

Comment Letter on Revised Proposed Amendments to NASD Sales Charge Rule, September 1998

September 8, 1998

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: File No. SR-NASD-98-14

Dear Mr. Katz:

The Investment Company Institute¹ appreciates the opportunity to comment on the revised proposed amendments to NASD Conduct Rule 2830 governing mutual fund sales charges.² We are pleased that the Revised Proposal reflects many of our comments on the previous version of the proposal.³ Our comments on the Revised Proposal are limited to the provisions concerning funds of funds, loads on reinvested dividends, and CDSL calculations. We also have several comments on issues related to the rulemaking process. All of these comments are set forth below.

Funds of Funds

The Institute's 1997 Letter generally supported the NASD's approach to regulating the sales charges that may be imposed by funds in a fund of funds structure. We are pleased that the NASD followed our recommendations concerning application of the cumulative sales charge limits to such funds and made certain technical changes that we suggested.

At the same time, however, we note that the Revised Proposal includes a definition of "fund of funds" that is significantly broader than the proposed definition of that term in the 1997 Proposal.⁴ This change is not mentioned in the release accompanying the revised proposal; however, it raises some concerns.

First, it could be confusing to include within the definition of "fund of funds" an investment company that invests any portion of its assets—even just a de minimis amount—in another registered open-end investment company or unit investment trust. This broad definition is inconsistent with common understanding of what constitutes a fund of funds.

Second, because the definition would have such a broad scope, it would extend to situations that do not raise to any significant degree the concerns the rule seeks to address (i.e., abusive layering of sales charges).⁵ At the same time, such a broad definition would make it much more difficult to monitor and enforce compliance with the rule's requirements.

For these reasons, if the NASD believes it is necessary to broaden the definition of "fund of funds," we recommend a revised approach. To avoid confusion and an overly broad scope, the definition should be tied to provisions under Section 12(d)(1) of the Investment Company Act. For example, it could cover funds that rely on Section 12(d)(1)(F) or 12(d)(1)(G) of the Act. Alternatively, it could apply to funds that exceed the percentage limits in Section 12(d)(1)(A).

Loads on Reinvested Dividends

The NASD proposes to prohibit the imposition of front-end or deferred sales loads on reinvested dividends.⁶ The Institute previously recommended that, in lieu of prohibiting such loads, the NASD should subject investment companies that impose them to lower maximum sales charge limits, consistent with the current treatment of front-end loads on reinvested dividends.⁷ We continue to support such an approach.

We oppose the NASD's proposed prohibition because it is inconsistent with Commission exemptive orders that permit certain unit investment trusts to impose front-end or deferred sales loads on reinvested dividends in accordance with the conditions of such orders (including appropriate disclosure). The Commission's release states that NASD Regulation "continues to believe that it is appropriate to prohibit loads on reinvested dividends for all investment companies, including UITs." It provides no rationale for this continued belief, however. In the absence of any compelling basis for the proposed prohibition, such as evidence of abusive practices, we urge that it be eliminated from the proposal.

CDSL Calculations

The NASD proposes to reinstate requirements previously applicable under Rule 6c-10 under the Investment Company Act of 1940 concerning the order in which fund shares subject to a contingent deferred sales load must be redeemed when an investor redeems some, but not all, of his or her fund shares. As previously indicated, the Institute does not object to this proposal. The Institute suggests, however, that proposed paragraph (d)(6)(A) of Conduct Rule 2830 be revised to specify that it applies to partial redemptions.

In addition, we recommended in our 1997 Letter that the NASD revise the last phrase of what is now proposed paragraph (d)(6)(A) of the rule to clarify that another order of redemption (other than first-in, first-out) may be used if such order could (rather than would) result in the shareholder paying a lower contingent deferred sales load. Our recommendation was intended to capture situations such as that described in an example set forth on p. 393 of NASD Regulation Request for Comment 97-48 (presumably consistent with the NASD's intent).⁸ We remain concerned that technically, the current wording of the provision would not encompass such situations. Therefore, we reiterate our comment that the proposal should be revised to substitute "could" for "would."

The Rulemaking Process

The Institute wishes to express its concern with certain issues in connection with the Revised Proposal that we believe diminish the effectiveness of the NASD rulemaking process. First, the change to the proposed definition of "fund of funds" is a material change to the proposal that should have been identified and discussed in the Commission's release. Also, given the significance of this change, it would seem to warrant a specific request for comments. Second, the release recites certain comments on the 1997 Proposal, but does not discuss the NASD's reaction to the comments or explain why changes were or were not made to the proposal in response to the comments. Third, the only way to determine what changes were made to the proposal (such as the material change to the definition of "fund of funds") was to do a word-for-word comparison of the Revised Proposal and the 1997 Proposal. Although we do this as a matter of course, it would be helpful if the release described—at the very least—any significant changes to the proposal, particularly given the relatively short period provided for commenting.

We strongly recommend that the Commission and the NASD consider ways to improve the usefulness of the information contained in Commission releases soliciting public comment on NASD rule proposals, including eliminating the types of problems noted above. Such efforts could help enhance the quality of comments submitted,⁹ which would be beneficial to the rulemaking process.

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Thank you for considering our comments on the revised proposed amendments to NASD Conduct Rule 2830. If you have any questions or need additional information, please call me at (202) 326-5822.

Sincerely,
Frances M. Stadler
Deputy Senior Counsel

cc: Thomas M. Selman
Vice President
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Joseph E. Price
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ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,288 open-end investment companies ("mutual funds"), 450 closed-end investment companies, and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about \$5.092 trillion, accounting for approximately 95% of total industry

assets, and have over 62 million individual shareholders.'

² See SEC Release No. 34-40310 (August 7, 1998); 63 Fed. Reg. 43974 (August 17, 1998) (Revised Proposal).

³ See Letter from Frances M. Stadler, Associate Counsel, Investment Company Institute, to Ms. Joan Conley, Secretary, NASD Regulation, Inc., dated September 29, 1997 (1997 Letter) (commenting on NASD Regulation Request for Comment 97-48 (1997 Proposal)).

⁴ Specifically, proposed paragraph (b)(11) of the rule would define a fund of funds as an investment company that invests any portion of its assets in the securities of registered open-end investment companies or registered unit investment trusts. (Emphasis added.) In contrast, the 1997 Proposal defined fund of funds as an investment company that invests its assets principally in the securities of registered open-end investment companies or registered unit investment trusts, and that limits its other investments to Government securities or short term paper. (Emphasis added.) This definition essentially covered fund of funds structures permitted under Section 12(d)(1)(G) of the Investment Company Act.

In connection with the 1997 Proposal, the NASD requested comments on whether the proposed definition of fund of funds established a sufficient test for ensuring that funds would not invest in the securities of another mutual fund or unit investment trust simply to avoid the cumulative cap on asset-based fees. 1997 Proposal at p. 392. As suggested by the Institute, however, the proposal was revised to subject funds of funds to the cumulative cap. Therefore, this concern is no longer relevant and would not provide a valid basis for broadening the definition.

⁵ For example, a fund with a service fee of .15% and no front-end, deferred, or asset-based sales charges would be prohibited from investing any of its assets in another open-end fund with a service fee of .15% and no other sales charges.

⁶ The Commissions release states that [t]he proposed amendments would prohibit loads on reinvested dividends. As noted in our earlier letter, if the prohibition is adopted, we suggest that NASDR clarify in a related Notice to Members that it would apply only to front-end or deferred sales charges on reinvested dividends (as indicated in the proposed rule text).

⁷ The 1997 Letter also suggested that appropriate disclosure should be required. We note that the fee table prescribed by Form N-1A requires disclosure of the maximum sales charge imposed on reinvested dividends or other distributions.

⁸ In the example, an investor invested \$10,000 in a fund in January 1996 and \$10,000 in November 1996, then redeemed \$10,000 in December 1996. The Notice indicates that the investor may benefit if the fund used a last-in, first-out calculation, because such a calculation could result in a lower CDSL if the investor redeems additional shares in 1997. As illustrated by this example, the fund would not know in December 1996 that a last-in, first-out calculation would result in the shareholder paying a lower CDSL, because it does not know whether the investor will redeem additional shares in 1997.

⁹ For example, if the release explained why the NASD revised the proposed definition of fund of funds, commenters would have the opportunity to recommend alternative means of addressing any specific concerns.