

MEMO# 5751

April 4, 1994

ISSUES RELATING TO PROPOSED RULE 6C-10

1 In its 1992 report on investment company regulation, the staff of the Division of Investment Management recommended that the Commission adopt proposed Rule 6c-10, "with certain modifications" relating to the mechanics of the rule. April 4, 1994 TO: SEC RULES COMMITTEE NO. 44-94 RE: ISSUES RELATING TO PROPOSED RULE 6c-10

Introduction In 1988, the Securities and Exchange Commission proposed Rule 6c-10 under the Investment Company Act of 1940, to permit mutual funds to impose contingent and non-contingent deferred sales loads without first obtaining exemptive relief from the Commission. In response to this proposal, the Institute filed a comment letter generally supporting the provisions relating to contingent deferred sales loads but opposing the non-contingent deferred load portion of the proposal. To this date, there has been no further Commission action on the proposed rule. 1 Currently, however, the Commission is considering another rule proposal (Rule 18f-3) that would permit mutual funds to issue multiple classes of shares without having to seek an exemptive order. Insofar as most funds with multiple classes impose a contingent deferred sales load on at least one class of shares, and at present must obtain exemptive relief to do so, we understand that it is likely that the Commission will adopt proposed Rule 6c-10 in some form at the time it adopts the multiple class proposal. Therefore, at the April 12th meeting of the SEC Rules Committee, we will ask the Committee to discuss whether any significant concerns remain in connection with the possible adoption of Rule 6c-10. As background for the discussion, this memorandum summarizes the issues the Institute identified in its 1989 comment letter on proposed Rule 6c-10, recent comment letters filed in support of the rule proposal, and certain developments in the area of mutual fund distribution since Rule 6c-10 originally was proposed. Copies of the Institute's comment letter and the recent comment letters are attached. Institute Comment Letter As noted above, the Institute's comment letter on proposed Rule 6c-10 generally supported the codification of exemptive relief for the imposition of contingent deferred sales loads. We suggested, however, that the NASD regulate these charges; that fund complexes be permitted to continue to rely on previously issued exemptive orders as to existing funds as well as funds created in the future; and that the proposed definition of contingent deferred sales load be modified slightly. With respect to non-contingent deferred loads (in particular, installment loads), the Institute's letter characterized the Commission's proposal as "uneconomic and unworkable." The letter criticized the proposal on the basis that it dealt with an area in which the staff had no experience and the industry had no interest. The Institute also strongly objected to the suggestion that non-contingent deferred loads could act as a substitute for spread-load 12b-1 plans. The Institute's letter described numerous specific problems under the proposal, which are discussed further below. A. Prohibition Against Charging Interest The Institute commented that the prohibition against charging

interest ignored economic reality and the manner in which sales charges are financed. In view of the subsequent adoption of amendments to the NASD's maximum sales charge rules (discussed below under "Other Developments") that specifically permit interest to be charged, and that were approved by the Commission, it appears that this issue may no longer be a problem, so long as the final rule makes clear that an allowance for interest can be made.

B. Payment and Tax Problems The letter noted certain problems with the payment of installment loads. For example, although deducting them from dividends might be the preferred method, this might not be feasible in the case of shareholders who have their dividends reinvested, since the proposed rule would prohibit the imposition of any deferred load on shares purchased through the reinvestment of dividends. Additional problems could result if dividend amounts were not sufficient to cover the amount of the installment payment. For example, involuntary redemptions would confuse and upset shareholders, and might lead to adverse tax consequences (e.g., shareholders incurring tax liabilities for gains when not actually receiving any distributions, or realizing losses; recordkeeping burdens because each installment payment would be treated as an increase in the shareholder's basis.)

C. Increased Costs of Individual Account Transactions The letter stated that the proposed rule's conditions would necessitate computer redesign and capacity augmentation to make possible individual shareholder accounting and monitoring. As a result, the letter asserted, the proposal would create additional costs for funds and their shareholders, and would substantially increase transfer agency costs. Broker-dealers would be burdened by the necessity to maintain detailed records and perform essentially transfer agency functions in the case of shares held in street name, the letter indicated.

D. Distributor's Accounting and Recordkeeping Burdens In addition, the letter noted that non-contingent deferred load arrangements may pose difficult accounting and recordkeeping problems for fund distributors, particularly in complying with Rule 17a-3 under the Securities Exchange Act of 1934. For example, the load due from each shareholder would have to be reflected as a receivable, but it could be difficult, if not impossible, to determine the exact amount of the receivable if it must be calculated on the basis of the lesser of net asset value at purchase or redemption.

E. Unworkable Conditions The Institute's letter stated that specific conditions under the rule raised ambiguities and anomalies demonstrating that the rule, as proposed, was unworkable. For example, according to the letter, the prohibition on imposing any deferred load on amounts representing capital appreciation, combined with the requirement to assess a deferred load at the lower of purchase or redemption price, would result in the underwriter receiving a load based on a lower net asset value than at the time of purchase, whether the net asset value had appreciated or depreciated. Finally, the Institute suggested that if the Commission wished to adopt a non-contingent deferred load option despite all these problems, the NASD should establish the specific conditions and standards that would apply, subject to Commission oversight.

Recent Comment Letters In recent months, several comment letters have been filed supporting the portion of the Commission's proposal that would permit installment loads. Generally, these letters urge the Commission to allow installment load arrangements as an alternative method of financing the sale of mutual fund shares. The letters, which are summarized below, represent the views of a bank and its counsel and one fund group. In the first letter, the bank's counsel recommends that the Commission adopt proposed Rule 6c-10, but with clarifications in three areas. First, the letter asks the Commission to clarify that all payments under an installment load structure are permitted to be calculated on the basis of NAV at the time of purchase. Second, the letter requests clarification that an "implicit interest charge" comprising a portion of stated deferred sales loads would be permitted under the rule. Finally, clarification is sought that deferred sales load arrangements (whether or not interest is charged) will not be viewed as extensions of credit from the principal underwriter to the shareholder in violation of Section 11(d)(1) of the

Securities Exchange Act of 1934. In a second letter, at the staff's request, the bank's counsel analyzes certain tax and ERISA issues raised by the installment load proposal. These include prohibited transaction and other concerns in connection with the use of non-contingent deferred loads in tax-privileged situations such as individual retirement accounts and tax-qualified retirement plans. The letter expresses the view that installment load arrangements could be structured so as to minimize concerns that investors would incur tax liability for gains when not actually receiving distributions, or would realize losses. The letter basically concludes that none of the issues raised should prevent the Commission from adopting the proposal. Attached to that letter, a letter from the bank to its counsel discusses the perceived advantages of installment load arrangements over distribution arrangements that use a 12b-1 plan, from the perspective of "financiers to the industry." According to the letter, such issues as termination risk, the impact of NAV fluctuations, prudent limits of borrowing and a limited supply of credit, are absent or minimal in the case of installment loads. The comment letter of the fund group endorses the letters described above. It supports permitting installment load structures as an alternative to existing spread-load structures. The letter claims that the spread-load structure has been very popular with shareholders, but that it is difficult for smaller or independent fund groups to obtain the financing necessary to support such a structure. The letter asserts that financing would be more readily available in connection with an installment load structure because, among other things, it does not involve the termination risk associated with 12b-1 payments.

Other Developments The Institute's comment letter on proposed Rule 6c-10 was filed in January 1989, over five years ago. At that time, proposed amendments to Rule 12b-1 were pending that, in effect, would have eliminated spread-load plans. Although those amendments are still pending, the staff's 1992 report on investment company regulation recommended that "the Commission adopt only the portions of the proposed amendments to rule 12b-1 that are consistent with the use of spread loads." Thus, it no longer appears that installment loads would be presented as a substitute for spread-load 12b-1 plans, which was a major (if not the primary) concern when Rule 6c-10 originally was proposed. Also, effective July 7, 1993, the NASD's Rules of Fair Practice were amended so that all mutual fund sales charges -- front-end, deferred and asset-based -- are subject to maximum limits under those rules. The staff's 1992 report had recommended adoption of the NASD's proposal, and it subsequently was approved by the Commission. Under the NASD's rules, the limits on total sales charges for funds with an asset-based sales charge specifically contemplate an interest component. Thus, as the Institute had suggested, the NASD has formally asserted its regulatory authority over all mutual fund sales charges. In addition, by approving the NASD's amended maximum sales charge rules, the Commission implicitly has accepted the premise that a fund underwriter that advances commissions to brokers and is paid back over time should be compensated (through interest payments) for the cost of the amounts advanced. It is our understanding that the staff is aware of the apparent inconsistency between the prohibition on interest in proposed Rule 6c-10 and the specific provision for interest in the NASD rules.

Issues for Discussion Based on the developments described above, it appears that some of the concerns the Institute raised in 1989 no longer exist. Nevertheless, if the Commission intends to permit funds to adopt installment load arrangements, it would be useful to ensure that the many operational and other technical issues discussed in the Institute's comment letter, to the extent that they still would be problems, will be addressed in an appropriate manner in the final rule. Thus, in preparation for the discussion at the April 12 meeting, please consider: (1) which issues still would affect the feasibility of utilizing installment loads, (2) specific recommendations for addressing these issues, and (3) if the remaining unresolved issues are numerous and significant, whether the Institute should urge the Commission to repropose the portion of its proposal relating to non-contingent deferred loads. Frances M. Stadler Associate Counsel

Attachments

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