The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

September 29, 1997

Comment Letter on Proposed Amendments to NASDR Sales Charge Rules, September 1997

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Ms. Joan Conley
Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500

Re: Amendments to Rules Governing Sale and Distribution of Investment Company Shares (NASD Regulation Request for Comment 97-48)

Dear Ms. Conley:

The Investment Company Institute[1] appreciates the opportunity to respond to NASD Regulation, Inc.'s request for comments on proposed amendments to the provisions of NASD Conduct Rule 2830 that govern investment company sales charges. The amendments would: (1) impose maximum aggregate sales charge limits on funds of funds; (2) permit mutual funds to charge installment loads; (3) prohibit loads on reinvested dividends; (4) reinstate a requirement specifying the order in which shares subject to a contingent deferred sales load ("CDSL") must be redeemed; and (5) eliminate a disclosure requirement regarding the effect of asset-based sales charges. The Institute's comments on each of these changes are set forth below.

Funds of Funds

NASDR proposes to revise the sales charge limit provisions of Rule 2830 to specify how they apply to investment companies structured as "funds of funds."[2] In general, the aggregate sales charges imposed by an acquiring fund and an acquired fund in a fund of funds structure would be subject to the same sales charge limits as any other investment company. Under the proposal, however, the aggregate asset-based sales charges of an acquiring fund and an acquired fund would not be subject to the cumulative sales charge limits that apply to other investment companies with asset-based sales charges. Rather, funds of funds simply would have to comply with aggregate annual limits (75 basis points and 25 basis points, respectively) on the asset-based sales charges and service fees that the accquiring fund and an acquired fund may pay.

The Institute generally supports NASDR's proposed approach, subject to the following comments. First, we recommend that NASDR clarify that the acquired and acquiring funds in a fund of funds structure would remain individually subject to the cumulative limits. Otherwise, master-feeder funds and multiple class funds, for example, would be subject to disparate treatment, which would be inappropriate. In addition, we recommend that the proposal be revised with respect to funds of funds consisting of affiliated funds (including master-feeder funds).3 In this situation, if an acquired fund has an asset-based sales charge, it should exclude sales made to the acquiring fund when calculating total new gross sales for purposes of applying the cumulative sales charge limits. Thus, the fund would not get "credit" for these sales, which presumably do not involve any selling effort.4 In this way, investors would not be subjected inappropriately to sales charges at two levels.

The Institute believes that an acquired fund in an unaffiliated fund of funds, however, should not have to exclude sales to the acquiring fund from total new gross sales, for the following reasons.5 First, in the case of unaffiliated funds, there is no incentive for "double charging" since any asset-based sales charges at the acquired fund level will only increase expenses (and thus, negatively impact performance) without any benefit flowing to the acquiring fund's manager. Second, the acquiring fund's manager does not have direct control over the distribution charges of unaffiliated funds in which it invests. In light of these distinguishing factors, it would be inappropriate to impose on unaffiliated acquired funds the administrative burdens of a requirement to exclude sales to an acquiring fund from total new gross sales.

The Institute also recommends certain technical changes to the proposed rule language to clarify how the annual limits on asset-based sales charges apply to funds of funds with asset-based sales charges at both levels. In particular, proposed Rule 2830(d)(3)(B) includes cross-references to the limits imposed by subparagraphs (d)(2)(E)(i) and (d)(5) of the rule. Subparagraph (d)(2)(E)(i) provides that an NASD member may not offer or sell the shares of an investment company with an asset-based sales charge if "[t]he amount of the asset-based sales charge exceeds .75 of 1% of the average annual net assets of the investment company . . . ."6

We believe NASDR's intent is to restrict the aggregate rate of asset-based sales charges imposed by an acquiring fund and an acquired fund to 75 basis points; however, the existing rule language would not have this effect. For example, assume that an acquiring fund has an asset-based sales charge of .50% of average annual net assets and an acquired fund has an asset-based sales charge of .35% of average annual net assets. Assume further that the acquiring fund is substantially larger than the acquired fund and that, as a result, .35% of the acquired fund's average annual net assets is less than .25% of the acquiring fund's average annual net assets. Read literally, subparagraph (d)(2)(E)(i) would appear to permit such a sales charge structure. We recommend that NASDR revise the proposal to address this problem.7

Finally, the proposal provides that, where either the acquiring fund or an acquired fund has an asset-based sales charge, the aggregate service fees charged by these funds are limited to 25 basis points. As drafted, however, the proposal does not impose an aggregate limit on the service fees of acquiring and acquired funds where neither fund has an asset-based sales charge. As a result, the rule would permit, for example, the acquiring fund and an acquired fund each to have service fees of up to 25 basis points. We recommend that NASDR revise the proposal to address this apparent oversight by extending the 25 basis point limit on the aggregate service fees charged by the acquiring fund and an acquired fund in a fund of funds structure to situations where neither fund has an asset-based sales

charge.

Installment Loads

The Institute supports the proposed amendment to the definition of "deferred sales charge" in Rule 2830 to conform it to the definition of "deferred sales load" in Rule 6c-10 under the Investment Company Act of 1940.8 This change will allow funds more flexibility in structuring deferred sales loads (e.g., by permitting installment loads), as contemplated by the SEC's 1996 amendments to Rule 6c-10. The amended definition also will eliminate possible confusion and compliance burdens that could result from inconsistent definitions in SEC and NASDR rules.

Loads on Reinvested Dividends

The proposed amendments would prohibit the imposition of front-end or deferred sales charges9 on shares purchased through dividend reinvestments. The Institute opposes this proposed prohibition. Although it appears that virtually no mutual funds currently impose sales charges on shares purchased through reinvested dividends, it is our understanding that certain unit investment trusts, pursuant to exemptive orders granted by the SEC, impose front-end or deferred loads on units issued in dividend reinvestments.10 We recommend that, rather than prohibiting such loads, NASDR amend Rule 2830 to treat deferred loads on shares purchased through reinvested dividends the same way as the rule currently treats front-end loads on reinvested dividends, i.e., by subjecting funds that impose such loads to lower maximum sales charge limits.11 The combination of this "haircut" requirement and appropriate disclosure, in our view, adequately protect investors and would avoid disrupting current industry practices that are permitted under SEC exemptive orders.

CDSL Calculations

NASDR proposes to reinstate a requirement that the SEC eliminated when it amended Rule 6c-10 concerning the order in which fund shares subject to a CDSL must be redeemed. The Institute believes that the requirement is largely superfluous because market forces effectively regulate the manner in which funds calculate these charges. Nevertheless, because it appears that the proposal would accommodate standard practices within the industry, we do not object to it.12

Prospectus Disclosure

The Institute strongly supports NASDR's proposal to eliminate the current prospectus disclosure requirement regarding the long-term effects of Rule 12b-1 plans. It is highly appropriate for NASDR to delete this requirement—in deference to the SEC's pending proposed amendments to Form N-1A, which would require similar disclosure in more straightforward terms.

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Thank you for considering the Institute's comments on the proposed changes to Rule 2830. If you have any questions or need additional information, please contact me at (202) 326-5822.

Sincerely,

Frances M. Stadler
Associate Counsel

cc: Thomas M. Selman, Director
Joseph E. Price, Counsel
Advertising/Investment Companies Regulation

Robert J. Smith, Senior Attorney
Office of General Counsel
NASD Regulation, Inc.

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,642 open-end investment companies ("mutual funds"), 443 closed-end investment companies, and 11 sponsors of unit investment trusts. Its mutual fund members have assets of about $4.206 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

2 As indicated in the Request for Comment, the proposed definition of "fund of funds" would include master-feeder funds.

3 The rule could describe these as funds of funds that consist exclusively of investment companies (or series or classes thereof) in a "single complex," a term that Rule 2830 already uses. In connection with this suggestion, we recommend that NASDR define the term "investment companies in a single complex" in a manner that is consistent with the definition of "group of investment companies" in Section 12(d)(1)(G)(ii) of the Investment Company Act of 1940 ("any 2 or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services").

4 This would be consistent with the treatment of sales from the reinvestment of distributions and exchanges of shares between funds in a single complex. See, e.g., Rule 2830(d)(2)(A).

5 Section 12(d)(1)(F) of the Investment Company Act of 1940 (which essentially governs unaffiliated funds of funds) imposes a 1.5% limit on the sales load that an acquiring fund may charge on its shares. The Securities and Exchange Commission has granted exemptive relief from this restriction in certain instances. In addition, Section 12(d)(1)(H) of the 1940 Act, which was part of the National Securities Markets Improvement Act of 1996, gives the SEC broad exemptive authority with respect to funds of funds. The SEC may use this authority to provide additional flexibility to unaffiliated funds of funds. Specific guidance from NASDR on application of the sales charge limits to such funds of funds therefore will be useful.

6 In the case of a fund of funds, "the investment company" would be the acquiring fund.

7 The same issue arises under subparagraph (d)(5), which sets forth the 25 basis point limit on service fees paid by an investment company.

8 In connection with this change, we recommend that NASDR revise subparagraph (d)(1)(A) of Rule 2830 by adding the word "Aggregate" at the beginning of that subparagraph. This revision would make clear that the 8.5% limit on front-end and/or deferred sales charges applies to the aggregate installment (and any front-end or other deferred) load charged, rather than to individual installment payments.

9 The Request for Comment states on p. 392 that NASDR proposes to amend the rule "to prohibit all loads on reinvested dividends . . . ." In contrast, proposed Rule 2830(d)(6)(A) refers specifically to front-end and deferred sales charges. Although the Institute opposes the proposed prohibition, if NASDR is not inclined to follow our recommendation, it should clarify that the prohibition would be limited to front-end and deferred sales charges on reinvested dividends. It would be inappropriate to prohibit funds from applying asset-based sales charges to these shares. The 75 basis point annual limit on asset-based sales charges applies to all fund assets. Moreover, funds with asset-based sales charges already are required to exclude sales from the reinvestment of distributions from total new gross sales when computing the cumulative sales charge caps. Thus, they do not get "credit" for these sales.

10 We understand that the NASD staff has taken the position that the sales charge limits of Rule 2830(d)(1) apply to these unit investment trusts.

11 See, e.g., Rule 2830(d)(1)(B)(ii).

12 We recommend that the last phrase of proposed subparagraph (d)(6)(B) of Rule 2830 be revised to indicate that "another order of redemption may be used if such order could [rather than would] result in the redeeming shareholder paying a lower contingent deferred sales load." As illustrated by the example on p. 393 of the Request for Comment, it may not be possible to know in advance that an alternative method (e.g., last-in-first-out) would result in a lower CDSL.
