable, notwithstanding the fact that the president of the organization had also been credited with commissions.[37] The Tax Court distinguished these commissions from the compensation received by the founder in People of God:

> Commissions are payable to an individual who procures contributions for [World Family]; payments are not limited to particular individuals. Moreover, commissions are directly contingent on success in procuring funds and as such are tied to services rendered.[38]

As a point of comparison, the Form 1023 for the Oppenheimer Program indicates that financial advisors are compensated for a maximum of five years. The commissions are not unlimited or indefinite, nor are they paid to insiders, which was clearly a concern of the Tax Court in People of God. Furthermore, according to the Program's Form 1023, the potential compensation that could be earned by financial advisors who refer donors to the Program and provide services to Program participants falls far short of the limits the Tax Court in World Family found to be acceptable. Therefore, applying the reasoning of these cases, the payment of commissions to brokers, dealers and financial advisors, in exchange for their referral of donors to the sponsoring charity and for providing bona fide on-going services, is acceptable as long as the compensation is reasonable in amount.

Other Legal Concerns. One concern that has been voiced with respect to the payment of trail commissions is that brokers will indefinitely discourage donors (or donor-advisors) from making grant recommendations, in an effort to avoid a decline in their commissions. The theory is that grant recommendations necessitate the redemption of underlying shares, thus

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33 *Id.*

34 81 T.C. 958 (U.S. Tax Court 1983).

35 *Id.* at 968.

36 *Id.* at 969.

37 *Id.* at 970.

38 *Id.*

reducing the amount invested in the fund and reducing the trail commissions to the broker. However, as discussed earlier, in many cases the broker is paid all or a significant portion of the sales commission up-front, so there is no incentive, or at least a reduced incentive, to discourage grant making because a redemption of the underlying shares will not materially impact the broker's compensation. With respect to trail commissions, as an example, the Form 1023 for the Oppenheimer Program indicates that financial advisors are paid commissions for a maximum of five years. While the argument might be made that brokers have a theoretical incentive to discourage grant recommendations until the payments received by the financial advisors cease, this would be improper behavior on the part of the broker, who has an explicit duty to deal fairly with his or her customers.[39] Moreover, this risk is combated by the sponsoring charity with proper disclosure, donor education and implementation of policies that require a minimum level of grantmaking. Finally, sponsoring charities generally will not permit a broker who receives such trail commissions to exercise a donor's privileges to recommend grants; the grant-recommendation privilege would remain with the donor, and not with the broker.

Nonetheless, as fiduciaries, the Board of Directors of the sponsoring charity must consider, among other factors, the reasonableness of the fees associated with the underlying mutual funds, including 12b-1 fees and sales charges. If the underlying mutual funds are ones that offer investors the option of investing in one of several classes pursuant to a multiple-class structure, the Board of Directors of the sponsoring charity should make certain to understand the differences between those classes to make sure that the class in which the assets of a donor-advised fund account are invested is the appropriate class. The Board should seek to ensure that inappropriate incentives are minimized, if not eliminated, and that donors are well informed and educated.

Questions for the Board of a sponsoring charity to consider about the class of shares in which the donor-advised fund accounts will invest include the following:

1. Is there a front-end sales charge or a contingent deferred sales charge? Will these be waived?

2. Are there 12b-1 distribution and service fees? In what amounts?

3. What arrangements does the distributor have with brokers who refer donors and provide on-going services to donor-advised fund accounts?

4. Are the payments to a broker advanced up-front or paid out over time as trail commissions? How much is paid up-front and how much is paid over time? Are the payments made indefinitely? Is the total amount a reasonable amount (e.g., six percent or less)?

5. What are the sales charges and 12b-1 fees of the other classes?

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[39] See NASD Code of Conduct Rule 2310-2.

6. How do these fees and charges compare overall to other comparable mutual funds?

This information should assist the Board in making an informed judgment about the underlying mutual funds, and in particular about the class of shares in which the sponsoring charity will invest and its associated fees and charges.

Another legal area of consideration is state law requirements for the registration of paid solicitors. The brokers, dealers and financial advisors who are compensated in connection with the referral of donors, and/or their employers, may need to register in the various states that require registration. Whether the requirement to register would extend to the fund's distributor is also a question that should be considered.