

**MEMO# 2172**

September 6, 1990

## **NASD PROPOSED RULE REGARDING 12B-1 PAYMENTS**

September 6, 1990 TO: BOARD OF GOVERNORS NO. 63-90 SEC RULES MEMBERS NO. 63-90  
RULE 12b-1 AD HOC COMMITTEE RE: NASD PROPOSED RULE REGARDING 12b-1 PAYMENTS

The Board of Governors of the NASD is soliciting a membership vote on the attached proposed amendment to the mutual fund sales charge rule. Under this proposal, mutual fund asset-based sales charges, as well as front-end and deferred sales charges, would be subject to the maximum limits of the NASD rule. If approved by its membership, the NASD intends to seek SEC approval of the proposed amendments, which could become effective following a one year grace period. I. Background The solicitation of a membership vote on the NASD proposal is the latest in a series of events relating to the regulation of mutual fund 12b-1 payments which began with the SEC's proposal of substantial amendments to Rule 12b-1 in June 1988. (See Institute memorandum to Board of Governors No. 43-88, SEC Rules Members No. 35-88, Operations Committee No. 20-88, Accounting/ Treasurers Advisory Committee No. 22-88, Marketing Committee No. 21-88, Sales Force Marketing Committee No. 24-88 and Direct Marketing Committee No. 23-88 dated June 17, 1988.) In its comment letter on the SEC proposed amendments, the Institute suggested that the NASD propose a rule governing the payment of 12b-1 fees pursuant to its authority to regulate sales charges on mutual fund shares. (See Institute memorandum to Board of Governors No. 59-88, Members - One Per Complex No. 49-88 and SEC Rules Committee No. 52-88, dated September 21, 1988.) In April of this year the NASD proposed for comment a rule that would subject asset-based sales charges to the NASD maximum sales charge limits. (See Institute memorandum to Board of Governors No. 27-90 and SEC Rules Members No. 30-90, dated April 18, 1990.) This proposal was designed to achieve economic equivalence between the maximum permitted front-end sales load and an asset-based sales charge (possibly combined with a front-end load and/or a contingent deferred sales charge). The Institute comment letter on the NASD proposal noted the strong support of the Institute's ad hoc committee on Rule 12b-1 and urged the adoption of the proposal with certain clarifications. (See Institute memorandum to Board of Governors No. 39-90, SEC Rules Members No. 40-90, and Rule 12b-1 Ad Hoc Committee, dated June 4, 1990). Almost all of the Institute's suggested clarifications have been included in the attached proposal. II. The Proposed Amendment The proposed amendment revises the current mutual fund sales charge rule by dividing it into two parts. The first part covers funds with no asset-based sales charge, and the second part covers those with an asset-based sales charge. A. Funds With No Asset-Based Sales Charge The first part of the rule provides that a fund with no asset-based sales charge may pay each year a continuing service fee of up to 25 basis points, provided that aggregate front-end and/or deferred sales charges do not exceed 7.25 percent of the offering price. For purposes of the proposal, service fees are defined as payments by an investment company

for personal service and/or the maintenance of shareholder accounts. The service fees paid to any person are limited under the rule to .25 percent of the average annual net asset value of the shares sold by that person. In addition, the proposal has been modified to permit a fund with no asset-based sales charge which reinvests dividends at offering price to pay a service fee, provided that the fund offers quantity discounts and rights of accumulation and aggregate front-end and/or deferred sales charges do not exceed 6.25 percent of the offering price.

**B. Funds With an Asset-Based Sales Charge**

**1. Maximum Caps** The new portion of the sales load limitation rule would impose two separate caps on sales charges for funds with asset-based sales charges. The first is an aggregate sales charge cap of 6.25 percent of new gross sales, plus interest at the rate of prime plus one, imposed on funds which pay a service fee. This cap would be 7.25 percent of new gross sales for funds which do not pay a service fee. In both instances, front-end and/or deferred sales charges cannot exceed 6.25 or 7.25 percent of the amount invested by any person. The aggregate cap is to be reduced over time by front end, deferred and asset-based sales charges paid and increased by accrued interest. If the aggregate cap of a fund has been reduced to 0, any deferred sales charges must be credited to the fund. A second cap of .75 percent of average annual net assets would also be imposed on any asset-based sales charges paid by a fund.

**2. Sales Prior to the Effective Date** The rule clarifies the treatment of distribution of expenses incurred in connection with sales prior to the effective date of the NASD rule. Thus, a fund that had an asset-based sales charge in the past could apply the 6.25 or 7.25 cap retroactively to sales from the date of adoption of the 12b-1 plan until the effective date of the rule. This cap would be increased by interest at the rate of prime plus one and decreased by front-end, deferred or asset-based sales charges paid. The total remaining balance would be added to the aggregate cap computed with respect to new gross sales after the effective date of the rule. The grand total would be adjusted in a similar manner, i.e., reduced by sales charges received and increased by interest.

**3. Exchanges** The revised NASD proposal includes a provision permitting a fund to make adjustments to its aggregate cap to reflect exchanges. Under the rule, a fund could increase its aggregate cap by treating exchanges into the fund as new gross sales, provided that the amount of such increase is deducted from the aggregate cap of the fund or funds with exchanges out.

**4. Use of Term No-Load** A fund will not be permitted to describe itself as no-load if it imposes sales charges, including asset-based sales charges, and/or a service fee which exceeds 25 basis points a year. The earlier NASD proposal would have prohibited the use of the term no-load by a fund with any deferred or asset-based sales charge.

**5. Accommodation of Alternatives** The NASD proposal does not provide a procedure for consideration of exemptions from the rule. However, the preamble to the rule states that the NASD Board will consider whether any changes are necessary after the rule has been in place for one year. \* \* \* \* We will keep you informed of further developments.

Catherine L. Heron Deputy General Counsel Attachment