MEMO# 5831

April 27, 1994

FORMATION OF SUBCOMMITTEE TO ADDRESS ISSUES RAISED BY SEC PROPOSED RULE 6C-10

1 In its 1992 report on investment company regulation, the staff of the Division of Investment Management recommended adoption of Commission's proposed Rule 6c-10, "with certain modifications" relating to the mechanics of the rule. April 27, 1994 TO: ACCOUNTING/TREASURERS COMMITTEE NO. 19-94 OPERATIONS COMMITTEE NO. 9-94 TAX COMMITTEE NO. 16-94 RE: FORMATION OF SUBCOMMITTEE TO ADDRESS ISSUES RAISED BY SEC 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, the Institute is forming a subcommittee to discuss whether any significant concerns remain in connection with the possible adoption of Rule 6c-10. A meeting of the subcommittee has been scheduled for Thursday, May 12, at 10:00 am in the Institute's David Silver Conference Room on the 12th floor at 1401 H Street, N.W., Washington, D.C. Please indicate on the attached form if you plan to attend. As background for the discussion at the meeting, this memorandum summarizes some of the issues the Institute identified in its 1989 comment letter on proposed Rule 6c-10, and certain developments in the area of mutual fund distribution since Rule 6c-10 originally was proposed. A copy of the Institute's comment letter is 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, some of which are discussed further below. Additional potential tax issues are also described. A. Tax Issues The proposed non-contingent deferred load provisions raise numerous tax concerns, some of which were identified in the Institute's comment letter. Additional issues were addressed in a recent comment letter submitted by counse to a bank, a copy of which is attached, that supported adoption of the non-contingent deferred sales load rules. It is likely that non-contingent deferred loads would be treated as non-recourse loans to shareholders secured by the shareholder's interest in the fund. If, the installment load is structured in such a way that no interest charge on the deferred load is specified, payments would be treated as having interest and principal components determined under the original issue discount ("OID") rules. The principal portion of each payment would be added to the basis of the shares while the interest portion generally would be deductible as investment interest. If an investor regularly purchased shares, the deferred load on each purchase would be subject to its own OID calculations, potentially at different interest rates for each purchase. (The OID calculation uses an interest factor that is adjusted periodically.) If the rule retains the requirement that the deferred load be calculated on the lower of the net asset value at time of purchase or time of redemption, deferred loads could be treated as contingent payments under the OID rules. If deferred loads are collected from dividends, shareholders will owe tax on dividend income they do not receive. In addition, dividend income may not be sufficient to cover the amount of the deferred load obligation. If shares are automatically redeemed to pay deferred loads, the shareholder may realize taxable gains or losses. The gains would generate a tax liability but no cash, while losses might be disallowed under the wash sale rules if the shareholder purchases new shares shortly before or after the redemption. Furthermore, redemptions might be treated as essentially equivalent to a dividend and therefore give rise to ordinary income instead of capital gain or loss. B. Payment Problems The Institute's 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. C. Accounting and Record-keeping Burdens The letter noted that non-contingent deferred load arrangements may pose difficult accounting and record-keeping 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. The letter also stated that the proposed rule's conditions would necessitate computer redesign and capacity augmentation to make possible individual shareholder accounting and monitoring. 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. D. 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. Other Developments The NASD's Rules of Fair Practice were amended, effective July 7, 1993, so that all mutual fund sales charges -- front-end, deferred and asset-based -- are subject to maximum limits under those rules. Under the NASD's rules, which were approved by the Commission, the limits on total sales charges for funds with an asset-based sales charge specifically contemplate an interest component. 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. In preparation for the discussion at the subcommittee 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 re-propose the portion of its proposal relating to non-contingent deferred loads, or to withdraw the proposal entirely. If you have comments on this matter but will not be able to attend the meeting, please contact the undersigned at (202) 326-5837, or Don Boteler at (202) 326-5845. Please indicate on the attached form if you plan to attend. Peter Cinquegrani Assistant Counsel-Tax Attachments