

August 12, 1998

Katherine A. England  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549  
Mail Stop 10-1

Re: **SR-NASD-98-14, Amendment No. 4**  
**Proposed Rule Relating to Sales Charges and Prospectus Disclosure**  
**for Mutual Funds and Variable Contracts**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed herewith is Amendment No. 4 to the above-numbered rule filing. In response to SEC staff, this amendment makes certain grammatical and technical changes to the rule language that are non-substantial in nature. This amendment supersedes and replaces the above-numbered rule filing. Also enclosed is a 3 1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register.

If you have any questions, please contact Joseph E. Price, Counsel, Advertising/Investment Companies Regulation, NASD Regulation, Inc., at (202) 728-8877; e-mail at PriceJE,@nasd.com. The fax number is (202) 728-6976.

Very truly yours,

Joan C. Conley  
Secretary

File No. SR- NASD-98-14,  
Amendment No. 4  
Consists of 55 Pages

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C.

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Form 19b-4

Proposed Rule Change

by

**NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

Pursuant to Rule 10b-4 under the  
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 (the “Act”), NASD Regulation, Inc. (“NASD Regulation”) is herewith filing with the Securities and Exchange Commission (“SEC” or Commission) a proposed rule change to amend Rule 2820 (the “Variable Contracts Rule”) and Rule 2830 (the “Investment Company Rule”) of the Conduct Rules of the National Association of Securities Dealers, Inc. (“NASD” or “Association”). The Investment Company Rule would be amended to: (1) provide maximum aggregate sales charge limits for fund of funds arrangements; (2) permit mutual funds to charge installment loads; (3) prohibit loads on reinvested dividends; (4) impose redemption order requirements for shares subject to contingent deferred sales loads; and (5) eliminate duplicative prospectus disclosure. The Variable Contracts Rule would be amended to eliminate the specific sales charge limitations in the rule and a filing requirement relating to changes in sales charges. Below is the text of the proposed rule amendments. Proposed new language is underlined; proposed deletions are in brackets.

**2800 SPECIAL PRODUCTS**

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**2820 VARIABLE CONTRACTS OF AN INSURANCE COMPANY**

**(a) Application**

This Rule shall apply exclusively (and in lieu of Rule 2830) to the activities of members in connection with variable contracts to the extent such activities are subject to regulation under the federal securities laws.

**(b) Definitions**

(1) The term "purchase payment" as used throughout this Rule shall mean the consideration paid at the time of each purchase or installment for or under the variable contract.

(2) The term "variable contracts" shall mean contracts providing for benefits or values which may vary according to the investment experience of any separate or segregated account or accounts maintained by an insurance company.

**[(c) Sales Charges]**

[No member shall participate in the offering or in the sale of variable annuity contracts if the purchase payment includes a sales charge which is excessive:]

[(1) Under contracts providing for multiple payments a sales charge shall not be deemed to be excessive if the sales charge stated in the prospectus does not exceed 8.5% of the total payments to be made thereon as of a date not later than the end of the twelfth year of such payments, provided that if a contract be issued for any stipulated shorter payment period, the sales charge under such contract shall not exceed 8.5% of the total payments thereunder for such period.]

[(2) Under contracts providing for single payments a sales charge shall not be deemed to be excessive if the prospectus sets forth a scale of reducing sales charges related to the amount of the purchase payment which is not greater than the following schedule:

First \$25,000 -8.5% of purchase payment

Next \$25,000 -7.5% of purchase payment

Over \$50,000 -6.5% of purchase payment]

[(3) Under contracts where sales charges and other deductions for purchase payments are not stated separately in the prospectus the total deductions from purchase payments (excluding those for insurance premiums and premium taxes) shall be treated as a sales charge for purposes of this rule and shall not be deemed to be excessive if they do not exceed the percentages for multiple and single payment contracts described in paragraphs (1) and (2) above.]

[(4) Every member who is an underwriter and/or issuer of variable annuities shall file with Advertising/Investment Companies Regulation Department, prior to implementation, the details of any changes or proposed changes in the sales charges of such variable annuities, if the changes or proposed changes would increase the effective sales charge on any transaction. Such filings should be clearly identified as an "Amendment to Variable Annuity Sales Charges."]

**[(d)] (c) Receipt of Payment**

No member shall participate in the offering or in the sale of a variable contract on any basis other than at a value to be determined following receipt of payment therefore in accordance with the provisions of the contract, and, if applicable, the prospectus, the Investment Company Act of 1940 and applicable rules thereunder. Payments need not be considered as received until the contract application has been

accepted by the insurance company, except that by mutual agreement they may be considered to have been received for the risk of the purchaser when actually received.

**[(e)] (d) Transmittal**

Every member who receives applications and/or purchase payments for variable contracts shall transmit promptly to the issuer all such applications and at least that portion of the purchase payment required to be credited to the contract.

**[(f)] (e) Selling Agreements**

No member who is a principal underwriter as defined in the Investment Company Act of 1940 may sell variable contracts through another broker/dealer unless (1) such broker/dealer is a member, and (2) there is a sales agreement in effect between the parties. Such sales agreement must provide that the sales commission be returned to the issuing insurance company if the variable contract is tendered for redemption within seven business days after acceptance of the contract application.

**[(g)] (f) Redemption**

No member shall participate in the offering or in the sale of a variable contract unless the insurance company, upon receipt of a request in proper form for partial or total redemption in accordance with the provisions of the contract undertakes to make prompt payment of the amounts requested and payable under the contract in accordance with the terms thereof, and, if applicable, the prospectus, the Investment Company Act of 1940 and applicable rule thereunder.

## **2830 INVESTMENT COMPANY SECURITIES**

### **(a) Application**

This Rule shall apply exclusively to the activities of members in connection with the securities of companies registered under the Investment Company Act of 1940 (“the 1940 Act”); provided, however, that Rule 2820 shall apply, in lieu of this Rule, to members’ activities in connection with “variable contracts” as defined therein.

### **(b) Definitions**

(1) “Associated person of an underwriter,” as used in paragraph (l), shall include an issuer for which an underwriter is the sponsor or a principal underwriter, any investment adviser of such issuer, or any affiliated person (as defined in Section 2(a)(3) of the [Investment Company Act of 1940] 1940 Act) of such underwriter, issuer or investment adviser.

(2) “Brokerage commissions,” as used in paragraph (k), shall not be limited to commissions on agency transactions but shall include underwriting discounts or concessions and fees to members in connection with tender offers.

(3) “Covered account,” as used in paragraph (k), shall mean (A) any other investment company or other account managed by the investment adviser of such investment company, or (B) any other account from which brokerage commissions are received or expected as a result of the request or direction of any principal underwriter of such investment company or of any affiliated person (as defined in the [Investment Company Act of 1940] 1940

Act) of such investment company or of such underwriter, or of any affiliated person of an affiliated person of such investment company.

(4) “Person” shall mean “person” as defined in the [Investment Company Act of 1940]1940 Act.

(5) “Prime rate,” as used in paragraph (d), shall mean the most preferential interest rate on corporate loans at large U.S. money center commercial banks.

(6) “Public offering price” shall mean a public offering price as set forth in the prospectus of the issuing company.

(7) “Rights of accumulation,” as used in paragraph (d), shall mean a scale of reducing sales charges in which the sales charge applicable to the securities being purchased is based upon the aggregate quantity of securities previously purchased or acquired and then owned plus the securities being purchased.

The quantity of securities owned shall be based upon:

(A) The current value of such securities (measured by either net asset value or maximum offering price); or

(B) Total purchases of such securities at actual offering prices;

or

(C) The higher of the current value or the total purchases of such securities.

The quantity of securities owned may also include redeemable securities of other registered investment companies having the same principal underwriter.

(8) “Sales Charge” and “sales charges,” as used in paragraph (d), shall mean all charges or fees that are paid to finance sales or sales promotion expenses, including front-end deferred and asset-based sales charges, excluding charges and fees for ministerial, recordkeeping or administrative activities and investment management fees. For purposes of this Rule, members may rely on the sales-related fees and charges disclosed in the prospectus of an investment company.

(A) An “asset-based sales charge” is a sales charge that is deducted from the net assets of an investment company and does not include a service fee.

(B) A “deferred sales charge” is [a sales charge that is deducted from the proceeds of the redemption of shares by an investor, excluding any such charges that are (i) nominal and are for services in connection with a redemption or (ii) discourage short-term trading, that are not used to finance sales-related expenses, and that are credited to the net assets of the investment company] any amount properly chargeable to sales or promotional expenses that is paid by a shareholder after purchase but before or upon redemption.

(C) A “front-end sales charge” is a sales charge that is included in the public offering price of the shares of an investment company.

(9) “Service fees,” as used in paragraph (d), shall mean payments by an investment company for personal service and/or the maintenance of shareholder accounts.

(10) The terms “underwriter,” “principal underwriter,” “redeemable security,” “periodic payment plan,” “open-end management investment company,” and “unit investment trust,” shall have the same definitions used in the [Investment Company Act of 1940] 1940 Act.

(11) A “fund of funds” is an investment company that invests any portion of its assets in the securities of registered open-end investment companies or registered unit investment trusts. An “acquiring company” in a fund of funds is the investment company that purchases or otherwise acquires the securities of another investment company, and an “acquired company” is the investment company whose securities are acquired.

(12) “Investment companies in a single complex” are any two or more companies that hold themselves out to investors as related companies for purposes of investment and investor services.

**(c) Conditions of Discounts to Dealers**

No member who is an underwriter of the securities of an investment company shall sell any such security to any dealer or broker at any price other than a public offering price unless such sale is in conformance with Rule 2420 and, if the security is

issued by an open-end management company or by a unit investment trust which invests primarily in securities issued by other investment companies, unless a sales agreement shall set forth the concessions to be received by the dealer or broker.

**(d) Sales Charge**

No member shall offer or sell the shares of any open-end investment company or any “single payment” investment plan issued by a unit investment trust (collectively “investment companies”) registered under the [Investment Company Act of 1940] 1940 Act if the sales charges described in the prospectus are excessive. Aggregate sales charges shall be deemed excessive if they do not conform to the following provisions:

(1) Investment Companies Without an Asset-Based Sales Charge

(A) Aggregate front-end and[/or] deferred sales charges described in the prospectus which may be imposed by an investment company without an asset-based sales charge shall not exceed 8.5% of the offering price.

[(B)(i) Dividend reinvestment may be made available at net asset value per share to any person who requests such reinvestment.

(ii) If dividend reinvestment is not made available as specified in subparagraph (B)(i) above, the maximum aggregate sales charge shall not exceed 7.25% of offering price.]

[(C)(i) ](B)(i) Rights of accumulation (cumulative quantity discounts) may be made available to any person in accordance with

one of the alternative quantity discount schedules provided in subparagraph ~~[(D)]~~(C)(i) below, as in effect on the date the right is exercised.

(ii) If rights of accumulation are not made available on terms at least as favorable as those specified in subparagraph ~~(C)~~(C)(i) the maximum aggregate sales charge shall not exceed[:]

~~[(a)]~~ 8.0% of offering price. [if the provisions of subparagraph (B)(i) are met; or

~~(b)~~ 6.75% of offering price if the provisions of subparagraph (B)(i) are not met.]

~~[(D)]~~(C)(i) Quantity discounts, if offered, shall be made available on single purchases by any person in accordance with one of the following two alternatives:

a. A maximum aggregate sales charge of 7.75% on purchases of \$10,000 or more and a maximum aggregate sales charge of 6.25% on purchases of \$25,000 or more, or

b. A maximum aggregate sales charge of 7.50% on purchases of \$15,000 or more and a maximum aggregate sales charge of 6.25% on purchases of \$25,000 or more.

(ii) If quantity discounts are not made available on terms at least as favorable as those specified in subparagraph

~~[(D)(i)]~~~~(C)(i)~~ the maximum aggregate sales charge shall not exceed:

a. 7.75% of offering price if the provisions of subparagraphs ~~[(B)(i) and (C)(i)]~~(B) are met.

b. 7.25% of offering price if [the provisions of subparagraph (B)(i) are met but] the provisions of subparagraph ~~[(C)(i)]~~(B) are not met.

c. 6.50% of offering price if the provisions of subparagraph (C) (i) are met but the provision of subparagraph (B)(i) are not met.]

[d. 6.25% of offering price if the provisions of subparagraphs (B)(i) and (C)(i) are not met.]

~~[(E)]~~(D) If an investment company without an asset-based sales charge pays a service fee, the maximum aggregate sales charge shall not exceed 7.25% of the offering price.

[(F) If an investment company without an asset-based sales charge reinvests dividends at offering price, it shall not offer or pay a service fee unless it offers quantity discounts and rights of accumulation and the maximum aggregate sales charge does not exceed 6.25% of the offering price.]

## (2) Investment Companies With an Asset-Based Sales Charge

(A) Except as provided in subparagraphs (C) and (D), the aggregate asset-based, front-end and deferred sales charges described

in the prospectus which may be imposed by an investment company with an asset-based sales charge, if the investment company has adopted a plan under which service fees are paid, shall not exceed 6.25% of total new gross sales (excluding sales from the reinvestment of distributions; [and] exchanges of shares between investment companies in a single complex, between classes [of shares] of an investment company with multiple classes of shares or between series [shares] of a series investment company) plus interest charges on such amount equal to the prime rate plus one percent per annum. The maximum front-end or deferred sales charge resulting from any transaction shall be 6.25% of the amount invested.

(B) Except as provided in subparagraphs (C) and (D), if an investment company with an asset-based sales charge does not pay a service fee, the aggregate asset-based, front-end and deferred sales charges described in the prospectus shall not exceed 7.25% of total new gross sales (excluding sales from the reinvestment of distributions; [and] exchanges of shares between investment companies in a single complex, between classes [of shares] of an investment company with multiple classes of shares or between series [shares] of a series investment company) plus interest charges on such amount equal to the prime rate plus one percent per annum. The maximum front-end or deferred sales charge resulting from any transaction shall be 7.25% of the amount invested.

(C) The maximum aggregate sales charge on total new gross sales set forth in subparagraphs (A) and (B) may be increased by an amount calculated by applying the appropriate percentages of 6.25% or 7.25% of total new gross sales which occurred after an investment company first adopted an asset-based sales charge until July 7, 1993 plus interest charges on such amount equal to the prime rate plus one percent per annum less any front-end, asset-based or deferred sales charges on such sales or net assets resulting from such sales.

(D) The maximum aggregate sales charges of an investment company in a single complex, a class or share issued by an investment company with multiple classes of shares or a separate series of a series investment company, may be increased to include sales of exchanged shares provided that such increase is deducted from the maximum aggregate sales charges of the investment company, class or series which redeemed the shares for the purpose of such exchanges.

(E) No member shall offer or sell the shares of an investment company with an asset-based sales charge if:

(i) The amount of the asset-based sales charge exceeds .75 of 1% per annum of the average annual net assets of the investment company; or

(ii) Any deferred sales charges deducted from the proceeds of a redemption after the maximum cap<sub>1</sub> described in

subparagraphs (A), (B), (C) and (D) hereof, has been attained are not credited to the investment company.

(3) Fund of Funds

(A) If neither an acquiring company nor an acquired company in a fund of funds structure has an asset-based sales charge, the maximum aggregate front-end and deferred sales charges that may be imposed by the acquiring company, the acquired company and those companies in combination, shall not exceed the rates provided in paragraph (d)(1).

(B) Any acquiring company or acquired company in a fund of funds structure that has an asset-based sales charge shall individually comply with the requirements of paragraph (d)(2), provided:

(i) If the acquiring and acquired companies are in a single complex and the acquired fund has an asset-based sales charge, sales made to the acquiring fund shall be excluded from total gross new sales for purposes of acquired fund's calculations under subparagraphs (d)(2)(A) through (d)(2)(D); and

(ii) If both the acquiring and acquired companies have an asset-based sales charge: (a) the maximum aggregate asset-based sales charge imposed by the acquiring company, the acquired company and those companies in combination, shall not exceed the rate provided in subparagraph (d)(2)(E)(i); and

(b) the maximum aggregate front-end or deferred sales charges shall not exceed 7.25% of the amount invested, or 6.25% if either company pays a service fee.

(C) The rates described in subparagraphs (d)(4) and (d)(5) shall apply to the acquiring company, the acquired company and those companies in combination. The limitations of subparagraph (d)(6) shall apply to the acquiring company and the acquired company individually.

~~[(3)](4)~~ No member or person associated with a member shall, either orally or in writing, describe an investment as being “no load” or as having “no sales charge” if the investment company has a front-end or deferred sales charge or if the investment company’s total charges against net assets to provide for sales related expenses and/or service fees exceed .25 of 1% of average net asset per annum.

[(4) No member or person associated with a member shall offer or sell the securities of an investment company with an asset-based sales charge unless its prospectus discloses that long-term shareholders may pay more than the economic equivalent of the maximum front-end sales charges permitted by this Rule. Such disclosure shall be adjacent to the fee table in the front section of a prospectus. This subparagraph shall not apply to money market mutual funds which have asset-based sales charges equal to or less than .25 of 1% of average net assets per annum.]

(5) No member or person associated with a member shall offer or sell the securities of an investment company if the service fees paid by the investment company, as disclosed in the prospectus, exceed .25 of 1% of its average annual net assets or if a service fee paid by the investment company, as disclosed in the prospectus, to any person who sells its shares exceeds .25 of 1% of the average annual net asset value of such shares.

(6) No member or person associated with a member shall offer or sell the securities of an investment company if:

(A) The investment company has a deferred sales charge paid upon redemption that declines over the period of a shareholder's investment ("contingent deferred sales load"), unless the contingent deferred sales load is calculated as if the shares or amounts representing shares not subject to the load are redeemed first, and other shares or amounts representing shares are then redeemed in the order purchased, provided that another order of redemption may be used if such order would result in the redeeming shareholder paying a lower contingent deferred sales load; or

(B) The investment company has a front-end or deferred sales charge imposed on shares, or amounts representing shares, that are purchased through the reinvestment of dividends, unless the registration statement registering the investment company's securities under the Securities Act of 1933 became effective prior to [insert the effective date of this rule amendment].

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2. Procedures of the Self-Regulatory Organization

(a) The proposed rule amendments were approved by the Board of Directors of NASD Regulation at its meeting on January 21, 1998 and were reviewed by the Board of Governors of the NASD at its meeting on January 22, 1998, which authorized the filing of the proposed rule amendments with the Securities and Exchange Commission (“Commission”). No other action is necessary for the filing of the rule amendments. Section 1(a)(ii) to Article VII of the By-Laws permits the NASD Board of Governors to adopt amendments to the Conduct Rules without recourse to the membership for approval. The staff of NASD Regulation has provided an opportunity for the staff of The Nasdaq Stock Market, Inc. to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries. The NASD will make the proposed amendments effective within 45 days of Commission approval.

(b) Questions regarding this rule filing may be directed to Joseph E. Price, Counsel, Advertising/Investment Companies Regulation, at (202) 728-8330.

3. Self Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a)

**Background**

Regulatory initiatives adopted in 1996 by Congress and the Commission provide mutual funds and variable insurance sponsors with greater flexibility in structuring distribution arrangements. In 1997, NASD Regulation published Notice

to Members 97-48 requesting comment on proposed amendments to the sales charge provisions in Rule 2830 (the Investment Company Rule) and Rule 2820 (the Variable Contracts Rule) that would adapt the rules to these regulatory initiatives and new distribution arrangements. NASD Regulation received nine comment letters in response to Notice to Members 97-48. The commenters generally supported the proposed amendments to Investment Company Rule. The commenters strongly supported the proposed amendments to the Variable Contracts Rule.

## **Description**

### **1. Proposed Amendments to the Investment Company Rule**

#### *A. Fund of Funds*

The National Securities Markets Improvement Act of 1996 (the “1996 Amendments”) amended the Investment Company Act of 1940 (the “1940 Act”) to, among other things, broaden the ability of mutual fund sponsors to establish “fund of funds” arrangements.

The Investment Company Rule currently does not take into account two-tier fund of funds structures in which asset-based sales charges are imposed at both the acquiring and acquired fund levels. The proposed amendments would amend the Investment Company Rule to ensure that if a fund of funds charges distribution fees at both levels, the combined sales charges do not exceed the maximum percentage limits currently contained in the rule.

*B. Deferred Sales Loads*

In September 1996, the Commission amended Rule 6c-10 under the 1940 Act to permit new types of deferred loads, such as back-end and installment loads. The proposed amendments to the Investment Company Rule also would permit these types of deferred sales charges. The amendments would conform the definition of “deferred sales charge” in the Investment Company Rule to the definition of “deferred sales load” in Rule 6c-10 (*i.e.*, “any amount properly chargeable to sales or promotional expenses that is paid by a shareholder after purchase but before or upon redemption”).

*C. Loads on Reinvested Dividends*

The proposed amendments would prohibit loads on reinvested dividends. When NASD Regulation proposed to prohibit loads on reinvested dividends in Notice to Members 97-48, commenters representing unit investment trust (“UIT”) sponsors objected to the proposed amendments. NASD Regulation, however, continues to believe that it is appropriate to prohibit loads on reinvested dividends for all investment companies, including UITs. NASD Regulation believes that this practice is not prevalent. However, in order to avoid the disruption, system costs, and reallocation of expenses that otherwise would be paid through such loads, the proposed amendments include a “grandfather provision” that would exempt from the operation of the prohibition all investment companies that currently impose such fees.

*D. CDSL Calculations*

The proposed amendments would prohibit members from selling fund shares that impose a CDSL unless the method used by the fund to calculate CDSLs in partial redemptions requires that investors are given full credit for the time they have invested in the fund. Because a CDSL declines over the period of a shareholder's investment, a first-in-first-out ("FIFO") redemption order requirement generally would ensure that transactions are subject to the lowest applicable CDSL. The proposed amendments, however, also would expressly provide that if a redemption order other than FIFO (for example, last-in first-out) would result in a redeeming shareholder paying a lower CDSL, the other method could be used.

*E. Prospectus Disclosure*

The Investment Company Rule currently prohibits a member from offering or selling shares of a fund with an asset-based sales charge unless its prospectus discloses that long-term shareholders may pay more than the economic equivalent of the maximum front-end sales charges permitted by the rule. In March 1998, the Commission adopted significant revisions to prospectus disclosure requirements for mutual funds. Included in the amendments is a requirement that the prospectuses of funds with asset-based sales charges include disclosure regarding Rule 12b-1 plans that is similar to the disclosure required in the Investment Company Rule. Accordingly, the proposed amendments would eliminate the prospectus disclosure requirement in the Investment Company Rule.

## **2. Amendments to the Variable Contracts Rule**

In Notice to Members 97-48, NASD Regulation proposed to amend the Variable Contracts Rule to eliminate the maximum sales charge limitations. The commenters strongly supported the proposed amendment because they view specific sales charge limits in the Variable Contracts Rule as unnecessary and inconsistent with the “reasonableness” standard enacted in the 1996 Amendments. Consistent with these comments, the proposed amendments would eliminate the maximum sales charge limitations in the Variable Contracts Rule. The proposed amendments also would make a conforming change to eliminate the requirement in the rule to file with the Advertising/Investment Companies Regulation Department the details of any changes in a variable annuity’s sales charges.

(b) NASD Regulation believes that the proposed rule changes are consistent with the provision of Section 15A(b)(6) of the Securities Exchange Act of 1934, which require, among other things, that the Association’s rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest, in that the proposed rule change, by adapting the Investment Company Rule and the Variable Contracts Rule to take into account recent legislation, regulations promulgated by the Commission and new distribution arrangements, will further these requirements.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The commenters generally supported the proposed amendments to the Investment Company Rule. The commenters strongly supported the proposed amendments to the Variable Contracts Rule. The comments are summarized below.

**I. Amendments to the Investment Company Rule**

A. *Fund of Funds*

NASD Regulation proposed to amend the Investment Company Rule to ensure that the combined sales charges for funds of funds that charge a sales load or asset-based distribution fee at both the acquiring and underlying fund levels do not exceed the maximum percentage limits that are currently contained in the Rule. The proposed amendments, however, would not require funds of funds to calculate cumulative sales charge limits required for funds that charge asset-based fees. The Investment Company Institute (ICI) and the Securities Industry Association (SIA) supported the proposed approach to regulating fees charged by funds of funds. The ICI recommended certain technical changes to the proposed rule language to clarify that the limits apply to the aggregate rate of asset-based sales charges rather than the

amount deducted based on net asset values. In addition, the ICI recommended that NASD Regulation clarify that the acquiring and acquired funds in a fund of funds structure remain individually subject to the cumulative limits in the rule.

Banc One Corporation (Banc One) stated that the cumulative limits should apply to funds of funds. Banc One noted that acquiring funds in a fund of funds structure typically purchase institutional class shares in underlying funds that typically do not carry an asset-based sales charge. Accordingly, Banc One believes that it is feasible for the acquiring fund to calculate a single remaining amount that reflects both its own gross new sales and its proportionate share of the underlying fund's new sales and charges.

*B. Installment Loads*

NASD Regulation proposed to amend the definition of “deferred sales charge” in the Investment Company Rule to permit installment loads. The ICI was the only commenter on this proposal, which it supported.

*C. Loads on Reinvested Dividends*

NASD Regulation proposed to prohibit sales loads on reinvested dividends. The ICI and Davis Polk & Wardwell (Davis Polk) opposed this proposal. The ICI believes that, as an alternative to prohibiting loads on reinvested dividends, funds that impose such charges should be subject to lower maximum limits in the Rule and be required to make appropriate disclosure.

*D. CDSL Calculations*

NASD Regulation proposed to impose redemption order requirements (first-in-first-out or FIFO) for shares subject to contingent deferred sales loads so that investors incur only the lowest applicable CDSL. The proposed amendments also would provide that if a redemption order other than FIFO (*e.g.*, LIFO) would result in a redeeming shareholder paying a lower CDSL, that method could be used. In addition, the Notice to Members clarified that the proposed amendment would concern only the manner in which a fund calculated the CDSL and should not affect a shareholder's ability to identify for tax purposes which shares have been redeemed. The ICI did not object to NASD Regulation's approach. The SIA, however, stated that NASD Regulation should not impose order of redemption requirements because marketing or business considerations may justify use of methodologies other than FIFO, and investors should retain the right to designate which shares they wish to sell for tax purposes.

*E. Prospectus Disclosure*

In deference to the recent adoption by the SEC of new prospectus disclosure regarding the long-term effects of Rule 12b-1 fees, NASD Regulation proposed to eliminate the equivalent prospectus disclosure requirement in the Investment Company Rule. The ICI and the SIA supported this proposal.

*F. Other Comments*

Federated Investors (Federated) recommended that NASD Regulation consider an additional amendment to the Investment Company Rule that would permit funds to calculate the cumulative limits in the Rule by aggregating all shares of the same class within a fund complex that have exchange privileges, rather than calculating the cap for each fund individually. For example, all sales charges for “B” shares in a fund complex and gross new sales of B shares would be aggregated to determine the remaining amount under the rule.

Federated claimed that the current calculation methods for the transfer of remaining amount balances in share exchanges within a fund complex result in some funds being undercharged while others are overcharged. (The Investment Company Rule permits a fund either to increase its remaining amount by treating the shares received through an exchange as gross new sales and deducting the amount of such increase from the remaining amount of the fund from which shares were exchanged, or to transfer less than this maximum amount pursuant to a fund policy that is consistently applied.) Federated believes that if fund companies are permitted to aggregate the remaining amount pools for exchangeable shares, inaccuracies inherent in the current methods would be significantly reduced.

## **II. Amendments to the Variable Contracts Rule**

### *A. Sales Charge Limits*

The National Association for Variable Annuities (NAVA), Allstate Life Financial Services (Allstate), New England Insurance and Investment Company (New England) strongly supported the proposed amendment to the Variable Contracts Rule to eliminate the sales charge limit for variable annuities. They viewed the specific sales charge limits in the Rule as unnecessary and inconsistent with the “reasonableness standard” enacted in National Securities Market Improvement Act (1996 Act). NAVA described the reasonableness standard as a compromise between the SEC and the insurance industry that was intended to eliminate SEC regulation of individual charges in favor of the new comprehensive standard. Allstate believes that the intent of the 1996 Act was to eliminate specific limits on fees in favor of a reasonableness standard for aggregate fees. New England also noted that practical considerations render the fee limits in the Variable Contracts Rule ineffective because distribution expenses typically are not recovered by charging sales loads on premium payments.

### *B. Limitations on Sales Charges of Underlying Funds*

NAVA and New England believe that sales charge limits on funds underlying variable annuities would be unnecessary and inconsistent with the 1996 Act. NAVA notes that the 1996 Act provides that for purposes of the reasonableness requirement, “the fees and charges deducted under the contract shall include all fees and charges imposed for any purpose and in any

manner.” Allstate stated that specific limits on underlying funds should not be necessary, but NASD Regulation should consider how insurance company issuers are administering the “reasonableness” requirement. The NASD has determined not to impose sales charge limits in the Investment Company Rule on funds underlying variable annuities. The Variable Contracts Rule will continue to apply exclusively to the activities of members in connection with variable contracts.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibit

1. Completed notice of proposed rule change for publication in the Federal Register

Pursuant to the requirements of the Securities Exchange Act of 1934,  
NASD Regulation has duly caused this filing to be signed on its behalf by the  
undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: \_\_\_\_\_  
Joan C. Conley, Secretary

Date: August 12, 1998

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-98-14, Amendment No. 4)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Concerning Related Performance Information.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS AND SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing amendments to Rule 2820 (the "Variable Contracts Rule") and Rule 2830 (the "Investment Company Rule") of the Conduct Rules of the National Association of Securities Dealers, Inc. ("NASD" or "Association"). The Investment Company Rule would be amended to: (1) provide maximum aggregate sales charge limits for fund of funds arrangements; (2) permit mutual funds to charge installment loads; (3) prohibit loads on reinvested dividends; (4) impose redemption order requirements for shares subject to contingent deferred sales loads; and (5) eliminate duplicative prospectus disclosure. The Variable Contracts Rule would be amended to eliminate the

specific sales charge limitations in the rule and a filing requirement relating to changes in sales charges. Below is the text of the proposed rule amendments.

Proposed new language is underlined; proposed deletions are in brackets.

**2800 SPECIAL PRODUCTS**

\*\*\*\*\*

**2820 VARIABLE CONTRACTS OF AN INSURANCE COMPANY**

**(a) Application**

This Rule shall apply exclusively (and in lieu of Rule 2830) to the activities of members in connection with variable contracts to the extent such activities are subject to regulation under the federal securities laws.

**(b) Definitions**

(1) The term "purchase payment" as used throughout this Rule shall mean the consideration paid at the time of each purchase or installment for or under the variable contract.

(2) The term "variable contracts" shall mean contracts providing for benefits or values which may vary according to the investment experience of any separate or segregated account or accounts maintained by an insurance company.

**[(c) Sales Charges]**

[No member shall participate in the offering or in the sale of variable annuity contracts if the purchase payment includes a sales charge which is excessive:]

[(1) Under contracts providing for multiple payments a sales charge shall not be deemed to be excessive if the sales charge stated in the prospectus

does not exceed 8.5% of the total payments to be made thereon as of a date not later than the end of the twelfth year of such payments, provided that if a contract be issued for any stipulated shorter payment period, the sales charge under such contract shall not exceed 8.5% of the total payments thereunder for such period.]

[(2) Under contracts providing for single payments a sales charge shall not be deemed to be excessive if the prospectus sets forth a scale of reducing sales charges related to the amount of the purchase payment which is not greater than the following schedule:

First \$25,000 -8.5% of purchase payment

Next \$25,000 -7.5% of purchase payment

Over \$50,000 -6.5% of purchase payment]

[(3) Under contracts where sales charges and other deductions for purchase payments are not stated separately in the prospectus the total deductions from purchase payments (excluding those for insurance premiums and premium taxes) shall be treated as a sales charge for purposes of this rule and shall not be deemed to be excessive if they do not exceed the percentages for multiple and single payment contracts described in paragraphs (1) and (2) above.]

[(4) Every member who is an underwriter and/or issuer of variable annuities shall file with Advertising/Investment Companies Regulation Department, prior to implementation, the details of any changes or proposed changes in the sales charges of such variable annuities, if the changes or

proposed changes would increase the effective sales charge on any transaction.

Such filings should be clearly identified as an "Amendment to Variable Annuity Sales Charges."]

**[(d)](c) Receipt of Payment**

No member shall participate in the offering or in the sale of a variable contract on any basis other than at a value to be determined following receipt of payment therefore in accordance with the provisions of the contract, and, if applicable, the prospectus, the Investment Company Act of 1940 and applicable rules thereunder. Payments need not be considered as received until the contract application has been accepted by the insurance company, except that by mutual agreement they may be considered to have been received for the risk of the purchaser when actually received.

**[(e)](d) Transmittal**

Every member who receives applications and/or purchase payments for variable contracts shall transmit promptly to the issuer all such applications and at least that portion of the purchase payment required to be credited to the contract.

**[(f)](e) Selling Agreements**

No member who is a principal underwriter as defined in the Investment Company Act of 1940 may sell variable contracts through another broker/dealer unless (1) such broker/dealer is a member, and (2) there is a sales agreement in effect between the parties. Such sales agreement must provide that the sales commission be returned to the issuing insurance company if the variable contract is tendered for redemption within seven business days after acceptance of the contract application.

**[(g)]f) Redemption**

No member shall participate in the offering or in the sale of a variable contract unless the insurance company, upon receipt of a request in proper form for partial or total redemption in accordance with the provisions of the contract undertakes to make prompt payment of the amounts requested and payable under the contract in accordance with the terms thereof, and, if applicable, the prospectus, the Investment Company Act of 1940 and applicable rule thereunder.

**2830 INVESTMENT COMPANY SECURITIES**

**(a) Application**

This Rule shall apply exclusively to the activities of members in connection with the securities of companies registered under the Investment Company Act of 1940 (“the 1940 Act”); provided, however, that Rule 2820 shall apply, in lieu of this Rule, to members’ activities in connection with “variable contracts” as defined therein.

**(b) Definitions**

(1) “Associated person of an underwriter,” as used in paragraph (l), shall include an issuer for which an underwriter is the sponsor or a principal underwriter, any investment adviser of such issuer, or any affiliated person (as defined in Section 2(a)(3) of the [Investment Company Act of 1940] 1940 Act) of such underwriter, issuer or investment adviser.

(2) “Brokerage commissions,” as used in paragraph (k), shall not be limited to commissions on agency transactions but shall include underwriting

discounts or concessions and fees to members in connection with tender offers.

(3) “Covered account,” as used in paragraph (k), shall mean (A) any other investment company or other account managed by the investment adviser of such investment company, or (B) any other account from which brokerage commissions are received or expected as a result of the request or direction of any principal underwriter of such investment company or of any affiliated person (as defined in the [Investment Company Act of 1940] 1940 Act) of such investment company or of such underwriter, or of any affiliated person of an affiliated person of such investment company.

(4) “Person” shall mean “person” as defined in the [Investment Company Act of 1940] 1940 Act.

(5) “Prime rate,” as used in paragraph (d), shall mean the most preferential interest rate on corporate loans at large U.S. money center commercial banks.

(6) “Public offering price” shall mean a public offering price as set forth in the prospectus of the issuing company.

(7) “Rights of accumulation,” as used in paragraph (d), shall mean a scale of reducing sales charges in which the sales charge applicable to the securities being purchased is based upon the aggregate quantity of securities previously purchased or acquired and then owned plus the securities being purchased.

The quantity of securities owned shall be based upon:

- (A) The current value of such securities (measured by either net asset value or maximum offering price); or
  - (B) Total purchases of such securities at actual offering prices;
- or
- (C) The higher of the current value or the total purchases of such securities.

The quantity of securities owned may also include redeemable securities of other registered investment companies having the same principal underwriter.

(8) “Sales Charge” and “sales charges,” as used in paragraph (d), shall mean all charges or fees that are paid to finance sales or sales promotion expenses, including front-end deferred and asset-based sales charges, excluding charges and fees for ministerial, recordkeeping or administrative activities and investment management fees. For purposes of this Rule, members may rely on the sales-related fees and charges disclosed in the prospectus of an investment company.

(A) An “asset-based sales charge” is a sales charge that is deducted from the net assets of an investment company and does not include a service fee.

(B) A “deferred sales charge” is [a sales charge that is deducted from the proceeds of the redemption of shares by an investor, excluding any such charges that are (i) nominal and are for services in

connection with a redemption or (ii) discourage short-term trading, that are not used to finance sales-related expenses, and that are credited to the net assets of the investment company] any amount properly chargeable to sales or promotional expenses that is paid by a shareholder after purchase but before or upon redemption.

(C) A “front-end sales charge” is a sales charge that is included in the public offering price of the shares of an investment company.

(9) “Service fees,” as used in paragraph (d), shall mean payments by an investment company for personal service and/or the maintenance of shareholder accounts.

(10) The terms “underwriter,” “principal underwriter,” “redeemable security,” “periodic payment plan,” “open-end management investment company,” and “unit investment trust,” shall have the same definitions used in the [Investment Company Act of 1940] 1940 Act.

(11) A “fund of funds” is an investment company that invests any portion of its assets in the securities of registered open-end investment companies or registered unit investment trusts. An “acquiring company” in a fund of funds is the investment company that purchases or otherwise acquires the securities of another investment company, and an “acquired company” is the investment company whose securities are acquired.

(12) “Investment companies in a single complex” are any two or more companies that hold themselves out to investors as related companies for purposes of investment and investor services.

**(c) Conditions of Discounts to Dealers**

No member who is an underwriter of the securities of an investment company shall sell any such security to any dealer or broker at any price other than a public offering price unless such sale is in conformance with Rule 2420 and, if the security is issued by an open-end management company or by a unit investment trust which invests primarily in securities issued by other investment companies, unless a sales agreement shall set forth the concessions to be received by the dealer or broker.

**(d) Sales Charge**

No member shall offer or sell the shares of any open-end investment company or any “single payment” investment plan issued by a unit investment trust (collectively “investment companies”) registered under the [Investment Company Act of 1940] 1940 Act if the sales charges described in the prospectus are excessive. Aggregate sales charges shall be deemed excessive if they do not conform to the following provisions:

(1) Investment Companies Without an Asset-Based Sales Charge

(A) Aggregate front-end and[/or] deferred sales charges described in the prospectus which may be imposed by an investment company without an asset-based sales charge shall not exceed 8.5% of the offering price.

[(B)(i) Dividend reinvestment may be made available at net asset value per share to any person who requests such reinvestment.

(ii) If dividend reinvestment is not made available as specified in subparagraph (B)(i) above, the maximum aggregate sales charge shall not exceed 7.25% of offering price.]

[(C)(i) ](B)(i) Rights of accumulation (cumulative quantity discounts) may be made available to any person in accordance with one of the alternative quantity discount schedules provided in subparagraph [(D)](C)(i) below, as in effect on the date the right is exercised.

(ii) If rights of accumulation are not made available on terms at least as favorable as those specified in subparagraph (C)(i) the maximum aggregate sales charge shall not exceed[:]

[(a)] 8.0% of offering price. [if the provisions of subparagraph (B)(i) are met; or

(b) 6.75% of offering price if the provisions of subparagraph (B)(i) are not met.]

[(D)](C)(i) Quantity discounts, if offered, shall be made available on single purchases by any person in accordance with one of the following two alternatives:

a. A maximum aggregate sales charge of 7.75% on purchases of \$10,000 or more and a

maximum aggregate sales charge of 6.25% on purchases of \$25,000 or more, or

b. A maximum aggregate sales charge of 7.50% on purchases of \$15,000 or more and a maximum aggregate sales charge of 6.25% on purchases of \$25,000 or more.

(ii) If quantity discounts are not made available on terms at least as favorable as those specified in subparagraph ~~[(D)(i)]~~(C)(i) the maximum aggregate sales charge shall not exceed:

a. 7.75% of offering price if the provisions of subparagraphs ~~[(B)(i) and (C)(i)]~~(B) are met.

b. 7.25% of offering price if [the provisions of subparagraph (B)(i) are met but] the provisions of subparagraph ~~[(C)(i)]~~(B) are not met.

[c. 6.50% of offering price if the provisions of subparagraph (C) (i) are met but the provision of subparagraph (B)(i) are not met.]

[d. 6.25% of offering price if the provisions of subparagraphs (B)(i) and (C)(i) are not met.]

~~[(E)]~~(D) If an investment company without an asset-based sales charge pays a service fee, the maximum aggregate sales charge shall not exceed 7.25% of the offering price.

[(F) If an investment company without an asset-based sales charge reinvests dividends at offering price, it shall not offer or pay a service fee unless it offers quantity discounts and rights of accumulation and the maximum aggregate sales charge does not exceed 6.25% of the offering price.]

(2) Investment Companies With an Asset-Based Sales Charge

(A) Except as provided in subparagraphs (C) and (D), the aggregate asset-based, front-end and deferred sales charges described in the prospectus which may be imposed by an investment company with an asset-based sales charge, if the investment company has adopted a plan under which service fees are paid, shall not exceed 6.25% of total new gross sales (excluding sales from the reinvestment of distributions;[and] exchanges of shares between investment companies in a single complex, between classes [of shares] of an investment company with multiple classes of shares or between series [shares] of a series investment company) plus interest charges on such amount equal to the prime rate plus one percent per annum. The maximum front-end or deferred sales charge resulting from any transaction shall be 6.25% of the amount invested.

(B) Except as provided in subparagraphs (C) and (D), if an investment company with an asset-based sales charge does not pay a service fee, the aggregate asset-based, front-end and deferred sales charges described in the prospectus shall not exceed 7.25% of total

new gross sales (excluding sales from the reinvestment of distributions; [and] exchanges of shares between investment companies in a single complex, between classes [of shares] of an investment company with multiple classes of shares or between series [shares] of a series investment company) plus interest charges on such amount equal to the prime rate plus one percent per annum. The maximum front-end or deferred sales charge resulting from any transaction shall be 7.25% of the amount invested.

(C) The maximum aggregate sales charge on total new gross sales set forth in subparagraphs (A) and (B) may be increased by an amount calculated by applying the appropriate percentages of 6.25% or 7.25% of total new gross sales which occurred after an investment company first adopted an asset-based sales charge until July 7, 1993 plus interest charges on such amount equal to the prime rate plus one percent per annum less any front-end, asset-based or deferred sales charges on such sales or net assets resulting from such sales.

(D) The maximum aggregate sales charges of an investment company in a single complex, a class or share issued by an investment company with multiple classes of shares or a separate series of a series investment company, may be increased to include sales of exchanged shares provided that such increase is deducted from the maximum aggregate sales charges of the investment company, class or series which redeemed the shares for the purpose of such exchanges.

(E) No member shall offer or sell the shares of an investment company with an asset-based sales charge if:

(i) The amount of the asset-based sales charge exceeds .75 of 1% per annum of the average annual net assets of the investment company; or

(ii) Any deferred sales charges deducted from the proceeds of a redemption after the maximum cap<sub>2</sub> described in subparagraphs (A), (B), (C) and (D) hereof, has been attained are not credited to the investment company.

(3) Fund of Funds

(A) If neither an acquiring company nor an acquired company in a fund of funds structure has an asset-based sales charge, the maximum aggregate front-end and deferred sales charges that may be imposed by the acquiring company, the acquired company and those companies in combination, shall not exceed the rates provided in paragraph (d)(1).

(B) Any acquiring company or acquired company in a fund of funds structure that has an asset-based sales charge shall individually comply with the requirements of paragraph (d)(2), provided:

(i) If the acquiring and acquired companies are in a single complex and the acquired fund has an asset-based sales charge, sales made to the acquiring fund shall be excluded from total gross new sales for purposes of acquired fund's

calculations under subparagraphs (d)(2)(A) through (d)(2)(D);  
and

(ii) If both the acquiring and acquired companies have an asset-based sales charge: (a) the maximum aggregate asset-based sales charge imposed by the acquiring company, the acquired company and those companies in combination, shall not exceed the rate provided in subparagraph (d)(2)(E)(i); and (b) the maximum aggregate front-end or deferred sales charges shall not exceed 7.25% of the amount invested, or 6.25% if either company pays a service fee.

(C) The rates described in subparagraphs (d)(4) and (d)(5) shall apply to the acquiring company, the acquired company and those companies in combination. The limitations of subparagraph (d)(6) shall apply to the acquiring company and the acquired company individually.

~~[(3)]~~(4) No member or person associated with a member shall, either orally or in writing, describe an investment as being “no load” or as having “no sales charge” if the investment company has a front-end or deferred sales charge or if the investment company’s total charges against net assets to provide for sales related expenses and/or service fees exceed .25 of 1% of average net asset per annum.

[(4) No member or person associated with a member shall offer or sell the securities of an investment company with an asset-based sales charge

unless its prospectus discloses that long-term shareholders may pay more than the economic equivalent of the maximum front-end sales charges permitted by this Rule. Such disclosure shall be adjacent to the fee table in the front section of a prospectus. This subparagraph shall not apply to money market mutual funds which have asset-based sales charges equal to or less than .25 of 1% of average net assets per annum.]

(5) No member or person associated with a member shall offer or sell the securities of an investment company if the service fees paid by the investment company, as disclosed in the prospectus, exceed .25 of 1% of its average annual net assets or if a service fee paid by the investment company, as disclosed in the prospectus, to any person who sells its shares exceeds .25 of 1% of the average annual net asset value of such shares.

(6) No member or person associated with a member shall offer or sell the securities of an investment company if:

(A) The investment company has a deferred sales charge paid upon redemption that declines over the period of a shareholder's investment ("contingent deferred sales load"), unless the contingent deferred sales load is calculated as if the shares or amounts representing shares not subject to the load are redeemed first, and other shares or amounts representing shares are then redeemed in the order purchased, provided that another order of redemption may be used if such order would result in the redeeming shareholder paying a lower contingent deferred sales load; or

(B) The investment company has a front-end or deferred sales charge imposed on shares, or amounts representing shares, that are purchased through the reinvestment of dividends, unless the registration statement registering the investment company's securities under the Securities Act of 1933 became effective prior to [insert the effective date of this rule amendment].

\* \* \* \* \*

II. SELF REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

(a)

**Background**

Regulatory initiatives adopted in 1996 by Congress and the Commission provide mutual funds and variable insurance sponsors with greater flexibility in structuring distribution arrangements. In 1997, NASD Regulation published Notice to Members 97-48 requesting comment on proposed amendments to the sales charge provisions in the Investment Company Rule and the Variable Contracts Rule that would adapt the rules to these regulatory initiatives and new distribution arrangements. NASD Regulation received nine comment letters in response to Notice to Members 97-48. The commenters generally supported the proposed amendments to the Investment Company Rule. The commenters strongly supported the proposed amendments to the Variable Contracts Rule.

## **Description**

### **1. Proposed Amendments to the Investment Company Rule**

#### *A. Fund of Funds*

The National Securities Markets Improvement Act of 1996 (the “1996 Amendments”) amended the Investment Company Act of 1940 (the “1940 Act”) to, among other things, broaden the ability of mutual fund sponsors to establish “fund of funds” arrangements.

The Investment Company Rule currently does not take into account two-tier fund of funds structures in which asset-based sales charges are imposed at both the acquiring and acquired fund levels. The proposed amendments would amend the Investment Company Rule to ensure that if a fund of funds charges distribution fees at both levels, the combined sales charges do not exceed the maximum percentage limits currently contained in the rule.

#### *B. Deferred Sales Loads*

In September 1996, the Commission amended Rule 6c-10 under the 1940 Act to permit new types of deferred loads, such as back-end and installment loads. The proposed amendments to the Investment Company Rule also would permit these types of deferred sales charges. The amendments would conform the definition of “deferred sales charge” in the Investment Company Rule to the definition of “deferred sales load” in Rule 6c-10 (*i.e.*, “any amount properly chargeable to sales or promotional expenses that is paid by a shareholder after purchase but before or upon redemption”).

*C. Loads on Reinvested Dividends*

The proposed amendments would prohibit loads on reinvested dividends. When NASD Regulation proposed to prohibit loads on reinvested dividends in Notice to Members 97-48, commenters representing unit investment trust (“UIT”) sponsors objected to the proposed amendments. NASD Regulation, however, continues to believe that it is appropriate to prohibit loads on reinvested dividends for all investment companies, including UITs. In order to minimize the possibility that investors could incur additional costs associated with the restructuring of distribution financing to eliminate loads on reinvested dividends, the proposed amendments include a “grandfather provision” that would exempt from the operation of the prohibition all investment companies that currently impose such fees.

*D. CDSL Calculations*

The proposed amendments would prohibit members from selling fund shares that impose a CDSL unless the method used by the fund to calculate CDSLs in partial redemptions requires that investors are given full credit for the time they have invested in the fund. Because a CDSL declines over the period of a shareholder’s investment, a first-in-first-out (“FIFO”) redemption order requirement generally would ensure that transactions are subject to the lowest applicable CDSL. The proposed amendments, however, also would expressly provide that if a redemption order other than FIFO (for example, last-in first-out) would result in a redeeming shareholder paying a lower CDSL, the other method could be used.

*E. Prospectus Disclosure*

The Investment Company Rule currently prohibits a member from offering or selling shares of a fund with an asset-based sales charge unless its prospectus discloses that long-term shareholders may pay more than the economic equivalent of the maximum front-end sales charges permitted by the rule. In March 1998, the Commission adopted significant revisions to prospectus disclosure requirements for mutual funds. Included in the amendments is a requirement that the prospectuses of funds with asset-based sales charges include disclosure regarding Rule 12b-1 plans that is similar to the disclosure required in the Investment Company Rule. Accordingly, the proposed amendments would eliminate the prospectus disclosure requirement in the Investment Company Rule.

**2. Amendments to the Variable Contracts Rule**

In Notice to Members 97-48, NASD Regulation proposed to amend the Variable Contracts Rule to eliminate the maximum sales charge limitations. The commenters strongly supported the proposed amendment because they view specific sales charge limits in the Variable Contracts Rule as unnecessary and inconsistent with the “reasonableness” standard enacted in the 1996 Amendments. Consistent with these comments, the proposed amendments would eliminate the maximum sales charge limitations in the Variable Contracts Rule. The proposed amendments also would make a conforming change to eliminate the requirement in the rule to file with the

Advertising/Investment Companies Regulation Department the details of any changes in a variable annuity' sales charges.

(b) NASD Regulation believes that the proposed rule changes are consistent with the provision of Section 15A(b)(6) of the Securities Exchange Act of 1934, which require, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest, in that the proposed rule change, by adapting the Investment Company Rule and the Variable Contracts Rule to take into account recent legislation, regulations promulgated by the Commission and new distribution arrangements, will further these requirements.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The commenters generally supported the proposed amendments to the Investment Company Rule. The commenters strongly supported the proposed amendments to the Variable Contracts Rule. The comments are summarized below.

**I. Amendments to the Investment Company Rule**

*A. Fund of Funds*

NASD Regulation proposed to amend the Investment Company Rule to ensure that the combined sales charges for funds of funds that charge a sales load or asset-based distribution fee at both the acquiring and underlying fund levels do not exceed the maximum percentage limits that are currently contained in the Rule. The proposed amendments, however, would not require funds of funds to calculate cumulative sales charge limits required for funds that charge asset-based fees. The Investment Company Institute (ICI) and the Securities Industry Association (SIA) supported the proposed approach to regulating fees charged by funds of funds. The ICI recommended certain technical changes to the proposed rule language to clarify that the limits apply to the aggregate rate of asset-based sales charges rather than the amount deducted based on net asset values. In addition, the ICI recommended that NASD Regulation clarify that the acquiring and acquired funds in a fund of funds structure remain individually subject to the cumulative limits in the rule.

Banc One Corporation (Banc One) stated that the cumulative limits should apply to funds of funds. Banc One noted that acquiring funds in a fund of funds structure typically purchase institutional class shares in underlying funds that typically do not carry an asset-based sales charge. Accordingly, Banc One believes that it is feasible for the acquiring fund to calculate a single

remaining amount that reflects both its own gross new sales and its proportionate share of the underlying fund's new sales and charges.

*B. Installment Loads*

NASD Regulation proposed to amend the definition of “deferred sales charge” in the Investment Company Rule to permit installment loads. The ICI was the only commenter on this proposal, which it supported.

*C. Loads on Reinvested Dividends*

NASD Regulation proposed to prohibit sales loads on reinvested dividends. The ICI and Davis Polk & Wardwell (Davis Polk) opposed this proposal. The ICI believes that, as an alternative to prohibiting loads on reinvested dividends, funds that impose such charges should be subject to lower maximum limits in the Rule and be required to make appropriate disclosure.

*D. CDSL Calculations*

NASD Regulation proposed to impose redemption order requirements (first-in-first-out or FIFO) for shares subject to contingent deferred sales loads so that investors incur only the lowest applicable CDSL. The proposed amendments also would provide that if a redemption order other than FIFO (*e.g.*, LIFO) would result in a redeeming shareholder paying a lower CDSL, that method could be used. In addition, the Notice to Members clarified that the proposed amendment would concern only the manner in which a fund calculated the CDSL and should not affect a shareholder's ability to identify for tax purposes which shares have been redeemed. The ICI did not object to

NASD Regulation's approach. The SIA, however, stated that NASD Regulation should not impose order of redemption requirements because marketing or business considerations may justify use of methodologies other than FIFO, and investors should retain the right to designate which shares they wish to sell for tax purposes

*E. Prospectus Disclosure*

In deference to the recent adoption by the SEC of new prospectus disclosure regarding the long-term effects of Rule 12b-1 fees, NASD Regulation proposed to eliminate the equivalent prospectus disclosure requirement in the Investment Company Rule. The ICI and the SIA supported this proposal.

*F. Other Comments*

Federated Investors (Federated) recommended that NASD Regulation consider an additional amendment to the Investment Company Rule that would permit funds to calculate the cumulative limits in the Rule by aggregating all shares of the same class within a fund complex that have exchange privileges, rather than calculating the cap for each fund individually. For example, all sales charges for "B" shares in a fund complex and gross new sales of B shares would be aggregated to determine the remaining amount under the rule.

Federated claimed that the current calculation methods for the transfer of remaining amount balances in share exchanges within a fund complex result in some funds being undercharged while others are overcharged. (The

Investment Company Rule permits a fund either to increase its remaining amount by treating the shares received through an exchange as gross new sales and deducting the amount of such increase from the remaining amount of the fund from which shares were exchanged, or to transfer less than this maximum amount pursuant to a fund policy that is consistently applied.)

Federated believes that if fund companies are permitted to aggregate the remaining amount pools for exchangeable shares, inaccuracies inherent in the current methods would be significantly reduced.

## **II. Amendments to the Variable Contracts Rule**

### *A. Sales Charge Limits*

The National Association for Variable Annuities (NAVA), Allstate Life Financial Services (Allstate), New England Insurance and Investment Company (New England) strongly supported the proposed amendment to the Variable Contracts Rule to eliminate the sales charge limit for variable annuities. They viewed the specific sales charge limits in the Rule as unnecessary and inconsistent with the “reasonableness standard” enacted in National Securities Market Improvement Act (1996 Act). NAVA described the reasonableness standard as a compromise between the SEC and the insurance industry that was intended to eliminate SEC regulation of individual charges in favor of the new comprehensive standard. Allstate believes that the intent of the 1996 Act was to eliminate specific limits on fees in favor of a reasonableness standard for aggregate fees. New England also noted that practical considerations render the fee limits in the Variable Contracts Rule

ineffective because distribution expenses typically are not recovered by charging sales loads on premium payments.

*B. Limitations on Sales Charges of Underlying Funds*

NAVA and New England believe that sales charge limits on funds underlying variable annuities would be unnecessary and inconsistent with the 1996 Act. NAVA notes that the 1996 Act provides that for purposes of the reasonableness requirement, “the fees and charges deducted under the contract shall include all fees and charges imposed for any purpose and in any manner.” Allstate stated that specific limits on underlying funds should not be necessary, but NASD Regulation should consider how insurance company issuers are administering the “reasonableness” requirement. The NASD has determined not to impose sales charge limits in the Investment Company Rule on funds underlying variable annuities. The Variable Contracts Rule will continue to apply exclusively to the activities of members in connection with variable contracts.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz