August 19, 1977

MEMORANDUM

TO: The Commission

FROM: The Division of Enforcement

SUBJECT: Funds Bearing Distribution Expenses
Proposed Release

RECOMMENDATION: That the release be modified to include the following provisions:

(1) a statement that the Commission is not disposed to grant applications at this time and any such application will be set down for a hearing absent compelling circumstances to the contrary;

(2) a statement that in almost all instances in which a fund is using or proposing to use fund assets for distribution expenses an application to the Commission pursuant to Section 17(d) or various other provisions of the Investment Company Act is required; and

(3) eliminate any suggestion, that the Commission will take action only in circumstances involving future implementation of a plan to use mutual fund assets for such purposes or that it may be excusing past or ongoing uses of fund assets for such purposes.

DISCUSSION

On July 22, 1977 the Division of Investment Management ("DIM") submit a memorandum to the Commission proposing an Interim Rule under Section 12 of the Investment Company Act ("Act") which would prevent funds from bear selling expenses. The Commission considered the proposal but deferred decision pending submission of the Division of Enforcement's substantive objections to the "grandfather" provisions of the proposed Rule.

On August 1, 1977, DIM submitted a memorandum and draft release to th Commission. The release contained a broad "grandfather" clause which would have exempted from the rule funds which were already bearing such expenses as of the date of the notice of the rule, whether or not that

practice had been disclosed or approved by the Commission. The rule as proposed would not have grandfathered any funds which had applications on file or which were not already bearing selling expenses. Rather than authorizing a Rule proposal which contained any exemptions of past conduct the Commission instructed DIM, pending the resolution of the basic issues, to prepare a release of general applicability, announcing the Commission's adherence to its traditional position that funds may not bear distribution expenses and advising the public that any such applications would be set down for hearing.

DIM has now submitted a draft release which would reiterate the Commission's previous position that it is generally improper for mutual funds to use their assets to finance the distribution of their shares.

As now drafted, the release contains what we view as substantial defects. First, the release does not as now worded say anything at all about what will happen if applications are made. By indicating that, if necessary, applications are not made, the Commission will take action, it is inviting funds and their advisors to make such applications. As we understand it, the Commission is not disposed to grant such individual applications at this time, but prefers to deal with the overall problem of mutual funds bearing distribution expenses by rule of otherwise. We may therefore be misleading many people into thinking that such applications might be granted when this is in fact not the case. Accordingly, we believe that a statement should be included in the release indicating that the Commission is not disposed to grant such applications at this time and will set down all such applications for hearing in the absence of compelling circumstances to the contrary.

Secondly, we thought an important objective of the release is to alert the fund industry to the Commission's view that in most instances before a fund may bear distribution expenses, it would have to make application to the Commission and have the Commission issue an appropriate order. The release the way it is worded now simply does not do this. All the proposed release says as it is now worded, is that the Commission will take action if necessary orders are not obtained without saying that it is necessary to obtain an order.

In addition, the release reintroduces the Grandfather clause in a much broader context making it applicable to all the provisions of the federal securities laws and not merely the original proposed rule which was limited to 12(b)(2). The proposed release accomplishes this objective by limiting the statement about the Commission's preparedness to take action to situations in which mutual funds might implement arrangements involving such action of their assets. This clearly suggests that the Commission will not take action if the arrangement has already

been implemented even though it is ongoing, even where the activity has not been disclosed. We do not believe that the Commission even by implication should suggest that it is giving people a walk for their past and ongoing conduct particularly if the conduct may have been deliberately hidden by failing to disclose it in registration statements. Furthermore, the Commission would appear to be giving a pass to activities where it has no idea of the scope or nature of or motivations for the conduct.

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