ACTION MEMORANDUM

AUG 17 1977

TO	:	The Commission
FROM	:	The Division of Investment Management
SUBJECT	:	Mutual Fund Distribution Expenses
RECOMMENDATION	:	That the Commission issue the attached release indicating that the Commission has not changed its previous position that it is generally improper for mutual funds to use their assets to finance the distribution of shares, and that it will be prepared to take action against any mutual funds which might implement arrangements involving use of their assets to finance distribution without seeking and obtaining any necessary orders of the Commission.
NOVEL, UNIQUE OR COMPLEX ISSUES	:	Whether, in issuing such a release, the Commission should avoid stating that action will be taken with regard to mutual funds which might presently be using their assets to finance distribution.
ACTION REQUESTED BY	:	Week of August 22, 1977
OTHER DIVISIONS OR OFFICES CONSULTED	:	Office of the General Counsel (A. Rosenblat), which concurs in the Division's recommendation. Division of Enforcement (I. Borowski) and Directorate of Economic and Policy Research (G. Finn), which disagree with a certain aspect of the Division's recommendation. We understand that the views of the Division of Enforcement are set forth in a separate memorandum.
STAFF MEMBERS RESPONSIBLE	:	Joel H. Goldberg 755-0242 Dianne E. O'Donnell 755-0225

Summary and Background

On August 5, 1977, the Commission considered a recommendation of the Division that, as an interim measure, a proposed rule be issued to prevent mutual funds from implementing arrangements whereby they would bear distribution expenses. However, the Commission determined that such a proposed rule was unnecessary, and instead instructed the staff to prepare an interpretative release reaffirming the Commission's previous position that it is generally improper for mutual funds to use their assets to finance the distribution of shares. Such a release is attached.

Discussion

The release states that it has been the Commission's position that it is generally improper under the Investment Company Act of 1940 ("Act") for mutual funds to use their assets, directly or indirectly, to finance the distribution of their shares, and that the Commission has no reason at this time to change its position. The release further states that the Commission will be prepared to take action under such sections of the securities laws as might be appropriate with regard to any funds which might implement such arrangements without seeking and obtaining any necessary orders of the Commission.

We understand that the Division of Enforcement believes that the release should indicate not merely that enforcement action might be taken against funds which begin bearing distribution expenses in the future, but also that action might be taken against funds already doing so. The Directorate of Economic and Policy Research agrees with the Division of Enforcement insofar as the Directorate believes that, with regard to the possibility of enforcement action, the release should not imply any distinction between funds which might now be bearing distribution expenses and those which might do so in the future.

We believe, on the other hand, that any suggestion that the Commission is prepared to take action with regard to existing arrangements involving the use of fund assets to finance distribution should be avoided at this time, since the purpose of the release is merely to prevent new arrangements of this type from being implemented at least until the Commission gives further consideration to the issue involved. However, it should be noted that the release would not necessarily foreclose the Commission from taking action with regard to a fund presently bearing distribution expenses, if such action at some point seems appropriate.

Attachment:

Draft Interpretative Release.

Title 17 - Commodity and Securities Exchanges

Chapter II - SECURITIES AND EXCHANGE COMMISSION

[Release No. IC-   ]

PART 271 - INTERPRETATIVE RELEASES RELATING TO THE INVESTMENT COMPANY ACT OF 1940 AND GENERAL RULES AND REGULATIONS THEREUNDER

BEARING OF DISTRIBUTION EXPENSES BY MUTUAL FUNDS

AGENCY: Securities and Exchange Commission.

ACTION: Statutory Interpretation.

SUMMARY: The Securities and Exchange Commission announced a statement that it has not changed its previous position that it is generally improper for registered open-end management investment companies ("mutual funds" or "funds") to use their assets to finance the distribution of their shares. This action is being taken to eliminate any doubt concerning the present position of the Commission with regard to the propriety of mutual fund assets being used to finance the distribution of shares.

EFFECTIVE DATE: Immediately.

FOR FUTHER INFORMATION CONTACT:

Dianne E. O'Donnell, Esq.
Division of Investment Management
Securities and Exchange Commission
Washington, D.C. 20549
(202-755-0225)

SUPPLEMENTARY INFORMATION: In the past, the Commission has generally taken the position that use of mutual fund assets for the purpose of financing the distribution of fund shares would be improper. For example, in its Statement on the Future Structure of the Securities Markets, the Commission stated that:

> "[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." 1/

In the past year the Commission has been engaged in a review of this area. In this connection, the Commission held

1/ SEC, Statement on the Future Structure of the Securities Markets (Feb. 1972), in BNA Sec. Reg. and L. Rep. No. 137 pt. II at 7.

public hearings on November 17, 18, 22 and 23, 1976, and received written statements, concerning the public policy and legal implications of arrangements whereby mutual funds would, directly or indirectly, bear expenses related to the distribution of their shares. 2/

At those hearings, it was argued on the one hand that increased sales of fund shares could benefit shareholders, and therefore that the use of fund assets to pay distribution expenses should be permitted at least under some circumstances. On the other hand, it was argued by others that any increased sales of shares resulting from the use of mutual fund assets to finance distribution activities would benefit mainly the management of a mutual fund rather than its shareholders, and therefore that such use of fund assets should not be permitted.

The Commission has not yet completed its consideration of the relevant issues and is not yet prepared to suggest whether, and if so under what circumstances, mutual funds should be permitted to bear distribution expenses. Accordingly, the Commission has no reason at this time to change its previous position that it is generally improper under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.] ("Act") for

2/ The hearings were announced in Investment Company Act Release No. 9470, October 4, 1976 [41 FR 44770, October 12, 1976].

mutual funds to use their assets, directly or indirectly, to finace the distribution of their shares. Therefore, directors, officers and investment advisers which authorize mutual funds to bear the expenses of distribution will be doing so at their risk.

To the extent that, notwithstanding the reiteration of the Commission's position announced herein, any mutual funds might implement arrangements involving use of their assets to finance distribution without seeking and obtaining any necessary orders of the Commission, the Commission will be prepared to take action under such sections of the securities laws as might be appropriate.

By the Commission.

George A. Fitzsimmons
Secretary

August , 1977