

MEMO# 6707

February 28, 1995

SEC ADOPTS MULTIPLE CLASS AND MASTER-FEEDER PROVISIONS; ADOPTS AND PROPOSES AMENDMENTS TO RULE 6C-10

February 28, 1995 TO: ACCOUNTING/TREASURERS COMMITTEE No. 12-95 INSTITUTIONAL FUNDS COMMITTEE No. 4-95 OPERATIONS COMMITTEE No. 10-95 SEC RULES COMMITTEE No. 32-95 UNIT INVESTMENT TRUST COMMITTEE No. 23-95 RE: SEC ADOPTS MULTIPLE CLASS AND MASTER-FEEDER PROVISIONS; ADOPTS AND PROPOSES AMENDMENTS TO RULE 6c-10 _____ The

Securities and Exchange Commission recently amended its rules to require certain disclosure concerning multiple class and master-feeder funds and adopted Rule 18f-3 under the Investment Company Act of 1940 to permit open-end funds to create multiple class structures without the need for an SEC exemptive order. The Commission also adopted Rule 6c-10 under the Investment Company Act to permit open-end funds to impose contingent deferred sales loads ("CDSLs") without the need for an SEC exemptive order. We are pleased to report that in both rulemakings the SEC substantially modified its proposals to reflect the comments of the Institute (and others). The effective date for each rulemaking is thirty days after publication in the Federal Register. The Commission also has proposed amendments to new Rule 6c-10 to permit funds to impose other types of deferred loads and to delete certain requirements from Rule 6c-10. The comment period on the proposal expires forty-five days after publication in the Federal Register. A meeting to discuss comments on the proposed amendments to Rule 6c-10 will be held at the Institute at 2:00 p.m. on Tuesday, March 14th. Please call Elizabeth Lyons at (202) 326-5823 by Friday, March 10th to let her know if you will attend. The Commission's releases are attached and the rules and proposed rule amendments are summarized below.

Multiple Class and Master-Feeder Fund Rules

1. Disclosure Requirements The Commission had proposed that certain multiple class and master feeder fund prospectuses contain full cross-disclosure concerning other feeders or classes and a line graph of annual hypothetical account values. Performance advertising for these funds would have been required to contain the performance of all classes and feeder funds. The Institute and other commenters strongly opposed the proposed cross-disclosure requirement, line graph and amendments to the advertising rules. We are pleased to report that the Commission determined not to adopt any of these requirements. Instead, the Commission amended Form N-1A generally to require that multiple class and master-feeder fund prospectuses describe: The salient features of the multiple class or master-feeder structure; for feeder funds, the circumstances under which the fund could no longer invest in the master fund and the consequences to shareholders of such an event; for prospectuses that do not offer all

classes or feeder funds, the fact that there are other classes or feeder funds and a telephone number investors can call to obtain additional information about other classes or feeder funds available through their sales representative; and for feeder funds, the expenses of both the master fund and the feeder fund, as reflected in a single fee table. More extensive disclosure will be required in only two cases. First, if a prospectus offers more than one class or feeder fund, it must discuss briefly the differences between the classes or feeder funds and arrange the fee table to facilitate a comparison by shareholders of the different fee structures. Second, if a fund is offering a class that will or may convert or be exchanged into other classes of the same fund, the prospectus must provide disclosure about the other classes. Multiple class funds that will continue to operate under an existing exemptive order rather than rely on Rule 18f-3 must comply with the new disclosure requirements described above. The attached release notes that the Commission, as recommended by the Institute and other commenters, will work with the NASD to provide guidance about the duties of sales representatives when recommending the purchase of multiple class and master-feeder funds. While the Commission did not adopt the proposed amendments to its advertising rules, the adopting release does caution "multiple class funds to use care not to mislead investors in advertising the performance of one class when multiple classes are being offered to the same persons." For example, "it may be misleading to quote only performance of a class for institutional or inside investors (with low expenses) in a publication with a retail readership."

2. Rule 18f-3 The Commission adopted Rule 18f-3 substantially as proposed. Rule 18f-3 requires each class relying on the rule to: have a different arrangement for distribution or shareholder services; 3 bear all of the expenses of its arrangement; have the exclusive right to vote on matters relating solely to its arrangement; and vote separately on matters in which the interests of that class are different from the interests of any other class. In all other respects, fund shareholders must be given the same rights and obligations regardless of class. Expenses relating to the management of the funds assets must be allocated to all classes, but other expenses may be allocated to different classes under certain circumstances. The Commission thus adopted the flexible approach to expense allocation that was supported by the Institute and others. The Commission adopted two methods for the allocation of income, gains and losses, and expenses not assigned to a particular class. Non-daily distribution funds must allocate these items based on the relative net assets. Money market funds and other funds making daily distributions of their net investment income may allocate these items to each share regardless of class or based on the relative net assets of settled shares. The Commission did not adopt the proposed amendments to Form N-SAR, relating to an accountants report on a funds system of internal controls. The Commission recognized that the assessment of internal controls currently required by Form N-SAR must include a review of the system for calculating multiple-class net assets, and that the proposed amendments to Form N-SAR were unnecessary. Rule 18f-3 expressly allows a funds underwriter, adviser, or other provider of services to waive or reimburse the expenses of a specific class or classes. The rule also allows funds to offer different exchange privileges to different classes and to offer automatic conversions into another class after a specified period under certain circumstances. As suggested by the Institute, total expenses (not just those associated with a Rule 12b-1 plan) may not be higher for the new class than for the old class. Conversions also may occur when a shareholder ceases to be eligible to invest in a class, under certain circumstances. Rule 18f-3 requires the fund to adopt a written plan specifying all the differences among classes. The board of directors, including a majority of the independent directors, has to approve the plan before issuance of multiple classes and before any material change to the plan. As recommended by the Institute and others, the Commission deleted a proposal for annual board approval. The Commission also adopted amendments to Rule 12b-1 substantially as proposed. Multiple class funds relying on existing exemptive

orders, including those that provide an exemption for "future classes," may continue to do so. If they choose to operate instead under Rule 18f-3, they must prepare and file plans under the rule.

Deferred Sales Charges 4 In 1988, the Commission proposed Rule 6c-10 to allow mutual funds to impose deferred sales loads (including CDSLs, other loads paid at redemption, and sales loads payable in installments). The Commission has adopted Rule 6c-10 to permit the imposition of CDSLs, but not other forms of deferred sales loads. Mutual funds that have received exemptive orders allowing CDSLs may continue to rely on those orders for all funds covered by the order, but must comply with the new rule if the order is conditioned on compliance with the rule as adopted. The Commission also has proposed amendments to Rule 6c-10 to permit these other deferred sales loads and to remove some of the substantive requirements of the rule.

1. Adoption of Rule 6c-10 Rule 6c-10 requires CDSLs to be calculated based on the lesser of the net asset value at the time of purchase or the NAV at the time of redemption. The rule also specifies a particular order of load calculation in a partial redemption and prohibits CDSLs on reinvested dividends and capital gains distributions. As proposed, the rule would have prohibited a fund from imposing a deferred load if any amount were charged that was intended to be a payment of interest related to the load or a similar charge. In response to a comment from the Institute and others, the adopting release states that the provision was not intended to prohibit an interest component of the specified load amount; rather, it was intended to prohibit an interest charge separate from the load amount. Because paragraph (a)(1) of the rule requires all components of a deferred load to be included in one specified amount, the Commission deleted the interest charge prohibition from the rule. The rule permits a fund to offer a scheduled variation in or eliminate a CDSL for a particular class of shareholders or transactions, provided that the scheduled variation meets the conditions in Rule 22d-1 under the Investment Company Act.

2. Proposed Amendments to Rule 6c-10 Under the proposal, Rule 6c-10 would define a "deferred sales load" as any amount properly chargeable to sales or promotional expenses that is paid by a shareholder after purchase but before or upon redemption. The proposal would not extend to unit investment trusts. The proposing release requests comment on the appropriateness of a rule allowing UITs to assess deferred loads. As recommended by the Institute and others, the proposal would delete a provision in the 1988 proposal that would have required installment loads to be deducted directly from a shareholders account. The release requests comment on the methods that could be used to pay installment loads. As recommended by the Institute and others, the proposal also would delete from Rule 6c-10 the requirement that a CDSL be based on the lesser of the net asset value at the time of purchase or the NAV at the time of redemption and the prescribed method for calculation of a CDSL in a partial redemption. In addition, the proposal would delete the prohibition of CDSLs on shares purchased through the reinvestment of distributions. The Institute and other commenters to the 1988 proposal had argued that these restrictions and prohibitions are unnecessary as long as deferred loads are subject to the NASD Sales Charge Rule and there is proper disclosure. The proposal includes various disclosure requirements concerning deferred loads. For example, the proposal would require prospectus disclosure concerning the way in which the deferred load is calculated (e.g., in the case of partial redemptions), an explanation of the ways in which a shareholder may be required to pay an installment load, and, if applicable, a statement that the load is applied to reinvested distributions. The deferred load would be subject to the NASD Sales Charge Rule, although the release contemplates certain amendments to the NASD Sales Charge Rule to address installment loads and loads on reinvested distributions. The Commission also has proposed to require deferred sales loads to be included in calculations of advertised total return data but not in advertised yield calculations. The proposing release requests comment on whether the Commission should require an installment load to be included as an expense in the yield formula or added to

the NAV to reach an assumed "offering price" in the yield formula. The Commission also requests comment on whether funds that impose deferred sales loads should disclose the commissions received by dealers selling the funds shares. As noted above, a meeting has been scheduled for Tuesday, March 14th to discuss comments on the proposed amendments to Rule 6c-10. If you have comments but are unable to attend the meeting, please call Frances Stadler at (202) 326-5822 by Friday, March 17th. Thomas M. Selman
Associate Counsel Attachments

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