



DIVISION OF
INVESTMENT MANAGEMENT

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

ACT ICA of 1940
SECTION 22(d)
RULE _____
PUBLIC _____
AVAILABILITY 11/15/94

May 17, 1993

J.J.G. Budden
Managing Director
Financial Management Division
Sedgwick Consulting Group
Winterton House, Nixey Close, Slough
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Dear Mr. Budden:

This responds to your letter of March 17, 1993. In your letter, you state that you are considering distributing mutual funds of United States organizations to United States investors. You ask for information on commonly used distribution channels in the United States, if United States investors use independent financial advisers to purchase mutual funds, and for information on the rates of commission payable on the sale of mutual funds. You also inquire as to whether United States investors, at the time of retirement, receive advice on investing in mutual funds, and as to the availability of performance information for United States mutual funds.

The Securities and Exchange Commission (the "Commission") regulates mutual funds and other investment companies primarily under the Investment Company Act of 1940 (the "1940 Act"). Under Section 22(d) of the 1940 Act, a registered investment company, and a principal underwriter or a dealer in its shares, cannot sell the shares except at a current public offering price described in the prospectus. This provision effectively prohibits competition of sales charges at the retail level, and as a result, the Commission has taken various actions to regulate the costs associated with the distribution of mutual fund shares and to foster retail price competition.

In the United States, mutual fund shares either are distributed by underwriters and marketed directly to the public, or are distributed through retail dealers, including independent financial advisers. Traditionally, most funds assessed a "front-end sales load," which is a sales charge that is deducted from a purchaser's initial investment to cover the broker's commission and other sales expenses.

Front-end sales loads are regulated in several ways. In 1976, the National Association of Securities Dealers ("NASD"), a self-regulatory organization, adopted a rule subjecting sales

loads to a maximum cap of 8.5% of a share's offering price. 1/ This "maximum sales charge rule" was expressed in terms of a front-end sales load, as this was the main type of sales charge assessed at that time. Moreover, since 1970, investment advisers of registered investment companies have been subject to a fiduciary duty with respect to the receipt of compensation for services and of payments paid to them by funds. 2/ And in 1985, the Commission adopted Rule 22d-1 under the 1940 Act to permit scheduled price variations in, or elimination of, front-end sales loads to particular classes of investors or transactions, subject to adequate disclosure to existing shareholders and prospective investors. 3/

In the 1970s, no-load funds, whose distribution costs are borne by the funds' investment advisers, became very popular. In response to the growth in this area of the industry and other developments, the Commission in 1980 adopted Rule 12b-1, which allows the use of fund assets to cover costs associated with distribution. 4/ These "12b-1 fees," as they are commonly called, are deducted from a fund's assets before net asset value is calculated and may be assessed continuously. Funds that assess 12b-1 fees instead of front-end sales loads typically levy charges ranging from .50% to 1.25% of a fund's net assets. These fees generally pay for initial sales charges and for "service fees," which compensate dealers for ongoing sales and shareholder servicing efforts. 5/ Moreover, many funds use 12b-1 fees in conjunction with sales loads. A common practice is for a fund's sponsor or underwriter to finance the sales commission paid to a retail dealer for the initial sale of the fund's shares, and then

1/ Subsections (b) and (d) of Article III, Section 26 of the NASD Rules of Fair Practice (the "NASD Rules"). The United States Congress, in a 1970 amendment to Section 22(b) of the 1940 Act, authorized the NASD to promulgate this rule.

2/ See Section 36 of the 1940 Act. This provision has been construed to include "distribution" fees paid out of a fund's assets to finance the fund's distribution pursuant to Rule 12b-1 under the 1940 Act.

3/ Investment Company Act Rel. No. 14390 (Feb. 22, 1985).

4/ Investment Company Act Rel. No. 11414 (Oct. 28, 1980).

5/ As discussed in more detail on page 3, the NASD recently amended the NASD Rules to limit 12b-1 fees to .75% of a fund's net assets, and to limit service fees paid to a fund's dealer to .25% of a fund's net assets. These amendments will take effect on July 7, 1993.

to assess a periodic 12b-1 fee to recoup the costs of the commission.

At about the same time that Rule 12b-1 was adopted, some mutual funds began applying for exemptive orders from the Commission to levy contingent deferred sales loads ("CDSLs"). 6/ A CDSL is a sales charge assessed upon redemption, the amount of which is contingent upon when the shares are redeemed. Generally, the longer shares are held, the lower the CDSL that is assessed when the shares are redeemed. CDSLs are sometimes used in conjunction with 12b-1 fees, and these arrangements are known as "spread loads." Retail dealers commonly use spread loads to finance front-end sales loads by advancing commissions to their salespersons and then recouping the costs through the contingent sales loads and 12b-1 fees.

The Commission recently approved an amendment to the NASD Rules to subject all sales charges, including 12b-1 fees, to the 8.5% maximum sales charge limit, and to tailor the rule's application to different sales compensation structures, including CDSLs. 7/ The amendment will also, among other things, prohibit a fund from assessing a 12b-1 fee that exceeds .75% of a fund's net assets, and will limit service fees to .25% of a fund's net assets. This rule change will take effect on July 7, 1993.

Some funds now allow investors to choose how they pay for distribution expenses. Pursuant to exemptive orders from the Commission, funds have offered "multiple class" arrangements, where classes represent different distribution arrangements that are subject to different sales charges, while representing interests in the same portfolio of securities. There are three basic types of these arrangements. "Multiclass" funds were created to compete for the short-term investments of certain institutional investors, who wanted services tailored to their particular needs. Under these arrangements, particular classes of shares are sold to specific institutional investors, who select only the shareholder and distribution services they wish to provide to their customers owning shares of a particular class. The funds then make payments to the institutions for providing these services to the class shareholders. "Dual

6/ Under Section 6(c) of the 1940 Act, the Commission, by order upon application, may exempt any person, security or transaction from any provision of the 1940 Act or its rules or regulations, if it is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes intended by the 1940 Act.

7/ Securities Exchange Act Rel. No. 30897 (July 7, 1992).

distribution" funds generally have two classes of shares, each subject to different distribution charges, thereby allowing investors to choose the method of financing distribution best suited to their investment objectives. "Conversion" funds are a variation on dual distribution funds, where investors may still choose between classes, but after a specified time, one class converts to the form of distribution in the other class. The conversion feature limits any 12b-1 fees paid by each shareholder to an amount approximately equal to the distribution expense incurred on the shareholder's behalf in the primary distribution.

There are several pending proposals that may affect how mutual fund distribution is financed in the future. In 1988, the Commission proposed Rule 6c-10 under the 1940 Act, which would codify the exemptive orders permitting the assessment of CDSLs. 8/ This rule would also permit the assessment of other deferred loads, such as installment loads, which would be deducted from a shareholder's account on a periodic basis. Also in 1988, the Commission proposed an amendment to Rule 12b-1 that would effectively preclude the use of spread loads as an alternative to front-end sales loads. 9/ This was due to concern with the "hidden" nature of spread loads, as 12b-1 fees are deducted as an expense at the fund level and CDSLs are deducted from redemption proceeds.

In addition, the Division of Investment Management, in a study of the investment company industry it issued in 1992, recommended that the Commission repeal the retail price maintenance provision in Section 22(d) of the 1940 Act. 10/ This proposal was due mainly to the belief that Section 22(d)'s primary purpose has been rendered moot. 11/ The Division also

8/ Investment Company Act Rel. No. 16619 (Nov. 2, 1988).

9/ Investment Company Act Rel. No. 16431 (June 13, 1988).

10/ See SEC Division of Investment Management, Protecting Investors: A Half-Century of Investment Company Regulation, The Sale of Open-End Investment Company Shares 291-346 (May 1992) ("Protecting Investors Study").

11/ Under the system of backward pricing of shares used when the 1940 Act was passed, the price of a mutual fund share was based upon the fund's net asset value per share determined at the close of the market on the previous day. Insiders could often purchase fund shares without paying sales loads, which, under this system, enabled them to engage in riskless trading of the shares. By requiring all investors to pay the same sales load, Section 22(d) reduced the degree of

believed that this anticompetitive provision had the effect of raising, not lowering, mutual fund share prices to investors, 12/ and that competition would result in lower sales loads, which would increase, rather than decrease, sales of mutual fund shares. 13/ The Commission has not yet considered this proposal, which also requires Congressional approval. The study also suggested that the Commission adopt a rule to codify the exemptive orders permitting multiple classes of mutual fund shares. 14/ The Division is currently drafting a rule proposal for the Commission's review.

In response to your other questions, United States investors may receive investment advice at any time, including at the time of retirement. Moreover, while the Commission does not compile fund performance information, there are several private organizations that do provide such information, including Lipper Analytical Services, Incorporated, 74 Trinity Place, New York, NY 10006, tel. (212) 393-1300; and Morningstar, Incorporated, 53 West Jackson Blvd, Chicago, IL 60604, tel. (800) 876-5005.

You should note that if you intend to distribute mutual funds in the United States, you may need to register with the Commission as a broker or dealer under the Securities Exchange Act of 1934 (the "Exchange Act"). For more information with respect to broker-dealer registration obligations, you should contact the Office of Chief Counsel in the Commission's Division

dilution occurring from this riskless trading. Such riskless trading, however, has not been possible since 1968, when the Commission adopted Rule 22c-1 under the 1940 Act to require "forward" pricing of fund shares. Investment Company Act Rel. No. 5519 (Oct. 16, 1968).

12/ See Protecting Investors Study. The Commission, in 1966, issued a report concluding that, because Section 22(d) prohibited competition among retail dealers, competition among distributors (principal underwriters) had the effect of raising, rather than lowering, mutual fund share prices to investors. The Commission found that, instead of competing for sales through lower sales loads to investors, underwriters competed for the favor of the retailers who sold the shares by increasing the sales loads, and thus the retailers' compensation. SEC, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 208-09, 221-23 (1966).

13/ See Protecting Investors Study.

14/ See Protecting Investors Study.

of Market Regulation. You should also contact the NASD for information on its registration requirements for selling mutual fund shares in the United States.

Finally, if you intend to provide advice to investors regarding the purchase and sale of mutual funds, you also may need to register with the Commission as an investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act"). ^{15/} I have enclosed copies of the Commission's Investment Adviser Registration package, which includes a copy of the Advisers Act, Form ADV, the form used to register as an investment adviser, and other explanatory materials. I have also enclosed the Commission's Investment Company Registration package, and a copy of an unpublished article entitled "The Regulation of Investment Companies in the United States," which provides an overview of how the Commission regulates mutual funds and other investment companies. You may want to contact an attorney for additional guidance in this area. If you have any further questions, you may write or call this Office at (202) 272-2030.

Sincerely,



Alison E. Baur
Attorney
Office of Chief Counsel

Enclosures

^{15/} A broker or dealer registered with the Commission under the Exchange Act need not also register under the Advisers Act if the investment advisory services performed are solely incidental to the brokerage business, and the broker or dealer does not receive special compensation (other than sales commissions) for its services. See Section 202(a)(11)(C) of the Advisers Act.



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March 17, 1993

Dear Sirs,

In confidence, I am giving consideration to distributing mutual funds in the United States, I hasten to add not our own funds, but funds of US organisations to US citizens (as we do in the UK), and would be grateful for some information:-

1. Could you advise me of the distribution channels most commonly used in the United States.
2. Do Americans use independent financial advisors to purchase mutual funds.
3. What rates of commission are payable on the sale of mutual funds;
 - a. Initial commission.
 - b. Regular commission.
4. Are you aware of whether people receive advice on investment in mutual funds at the time of retirement ?
5. Can you advise me of the performance information which is available (in the UK we have Micropal which is computer-based).

I would be most grateful for any similar information you can give me.

The reason I ask for this to be kept in confidence, is that at the moment we have not made public our plans, but in due course I would hope that it would be to the advantage of your members, in the same way that we have an extremely close relationship with the Unit Trust Association in the UK.

Yours sincerely,

AJ. Lloyd

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J.J.G. Budden
Managing Director
Financial Management Division