Chapter 8

The Sale of Open-End Investment Company Shares

I. Introduction and Summary of Recommendations

Over the past fifty years, tremendous changes have taken place in how open-end investment companies, known as "mutual funds," sell their securities and in how the sales are regulated under the Investment Company Act[1]. The evolution of the current sales or "distribution" system reflects an ongoing search for the proper balance between competition and regulation. As distribution methods have changed, Congress and the Commission have had to examine the effectiveness of competition in a number of contexts. While Congress historically has preferred to rely on competition to check the level of investment company fees and expenses, Congress has substituted regulation where it determined effective competition was lacking.

Today, as in 1940, the sale of fund shares is almost always contracted out, on an exclusive basis, to a "principal underwriter," which in most cases is the adviser itself or a close affiliate. Principal underwriters typically confine themselves to wholesale transactions and leave the public selling to independent retail dealers, under sales agreements. Some principal underwriters, *e.g.*, insurance companies that own advisers, have their own retail sales organizations sometimes referred to as "captive sales forces." Captive sales forces sell primarily funds the underwriter represents or other securities issued by the underwriter and its affiliates?[2] Most retail dealers have contracts with numerous principal underwriters and sell the shares of many different funds simultaneously.

In 1940, most investors paid a "sales load"[3] when they purchased shares, which was retained by the principal underwriter and the selling broker-dealer and no part of which was paid to the fund. The load was used to finance the underwriter's profit, the broker's commission, and other sales and promotional expenses.

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[1]Investment Company Act of 1940, 15 U.S.C. § 80a.

[2]*See, e.g.,* INVESTMENT COMPANY INSTITUTE ("ICI"), 1991 MUTUAL FUND FACT BOOK: INDUSTRY TRENDS AND STATISTICS FOR 1990, at 34-36 (1991) [hereinafter 1991 ICI FACT BOOK].

[3]Sales load is defined as the difference between the public offering price paid by investors and the current net asset value per share received by the fund, less any portion of such difference deducted for administrative expenses not properly chargeable to sales or promotional activities. See Investment Company Act § 2(a)(35), 15 U.S.C. § 80a-2(a)(35).

This "front-end sales load" was and is expressed as a percentage of the total purchase or offering price.[4] For example, if the current net asset value of a fund[5] is $9.15 per share and the front-end sales load is 8.5%, the public offering price will be $10 per share. The $0.85 sales load per share is a markup of **9.3%** on the $9.15 per share actually invested in the fund.

In 1940, a small number of funds, called "no-load" funds, marketed their shares directly to the public, primarily through advertising, and did not charge sales loads. Their more limited sales expenses were paid by the funds' investment advisers or principal underwriters out of their own profits,

As enacted in 1940, the Investment Company Act[6] had few limits on the levels of sales loads or other fees. The Act included a general prohibition on unconscionable or grossly excessive sales loads, to be defined by a registered securities association, such as the National Association of Securities Dealers, Inc. ("NASD")? The Act also required that advisory services and fees be stipulated in a written contract approved initially by a fund's shareholders and directors.[8]

To prevent abusive trading practices that resulted from the "backward pricing" method used by funds before 1940,[9] the Act required that all sales of registered investment company shares be made at a fixed offering price specified in the prospectus. The base price of a mutual fund is always derived from net asset value, so this requirement fixed the *sales load* component of the public offering price. Although this provision, section 22(d),[10] minimized the identified

[4]In contrast, sales commissions or markups in most securities transactions are expressed as a percentage of the net amount actually invested.

[5]The offering price of a mutual fund's shares is based on the fund's current net asset value, which is a term designating the excess of the value of portfolio securities owned, cash, receivables, and other assets of the fund over the liabilities of the fund. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AUDIT AND ACCOUNTING GUIDE: AUDITS OF INVESTMENT COMPANIES 209 (3d ed., revised 1987). Funds must redeem their shares at net asset value, calculated daily. Rule 22c-1, 17 C.F.R. § 270.22c-1.

[6]Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (1940).

[7]*Id.* § 22(b), 54 Stat. 789,823 (codified as amended at 15 U.S.C. § 80a-22(b)). The NASD is the only securities association registered under section 15A of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-3.

'Investment Company Act of 1940, Pub. L. No. 76-768, § 15/54 Stat. 789, 812 (codified at 15 U.S.C. § 80a-15).

[9]*See* infra notes 39-43 and accompanying text.

[10]15 U.S.C. § 22(d).

trading abuses, it also made lawful a system of retail price maintenance, eliminated all secondary market trading, and impeded price competition. Thus, the Act provided that the sale of mutual fund shares is exempt from normal antitrust law principles of free competition.

In the 1960's, the Commission recommended greater regulation of sales loads and advisory fees because competition had not been an effective check on their levels.[11] The Commission found that retail price maintenance, the external management structure of mutual funds, and a lack of investor sophistication and influence had all interfered with competition. In effect, mutual fund fees and charges had become insulated from both competition and regulation.

In response, Congress imposed on advisers a fiduciary duty with respect to the receipt of compensation for services and also imposed on advisers a duty to furnish, and on directors a duty to evaluate, all information relevant to the review of advisory contracts.[12] Congress considered repealing the retail price maintenance provision, section 22(d), but deferred action pending a formal Commission study. **As** an interim measure, Congress gave a registered national securities association rulemaking authority to prevent "excessive sales loads." Under this authority, the NASD has imposed an 8.5% cap on front-end sales loads.[13]

After study, the Commission did not recommend an immediate repeal of section 22(d), but instead recommended an administrative program to allow the retail price maintenance system to be replaced over time by competition. The administrative program sought to promote efficiencies in mutual fund distribution through a gradual introduction of limited forms of retail price competition, *i.e.*, by relaxing rigid advertising rules and permitting more sales load variations.[14]

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[11]SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 126-27, 143-47, 221-23 (1966) [hereinafter PPI REPORT]. The PPI REPORT drew upon a report by the Wharton School of Finance and Commerce on mutual funds requested by the Commission (WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. No. 2274, 87th Cong., 2d Sess. (1962) [hereinafter WHARTON REPORT]), and a Commission staff report that examined, among other things, the way in which mutual funds were bought and sold (SEC, SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 (1963) [hereinafter 1963 SPECIAL STUDY]).

[12]Investment Company Act §§ 15(c), 36(b), 15 U.S.C. §§ 80a-15(c), -35(b).

[13]*See infru* notes 109-110 and accompanying text.

[14]SEC DIVISION OF INVESTMENT MANAGEMENT REGULATION, MUTUAL FUND DISTRIBUTION AND SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940 at 10-16 (1974) [hereinafter 1974 DISTRIBUTION REPORT].

In 1980, after much debate, the Commission adopted rule 12b-1, which permits funds conditionally to use their assets to make continuing payments to distributors and other sellers of fund shares.[15] Funds that adopt rule 12b-1 plans under the rule as a substitute for front-end sales loads typically assess charges that range today from 0.50% to 1.25% of average daily net assets to pay for sales commissions, "trail" commissions, and other distribution expenses.[16]

Shortly thereafter, the Commission issued the first of many exemptive orders allowing the deduction of contingent deferred sales loads ("CDSLs") upon redemption of fund shares.[17] CDSLs are "contingent" since they are paid only on redemptions that occur within a specified period after purchase and may be expressed as a percentage of either the original purchase price, or more typically, the redemption proceeds. Almost since rule 12b-1's inception, CDSLs have been used in combination with plans of distribution under the rule (a "spread load") as an alternative to high front-end sales loads. For example, instead of a fund charging a *6%* front-end load, it could recoup roughly the same amount through a combination of an annual 1% rule 12b-1 fee and a CDSL of *6%* that declined **1%** per year until it reached zero at the end of the sixth year. CDSLs protect underwriters from early redemptions as the high initial outlays in commissions to a sales force are recouped over time through the rule 12b-1 fees. To some degree, spread loads have replaced high front-end loads, but they have also been criticized as "hidden loads" because they permit funds to impose high sales costs without the visibility of front-end loads.[18]

[15] 17 C.F.R. § 270.12b-1. Rule 12b-1 was adopted in Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980), 45 FR 73898.

[16] *See* Letter of the ICI to Jonathan G. Katz, Secretary, SEC 21 (Sept. 19,1988)' File No. S7-10-88 (responding to Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431 (June 13, 1988), 53 FR 23258) [hereinafter ICI Rule 12b-1 Comment]. *See also* Lipper Directors' Analytical Data, Vol. I, Sec. III, Table VII Study on 12b-1 Plans (1st ed. 1992). In addition to transaction-based sales commission payments, smaller "trail commissions" are often used to compensate broker-dealers and other sellers for ongoing sales and shareholder servicing efforts. They are generally assessed either separately as service fees or are part of rule 12b-1 fees. Under the NASD proposal to regulate asset-based sales loads, service fees would be limited to 0.25% of a fund's average daily net assets. *See infra* notes 145-148 and accompanying text.

[17] E.F. Hutton Investment Series, Inc., Investment Company Act Release Nos. 12079 (Dec. 4, 1981), 46 FR 60703 (Notice of Application) and 12135 (Jan. 4, 1982), 24 SEC Docket **647** (Order).

[18] *See, e.g.*, Albert B. Crenshaw, *New Rules Drafted for Mutual Funds*, Wash. Post, Jun. 19, 1988, at H3 and Letter from Charles Trzcinka to Jonathan G. Katz, Secretary, SEC 1 (May 23, 1991), File No. SR-NASD-90-69 (responding to Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Exchange Act Release No. 29070 (Apr. 12, 1991), 56 FR 16137).

In 1988, because of concern about the open-ended nature of rule 12b-1 fees as well as their "opaqueness," the Commission proposed amendments to rule 12b-1 that, in effect, would have precluded spread loads[19]. Shortly thereafter, the Commission proposed rule 6c-10 to permit not onl CDSLs but also deferred loads generally as an alternative to spread loads? In response to those initiatives, the **NASD** proposed amendments to regulate rule 12b-1 fees and CDSLs under its maximum sales load rule?' The three proposals are still outstanding.

Two other regulatory developments deserve brief mention. In 1985, the Commission by rule permitted funds to schedule variations in, or eliminate, front-end sales loads.[22] More recently, the Commission has issued a number of exemptive orders permitting funds to issue multiple classes of securities, each subject to a different distribution arrangement, but representing interests in the same portfolio of investments.[23]

The fund industry's explosive growth and diversity in the 1980's is partially attributable to the changes in the regulation of the marketing of funds, especially the relaxation of restrictions on investment company advertising. Of course, favorable market conditions and changes in the financial services industry are other important factors in the decade's record level of sales.[24]

As the fund industry has grown and diversified, the channels of mutual fund distribution have expanded. Generally, the distribution of funds in the individual investor market still may be divided into two main channels: shares sold by direct marketing and shares sold by commissioned sales forces. Direct marketers offer shares to investors through the mail, or by telephone, or at fund offices. Commissioned sales forces are used by securities firms and, in addition,

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[19]**Inv.** Co. Act Rel. 16431, supra note 16.

[20]**Exemptions** for Certain Registered Open-End Management Investment Companies to Impose Deferred Sales Loads, Investment Company Act Release No. 16619 (Nov. 2, 1988), 53 FR 45275.

[21]*See infra* notes 149-150 and accompanying text.

[22]**Investment** Company Act rule 22d-1, 17 C.F.R. § 270.22d-1. Rule 22d-1 was adopted in Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices That Reflect Different Sales Loads, Investment Company Act Release No. 14390 (Feb. 22, 1985), 50 FR 7909.

[23]*See infra* notes 171-174.

[24]*See* ICI, A DECADE OF GROWTH, PERSPECTIVE ON MUTUAL FUND ACTIVITY 20-27 (Spring 1990) [hereinafter DECADE OF GROWTH]. Changes in pricing structures, restructuring of distribution channels, increased emphasis on promotion and public relations, and heightened awareness of investor needs also have contributed to this **growth.** Id.

financial planners, life insurers, and depositary institutions. In the past two decades, direct-marketed funds have come to represent a significant part of mutual fund distribution. In 1990, direct-marketed funds had sales of $51.8 billion, or thirty-five percent of stock, bond, and income fund sales, while funds sold through sales forces accounted for $90.2 billion, or sixty percent of stock, bond, and income fund sales.[25]

Investors today may select among a variety of methods to finance the purchase of shares. While the number of funds using high front-end sales loads certainly has decreased?' and funds have moved to rule 12b-1 fees, it is not clear whether investors' costs have in fact been lowered as a result of these changes.[27] Many of the factors recognized as impeding competition in the 1960's, such as retail price maintenance, still exist. Additionally, the increasing complexity and variety of sales and other charges may interfere with competitive pressures on fee levels. Thus, the major distribution issue facing the Commission continues to be the degree and effect of competition in the mutual fund industry.

Three factors are critical to the dynamics of distribution and the interplay of regulation and competition on distribution pricing.[28] First, the open-end nature of mutual funds gives rise to the tremendous and continuous pressures to

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[25]Other sales result from reinvested dividends in funds no longer offering shares and from variable annuities. **1991** ICI FACT **BOOK,** supra note 2, at **37.**

[26]In response to the Commission's request for comments on investment company regulation (Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. **17534 (June 15, 1990), 55** FR **25322** [hereinafter Study Release]), the ICI indicated that "the number of funds with a maximum sales load of **8.5** percent has decreased dramatically (from 341 funds with 80 percent of assets in **1972** to **159** funds with **60** percent of assets in **1983,** and to **60** funds with **18** percent of assets in **1990)."** Letter from the ICI to Jonathan G. **Katz,** Secretary, SEC **50** n.40 (Oct. **5, 1990),** File No. **S7-11-90** [hereinafter ICI Study Comment]. Of course, the nature of funds sold has changed markedly. For example, money market funds (including tax-exempt money-market funds), which typically charge little or no loads and did not exist until the early **1970's,** accounted for **744** funds with **47%** of mutual fund assets in **1990. 1991** ICI FACT BOOK, supra note 2, at **45, 74.**

[27]A result of this repositioning, however, is that average fund expense ratios in certain segments of the industry, *e.g.*, equity and taxable fixed income funds, have risen over the past decade. This is largely because rule 12b-1 fees are an annual fund expense that are included in the ratio while front-end sales loads are not.

[28]The Commission requested comment on the broad questions of whether the present regulatory approach should be changed and whether retail price competition would reduce the need for regulatory limitations, and encouraged commenters to consider any alternative approaches used by other pooled investment vehicles. See Study Release, **supra** note **26,** at § III.D. The Commission received over **90** comment letters on these topics, including almost *60* from individual investors. For the most part, industry related commenters favored the status quo, while individual investors believed that fees should be made simpler and more comparable.

sell new shares in order to offset redemptions (otherwise, funds are said to be in a state of "net redemption"). Second, the external management structure of investment companies brings with it certain built-in conflicts of interest in the pricing of advisory and other services provided to funds and in the decision to spend fund assets to promote distribution. Third, because funds may finance distribution costs through various methods, including sales loads, rule 12b-1 fees, advisory fees, and underwriting fees,[29] regulation of one method inevitably affects the others.

The Division has considered various ways to modify the present regulatory approach in light of these factors. Our recommendations focus on eliminating impediments to vigorous price competition, increasing investor understanding of total investment costs, promoting cost comparability among funds, and easing restrictions so that funds may experiment with distribution arrangements that make costs more explicit. We believe these changes would promote price competition and result in more economical and efficient distribution methods.

First, the Division recommends that the Commission seek legislation to amend section 22(d) to unfix front-end sales loads. This action would introduce price competition among dealers. In addition, repeal of the price maintenance provision could facilitate the creation of new and innovative securities products that depend on free secondary markets.

Second, the Division recommends several rule changes to address the variety of alternative distribution arrangements that have developed in the past decade. We generally endorse the concept of extending the NASDs maximum sales charge rule to rule 12b-1 fees and CDSLs on the same basis as front-end sales loads. NASD regulation of these charges is consistent with our view that regulation should be substituted where competition is ineffective; price competition cannot be relied upon to check the size of spread loads since those fees often are confusing and opaque to investors. We recommend that the Commission adopt a limited portion of the amendments to rule 12b-1 proposed in 1988. The amendments should clarify certain requirements for funds financing distribution through fund assets, including use of a spread load. In addition, we recommend that the Commission adopt the rule proposed in 1988 to permit deferred sales loads, including installment loads, with slight modifications. Finally, we recommend proposing a new rule that would codify existing exemptive orders permitting funds to offer shares in multiclass structures. This action would expand investor choice in the methods of financing distribution and eliminate the costs funds now bear of seeking individual exemptive orders.

[29]Before 1975 and the repeal of fixed commissions, fund brokerage commissions (in reciprocal and "customer-directed give-up" practices) were another important source of additional compensation for retailers selling mutual funds. PPI REPORT, *supra* note 11, at 162-72.

Third, the Division recommends that the Commission propose legislation to permit the introduction of an optional form **of** mutual fund with a simplified method of distribution financing: a unified fee investment company ("UFIC"). This type of fund would have a single fee, prominently disclosed, out of which the sponsor would pay all fund expenses other than extraordinary expenses and brokerage. No separate sales loads or distribution charges would be imposed. UFIC fee levels would be market-based and not subject to regulatory limits, other than a general prohibition on unconscionable or grossly excessive fees.

Section II of this chapter discusses the relationship between sales load levels and retail price maintenance and our recommendation to amend section 22(d) of the Act. Section III details the various methods currently available for distribution financing and our recommendations for change. Section IV discusses our recommendations for the UFIC.

11. Sales Loads and Retail Price Maintenance

Section 22(d) of the Act prohibits registered investment companies, their principal underwriters, and dealers in their redeemable securities from selling such securities except at a current public offering price described in their prospectus?' Thus, section 22(d) effectively prohibits price competition in sales loads on mutual fund shares at the retail level. Together with section 22(f), which permits mutual funds to impose restrictions on the transferability or negotiability of their shares, section 22(d) confers federal antitrust immunity for retail price maintenance and mutual fund distribution restrictions?'

Over the years, section 22(d) has been the subject of considerable analysis and debate. Many have argued that it effectively has raised investors' costs without compensating **benefits.**[32] Others have maintained that retail price maintenance is so fundamental to the distribution of the shares of open-end

[30]**Investment** Company Act section **2(a)(29)** (15 **U.S.C.** § **80a-2(a)(29))** defines a principal underwriter for an open-end investment company to be any underwriter who as principal purchases from such company securities for distribution, or as agent for such company sells such securities to a dealer or the public or both. Section 2(a)(40) defines an underwriter **to** be any person who purchases from an issuer with a view to distribution. Section 2(a)(11) defines a dealer to be any person engaged in buying and selling securities for his own account as part of a regular business.

[31]**United** States **v.** National Ass'n of Sec. Dealers, Inc., 422 **U.S.** 694 (1975).

[32]*See, e.g., PPI REPORT, supra* note 11, at 221; *Hearings on* S. *1659, Before the Senate* ***Comm.*** *on Banking and Currency,* 90th Cong., 1st Sess. 665 (1967) [hereinafter 1967 *Senate Hearings]* (statement *of* Professor Irwin Friend, one of the principal authors of the Wharton Report).

companies that its elimination would have a profoundly harmful impact on the industry and investors.[33]

Today, there no longer seems to be any basis for restricting retail price competition in mutual fund distribution. Developments in the last fifty years, most notably the introduction of mandatory forward pricing, have eliminated the original rationales for retail price maintenance. Moreover, the strength and creativity of the investment company industry make it unlikely that further competition would harm investors. Indeed, there is reason to believe that price competition would benefit investors, as it benefits consumers of other goods and services. Accordingly, the Division recommends amending section 22(d) to end retail price maintenance.

A. The Purposes of Section 22(d)

Section 22(d) departs from the usual congressional policy, expressed in the antitrust laws, against price fixing.[34] The le islation proposed by the Commission in 1940 contained no such provision? it was first suggested by industry representatives and set forth in a memorandum of agreement between those representatives and the Commission that was drafted after the Senate hearings on the initial bill.[36] Although the legislative history contains little explanation of the purpose of section 22(d), retail price maintenance does not

[33]*See, e.g.*, 1967 *Senate Hearings*, *supra* note 32, at 665 (statement of the ICI); 1974 DISTRIBUTION REPORT, *supra* note 14, at 51-53 (written comment of the ICI).

[34]Sherman Antitrust Act (15 U.S.C. § 1) and Federal Trade Commission Act (15 U.S.C. § 41). Although there is some difference in the standard, horizontal and vertical agreements to restrict resale prices are considered illegal per *se* and generally prosecuted as felonies under Sherman Act section 1. *See, e.g.*, Business Elect. Corp. v. Sharp Elect. Corp., 485 U.S. 717 (1988); Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752 (1984); United States v. U.S. Gypsum Co., 438 U.S. 422 (1978).

[35]Section 22 of the proposed legislation contained two subsections addressing dilution. Subsection (a) would have permitted the Commission to prescribe pricing rules for the purpose of eliminating or reducing dilution. Subsection (b) would have provided that no underwriter or dealer, in a primary distribution, could purchase securities from a registered investment company or underwriter except at the price at which it sold such securities, less a commission or spread allowed by the seller. S. 3580, 76th Cong., 3d Sess., § 22, at 48-50 (Mar. 14, 1940). *See Investment Trusts and Investment Companies: Hearings on S. 3580, Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 15 (1940) [hereinafter *1940 Senate Hearings]*.

[36]*Id.* at 1057.

itself appear to have been the purpose of the section.[37] Rather, the legislative history suggests that Congress intended retail price maintenance simply as a means of preventing certain activities that existed in the distribution of mutual fund shares before 1940: riskless trading by insiders and resulting dilution, disruption of distribution systems, and unjust discrimination.[38]

1. **Riskless** Trading **by** Insiders

The first activity to which we believe section 22(d) was primarily addressed was riskless trading by insiders and the resulting dilution of fund assets?' Under the system of backward pricing generally used before the Act's passage and for many years thereafter, the price of a mutual fund share was based upon the fund's net asset value per share determined at the close of the market on the previous day. If the market rose, an investor could purchase fund shares near the end of the day at the price based upon the previous day's valuation, knowing that the actual net asset value of the shares was greater than the price he or she was paying!' The transaction could be made riskless by redeeming the shares the following day, before a new and possibly lower price reflecting that day's market activity was established.[41]

For most investors, payment of a sales load made riskless trading unprofitable, since a load generally would more than offset any profit that could result from one day's increase in the value of a fund's shares. Insiders and favored customers, however, often could purchase fund shares without paying

[37]If section 22(d) was intended as a retail price maintenance provision, it seems reasonable to expect some discussion on that point. Yet, for example, there was no mention of retail price maintenance in a Commission representative's analysis of the final bill. *Hearings on H.R. 10065 Before the House Comm. on Interstate and Foreign Commerce,* 76th Cong., 3d Sess. 124 (1940) [hereinafter *2940 House Hearings]* (testimony of David Schenker, Chief Counsel, Investment Trust Study).

[38]A complete legislative and administrative history of section 22(d) was prepared as an appendix to the release proposing rule 22d-6 which was later adopted as rule 22d-1. *See* Exemption From Section 22(d) To Permit the Sale of Redeemable Securities at Prices That Reflect Different Sales Loads, Investment Company Act Release No. 13183 (Apr. 22, 1983), 44 FR 19887, 27 SEC Docket 1353 (May 10,1983) (Appendix).

[39]Some commentators have suggested that the only abuse that Congress addressed in section 22(d) was dilution. *See* James V. Heffernan & James F. Jorden, *Section 22(d) of the Investment Company Act of 2940 – Its Original Purpose and Present Function,* 1973 DUKE L.J. 975,984-93.

[40]*1940 Senate Hearings, supra* note 35, at 138-141 (statement of Baldwin Bane, Director, SEC Registration Division).

[41]*Id.* at 289 (statement of David Schenker).

sales loads.[42] Since the overwhelming majority of open-end funds in 1940 Act were front-end load funds, the enactment of section 22(d) reduced the degree of dilution occurring from such riskless trading practices by requiring all investors to pay the same sales load.[43]

2. Disruption of Orderly Trading

The second activity was the creation of unauthorized secondary markets which was said to cause the disruption in the orderly distribution of mutual fund shares.[44] Before **1940,** authorized dealers that distributed a fund's shares generally were bound by contract with the principal underwriter to charge the single price described in the prospectus and were not given the discretion to lower prices to meet competition from non-contract dealers. Non-contract dealers were able to purchase shares for slightly more than the published redemption price and to offer the shares for slightly less than the published sales price. Because authorized dealers could not compete with non-contract dealers, an active secondary market developed, the so-called "bootleg market."[45] This bootleg market resulted in the cancellation of many selling agreements between

[42]*See* SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. **279,** 76th Cong., **1st Sess.,** pt. **3,862 (1940)** [hereinafter INVESTMENT TRUST STUDY]. *See 1940 Senate Hearings, supra* note **35,** at **289.**

[43]The Commission would have cured riskless trading by requiring forward pricing. The industry, however, vigorously resisted, and section 22(d) as enacted was the compromise modeled on an Ohio securities provision that was designed to address insider riskless trading. *See* **1940** *Senate Hearings, supra* note **35,** at **523, 526-27, 859.**

[44]*See* INVESTMENT TRUST STUDY, pt. **3,** *supra* note 42, at **865.** *See also* United States v. National Ass'n of Sec. Dealers, Inc., **422** U.S. **694,** at **714-15** (1975); PPI REPORT, *supra* note 11, at 219; Survey, *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. Rev. **732, 850 (1969);** and Lawrence M. Greene, *The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940,* **37** *U.* DET. L.J. **369,371-72 (1960).** *But see* Heffernan & Jorden, *supra* note **39,** at **990, 996-97** (suggesting that this was a *post facto* argument with no basis in the legislative history).

[45]INVESTMENT TRUST STUDY, pt. **3,** *supra* note **42,** at **809, 856-57,** and **865** ("Such operations actually had the effect of initiating a small scale price war between retailers and tended generally to disrupt the established offering price"). *See* Greene, *supra* note **44; 4** TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS **10,** 42, **90 (1978** & Supp. **1990).** *See also* INVESTMENT TRUST STUDY, pt. **3,809,857** (noting the existence of a secondary market maintained by contract dealers, which apparently was stronger and more active, and contending the principal abuse within that market was not disruption of the offering price but rather the riskless profit obtained by contract dealers as a result of the backward pricing system).

contractual dealers and underwriters and threatened the contractual distribution system.[46]

Members of the industry have over the years, argued that an "orderly" distribution system under the control of fund underwriters facilitates the ability of mutual funds to offer constant redemption of their shares.[47] They have long urged that mutual fund distribution has a unique status because fund shares are redeemable at any time at the option of holders, making funds naturally shrinking entities. They have argued that net redemption status makes portfolio management difficult and can be prevented only by active sales of new shares; thus, secure dealer compensation is perceived as critical to the vitality of the fund industry. They also have argued that firms might suffer if non-contract dealers accumulated large blocks of shares and then, because of market fluctuations, redeemed them.[48]

A related argument for preserving retail price maintenance is that without section 22(d) non-contract dealers would bypass the primary distribution system, thereby avoiding paying their "fair share" of the promotional costs of the underwriter, giving the dealers an unfair advantage.[49]

[46] In 1975, the Commission argued that preservation of orderly distribution by eliminating secondary market competition from non-contract dealers was a probable aim of section 22(d). Amicus Brief for the SEC at 43-44, United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1975). The Commission pointed to the fact that, before the passage of the final bill, secondary market dealers apparently alerted the Commission and the Senate to the consequences of section 22(d) to their business in an unsuccessful attempt to have that section amended. The non-contract dealers complained in a memorandum that the section was designed to "effectively hamper [non-contract] . . . dealers in dealing in trust shares, concentrate such transactions in the hands of authorized dealers and principal underwriters, and thus create a virtual monopoly." Id. at n.95.

[47] *See, e.g.,* Statement of the ICI on the Potential Impact of the Repeal of Section 22(d) of the Investment Company Act of 1940 and on Other Matters Dealing with Distribution of Mutual Fund Shares 31-34 (Feb. 2, 1973, File No. 4-164 (Hearings on Mutual Fund Distribution and §22(d) of the Investment Company Act of 1940); 1974 DISTRIBUTION REPORT, *supra* note 14, at 52 (written comment of the ICI) ("ability of fund sales to keep pace with redemptions would be endangered" by the lowering of sales incentives to salesmen resulting from secondary market influences). But see Comments of the U.S. Dep't of Justice 35 (Feb. 2, 1973), File No. 4-164 [hereinafter 1973 Justice Department Comment] (contending this rationale is "sheer gloss on the legislative history" with the "patina of age upon the continued urging of the ICI").

[48] *See* 1974 DISTRIBUTION REPORT, *supra* note 14, at 53 (testimony of Carl Frischling, Channing Management Corporation).

[49] This line of argument is sometimes raised in antitrust cases dealing with distribution restraints, but courts have rejected such "unfair cost burden" arguments in favor of a rule which holds that such restraints are *per se* violations of the law. See, *e.g.,* 1973 Justice Department Comment, supra note 47, at 38 ("The *per se* rule is based on a recognition that the potential benefits
(continued...)

3. Unjust Discrimination

The third phenomenon arguably addressed by section 22(d) was discrimination among investors resulting from a fund charging different prices to different investors. While commentators have differed on whether the purpose of section 22(d) was to address such price discrimination, the Commission has cited it as such?' At the same time, however, the section has never been considered to require the same percentage load on every purchase, so long as variations (*e.g.*, quantity discounts) available to one purchaser also are available to the next.[51] Indeed, in 1966, the Commission expressed concern that retail price maintenance is unfair if investors requiring different levels of sales efforts must be charged the same sales load.[52] Today, any scheduled variation in front-end loads to particular classes of investors is permitted, if it is disclosed.[53] Alternatively, some have argued that the "investor discrimination" aimed at was not price discrimination, but discrimination that allowed favored "insider" purchasers to exploit backward pricing.[54]

B. Commission Action under Section 22(d)

Since 1940, the Commission has addressed the effect of section 22(d) on the pricing and distribution of mutual fund shares both in numerous reports and in rulemaking. The prevailing theme has been that retail price maintenance, as well

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[49](...continued)
of a market system where all dealers are free to buy from and sell to whomever they chose, at any price agreed upon, are more readily apparent than speculative disadvantages to the primary distributors and dealers forced to compete with the discounters.). *See also* VAN CISE AND LIFLAND, UNDERSTANDING THE ANTITRUST LAWS **120-123,126-27 (1980).**

[50]*Compare* Greene, *supra* note **44,** at **371** (citing, among other factors, prevention of discrimination as a purpose "well known in the industry and to the Commission"), *with* Heffernan & Jorden, *supra* note **39,** at **990** (arguing that legislative history does not support prevention of discrimination as a rationale). Unjust discrimination appears first to have been cited in a **1941** opinion of the Commission's General Counsel rather than in the legislative history (Investors Diversified Servs., Investment Company Act Release No. **89** (Mar. **13,1941)).** *But see* Heffernan & Jorden, at **994** (also suggesting that the discrimination referred to in the **1941** opinion involved the potential for insiders to obtain riskless profits, *i.e.,* the insider riskless trading abuse).

[51]The language of section 22(d) suggests that Congress contemplated that more than one offering price could be charged different investors since the section requires sales at "a current public offering price described in the prospectus" rather than "the price."

[52]PPI REPORT, ***supra*** note **11**, at **221**.

[53]Investment Company Act rule 22d-1.

[54]Heffernan & Jorden, *supra* note **39,** at **993.**

as inefficient distribution methods, have led to high sales costs for investors. While the Commission generally has viewed competition as the antidote to high costs and has questioned the need for section 22(d), it has not to date pursued outright repeal of the section.

The issue of retail price maintenance was highlighted in the Commission's **1966** report, entitled "The Public Policy Implications of Investment Company Growth" ("PPI Report"), on the adequacy of investor protections under the Act. The Commission concluded that, because section 22(d) prohibits competition among retail dealers, competition among distributors (principal underwriters) had the effect of raising rather than lowering mutual fund share prices to investors. Underwriters, instead of competing for sales through lower sales loads to investors, competed for the favor of the retailers who sold the shares by increasing the sales loads and thus the retailers' compensation.[55] The PPI Report stated that:

> [t]his reflects the industry view that mutual fund shares are sold, not bought. Retail dealers in and salesmen of fund shares are viewed as the key figures in the distribution process . . . .
>
> In a freely competitive market the load-raising effects of the vigorous competition among principal underwriters for the favor of dealers and salesmen could be restrained by countervailing downward pressures stemming from price competition among retailers for investor patronage. By precluding price competition at the retail level, section 22(d) suppresses the downward pressures that normal market forces might otherwise exert.[56]

While citing advantages to the repeal of section 22(d), the Commission ultimately recommended a fixed maximum sales load, principally to avoid any "unsettling and unforeseeable effects" repeal might have in the broker-dealer community while still reducing investors' sales costs.[57]

In 1970, Congress considered repealing section 22(d), but decided that it lacked sufficient information concerning the economic impact of repeal. The

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[55]PPI REPORT, *supra* note 11, at 208-09, 221.

[56]*Id.* at 221.

[57]*Id.* at 222-23. The Commission noted that the industry had accommodated itself to a system of retail price maintenance and that immediate repeal might disrupt distribution networks, harming investors' access to funds; the report instead recommended a maximum sales load of five percent.

Commission was directed to study the matter and report back.[58] As a more immediate solution, Congress amended section 22(b) to give rulemaking authority to a registered securities association, *i.e.,* the NASD, to prevent excessive sales loads, subject to Commission oversight.[59]

In 1972, the Commission submitted to Congress a report concerning the economic impact of repeal of section 22(d). The report was an analytical study that made no recommendations for legislative or administrative action. It disputed, however, the "disruption of distribution systems" argument; and the transmittal letter by Chairman Casey stated that the findings "certainly suggest there is no compelling public interest in continued retail price maintenance in this field and that the repeal of section 22(d) would on balance be desirable."[60]

Subsequent public hearings provided an opportunity for an in-depth exploration of mutual fund distribution and its regulation.[61] A very different picture of the mutual fund industry emerged from the 1973 hearings from that described in the Commission's 1966 PPI Report. Net redemptions had replaced the record sales the industry had enjoyed earlier.[62] Funds had lost ground with their traditional best customers, the small investors. In addition, the industry faced a number of disruptions to its marketing system. Competing products, such as variable annuities, real estate investment trusts, and oil and gas drilling funds, had made substantial inroads because they were often easier to sell and compensation to the broker-dealers was as high or higher than for mutual funds. Within the industry itself, "load" funds were losing sales to "no-load" funds. Fund

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[58] S. REP. NO. 184, 91st Cong., 1st Sess. 7-8 (May 21, 1969).

[59] The NASD enacted a maximum sales load rule that generally limits loads to 8½% of the offering price. See *infra* text accompanying note 110.

[60] REPORT OF THE SEC STAFF ON THE POTENTIAL ECONOMIC IMPACT OF A REPEAL OF SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940, at iii-vi (1972). Among other conclusions, the report found that: repeal would result in lower acquisition costs for many fund investors, although it was unlikely the very small investor (accounts of less than $1,000) would see any immediate benefit; reductions in fund sales charges would have an extremely modest impact on the securities industry and on most retail sellers of fund shares, except for the 13% of the broker-dealer community that obtained most of their gross revenue from sales of funds; repeal was unlikely to lead to protracted net redemptions on an industry-wide basis because any lessening of sellers' incentives would be offset to some extent by the diminished sales resistance normally associated with lower prices (citing the recent growth of the no-load sector); and concern over adverse consequences (end-running existing distribution procedures) that might result from the development of a secondary market seemed exaggerated.

[61] Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 9470 (Oct. 4, 1976), 41 FR 44770 (announcing public hearings).

[62] 1974 DISTRIBUTION REPORT, supra note 14, at 19.

distribution, seldom profitable, had become even less profitable, requiring greater subsidization of distribution from advisory profits.[63]

In this environment, the Commission did not recommend immediate repeal of retail price maintenance in its report to Congress.[64] The report concluded that, due to a lack of investor sophistication and price sensitivity, the industry would need to cultivate public demand and diminish its historic reliance on intensive personal selling efforts in order to avoid widespread disruption in the fund distribution system that might otherwise occur with an immediate repeal of section 22(d). The Commission decided to lay the groundwork for a gradual and orderly introduction of price competition through administrative action that would permit funds to adopt voluntarily pricing programs designed to foster retail competition. The report also recommended that Congress amend section 22(d) to expand the Commission's authority to take further steps toward "the ultimate goal of retail price competition."[65]

Since announcing that program, the Commission has taken a number of steps toward modifying regulation of sales loads and mutual fund distribution generally, including easing restrictions on mutual fund advertising,[66] permitting funds to finance distribution expenses out of their assets,[67] and adopting rules and issuing orders exempting some practices from section 22(d).[68] In **1983,** the

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[63]*Id.* at 17-43. In addition, the poor performance of the equity markets (in contrast to the "go-go" boom of the late 1960's) coupled with rising interest rates likely turned many investors to more secure products. *Id.* at 28/39.

[64]1974 DISTRIBUTION REPORT, *supra* note 14, at 76-83.

[65]*Id.* at 11.

[66]*See* Chapter 9.

[67]By adopting rule 12b-1, *supra* note 15.

[68]Rules 22d-1 through 22d-5 were adopted pursuant to this program. See Variations in Sales Load Permitted for Certain Sales of Redeemable Securities, Investment Company Act Release No. 2798 (Dec. 2, 1958), 23 FR 9603 (adoption of rule 22d-1); Sales of Redeemable Securities Without a Sales Load Following Redemption, Investment Company Act Release NO. 8235 (Feb. 20,19741, 39 FR 8321 (adoption of rule 22d-2); Variable Annuities, Adoption of Exemptive Rules, Investment Company Act Release No. 8878 (Aug. 7, 1975), 40 FR 33970 (adoption of rule 22d-3); Mergers and Consolidations Involving Registered Investment Companies, Investment Company Act Release No. 11053 (Feb. 19, 1980), 45 FR 12408 (adoption of rules 22d-4 and 22d-5). With the exception of rule 22d-3 (re-numbered rule 22d-2 (17 C.F.R. § 270,22d-2) and applicable to insurance products), they were subsequently rescinded with the adoption of rule 22d-1 (originally proposed as rule 22d-6). From 1974 through 1983, the year rule 22d-1 was adopted, the Commission received approximately 20 applications annually requesting exemptive relief from section 22(d) and the rules thereunder.

Commission proposed rule 22d-6, to permit all funds broad latitude to vary sales loads.[69] Under the rule as proposed, funds could establish a single public offering price; a schedule of fixed but different prices applicable in different transactions; or a system of unfixed prices arrived at by negotiation with purchasers. The majority of commenters (mostly industry members) expressed opposition to the negotiation aspect, positing potential market injury (concentration and disruption of distribution systems arguments), attacking the Commission's statutory authority to permit negotiated loads, and suggesting that permitting negotiation would eliminate antitrust immunity for fixed pricing of fund shares.

In 1985, the Commission adopted a revised rule permitting scheduled variations of prices, but dropping the provision allowing negotiation of prices.[70] The rule opened the way for all funds to sell their shares at prices that reflected different front-end sales loads, subject to the requirements that any variation be uniformly applied to all offerees in the class specified, that variations be described in the prospectus, and that current shareholders be advised within one year of any new sales load variations. While the Commission did not explain why it dropped the negotiation provision, concern over the Commission's authority was a primary factor, rather than a change in point of view about the policy.

C. Amendment of Section 22(d) to End Mandatory Retail Price Maintenance

The Division recommends amendment of section 22(d) to end retail price maintenance. This change would permit the development of retail price competition among dealers and the development of secondary markets in mutual fund shares.

Our recommendation is based on the general principle that the public benefits from free and vigorous price competition. Accordingly, an anticompetitive provision such as section 22(d) should be retained only if there is a convincing public policy rationale. **As** discussed below, since 1940 and even since the 1970's, changing circumstances, reflecting both regulatory and marketplace developments, have eliminated the rationales that apparently prompted enactment and retention of section 22(d). If the industry did need a transition period before section 22(d) could be amended or repealed, the past

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[69] Inv. Co. Act Rel. 13183, supra note 38.

[70] Inv. Co. Act Rel. 14390, *supra* note 22.

decade and a half has served that purpose.[71] There no longer are any compelling reasons to retain retail price maintenance.

1. Disappearance of Original Rationales for Retail Price Maintenance

The first, and we believe the primary, purpose of section 22(d) has been rendered moot. Riskless trading by fund insiders to the dilution of other shareholders has not been possible since **1968,** when the Commission adopted rule 22c-1, requiring "forward" pricing of fund shares.[72]

Nor is it likely that the introduction of retail competition would disrupt orderly distribution of mutual fund shares, another rationale for section 22(d). The "orderly distribution" point rests on two interrelated arguments: that orderly distribution gives "secure compensation" to the sellers of mutual fund products,[73] and that an active secondary market would threaten that compensation.[74] These arguments assume that only with the assurance of a fixed commission will a securities sales representative make the effort necessary to persuade an ordinary investor to buy shares. This ignores the vast changes in

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[71]For example, since adoption of rule 22d-1, funds have established a variety of scheduled variations in sales loads. By the ICI's assessment, the industry seems to be in a position to meet the demands of a competitive marketplace. DECADE OF **GROWTH,** supra note **24,** at 8. ("Despite rising competition from other financial institutions, mutual funds entered the decade of the **1990's** in excellent shape. The very size of assets now under management, in the vicinity of $1 trillion, virtually assures substantial additions to the asset base from reinvested dividends. . . . The most important secular economic and demographic trends, as they appear at the beginning of the decade, look quite favorable for investment in general, and mutual fund investing in particular.").

[72]Investment Company Act rule 22c-1. Under forward pricing, redemptions are effected at a price based on the net asset value next computed after receipt of an order, typically at the close of the United States securities markets. See Pricing of Redeemable Securities for Distribution, Redemption and Repurchase and Time-Stamping of Orders by Dealers, Investment Company Act Release No. **5519 (Oct. 16, 1968), 33** FR **16331.**

[73]In responding to the Study Release, the ICI concluded, as it had in earlier submissions spanning two decades, that the purpose of section 22(d) was to assure a stable, systematic, and ongoing sales effort at the retail level. ICI Study Comment, supra note **26,** at **49-51.**

[74]Some members of the industry have conceded that, under the right set of circumstances, section 22(d) could be repealed. See, *e.g.,* **1974** DISTRIBUTION REPORT, ***supra*** note **14,** at 60 (statement of Robert Loeffler, Senior Vice President, Investors Diversified Services) (opining that as the public became more familiar with funds, salesmen would produce higher sales volumes for the same amount of time, thus permitting a reduction of commission rates so that such rates ultimately might be "competitive with what the spread might be on just a shelf product, which it would be in the secondary market, at which point you could repeal 22(d) and it probably wouldn't make any difference because your levels would be the same").

public awareness and acceptance of mutual funds in the last twenty years?' The size and visibility of the fund industry and the increasing market share captured by direct-marketed funds today belie the assumption that "funds are sold not bought."

In addition, we agree with the prediction made by the Department of Justice almost twenty years ago that lower sales loads would increase, rather than decrease, sales.[76] In the 1973 hearings, the Justice Department argued that "[t]he Supreme Court has noted that ruinous competition, financial disaster, evils of price cutting and the like appear throughout our history as ostensible, albeit unpersuasive, justifications for price-fixing."[77]

The related concern that non-contract dealers might "free ride" by not paying their fair share of promotional costs carries far less weight today than it might have in 1940.[78] A secondary market probably would not eliminate the benefit to a principal underwriter of promoting the fund where there is affiliation between the underwriter and the investment adviser, as is true of many funds today. Underwriting of mutual funds has not been profitable historically, and

[75]The ICI has said that "[i]ncreased demand for mutual funds has resulted not only from these market changes but also from the public's increased awareness of funds. Industry research shows that the awareness of mutual funds among all U.S. households has expanded significantly since 1980, resulting in funds becoming a household word . . . ." *See* 1990 MUTUAL FUND FACT BOOK: INDUSTRY TRENDS AND STATISTICS FOR 1989, at 64 (1990).

[76]1973 Justice Department Comment, *supra* note 47, at 12-15. In addition, the Justice Department noted that Professor Paul Samuelson had testified that elimination of section 22(d) would result in a substantial decrease in sales loads and that these judgments were confirmed by the pre-1940 experience in the mutual fund industry which showed that retail price competition reduced costs to the investor. *Id.* A 1988 ICI-commissioned study suggested that there is a corresponding (and offsetting) increase in market share for a full service channel relative to the direct market channel as the former decreases its commission or fee charges. *See* ICI, THE DISTRIBUTION CONNECTION: A SUMMARY REPORT OF MAJOR RESEARCH FINDINGS 19 (1990).

[77]1973 Justice Department Comment, *supra* note 47, at 20-23; *see also Hearings Before the Sen. Comm. on Banking and Currency*, 91st Cong., 1st Sess. 65 (1969) (testimony of Professor Paul Samuelson); Donald Baker & W. Todd Miller, *Vertical Pricing, Territorial and Customer Restraints: The Search for Clarity, or At Least Sanity*, 30TH ANNUAL ADVANCED ANTITRUST SEMINAR, PLI Course Handbook Series No. 720, at 9/55 (1991) (citing SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 593 (2d ed. 1980)).

[78]The "free rider" argument resurfaced in the comments to the Study Release, *supra* note 26, with regard to unit investment trusts ("UITs"). *See* Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 83 (Oct. 10, 1990), File No. S7-11-90 [hereinafter Davis Polk Study Comment], Letter from Shearson Lehman Brothers to Jonathan G. Katz, Secretary, SEC 21 (Oct. 10, 1990), File No. S7-11-90.

underwriting expenses often have been subsidized by the investment adviser.[79] Thus, the real benefit of promoting a fund often lies in increasing the asset base of the fund on which the adviser's compensation is determined. The elimination of retail price maintenance would not impair that benefit. Finally, the underwriter's exclusive access to new shares from the fund is a substantial advantage over non-contract dealers, which have the expenses and uncertainties associated with maintaining inventory?'

Finally, section 22(d) is not needed to prevent "price discrimination." Competitive markets generally tend to eliminate discriminatory price differences, *i.e.,* differences unrelated to costs. In addition, competition generally should reduce prices for investors at all levels, even though reductions are likely to be most dramatic for the largest investors. The results of the unfixing of brokerage commission rates in 1975 bear these suppositions out; commission rates have declined sharply and fallen into rational patterns that reflect the sales costs and the services provided.[81] Moreover, if, as some have argued, the "investor discrimination" aimed at was not price discrimination, but the discrimination that allowed the favored "insider" purchaser to exploit backward pricing,[82] it became irrelevant in 1968 with the adoption of forward pricing.

2. Consequences of Retail Price Competition

In addition to considering whether the original bases for section 22(d) remain valid, we considered other concerns that could arise from retail price competition. In theory, repeal could lead to increased concentration and investor confusion, but we conclude that the benefits would more than offset any disadvantages. Residual rulemaking authority could give the Commission the ability to address any concerns.

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[79] *See, e.g.,* PPI REPORT, *supra* note **11,** at **209.** Of course, advisory fees and other compensation paid by a fund to its adviser must meet the requirements of section 36(b). See *infra* Section III.A.2.

[80] *See* **1973** Justice Department Comment, *supra* note **47,** at **38-39.** See *also* Davis Polk Study Comment, *supra* note **78,** at **81.** Non-contract dealers also would reduce the distribution system costs by taking on some of the promotional expenses that encourage investing in the fund as well as taking some of the redemption pressure, and attendant costs, off the underwriter and fund.

[81] *See* DIRECTORATE OF ECONOMIC POLICY AND ANALYSIS, REPORT ON THE SECURITIES INDUSTRY IN **1980 81-85** (Sept., **1981)** [hereinafter **1980** INDUSTRY REPORT].

[82] *See* Heffernan & Jorden, *supra* note **39,** at **994.** While this latter view has some support, there are numerous Commission interpretations to the contrary, including some issued after backward pricing was abolished. See, *e.g.,* Sale of Redeemable Securities Without a Sales Load Following Redemption, Investment Company Act Release No. **8235** (Feb. **20, 1974), 39 FR 8321;** Variable Annuities, Adoption of Exemptive Rule, Investment Company Act Release No. **8878** (Aug. **7, 1975), 40 FR 33970.**

We do not believe that retail price competition would lead to concentration in the mutual fund and broker-dealer industries, as some have argued. There is no reason to believe that repeal of section 22(d) would cause undue concentration any more than the 1975 unfixing of brokerage commission rates caused undue concentration among broker-dealers.[83] To the extent that some firms might not survive, as a former Commission Chairman stated, "it is hardly necessary or even desirable for the Government to maintain a price structure under which investors -- particularly small investors -- subsidize an inefficient, oversized distribution system . . . ."[84]

Nor does it seem likely that the range of commission charges would confuse investors. Negotiation of sales loads theoretically could result in infinite permutations but, as a practical matter, broker-dealers are likely to establish schedules of a limited range of possible loads, just as they currently do for negotiable commission rates on securities purchases for different customers. In essential respects, negotiated sales loads would expand the concept of scheduled variations in rule 22d-1, which is accepted and understood by both the industry and the public.[85]

The current widespread use of rule 12b-1 fees and contingent deferred sales loads[86] will complicate the elimination of retail price maintenance. Unlike front-end sales loads, rule 12b-1 fees do not easily lend themselves to negotiation and secondary markets in fund shares. For example, in the same fund customers

[83]Although concentration increased in the securities industry between **1971** and **1980,** the Directorate of Economic Policy and Analysis concluded that the trend toward concentration began well before the introduction of negotiated rates in **1975,** for various reasons, and that despite consolidations, the industry appeared to remain competitive in terms of structure, as well as conduct and performance. See **1980 INDUSTRY REPORT,** *supra* note **81,** at **79-80.** The staff also noted that the number of discount brokers continued to grow in the period following the full advent of negotiated rates and that their profitability was the highest among the industry segments. See, *e.g.*, id. at vi, **85-87.**

[84]*1967* Senate ***Hearings, supra*** note **32,** at **30** (statement of Chairman Cohen). Immediately following the elimination of fixed rates in **1975,** commission rates for both individual and institutional clients declined sharply. **1980 INDUSTRY** REPORT, ***supra*** note **81,** at **82.**

[85]For example, proposed rule 22d-6 permitting negotiated sales loads had several disclosure conditions designed to assist the investor in evaluating investment costs. The conditions included prospectus disclosure of the maximum load that could be charged, accompanied by a discussion of the circumstances under which a negotiated load was available. See Inv. Co. Act Rel. **13183,** ***supra*** note **38.** Similarly, the prospectus fee table used today also includes only the maximum sales load that can be charged and leaves scheduled variations of sales load to be discussed in the narrative. See Consolidated Disclosure of Mutual Fund Expenses, Investment Company Act Release No. **16244** (Feb. **1, 1988), 53** FR **3192.**

[86]***See supra*** notes **15-18** and accompanying text.

of non-contract dealers and customers of the principal underwriter and contract dealers would be bearing the same amount of rule 12b-1 fees, despite differences in sales costs.

Second, contingent deferred sales loads, while susceptible to negotiation, would present difficult tracking and inventory questions that are likely to limit the formation of secondary markets. To give an example, assume shareholder **A** wishes to sell, after two years, shares originally subject to a CDSL of five percent that declined one percent annually until year five when it disappeared. Shareholder A might offer the shares, with a current net asset value of $10,000, to a dealer, at a price of net asset value minus the CDSL of three percent (or what the fund would redeem them for), *e.g.*, $10,000 - $300 = $9,700, plus whatever premium the dealer was paying to attract redeeming shareholders, *e.g.*, $100.[87] The dealer, having paid $9,800 for shares with a value of $10,000 minus a declining CDSL of three percent, would hope to sell those same shares to shareholder B, at a discount from what the fund would offer shareholder B (shares at $10,000 with a contingent liability of five percent or $500), *e.g.*, $9,900 or maybe even $10,200. The spread between the price paid to the selling shareholder and the price paid by the buying shareholder would be the dealer's profit, *e.g.*, $100 or $400 in this example.

The market value of the shares depends on how long they have been outstanding (that is, what level the CDSL has reached) and the holding expectations of the buying shareholder. In the example above, the shares would still bear a load of three percent, if redeemed before the end of the third year of the original selling shareholder's purchase. If shareholder B planned to sell the shares quickly, he or she would have an incentive to pay a higher premium to the dealer than a shareholder who planned to hold the shares for two or three years. **A** shareholder planning to hold shares for the full five years would not pay more than the price at which the fund was offering shares. Dealers, therefore, would have to be able to identify the "aging" of each share in inventory and know their customer.

3. Development of Secondary Markets

To the extent that funds seek to restrict secondary market transactions, the Commission could use its existing rulemaking authority under section 22(f). Section 22(f) prohibits funds from restricting the transferability of their shares in

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[87]Securities firms today may act as statutory "brokers," *i.e.*, as agents in a sale of already issued shares between two investors. See, *e.g.*, United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1975). This practice is not common today.

contravention of any Commission rules.[88] To date, the Commission has not adopted any rules under section 22(f). The Commission's Investment Trust Study detailed a number of problems related to the secondary dealer (or "bootleg") market under the backward pricing system prevalent at the time and listed a variety of means used by funds to deal with those problems, including restricting the negotiability of shares so that they could only be tendered for redemption to the fund and rohibiting the underwriter from taking any trading position in the fund's shares.[89] Commission staff indicated that the provision was designed to provide regulatory "oversight" over these types of practices because of a concern that these practices might also penalize investors.[90]

Leaving section 22(f) intact would reserve authority with the Commission, consistent with the protection of the fund's shareholders, either to preclude certain restrictive practices or to protect contract dealers and underwriters from any unfair advanta e on the part of secondary market dealers, should events prove it necessary.[98]

Finally, it may be necessary to amend rule 22c-1 to permit secondary market transactions by dealers at negotiated prices. The rule now requires all dealers to effect transactions at prices based upon the next computation of net

[88]As the Supreme Court stated in 1975: "[s]ection 22(f) complements [section 22(d)] by authorizing the funds and the SEC to deal more flexibly with other detrimental trading practices by imposing SEC-approved restrictions on transferability and negotiability." Id. at 724-25.

[89]INVESTMENT TRUST STUDY, pt. 3, *supra* note 42, at 849,856-57,861,865,867-74. In addition, some funds required their underwriters to impose restrictions on the dealers or entered into restrictive agreements with the dealers directly. Id. at **868-71.**

%avid Schenker testified that

> some companies . . . have a provision in their certificates to the effect that you cannot sell that certificate to anybody else, and the only way you can sell it is to sell it back to the company. That is a technical problem. It presents a whole problem which they call the bootleg market. What happens is that dealers keep switching people from one company to another.

1940 Senate Hearings, supra note 35, at 292-93. Mr. Schenker went on to state that while the bootleg market was a problem, these restrictions "are taking away a big portion of the owner's right of initiative." His recommendation was that, rather than have an explicit prohibition, the subject "ought to be a matter of rules." Id.

[91]For example, a rule under section 22(f) might permit a fund to impose a reasonable fee when ownership of its shares is transferred from a non-contract dealer to a customer to compensate a fund for any administrative costs it incurs.

asset value.[92] Rule 22c-1 prevents dilution of the shareholders' equity that results from backward pricing. Amending the rule to permit dealers to make secondary markets in fund shares at fully negotiable prices would not be inconsistent with the rule's purpose. The issuance and redemption of shares by funds and their principal underwriters would continue to be based on forward pricing; therefore, secondary market transactions would not lead to dilution or opportunity for riskless trading.

D. Other Options Considered

1. "Voluntary" Retail Price Competition

We considered recommending that the Commission seek expanded authority to permit, but not require, retail price competition. This would permit the Commission to adopt a rule permitting the negotiation of sales loads, similar to proposed rule 22d-6, and also give the Commission flexibility to deal with any new products or any new questions involving secondary market trading of fund shares.

A permissive approach has some appeal. Permitting the voluntary negotiation of sales loads would allow funds to elect price competition to meet market needs, but not force all funds to face those particular competitive pressures immediately. A voluntary approach would allow funds to control the circumstances of their experiments with price competition and might yield some of the benefits of full retail price competition. Under a permissive rule, those funds that believe that retail price maintenance is desirable could continue it.

The obvious flaw with a permissive rule is that only a few funds, if any, likely would "elect" price competition. Historically, dealer pressure on underwriters has increased, not decreased, sales loads. We see no reason to believe that the same pressures would not continue under a voluntary system. Accordingly, we do not recommend this approach.

2. The Status Quo

We also considered maintaining the status quo. Opponents of repeal have argued that retail price maintenance has in fact permitted price competition and "worked well" over the last half century, as evidenced by the great variety of sales charges, the increases in the number of no-load funds and low-load funds, and

[92]The rule has a limited exemption for "backward pricing" by sponsors of unit investment trusts, allowing them conditionally to purchase or sell units in the secondary market at a price based on the offering side, determined weekly.

the apparent decline of the effective sales charges since 1960.[93] Thus, they conclude that section 22(d) need not be amended.

The Division disagrees. While there is a great degree of interbrand competition in the industry, nonetheless, the statute today precludes intrabrand competition. The original rationales for section 22(d) no longer exist and investors are harmed by higher prices than might otherwise be available in a competitive marketplace.

III. Sponsors' Options for Distribution Financing

Section 22(d) most directly affects funds with front-end sales loads, for a long time the only form of distribution charge paid by investors.[94] Alternative forms of distribution charges, such as rule 12b-1 fees and contingent deferred sales loads, have become increasingly prevalent and have resulted in complex distribution arrangements.

Because these distribution financing techniques are linked, regulation or competition affecting one leads to changes in use of another. Our general recommendation is to continue permitting a variety of distribution charges and regulating all distribution charges in as equivalent a manner as is feasible, and placing renewed emphasis on full and clear disclosure of those charges. Accordingly, the Division generally endorses the NASDs proposed extension of its maximum sales charge rule to asset-based sales charges and CDSLs. The Division also recommends minor amendments to rule 12b-1 to clarify its applicability to spread loads, adoption of proposed rule 6c-10 permitting CDSLs, and adoption of a rule permitting the issuance of multiple classes of shares in the same portfolio.

A. The Treatment of Fees and Distribution Charges under the Act

Several sections of the Investment Company Act address the use or level of various types of distribution charges. Under section 22(b), the NASD is authorized to prohibit "excessive" sales loads. Section 36(b) imposes a fiduciary duty on investment advisers with respect to fees, including distribution fees, paid

[93]*See, e.g.,* ICI Study Comment, *supra* note 26, at 50-51. It is difficult, however, to assess whether those rates actually have declined, however, in part because the introduction of rule 12b-1 fees makes comparison difficult, and because the types of funds sold have changed.

[94]Advisers to no-load funds in theory cover any limited distribution expenses out of their own resources.

by funds to advisers and their affiliates.[95] Section 12(b) authorizes the Commission to make rules governing funds' distribution of their own shares.[96]

1. Section 22(b)

In the 1930's, investment company underwriters maintained continuous sales pro rams to offset redemptions with new sales, with high costs to investors8 The costs were due in part to the dependence of underwriters on dealers for sales.[98] This dependence prevented reductions in sales charges[99] and fostered a number of questionable sales practices.'" In addition, a number of questionable computational techniques resulted in the actual distribution profits being larger than the load itself would have generated.[101]

The Commission addressed these problems in the legislation that it recommended to Congress in 1940.[102] The Commission recommended leaving the level of sales loads to competition among distributors, and retaining jurisdiction to act only where an "unconscionable or grossly excessive sales load" was charged (even if that load were disclosed).[103] Members of the industry expressed a preference for self-policing under the auspices of the NASD.[104] **As** enacted by Congress in 1940, section 22(b) included a general prohibition on

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[95]15 U.S.C. § 35(b).

[96]15 U.S.C. § 12(b).

[97]INVESTMENT TRUST **STUDY,** pt. 3, supra note 42, at 807, 809-13, 817, 856.

[98]In a highly competitive field, where most dealers had competing fund shares to sell, "maintenance of dealer good will" was "of paramount importance . . . . [I]n short, any device or practice which would facilitate the task of the dealer might be adopted or encouraged by open-end investment companies in order to assure the continued sale of their securities." Id. at 826-27.

[99]*Id.* at 826.

[100]*Id.* at 829-47.

[101]The Commission in the Investment Trust Study observed that "[tlhe open-end distribution system permits the inclusion of certain multiple and hidden profits . . . . Thus the various additions and adjustments made in the computation of the selling commission serve to enlarge the distribution profits beyond the apparent implications of the published load." *Id.* at 813.

[102]S. 3580, *supa* note 35, § 22(c).

[103]*1940 Senate **Hearings,*** supra note 35, at 290 (testimony of David Schenker).

[104]*See, e.g., **id.*** at 1057 (testimony of Arthur Bunker, Executive Vice President, Lehman Corp.).

"unconscionable or grossly excessive sales load[s]," and authorized the NASD to define these terms through rulemaking, subject to Commission review.[105]

By the mid 1960's, the PPI Report documented that the 8.5% front-end sales load then typical for mutual funds reflected large increases in sales charges since the early 1950's, with the increases going to higher dealer concessions.[106] The report observed that profits from advisory fees, and brokerage commissions, as well as a fund's own resources, often subsidized sales efforts.[107]

Although the Commission ultimately recommended a statutor cap of five percent on sales loads in lieu of ending resale price maintenance)[108] Congress decided to rely on the NASD to protect investors against unreasonable sales charges. As part of the 1970 amendments to the Act, section 22(b) was revised to provide for NASD-prescribed sales loads subject to Commission oversight under the Exchange Act.[109] In 1975, the NASD adopted an 8.5% maximum sales load limit, with lower ceilings if certain features were not offered.[110]

2. Section 36(b)

Section 36(b) imposes a fiduciary duty on the investment adviser of a registered investment company with respect to fund fees. The duty covers "the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person thereof." Thus, the adviser's duty

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[105]Investment Company Act of **1940,** Pub. L. No. **76-768, § 22(b), 54** Stat. **789, 823 (1940).**

[106]PPI REPORT, *supra* note 11, at **204, 207-09.** In addition, the report noted that the typical fund sales load was between two and a half and five times the "round trip" exchange commission charged for a trade in a listed security, and that loads were charged on reinvested dividends when they were not related to or justified by any special selling effort apart from the initial sale. *Id.* at **209-11, 215-16.**

[107]**All** or part of the cost of preparing prospectuses and sales-oriented shareholder reports were included in fund operating expenses and fund brokerage supplied added cash compensation to dealers selling fund shares. Id. at **201.**

[108]*Id.*

[109]Securities Exchange Act of **1934, 15** U.S.C. **§§ 78a-78*ll*.** Investment Company Act Amendments of 1970, Pub. L. No. **91-547, § 12(a), 84** Stat. **1413, 1422** (1970) (codified **as** amended at **15** U.S.C. § 80a-22(b)).

[110]Proposed Rule Change By the NASD, Investment Company Act Release Nos. **8893** (Aug. **14, 1975), 40 FR 36813** (Notice of Filing and Request for Comment), and **8980** (Oct. **10, 1975), 8 SEC** Docket **66** (Order Approving Rule Change).

under section 36(b) applies not only to advisory fees, but also to distribution charges such as rule 12b-1 payments.[111]

Congress adopted section 36(b) in 1970 in response to concerns articulated in the PPI Report that advisory fees were not subject to usual competitive pressures because of the external management of mutual funds.[112] The PPI Report concluded that the competitive forces that normally restrain prices did not operate efficiently in checking the costs of fund management. The primary reason was that, unlike typical corporations, funds were usually managed and operated by separate entities that provided investment advice and managerial services under contracts with funds. These separate entities usually had their own shareholders and were profit centers in their own right, creating a conflict of interest unique to mutual funds. The virtually complete merger of the funds' management with the advisory organizations meant that funds were not able to "bargain" for advice and the directors' ability to negotiate effectively on behalf of the funds was hampered by their inability, as a practical matter, to fire management in a dispute over fees.[113] In addition, investors did not understand or were not sensitive to the level of advisory fees or to fees generally and, in any case, were not influential because share ownership was so dispersed.[114]

The PPI Report concluded that "mutual fund shareholders need protection against incurring excessive costs in the acquisition and management of their investments and that, given the structure and incentives prevailing in the industry, neither competition nor the few elementary safeguards against conflict of interest deemed sufficient in 1940 . . . presently provide this protection in adequate measure."[115] Accordingly, the report recommended that the Act be amended to require that the compensation received by affiliated persons of investment companies for services furnished to an investment company be reasonable and that this standard be enforceable in the courts.[116]

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[111]*See, e.g.,* **Krinsk v. Fund Asset Management, 715 F. Supp. 472 (S.D.N.Y. 1988),** ***aff'd,*** **875 F.2d 404 (2d Cir.),** *cert. denied,* **110** *S.* **Ct. 281 (1989).**

[112]*See, e.g.,* **H.R. REP.** NO. **1631, 91st Cong., 2d Sess. (1970) (conference report); H.R.** REP. NO. **1382, 91st Cong., 2d** Sess. **7-8 (1970); id. at 86-88** *(Memorandum of the SEC on H.R.* **27333** *to the Comm. on Interstate and Foreign Commerce).*

[113]PPI **REPORT,** *supra* **note 11, at 10-12, 126-27, 130-32.**

[114]*Id.* at **126, 129-30.**

[115]*Id.* **at** viii.

[116]*Id.* **at** viii, **143-147.**

Rather than imposing a reasonableness standard, Congress imposed a fiduciary duty on investment advisers with respect to the receipt of compensation for services and instructed a court in any action brought under the provision to give only "appropriate" consideration to any prior approvals of the compensation by shareholders or directors. Congress also amended section 15(c) of the Act[117] to impose on directors a duty to evaluate, and on an adviser a duty to furnish, all relevant information needed to review the terms of advisory contracts. This amendment was designed to strengthen the ability of directors, particularly the independent directors, to carry out their responsibilities with respect to approval of these contracts.[118]

Since the enactment of section 36(b), the relatively few decided cases addressing the issue of management com ensation under the Act all have resulted in decisions for fund management.[119] The first of these cases remains the leading authority for evaluating an adviser's breach of fiduciary duty with regard to compensation.[120] One factor identified by that court,[121] the role and decision-making process of fund directors in approving compensation arrangements, has been uniformly considered by following courts as the most important factor in determining section 36(b) liability.[122]

[117]15 U.S.C. § 80a-15(c).

[118]*See* S. REP. No. 184, 91st Cong., 1st Sess. 15 (1969).

[119]*See* Gartenberg v. Merrill Lynch Asset Management, Inc., 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff'd,* 694 F.2d 923 (2d Cir. 1982) ("Gartenberg I"); Gartenberg v. Merrill Lynch Asset Management, Inc., 573 F. Supp. 1293 (S.D.N.Y. 1983), *aff'd,* 740 F.2d 190 (2d Cir. 1984); Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962 (S.D.N.Y.), *aff'd,* 835 F.2d 45 (2d Cir. 1987), *cert. denied,* 485 U.S. 1034 (1988); Krinsk v. Fund Asset Management, 715 F. Supp. 472 (S.D.N.Y. 1988), *aff'd,* 875 F.2d 404 (2d Cir.), *cert. denied,* 110 S. Ct. 281 (1989); Meyer v. Oppenheimer Management Corp., 609 F. Supp. 380 (S.D.N.Y. 1984), *rev'd,* 764 F.2d 76 (2d Cir. 1985), *on remand,* 707 F. Supp. 1394 (S.D.N.Y. 1988) (corrected version; originally published at 691 F. Supp. 669) (section 36(b) issue reserved but discussed in dicta), 715 F. Supp. 574 (S.D.N.Y. 1989) (addressing section 36(b) claim), *aff'd,* 895 F.2d 861 (2d Cir. 1990); and Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (S.D.N.Y. 1990), *aff'd,* 928 F.2d 590 (2d Cir.), *cert. denied,* 112 S. Ct. 75 (1991).

[120]Gartenberg I, 528 F. Supp. 1038.

[121]The court primarily examined six factors in determining whether a breach of fiduciary duty had occurred. These factors are the nature and quality of the services rendered to the fund; the profitability in providing those services; the economies of scale that may result from fund asset growth and the effect such economies have on the adviser's Compensation; potential fall-out benefits arising from the investment company relationship; fees and expense ratios of other similar funds; and the role and decision-making process of fund directors in approving compensation arrangements. Id.

[122]*See, e.g.,* Kalish, 742 F. Supp. at 1241-49; Schuyt, 663 F. Supp. at 980-88.

3. Section 12(b)

Section 12(b) generally provides that a registered open-end investment company may not act as a distributor of its securities, except through an underwriter, in contravention of any rules prescribed by the Commission. The Commission testified in **1940** that this provision was intended to protect investors in open-end companies "against excessive sales, promotion expenses, and so forth."[123] Another explanation of its purpose comes from a commentator writing shortly after the Act's adoption: "[a]pparently the Commission was particularly fearful of the possibility that open-end investment companies in their formative stages might be made to shoulder the unprofitable burden of selling and distributing their shares during this period of heavy expense and small return, building up the investment company for the benefit of some controlling person."[124] Thus, section 12(b) was intended to prevent abuses through the grant to the Commission of authority to regulate the use of fund assets to pay for distribution.[125]

B. Administrative Action Since 1940

1. The Use of Fund Assets to Pay for Distribution

The Commission did not exercise its authority under section 12(b) to prescribe a rule governing the use of fund assets for distribution until 1980, when it adopted rule 12b-1.[126] Since the adoption of the rule, more than half of all mutual funds have enacted rule 12b-1 plans, using these charges, alone or with sales loads, as the primary means of financing distribution.[127] Other funds, typically funds with no front-end loads, have added a relatively modest rule 12b-1 fee to pay for some sales commissions, printing prospectuses and sales literature, advertising, and similar expenses.

When the Act was adopted, most funds charged a front-end sales load. By the mid-1970's, the no-load segment of the industry had increased

[123] *1940 House Hearings, supra* note 37, at 112 (statement of David Schenker).

[124] Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L. Q. 303, 324-25 (1941).

[125] *See also* Inv. Co. Act Rel. 11414, *supra* note 15, at n.49 and accompanying text (adopting rule 12b-1).

[126] The legislative and administrative history leading up to the adoption of rule 12b-1 is lengthy. It is recounted in detail in Inv. Co. Act Rel. 16431, *supra* note 16.

[127] *See* Lipper Directors' Analytical Data Vol. I, Sec. III, at 3, Vol. 11, Sec. 11, at 157 (1st ed. 1992).

significantly.[128] The distribution expenses of these no-load funds were borne by their investment advisers. As the popularity and number of no-load funds increased, several of these funds requested that the staff take a no-action position allowing them to use fund assets to pay for distribution. These requests were generally denied in accordance with the traditional position of the Commission that the use of fund assets to pay the costs of distributing fund shares was improper.[129]

The industry nonetheless continued to press its view, pointing to the increase in net redemptions in some segments of the fund industry, the growing resistance to high front-end sales loads, and the rising popularity of no-load funds.[130] It argued that the rigidity of the regulatory approach for fund distribution put mutual funds at a disadvantage to competing investment products that could be offered to investors without such sales loads.[131] The industry also argued that use of fund assets for distribution expenditures would result in a net flow of cash into funds, and in turn, economies of scale and more effective portfolio management.[132]

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[128] *See* 1974 DISTRIBUTION REPORT, supra note 14, at 19, 20-22.

[129] *See, e.g.*, Axe-Houghton Funds (pub. avail. Nov. 15, 1973). See *also* Inv. Co. Act Rel. 9470, *supra* note 61, at n.1 and accompanying text. Despite the traditional position, investment companies were allowed on a number of occasions to bear distribution expenses under circumstances which served to lessen the potential for overreaching. First, certain funds that had internalized management functions were allowed to pay distribution expenses out of fund assets. See, *e.g.*, Broad Street Investing Corp., Investment Company Act Release Nos. 7071 and 7072 (Mar. 16, 1972), 37 FR 5846 (Notices of Applications) and 7114 and 7117 (Apr. 14, 1972)(Orders); see *generally* PPI REPORT, *supra* note 11, at 49. Nor did the Commission object generally to the payment of fund distribution expenses by the fund's investment adviser; where, however, the advisory fee was increased in contemplation of payments for distribution by the adviser, the staff took the position that the advisory fee might result in a violation of section 36(b). See Inv. Co. Act Rel. 16431, *supra* note 16, at nn.11-13 and accompanying text. Historically, the Commission's opposition was based on the potential conflict inherent in the fact that, given the external management of mutual funds, most decisions relating to the use of fund assets are made by a fund's adviser, which directly benefits from increased sales of fund shares because its compensation is based on a percentage of fund assets. The Commission also was concerned whether using fund assets for distribution would in fact benefit existing shareholders. See Inv. Co. Act Rel. 9470, supra.

[130] Hearings on the Bearing of Distribution Expenses by Mutual Funds, File No. 4-186, Tr. at 23, 248-49, 307-08. Inv. Co. Act Rel. 16431, *supra* note 16, at text following n.13.

[131] *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10252, text accompanying nn. 2-3 (May 23, 1978), 43 FR 23589 (advance notice of proposed rulemaking).

[132] *See id.*

In **1979,** after extensive **consideration,**[133] the Commission proposed rule 12b-1, stating that funds should be permitted to bear distribution expenses if they were disclosed and **regulated.**[134] The Commission adopted rule 12b-1 in October **1980.**[135]

2. Contingent Deferred Sales Loads

The use of CDSLs developed contemporaneously with the use of rule 12b-1 plans and indeed worked in tandem with them since the load is imposed to assure recoupment to the distributor of the costs of distribution. Where a fund might once have charged a six percent front-end load, it might now roughly recoup **the** same six percent through a combination of rule 12b-1 fees and contingent deferred **loads.**[136] This "spread load" arrangement grew in popularity during the 1980's as many retail broker-dealers advanced to their salespersons large amounts of commissions for mutual fund sales, expecting reimbursement from future rule 12b-1 fees and **CDSLs.**[137]

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[133]In late 1976, the Commission held public hearings on the appropriateness of open-end companies bearing expenses related to the distribution of their shares. In 1977, the Commission considered that proposal but later issued a release stating it was still considering the question. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 9915 (Aug. 31, 1977), 42 FR 44810. In 1978, the Commission issued an advance notice of proposed rulemaking stating that the Commission had not decided whether funds could benefit from paying distribution expenses. Inv. Co. Act Rel. 10252, *supra* note 131, at text accompanying n.4 and text following n.9.

[134]*See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10862 (Sept. 7, 1979), 44 FR 54014 (proposing rule 12b-1).

[135]**Inv.** Co. Act Rel. 11414, supra note 15.

[136]*See, e.g.*, Drexel Burnham Fund and DBL Tax-Free Fund, Inc., Investment Company Act Release Nos. 16201 (Jan. 22, 1988), 53 FR 2664 (Notice of Application), and 16284 (Feb. 24, 1988), 40 **SEC** Docket 548 (Order). The Commission's 1988 release proposing rule 6c-10, an exemptive rule permitting funds to impose deferred sales loads (including contingent loads), discusses the legislative and administrative history of these arrangements in detail. Inv. Co Act. Rel. 16619, ***supru*** note 20.

[137]For example, one fund that pioneered the use of a spread load grew from about $109 thousand to almost $4 billion in assets in a single year. During that year, the distributor spent roughly $205 million on behalf of the fund and received only $23 million in rule 12b-1 fees and $3 million in CDSLs, resulting in unreimbursed distribution fees of over $179 million. Assuming constant asset size and no redemptions, it would have taken five years to recover this "carryover" amount. Although the distributor treated the carryover as an asset – a receivable to be collected in future years -- the fund did not consider the carryover to be a liability. Rather, the fund recognized only a current expense in an amount equal to the amount of rule 12b-1 fees paid that year ($23 million) because it was not contractually obligated to pay any additional amounts if the
(continued...)

The spread load is essentially a financing of a front-end sales load. Unfortunately, neither component of the spread load is as obvious to investors as is a front-end sales load. The rule 12b-1 charge is deducted as an expense at the fund level, while the CDSL is deducted out of an individual shareholder's redemption proceeds.

3. The Commission's 1988 Proposals to Limit Spread Loads and Permit Installment Loads

In 1988, the Commission proposed broad amendments to rule 12b-1.[138] The proposal reflected concern with the open-ended nature of distribution payments and their criticism by some as "hidden loads." The proposal would have effectively prohibited the use of spread loads as alternatives to front-end loads.

Shortly thereafter, the Commission proposed rule 6c-10, in part to codify exemptive orders issued to applicants permitting CDSLs.[139] Proposed rule 6c-10 went beyond these orders to allow non-contingent deferred sales loads, including installment loads.[140] Proposed rule 6c-10 was intended to provide greater flexibility to mutual funds in their distribution arrangements, especially

[137](...continued)
rule 12b-1 plan was cancelled or allowed to lapse by the board of directors. Of the $205 million spent by the distributor, 45% represented commission credits to brokers and 52% represented an allocation of branch office overhead, sales seminar costs, travel expenses of mutual fund sales coordinators, and other incidental expenses related to branch sales promotion. Prudential-Bache Government Plus Fund, Inc., Prospectus 11-13 (May 1, 1986) and Statement of Additional Information B-15 to B-17, B-25 to E28 (May 1, 1986), SEC File No. 2-82976.

[138]*See* Inv. Co. Act Rel. 16431, ***supra*** note 16.

[139]Inv. Co. Act Rel. 16619, ***supra*** note 20.

[140]Commission rules relating to certain variable life insurance contracts permit sales loads to be deducted over time, as well as upon redemption. See rule 6e-3(T) under the Investment Company Act, 17 C.F.R. § 270.6e-3(T). See also Separate Accounts Funding Scheduled Premium Variable Life Insurance Contracts, Investment Company Act Release No. 14421 (Mar. 15, 1985), 50 FR 11709 (proposing amendments to Rule 6e-2 that would, among other things, permit installment loads and loads on redemption for scheduled contracts). In addition, the Commission has issued exemptive orders to permit sales loads to be deducted from variable annuity contract owner accounts over time. See, *e.g.*, MB Variable Life Ins. Co., et. al., Investment Company Act Release Nos. 18434 (Dec. 10, 1991), 56 FR 65528 (Notice of Application), and 18476 (Jan. 8, 1992), 50 SEC Docket 1145 (Order).

arrangements designed to offer shareholders deferred payments for sales charges without use of rule 12b-1 plans.[141]

Both proposals were met by a storm of criticism from the industry, which regarded them as dooming spread loads without a satisfactory replacement, forcing most spread load funds to revert to front-end loads.[142] They rejected installment loads as a feasible alternative to spread loads.[143] They predicted that investors would reject funds in favor of other investments that permitted deferred charges, *e.g.*, variable annuities.[144] Critics also argued that the proposals would jeopardize maintenance of viable distribution systems. Such systems, they argued, stimulate growth and benefit funds and shareholders by enabling advisers to build stronger advisory organizations, with greater economies of scale and more sophisticated communication and data processing facilities for shareholder servicing.[145] Many of these commenters contended that funds would not be interested in using non-contingent deferred sales loads because of high administrative costs and operational difficulties.[146]

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[141]Inv. Co. Act Rel. 16431, *supra* note 16, at n.84; Inv. Co. Act Rel. 16619, *supra* note 20, at text following n.33.

[142]*See, e.g.*, Letter from Keystone Group, Inc. to Jonathan G. Katz, Secretary, SEC 1 (Jan. 6, 1989), File No. S7-24-88 (responding to Inv. Co. Act Rel. 16619, *supra* note 20); ICI Rule 12b-1 Comment, *supra* note 16, at 4. They noted that spread load plans had been adopted by more than 300 funds with over seven million shareholder accounts and assets exceeding $70 billion. With respect to the rule 12b-1 amendments, the Commission received 91 letters from the industry, 1,650 letters from individual investors, and over 70 congressional inquiries regarding the proposing release. Generally, individual investors supported the amendments.

[143]*See, e.g.*, Letter from the ICI to Jonathan G. Katz, Secretary, SEC 13-16 (Jan. 9, 1989), File No. 57-24-88 (responding to Inv. Co. Act Rel. 16619, supra note 20) [hereinafter ICI Rule 6c-10 Comment]; Letter from the Subcomm. on Investment Companies and Investment Advisers of the Comm. on Federal Regulation of Securities, Section of Corporation, Banking and Business Law, American Bar Association, to Jonathan G. Katz, Secretary, SEC 3 (Jan. 31, 1989), File No. S7-24-88 (responding to Inv. Co. Act Rel. 16619, *supra* note 20).

[144]ICI Rule 12b-1 Comment, *supra* note 16, at 11.

[145]For example, the ICI also contended that the practical effect would be to prevent new and smaller funds from adopting or continuing spread loads while permitting large, established funds with a large asset base to finance new shares on the proposed current or one year basis. In addition, the ICI argued that the amendments would frustrate the legitimate expectations of underwriters and investors. ICI Rule 6c-10 Comment, *supra* note 143, at 15; ICI Rule 12b-1 Comment, *supra* note 16, at 5-6.

[146]*See, e.g.*, ICI Rule 6c-10 Comment, supra note 143, at 2-3. *Cf.* Letter from IDS Financial Corp. to Jonathan G. Katz, Secretary, SEC 1 (Jan. 3, 1989), File No. 57-24-88 (responding to Inv. Co. Act Rel. 16619, supra note 20).

Some critics also argued that the proposed prohibition on the use of the no-load label by all funds with rule 12b-1 plans did not distinguish between funds that are essentially no-load but assess a small charge to pay for supplemental distribution expenses and those that use rule 12b-1 plans as the functional equivalent of front-end sales loads.[147]

C. Proposed NASD Regulation of Rule 12b-1 Fees

In response to the 1988 proposal, the NASD sought to address the concern that rule 12b-1 fees were being used to circumvent the NASD imposed limitations on excessive sales loads[148]. Subsequently, it proposed amendments to its maximum sales load rule.[149] The amendments would limit all sales charges, including front-end loads, rule 12b-1 payments, and CDSLs.[150]

The NASDs espoused objective was to assure in the simplest and most expedient way that shareholders paying for distribution indirectly through rule

[147] *See, e.g.,* ICI Rule 12b-1 Comment, *supra* note 16, at 71-72; Letter from ICI to Jonathan G. Katz, Secretary, SEC 3-4 (May 10, 1991), File No. SR-NASD-90-69 (responding to Exch. Act Rel. 29070, *supra* note 18) [hereinafter ICI NASD Rule Comment].

[148] Form 19b-4, Proposed Rule Change by NASD 10-11 (Dec. 28, 19901, File No. SR-NASD-90-69 [hereinafter NASD Proposal].

[149] The NASD extensively regulates sales compensation paid in connection with sales of securities by its members under Article III, Section 1 of the Rules of Fair Practice. NASD Manual (CCH) ¶ 2151. *See also* NASD Proposal, *supra* note 148, Exhibit 5. *See* NASD Notice to Members No. 90-26 (Apr. 1990) and NASD Notice to Members No. 90-56 (Sept. 1990). In response to the Study Release *(supra* note 26), several commenters supported NASD regulation as a more acceptable alternative than the 1988 Commission proposal. *See, e.g.,* ICI Study Comment, *supra* note 26, at 52-53.

[150] In brief, the NASD proposal would create a rolling cap of 6.25% of new gross sales, plus annual interest equal to the prime rate plus one percent on the total sales charges -- front-end, asset-based, and deferred -- for funds that pay "service fees" and a rolling cap of 7.25% for funds that do not pay service fees. The reduction from 8.5%, the maximum permitted sales charge under the present rule governing front-end loads occurs because asset-based sales charges do not provide quantity discounts or rights of accumulation. New gross sales are defined to exclude the reinvestment of distributions and complex-wide exchanges of shares. Service fees are defined under the proposal as payments by a fund for personal service and/or shareholder account maintenance. The rule also imposes an annual cap on the amount of asset-based sales charges that may be collected in any one year of .75% of average annual net assets. In addition, a maximum .25 of 1% of its average annual net assets may be paid by a fund for personal service and/or account maintenance of shareholder accounts as a "service" fee, which is not counted in the .75% cap. If the maximum aggregate cap is reduced to zero, no more rule 12b-1 fees may be collected until there are new sales; if the fund continues to receive deferred charges on redemption, those monies may not be used to pay for sales-related expenses. *See* NASD Proposal, *supra* note 148, at 2-9.

12b-1 fees would pay no more than those paying at the front-end[151]. The present state of technology forced it to reject tagging rule 12b-1 fees to individual accounts. It opted, therefore, for fund-level accounting, which could be implemented rapidly and would not preclude the industry from eventually implementing individual shareholder accounting.[152] Accordingly, the NASD proposal requires fund-level accounting as the minimum standard. It preserves the use of spread loads.[153]

D. Limited Amendments to Rule 12b-1

In light of the NASD's proposal to limit asset-based sales charges, we recommend that the Commission adopt only limited changes to rule 12b-1, not the broader amendments proposed in 1988. The Division's recommendation would permit the continued use of spread loads.

Those opposing the 1988 rule proposal generally have argued that the present variety of fees and charges provides fund sponsors with needed pricing flexibility and gives investors a wide range of payment options.[154] For example, the ICI believes that improved required disclosures, such as the prospectus fee table[155] and disclosure of the existence of CDSLs on the front of confirmations,[156] will reduce investor confusion about the multiplicity of sales load structures.[157] The ICI also argues that the Commission's concerns about the level of rule 12b-1 fees are most effectively addressed by direct NASD regulation.[158]

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[151]*Id.* at **10-11** and **17-19.**

[152]*See* Exch. Act Rel. **29070,** *supra* note **18** at II.C. Fund-level accounting requires that all sales charges end when a percentage of gross sales is reached while individual shareholder accounting requires separate tabulation of all charges paid by each shareholder. Id.

[153]In addition to addressing rule **12b-1** fees, the current rule would be modified to include explicitly deferred sales charges.

[154]*See* ICI Study Comment, *supra* note **26,** at **51-53.**

[155]*See infra* notes **181** and **200** and accompanying text.

[156]Order Granting Approval to Proposed Rule Change Relating to Disclosure of Deferred Sales Charges, Exchange Act Release No. **29069** (Apr. **11,** 1991), **56 FR 15654.**

[157]*See* ICI Study Comment, *supra* note **26,** at **53;** ICI Rule **12b-1** Comment, *supra* note **16,** at **17-18.**

[158]*See* ICI NASD Rule Comment, *supra* note **147,** at **1-2.**

While the NASD proposal would not entirely resolve the problems that gave rise to the 1988 proposals, it is a step in the direction of limiting fee levels. In addition, while reverting to the status quo ante may have some appeal to those who yearn for a simpler time, the fact is that many investors may wish to finance their sales loads through a spread load arrangement and would not appreciate elimination of that option.

We remain concerned, however, that the inherent lack of transparency of spread loads compromises competitive pressures on fee levels. Although the methods for calculating shareholder transaction expenses and fund operating expenses are disclosed in the prospectus, comprehensible disclosure of spread loads, and what amount an individual ultimately will pay, is inherently difficult. The rule 12b-1 fee component of this type of sales load is deducted at the fund level as an expense of the fund, before the calculation of net asset value and investment return, and not as a dollar amount periodically deducted from a shareholder's account as an installment load would be. In the prospectus, it is listed with the other fund operating expenses, such as management and other fees, and not with the shareholder transaction expenses which include the other types of sales loads. The CDSL component of the spread load is even less visible or convertible to a "sum certain" at the time the investment is made.[159]

To address the disclosure problem, we considered recommending that all funds be required to pay for transaction-based distribution charges (largely sales commissions) out of individual shareholder sales loads, which could be either the front-end or the installment type, rather than out of fund assets. All other types of distribution expenses could be paid for by the adviser, out of its management fee.

While this approach has considerable appeal, we concluded that tax law complications[160] would make the method essentially impossible. Unless and until the tax laws change, we think spread loads generally should be permitted. Thus, at least at present, the Division recommends that the Commission adopt **only** the portions of the proposed amendments to rule 12b-1 that are consistent with the use of spread loads.

The Division, however, remains concerned with investor understanding of rule 12b-1 fees and will continue to focus on improving disclosure of these

[159]The accounting treatment of spread loads exacerbates the confusion. When a principal underwriter advances commissions to salespersons, it records as an asset on its books a receivable from the fund, but the fund does not report a matching liability on its books. In economic reality, however, the fund probably will be paying for much of the sales commission over the next several years.

[160]*See infra* text accompanying notes 165-68.

arrangements. The recent NASD rule amendment to require disclosure of the existence of contingent deferred sales loads on confirmations is a positive step. In addition, we believe investor demand may cause more funds to adopt methods of financing distribution other than spread loads, such as multiple class arrangements with a "conversion" feature,[161] and low front-end sales loads.[162] We believe, too, that the unified fee investment company proposal that we discuss below also will be used by funds to meet investor demand for simple and more easily understandable fee arrangements.

E. Adoption of Rule 6c-10

The Division recommends that the Commission adopt rule 6c-10 largely as proposed to provide for both CDSLs and non-contingent deferred loads such as installment loads. Commenters supported adoption of proposed rule 6c-10 to the extent it would have codified exemptive orders for CDSLs.[163] By and large, they roundly criticized the proposal for non-contingent loads, however, as operationally infeasible because of high administrative costs and operational difficulties associated with the implementation of such charges, adverse tax consequences for shareholders, and aspects that would make the loads economically undesirable for underwriters.[164]

The Division disagrees with that criticism. The funds that currently impose a contingent load or offer class conversions may well possess the type of operational systems and procedures necessary to offer the non-contingent deferred loads that would be permitted under the rule. In addition, whether the implementation of a deferred load would result in substantial costs or difficulties will depend on many factors, including the complexity of the load. In any case,

[161] *See, e.g., infra* note **174** and accompanying text.

[162] For example, the Lexington family of funds recently changed from front-end loads to a no-load structure. See Lexington Goes No-had, DONOGHUE'S MONEYLETTER 7 (Oct. **1990).**

[163] Thirty-eight commenters responded; seven commented only on the life insurance separate account rules. Almost all supported codification of CDSL exemptive orders. See, *e.g.*, ICI Rule 6c-10 Comment, supra note **143,** at **2-3.**

[164] Eight commenters opposed non-contingent deferred sales loads. See Letter from the American Bar Association, Section of Business Law, to Jonathan G. Katz, Secretary, SEC **4** (Jan. **31, 1989),** File No. **S7-24-88;** Letter from the ICI to Jonathan G. Katz, Secretary, SEC **2-3, 6, 8-11** (Jan. **9, 1989),** File No. **S7-24-88;** Letter from IDS Financial Co., to Jonathan G. Katz, Secretary, SEC **1-2** (Jan. **3, 1989),** File No. **S7-24-88;** Letter from Keystone Group to Jonathan G. Katz, Secretary SEC 1 (Jan. **6, 1989),** File No. **S7-24-88;** Letter from the NASD to Jonathan G. Katz, Secretary, SEC **1** (Mar. **14, 1989),** File No. **S7-24-88;** Letter from **NYLIFE** Securities to Jonathan G. **Katz,** Secretary, **SEC** 2-4 **(Dec. 30, 1988),** File No. **S7-11-88;** and two individual investors. Sixteen commenters supported non-contingent deferred sales loads; of those, fifteen were individual investors.

technology is evolving rapidly and it is reasonable to anticipate that cost-effective systems for implementing even the most complex types of loads will be available soon, if they are not already.

We also note that the rule offers a voluntary option. A fund not able to take advantage of its provisions would not be required to do so.

We recognize that the tax laws are a significant impediment to implementing non-contingent deferred loads and installment loads. The tax laws may prohibit payments of installment loads in certain tax-privileged situations, such as Individual Retirement Accounts or pension accounts.[165] In addition, the collection of installment loads is likely to occur through redemptions of fund shares,[166] which is a taxable event. Investors either would incur tax liabilities for gains when not actually receiving any distributions or would realize losses.[167] Investors also would bear added recordkeeping burdens, because each installment of a deferred load would be treated as an increase in the shareholder's basis.[168]

On balance, we conclude the benefits of proposed rule 6c-10, a permissive rule, outweigh the problems raised by commenters. In addition to codifying orders permitting CDSLs, the proposed rule would allow noncontingent deferred loads, which some funds may choose to implement. Indeed, the Division proposed the rule only after receiving informal inquiries whether such loads could be imposed on fund shares. Accordingly, the Division recommends that rule 6c-10 be adopted, largely as proposed, but with certain modifications suggested by commenters to improve the mechanics of the rule. We recognize, however, that installment loads likely will not be used without tax reform.

[165]Payments from pension plans and individual retirement accounts and annuities that are not considered rollovers would likely be taxed to the investor as a distribution. See Internal Revenue Code of 1986, 26 U.S.C. §§ 402(a)(5) and 408(d)(3). For an IRA, the entire account may lose its exempt status and the investor would recognize the amount of that distribution in taxable income for that tax year. See Internal Revenue Code of 1986, 26 U.S.C. §§ 4975(e)(2)(A), (B), 408(e)(2), 402(a)(1) and 408(d)(1).

[166]Alternatively, the installment load could be billed directly to the customer (with no adverse tax consequences in most cases) or deducted from the shareholder's dividends; or the customer's shares, if any, in a related money market fund could be redeemed to cover the charges. The tax consequences for shareholders of an annual installment payment would be similar to those of an annual redemption elected by a shareholder for trading or other purposes.

[167]In addition to shareholder recognition problems, tax-related issues involve imputed interest (and investment interest expense) and withholding; other difficult issues raised by deferred loads would include access to margin securities and receivables at the distributor level.

[168]Bills introduced in the 102nd Congress would require funds to provide shareholders and the Internal Revenue Service with cost basis information for all fund shares redeemed, taking into account all adjustments to basis, *e.g.*, returns of capital, wash sales. See, *e.g.*, H.R. 2735 and S. 530, 102nd Cong., 1st Sess. (1991).

F. Multiple Class Exemptive Rule

Since 1985, a number of funds have obtained exemptive orders permitting them to issue multiple classes of securities, with each class subject to a different distribution arrangement, but representing interests in the same portfolio of investments.[169] Typically, the classes are identical in all respects except for the allocation of distribution, administrative, or support service expenses, and related incremental expenses (*i.e.,* transfer agency fees), differences in voting rights, and dividend payment differences. The funds fall into three basic types, which roughly may be characterized as "multiclass" funds, "dual distribution" funds, and "conversion" funds, although more recent orders have mixed some of the features of these types.[170]

"Multiclass" funds were the first type used. They were created to compete for the short-term investments of certain institutional investors. The investors wanted services adapted to their particular needs. Typically, multiclass funds enter into arrangements whereby particular classes of fund shares are sold to specific institutional investors, such as banks acting in a fiduciary, advisory, agency, custodial, or similar capacity on behalf of customer accounts, insurance companies, investment counselors, brokers, or other financial institutions.[171] In some cases, one or more of the classes are sold directly to individuals.[172] The fund usually makes payments to the institution for providing administrative or shareholder services and, sometimes, for distribution services as well. This arrangement allows the "unbundling" of services typically provided by the fund and permits institutional investors to select the services they wish to provide to their shareholders.

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[169] The applicants received exemptive orders under section **6(c) (15** U.S.C. § 80a-6(c)) from section **18 (15 U.S.C. § 80a-18)** to the extent that the arrangements might be deemed to result in the issuance of a "senior security" and to be inconsistent with the requirement that every share have equal voting rights. See releases cited *infra* notes **171-74.**

[170] A recent related development is the "hub and spoke" fund structure, under which funds with different costs share a single investment portfolio. It is similar to a multiclass structure, but uses separate funds instead of classes. Typically, the spoke funds invest solely in the hub fund, which holds the investment portfolio and bears advisory fees.

[171] See, *e.g.,* The Hex-Funds, Investment Company Act Release Nos. **18110** (Apr. **23, 1991), 56 FR 19888** (Notice of Application) and **18162** (May **21, 1991), 48** SEC Docket **1685** (Order); Federated Securities Corp., Investment Company Act Release Nos. **17645** (Aug. **2, 1990), 55** FR **32531** (Notice of Application), and **17715** (Aug. **30, 1990), 46** SEC Docket **1993** (Order) (permitting unlimited number of future classes and allocation of a broad array of expenses by class).

[172] *See, e.g.,* Mutual Fund Group, Investment Company Act Release Nos. **17539** (June **19, 1990), 55** FR **26045** (Notice of Application), and **17590** (July **17,19901, 46** SEC Docket **1366** (Order).

"Dual distribution" funds typically have two classes that bear different distribution charges, *e.g.*, a front-end load and a spread load. They have a somewhat different purpose -- to allow investors to select the method of financing distribution best suited to their investment horizon and the size of their investment. For example, investors who would qualify for a significant reduction in the front-end load or investors who will be holding their shares for a long time may decide that a front-end sales load is preferable to an ongoing distribution fee under a spread load.[173]

The "conversion" funds are a variant of the dual distribution funds. Typically, investors may still choose between two classes, one with a front-end load and no or a relatively low rule 12b-1 fee, and the other with a spread load, but with a relatively large rule 12b-1 fee. Shares of the spread load class convert to shares of the other class, without payment of any fee or load, after a specified period (*e.g.*, four to eight years) designed to permit the principal underwriter to recover its distribution expenses.[174] The conversion feature limits the rule 12b-1 plan payments borne by each shareholder to an amount approximately equal to the distribution expenses incurred on the shareholder's behalf in the primary distribution while also placing a ceiling on the compensation received by the distributor for these initial distribution expenses.

The conditions to exemptive orders have addressed three areas of concern. The first is possible conflicts of interest among the classes of shareholders, especially as to the allocation of expenses. To address this concern, the applicants have agreed that the funds' directors will monitor for material conflicts and take action necessary to remedy such conflicts. In addition, the funds' methodology for allocating direct and indirect distribution expenses among the classes is reviewed by an outside expert and approved by the independent directors.

The second area addressed is the funds' calculation of different net asset values. The net asset values of the classes in some types of funds usually will vary. For example, a front-end load class having lower expenses than a spread load class, which bears the rule 12b-1 plan expenses and the related higher transfer agency costs, will be entitled to receive more of the fund's current net

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[173]*See, e.g.*, **Merrill Lynch California Municipal Series Trust, Investment Company Act Release Nos. 16503 (July 28, 1988), 53 FR 29294 (Notice of Application), and 16535 (Aug. 23, 1988), 41 SEC Docket 1165 (Order) (first dual distribution order) [hereinafter Merrill Order],** ***amended in*** **Merrill Lynch Short-Term Global Income Fund, Inc., Investment Company Act Release Nos. 18015 (Feb. 22, 1991), 56 FR 8814 (Notice of Application), and 18059 (Mar. 22, 1991), 48 SEC Docket 838 (Order).**

[174]*See, e.g.*, **Alliance Short-Term Multi-Market Trust, Inc., Investment Company Act Release** Nos. **17295 (Jan. 8, 1990), 54 FR 1300 (Notice of Application), and 17330 (Feb. 2, 1990), 45 SEC Docket 1024 (Order).**