

MEMO# 1326

August 7, 1989

SEC ADOPTS RULE 11A-3, GOVERNING EXCHANGE OFFERS BY MUTUAL FUNDS

- 1 - August 7, 1989 TO: SEC RULES MEMBERS NO. 37-89 OPERATIONS MEMBERS NO. 25-89
RE: SEC ADOPTS RULE 11a-3, GOVERNING EXCHANGE OFFERS BY MUTUAL FUNDS

The SEC has adopted Rule 11a-3 under the 1940 Act, which will permit mutual funds to make exchange offers to shareholders, subject to various conditions. Rule 11a-3 was originally proposed in December 1986 and was repropoed in July 1988. The Institute filed a comment letter on the repropoed rule, which opposed several of its provisions. Portions of the rule were changed in response to comments by the Institute and others. Rule 11a-3 will supersede prior orders issued by the Commission that allowed funds to make exchange offers. Funds that received such orders that were not expressly conditioned on compliance with Rule 11a-3, when adopted, will have one year from the Rule's effective date to comply with the Rule's limitations on fees and sale charges. In its July 1988 release repropoing Rule 11a-3, the Commission announced that the Chase Fund of Boston no-action letter (pub. avail. July 28, 1980), which deemed an exchange offer with a \$5.00 administrative fee to be at net asset value, would be withdrawn "after the effective date of rule 11a-3" at which time "funds relying on that letter . . . will be required to bring their exchange offers into compliance with the provisions of the rule". The adopting release does not mention the withdrawal of the Chase Fund of Boston letter. A brief summary of Rule 11a-3 follows.

Limits on Sales Loads and Fees Rule 11a-3 allows a fund or its principal underwriter (the "offering company") to make an exchange offer to a shareholder in that fund or another fund in the same group of investment companies and to charge that shareholder a sales load, redemption fee, administrative fee or any combination thereof, subject to the following conditions.

- 2 - **Calculation of Sales Load** The sales load on the security acquired in the exchange cannot exceed a percentage rate equal to the excess of the sales load rate applicable to the acquired security over the sum of the rates of all sales loads previously paid on the exchanged security and any predecessor of the exchanged security. In calculating the permissible sales load, where a shareholder exchanges less than all of his or her securities, the securities subject to the highest load are to be deemed exchanged first. Exchanged securities that were acquired through reinvestment of dividends or capital gains distributions are deemed to have been subject to the same sales load rate as the security on which the dividend or capital gains distribution was paid.

Deferred Sales Loads The imposition of a deferred load on the exchanged security at the time of the exchange is prohibited. A deferred load may be imposed at the time the acquired security is redeemed (as a result of a deferred load normally imposed on either the exchanged security or the acquired security). Such load is limited to the excess of the applicable rate over the sum of the rates of all loads previously paid on the acquired security. In addition, the total of the

rates of all sales loads charged prior to and at the time the acquired security is redeemed cannot exceed the maximum rate that would be applicable, in the absence of any exchange, to the exchanged security or the acquired security, whichever is higher. In general, a deferred sales load must be calculated as if the shareholder held the acquired security from the date on which he became the holder of the exchanged security. (Holding periods may be computed as of month end.) This applies to deferred loads with respect to both the exchanged and the acquired security. However, the time period during which the acquired security was held need not be included (i.e., may be "tolled") in order to compute a deferred load on the exchanged security if no loads are imposed with respect to the acquired security and the deferred load on the exchanged security is reduced by the amount of any 12b-1 fees collected on the acquired security. Conversely, the time period during which the exchanged security was held may be tolled for purposes of computing a deferred load on the acquired security provided no loads are imposed with respect to the exchanged security and the deferred load on the acquired security is reduced by 12b-1 fees collected on the exchanged security. As a result, tolling for a fund with a 12b-1 plan will only be permitted if the fund can account for 12b-1 payments on an individual shareholder basis.

- 3 - Administrative Fees A fund may charge an administrative fee, which must be either slight or de minimis, or reasonably intended to cover the costs of processing exchanges. If the latter, the fund must maintain and preserve records with respect to costs incurred in processing exchanges. Any administrative fee or scheduled variation must be applied uniformly. Redemption Fees A fund may charge a redemption fee, which is a fee paid to the fund and is reasonably intended to compensate the fund for expenses related to redemptions of shares. The fee must be applied uniformly and cannot exceed a redemption fee charged in the absence of an exchange. Any scheduled variation of the fee must be reasonably related to the costs involved in processing redemptions of the type for which the fee is charged.

Disclosure Requirements Advertising and Sales Literature Any advertising and sales literature that mentions an exchange offer must disclose (1) the existence of any administrative fee or redemption fee and (2) if the offering company reserves the right to terminate or change the terms of the offer, that the offer is subject to termination or its terms are subject to change.

Prospectus The prospectus of an offering company must disclose (1) the amount of any administrative fee or redemption fee and (2) that the offer is subject to termination or its terms subject to change, if either is the case.

Termination or Amendment of Offer An offering company must provide notice to any holder of a security subject to an exchange offer 60 days prior to terminating or materially amending such offer (except for reductions in fees or sales charges). The notice requirement does not apply (1) if redemptions of the exchanged securities are suspended under Section 22(e) of the 1940 Act or (2) if the offering company delays or ceases sales of the acquired securities "because it is unable to invest amounts effectively in accordance with applicable investment objectives, policies and restrictions".

Effectiveness of Rule Rule 11a-3 is effective sixty days after the date of its publication in the Federal Register. However, funds that have obtained orders under Section 11 that are not conditioned upon compliance with Rule 11a-3, when adopted, have one year from the effective date to adjust fees and sales loads in conformity with Rule 11a-3. All shares acquired prior to the time the offer has been brought into compliance with Rule 11a-3, as well as shares acquired through reinvestment of dividends and capital gains distributions based on those shares, may continue to be subject to the "old" fees and sales loads, until those shares are redeemed.

- 4 - A fund with an existing exchange offer may rely on the rule to amend its offer only if its prospectus disclosed for at least two years prior to the amendment (or the entire time the offer was outstanding, if less than two years) that the terms of the offer were subject to change, unless the only effect of the change is to reduce fees or sales loads. Therefore, if a fund's existing exchange offer is subject to terms different from the terms of the rule and

the fund has not had the required disclosure in its prospectus for the past year, the fund may have to terminate its exchange offer or apply for exemptive relief from Section 11 within a year because the fund would not be able to rely on the rule to amend its offer of exchange to bring that offer into compliance with the rule. Other Provisions Holding Period If there is no sales load imposed on the acquired security or the load is less than the maximum allowed, the offering company may establish a minimum holding period prior to any exchange, provided it is applied uniformly. "Group of Investment Companies" Rule 11a-3 defines "group of investment companies" for purposes of the rule to include funds with affiliated investment advisers or principal underwriters. * * * A copy of the release adopting Rule 11a-3 is attached. The release contains an appendix with examples of how to calculate sales loads on exchanges. Craig S. Tyle Assistant General Counsel Attachment

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