112-28

# MEMORANDUM

JUL 16 1976

TO: The Commission

FROM: Division of Investment Management *Anne P. Jones*

SUBJECT: Public Hearings Concerning Appropriateness of Mutual Fund Assets Being Used to Finance Distribution Expenses

RECOMMENDATION: That the Commission determine whether such hearings would be appropriate, and, if so, that it issue the attached draft release announcing such hearings.

NOVEL, UNIQUE OR COMPLEX ISSUES: None

ACTION REQUESTED BY: Concurrently with the Commission's consideration of the Division's recommendation concerning draft application of Investors Diversified Services, Inc., which is on the Commission's calendar for the week of July 19, 1976. 1/

OTHER DIVISIONS OR OFFICES CONSULTED: None

Background and Discussion

During the Commission's discussion on July 8, 1976, of the Division's recommendation with respect to the acceleration of the registration statements of Mutual Liquid Assets, Inc., and Fiduciaries Fund for Cash Reserves, 2/ Chairman Hills suggested that hearings be held on the subject of mutual funds

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1/ See the Division's memorandum to the Commission dated July 8, 1976. That matter also relates to the question of whether it is appropriate for mutual fund assets to be used to finance distribution expenses.

2/ See the Division's memorandum to the Commission dated July 2, 1976.

bearing distribution expenses. Accordingly, he instructed the Division to prepare a draft release announcing such hearings, for consideration during the week of July 19, 1976.

The attached draft release announces the commencement of hearings on October 19, 1976, and requests interested persons to submit written comments by September 14, 1976. These would appear to be the earliest dates feasible, since typically, documents issued by the Commission appear in the Federal Register approximately one week after they are issued. Thus, if the Commission issues this release during the week of July 19, 1976, the release likely will be published in the Federal Register near the end of July. Interested persons thus will have approximately forty-five days to prepare and submit their written statements, which is the length of time commonly allowed for filing comments with regard to proposed rules. The staff then will study the written submissions, make recommendations to the Commission as to the individuals who should be invited to make oral presentations, and notify those individuals whose presentations the Commission wishes to hear. It will be necessary to complete these tasks within approximately three weeks after the close of the period for filing written statements, since it would seem courteous to notify prospective participants at the oral hearings at least ten days in advance of their appearance. 3/

The draft release indicates that both the relevant legal and policy issues may be discussed in the written submissions, but requests that the oral presentations be confined to discussion of the policy issues.

Attachment - Draft release

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GMcCurdy x50233
JGoldberg x50242

3/ This discussion presupposes that no extensions of time for filing written statements will be granted. However, such extensions frequently are granted with respect to rule making proceedings, and it is likely that requests for extensions of time will be made with respect to this matter, particularly in view of the novelty and complexity of the issues presented. If any extensions of time are granted for the filing of written statements, it may be necessary to postpone the date of the oral hearings.

SECURITIES AND EXCHANGE COMMISSION

[Release No. IC-        ; File No.        ]

THE BEARING OF DISTRIBUTION EXPENSES BY MUTUAL FUNDS

Announcement of Hearings

The Securities and Exchange Commission today announced that it will hold public hearings concerning the appropriateness of arrangements whereby mutual funds would, directly or indirectly, incur expenses related to the distribution of their shares, such as the costs of advertising and providing compensation for dealers. The hearings, which will commence on October 19, 1976, are designed to give the Commission the benefit of the views of interested members of the public with respect to this matter, in order to assist the Commission in its current consideration of the legal and policy implications of such arrangements and its re-examination of past positions with respect to this matter.

The Commission will then be in a better position to formulate guidance for the mutual fund industry with respect to the propriety of using fund assets to finance advertising, dealer compensation, and other distribution expenses. Such guidance could be provided by means of a rule-making proceeding or the publication of guidelines, or by some other means.

BACKGROUND

In the past, the Commission and its staff generally have questioned the propriety of arrangements under which open-end investment companies would bear the costs of distribution 1/ although, in certain unusual circumstances, the Commission or its staff has not objected to such arrangements. 2/

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1/ See, e.g., letter to counsel for the Axe-Houghton Funds, November 15, 1973, from the Division of Investment Management Regulation. It might be noted also that, with reference to reciprocal sales practices, the Commission has stated:

> "/T/he cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment, and not, even in part, by the existing shareholders of the fund who often derive little or no benefit from the sale of new shares. To impose a portion of the selling cost upon the existing shareholders of the fund may violate principles of fairness which are at least implicit in the Investment Company Act." SEC, Statement on the Future Structure of the Securities Markets (Feb. 1972) in BNA Sec. Reg. & L. Rep. No. 137, pt. II, at 7.

2/ See, e.g., In the Matter of Broad Street Investing Corporation, et al., Investment Company Act Release No. 7114 (April 4, 1972); letter to counsel for Pegasus Fund, Inc., et al., May 21, 1975, from the Division of Investment Management Regulation.

However, recently the staff has taken a qualified no-action position under the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq.*] with respect to a proposed arrangement whereby 50% of the management fee paid by a newly-organized "money market" mutual fund would be reallocated by the manager-distributor to dealers who sold shares of the fund (letter to counsel for Mutual Liquid Assets, Inc., June 15, 1976, from the Division of Investment Management). In that letter, the staff alluded to the uncertain legal status of such arrangements and stated that it was in the process of analyzing a number of issues related to the distribution of investment company shares, including the question of whether any portion of the assets of an open-end fund properly may be used, directly or indirectly, to pay distribution expenses.

PROCEDURES

In order to facilitate consideration of the relevant issues, the Commission requests that all interested persons submit written statements, in the manner described below, setting forth views and information with respect to the issues enumerated below, or other relevant issues. All such submissions will be made available for public inspection.

After the Commission has had an opportunity to review the written submissions, brief oral statements will be invited from among those persons who have made such submissions and have requested to be heard orally. Persons making oral presentations should be prepared to respond to inquiries from the Commission and its staff.

It appears that the issues relating to this matter fall into two broad categories. First, there are issues relating to the legal question of whether, and to what extent, the Commission presently has authority to permit, prohibit, or limit the use of mutual fund assets to finance various costs of distribution. Second, there are issues relating to the policy question of whether such use of fund assets would be in the public interest, assuming this is, or could be made, legal. Commentators may address issues relating to both the legal and policy questions in their written submissions. However, the Commission will request that all oral presentations be confined to the issues relating to the policy question.

Interested persons are requested to submit relevant views and information, in triplicate, to Anne P. Jones, Director, Division of Investment Management, Washington, D.C. 20549, not later than September 14, 1976. All such material should be designated "Hearings on Mutual Fund Distribution Expenses," File No.        . Persons making such submissions who wish to make oral presentations should so indicate in their written statements.

ISSUES TO BE CONSIDERED

A. Policy Issues

1. Can it be demonstrated that additional sales of shares benefit the shareholders of a mutual fund under some or all circumstances? What is the nature and extent of any such benefit? Would the benefit depend upon the present size of the fund?

2. Would it be more economical for investors to pay for selling services by means of periodic charges against assets of the fund after they invest, rather than by means of a sales load paid at the time of purchase? Would the institution of such charges against assets be inequitable with respect to existing shareholders who already paid an initial sales load? If so, how could such inequity be alleviated?

3. Would the use of mutual fund assets to finance distribution expenses have significant effects upon competition within the mutual fund industry? If so, what would be the nature of these effects?

4. If it be concluded that the use of mutual fund assets to finance distribution would result in certain benefits to new or existing fund shareholders, under what circumstances should such use of assets be permitted? Should it be confined to funds which are newly organized? Should it be permitted only as a substitute for a sales load paid at the

time of purchase, or should it also be permitted in addition to an initial sales load?

B. Legal Issues

1. What, if any, provisions of law prohibit or limit the use of fund assets to pay distribution expenses in the absence of any relevant rules?

2. Does the Commission have authority to adopt rules which would permit, prohibit, or limit the use of fund assets to pay distribution expenses?

By the Commission.

George A. Fitzsimmons
Secretary

Date