NASD Notice to Members 97-48

NASD Regulation Requests Comment On Amendments To Rules Governing Sale And Distribution Of Investment Company Shares And Variable Insurance Products; **Comment Period Expires September 29, 1997**

Suggested Routing

- ■ Senior Management
- ☐ Advertising
- ☐ Corporate Finance
- ☐ Government Securities
- ☐ Institutional
- ☐ Internal Audit
- ■ Legal & Compliance
- ☐ Municipal
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- ☐ Trading
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Executive Summary

NASD Regulation, Inc. (NASD Regulation℠) requests member comment on proposed amendments that would revise NASD® Conduct Rule 2830, governing the sale and distribution of investment company shares (the Investment Company Rule), and NASD Conduct Rule 2820, governing the sale and distribution of variable insurance contracts (the Variable Contracts Rule).

Questions concerning this *Request For Comment* should be directed to Thomas M. Selman, Director, or Joseph E. Price, Counsel, Advertising/Investment Companies Regulation, NASD Regulation, at (202) 728-8330 or Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 726-8176.

Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley
Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, D.C. 20006-1500;

or e-mailed to:
pubcom@nasd.com

Comments must be received **by September 29, 1997**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation, Inc. Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

NASD Regulation Request for Comment 97-48

Executive Summary

NASD Regulation, Inc. (NASD Regulation[SM]) requests member comment on proposed amendments that would revise NASD® Conduct Rule 2830, governing the sale and distribution of investment company shares (the Investment Company Rule), and NASD Conduct Rule 2820, governing the sale and distribution of variable insurance contracts (the Variable Contracts Rule).

The proposed amendments to the Investment Company Rule would: (1) provide maximum aggregate sales charge limits for funds of funds; (2) permit funds to charge installment loads, but prohibit loads on reinvested dividends; (3) impose redemption order requirements for shares subject to contingent deferred sales loads; and (4) eliminate duplicative prospectus disclosure. The proposed amendments to the Variable Contracts Rule would ensure that the treatment of sales charges is consistent with recent legislation that establishes standards limiting aggregate fees and charges deducted under variable insurance contracts.

Questions concerning this *Request For Comment* should be directed to Thomas M. Selman, Director, or Joseph E. Price, Counsel, Advertising/Investment Companies Regulation, NASD Regulation, at (202) 728-8330 or Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 726-8176.

Background

Regulatory initiatives adopted last year by Congress and the Securities and Exchange Commission (SEC) provide mutual funds and variable insurance contracts with greater flexibility in structuring distribution arrangements. In connection with these initiatives, Congress and the SEC looked to the National Association of Securities Dealers, Inc. (NASD) to adapt the sales charge provisions in the Investment Company Rule and the Variable Contracts Rule to the new distribution arrangements.

1. Recent Legislation

On October 11, 1996, the National Securities Markets Improvement Act of 1996 (1996 Amendments or Amendments) was signed into law.[1] The legislation amended the Investment Company Act of 1940 (1940 Act) to, among other things, broaden the ability of mutual fund sponsors to establish "fund of funds" arrangements and significantly alter the basis on which the SEC regulates sales charges deducted under variable insurance contracts.

a. Fund of Funds

Before the 1996 Amendments were enacted, the 1940 Act had subjected fund of funds arrangements to percentage limitations on the value and amount of fund shares that could be acquired by another fund. These restrictions reflected a concern that funds of funds could result in excessive layering of fees and concentration of voting power in the acquiring fund.

The 1996 Amendments relaxed these restrictions, subject to certain conditions. These conditions include the requirement that both the fund purchasing shares and the funds whose shares are purchased be members of the same "group" of funds.[2] Other requirements in the 1996 Amendments address abusive layering of sales charges in the two-tier structure of funds of funds by requiring either that: (a) if the acquiring fund charges a sales load or other distribution fees, it does not incur such charges at the underlying fund level; or (b) if such fees are charged at both the acquiring and underlying fund levels, the combined charges at both levels do not exceed the NASD sales charges limits. The Amendments also provide the SEC with broad rulemaking and exemptive authority that could be used, for example, to accommodate smaller fund complexes that may lack a sufficient variety of funds and wish to offer investments in unaffiliated funds.

b. Variable Insurance Contracts

Before 1996, various 1940 Act provisions had limited the amount, type and timing of sales charges that could be imposed in connection with variable insurance contracts.[3] The 1996 Amendments exclude variable insurance contracts and the insurance companies selling such contracts from these provisions. This approach is consistent with an earlier SEC staff recommendation to "fundamentally change" the regulation of variable insurance contracts by exempting these products and sponsoring insurance companies from specific sales charge restrictions under the 1940 Act, and instead requiring aggregate charges under variable contracts to be "reasonable."[4]

A variable insurance contract may include at least five types of charges: (1) sales loads or surrender charges that operate like a contingent deferred sales load (CDSL) and permit an insurer to deduct proceeds from the redemption of a contract; (2) administrative expense charges, which had been limited under the 1940 Act to the cost of services provided; (3) mortality and risk expense charges (M&E charges), which compensate the insurer for mortality and risk expenses; (4) investment-related charges, such as investment advisory fees; and (5) other insurance charges, especially with respect to variable life contracts. Because the SEC's jurisdiction to impose specific limits on the charges associated with variable insurance contracts under the 1940 Act had extended only to the securities-related charges, with the states retaining exclusive jurisdiction to impose specific limits on the insurance charges, the SEC's regulation of variable insurance charges had been characterized by arguments over where the jurisdictional lines should be drawn, especially with regard to M&E charges. The insurance industry contended that M&E charges are insurance charges outside of SEC jurisdiction, but the SEC was concerned that M&E charges were being used to pay for distribution. The SEC considered its efforts to regulate distribution charges to be ineffectual because issuers could compensate for restrictions on sales charges by increasing M&E charges and using the proceeds for distribution.[5]

The 1996 Amendments provide the SEC with rulemaking authority to impose specific limits on all charges deducted under variable insurance contracts, including insurance charges.[6] The Amendments also establish a "reasonableness" standard and make it unlawful for a registered separate account or sponsoring insurance company to sell a variable insurance contract unless the fees and charges deducted are reasonable. Aggregate charges must be "reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company."[7] The sponsoring insurance company is required to represent in the variable insurance contract registration statement that the charges deducted meet the reasonableness standard.

2. Recent Regulatory Developments

a. Deferred Sales Loads

In 1995, the SEC adopted Rule 6c-10, which permits funds to deduct a CDSL upon redemption of fund shares.[8] Rule 6c-10 codified approximately 300 exemptive orders issued by the SEC to allow funds to impose CDSLs. CDSLs typically are combined with an asset-based sales charge in an arrangement known as a "spread load." A spread load permits a fund's underwriter over time to recover its distribution expenses, including commissions, through assessment of asset-based sales charges or the CDSL.

In September 1996, the SEC amended Rule 6c-10 to replace certain conditions in the rule with a general requirement that deferred loads comply with the Investment Company Rule. The amendments to Rule 6c-10 permit new types of deferred loads, such as back-end and installment loads and deferred loads on reinvested dividends. The amendments also impose new prospectus disclosure requirements for deferred loads and eliminate other requirements relating to the calculation of CDSLs. In adopting the amendments to Rule 6c-10, the SEC noted that, despite its changes to the rule, funds could not charge installment loads or deferred loads on reinvested dividends because they currently are not permitted under the Investment Company Rule.[9]

b. Variable Insurance Contracts

In May 1996, the SEC's Division of Investment Management announced in a letter to industry trade groups that it would permit a mutual fund that offers its shares to insurance company separate accounts (Underlying Fund) to adopt a Rule 12b-1 plan[10] to use fund assets to finance distribution expenses.[11] The Division emphasized that although it would permit Underlying Funds to adopt Rule 12b-1 plans, it is the responsibility of the Underlying Fund's board of directors to ensure that a Rule 12b-1 plan will benefit the fund and its shareholders. The Division further emphasized that, in the context of a two-tier variable insurance contract, the finding of a benefit to shareholders requires the likelihood of a benefit to the individual contract holders, not the insurance company separate account that may be the technical owner of the fund's shares.

The Variable Contracts Rule and the Investment Company Rule impose limits on distribution fees that may be charged by separate accounts and mutual funds, but they do not specifically address distribution fees charged by an Underlying Fund or total asset-based sales charges imposed at both the separate account and Underlying Fund levels.

Discussion

1. Investment Company Rule

The NASD adopted the Investment Company Rule in 1975 to prohibit members from offering or selling to the public fund shares that include an excessive sales load.[12] Sales charges are deemed excessive unless they conform to the specific limits provided in the rule. The NASD amended the rule in 1993 to address concerns that Rule 12b-1 fees were being used to circumvent the rule's sales charge limits. The 1993 amendments provide maximum limits for front-end loads, Rule 12b-1 payments and CDSLs.

The sales charge provision in the Investment Company Rule generally is divided into two parts. Subsection (d)(1) limits sales charges assessed by investment companies that do not have asset-based sales charges by prohibiting members from offering or selling fund shares if the front-end and/or deferred sales charges described in the prospectus are excessive. Because sales charges assessed by the acquiring fund and the underlying funds in a fund of funds arrangement are required to be disclosed in the acquiring fund's prospectus, subsection (d)(1) effectively regulates funds of funds that do not include asset-based sales charges.

Subsection (d)(2) limits sales charges assessed by investment companies that have asset-based sales charges. Subsection (d)(2), however, does not effectively regulate funds of funds with asset-based sales charges because it requires calculations based on "fund level accounting" that are problematic in a two-tier structure.

Subsection (d)(2) limits aggregate sales charges to 7.25 percent of new gross sales, plus interest charges assessed at the prime rate, plus one percent per annum. If the fund pays a service fee, the cap is reduced to 6.25 percent. Asset-based sales charges may not exceed .75 percent of a fund's average net assets. A service fee is not subject to the aggregate cap, but service fees may not exceed .25 percent of a fund's average net asset. The maximum front-end or deferred sales charge on any one transaction may not exceed the applicable 7.25 percent or 6.25 percent maximum rate.

Subsection (d)(2) requires fund-level accounting in which all sales charges terminate when a percentage of gross sales is reached. For example, a fund with $1 million of sales subject to the 6.25 percent cap would have a "remaining amount" of $62,500 from which sales-related expenses could be deducted. Although all sales would terminate after $62,500 (plus interest) had been charged, new gross sales increase the remaining amount and a long-term investor likely would pay more than the economic equivalent of the maximum sales charge permitted under the rule before the remaining amount is depleted. (Reinvested dividends and exchanges within a family of funds, with certain exceptions, are excluded from the new gross sales calculation.)

a. Proposed Amendments to Accommodate Funds of Funds

NASD Regulation proposes to amend the Investment Company Rule so that if a fund of funds charges a sales load or other distribution fee at both the acquiring and underlying fund levels, the combined sales charges do not exceed the maximum percentage limits currently contained in the Investment Company Rule. The amended rule would permit the acquiring fund, the underlying fund, or both to charge an asset-based sales fee that in the aggregate does not exceed .75 percent of average net assets and a service fee that in the aggregate does not exceed .25 percent of average net assets. Consistent with the current rule, aggregate front-end and deferred sales charges would be limited in any transaction to 7.25 percent, or 6.25 percent for a contract that includes a service fee. NASD Regulation also requests comment on whether these percentage limitations provide adequate protection against excessive layering of distribution fees.

NASD Regulation is not proposing to require funds of funds to calculate a remaining amount balance similar to the calculations required under the Investment Company Rule for other funds with an asset-based sales charge. Consequently, asset-based sales charges would not terminate when a dollar amount representing a percentage of gross sales is reached. A fund's remaining amount is calculated through fund-level accounting, by looking to the gross new sales and charges of the fund as a whole. It would not seem feasible to require the acquiring fund in a fund of funds structure to calculate a single remaining amount that reflects not only its own gross new sales and charges, but also its proportionate share of the underlying funds' gross new sales and their charges. Even if such a remaining amount could be calculated, it probably would be a hypothetical number that may not serve the purposes of the rule in many cases.

Because the amended rule would not impose a cumulative cap on asset-based sales charges for funds of funds, long-term investors who pay asset-based sales charges could pay more than the economic equivalent of the maximum cap.[13] NASD Regulation requests comment on whether a cumulative cap should apply and, if so, how it could be calculated.

As written, the proposed definition of "fund of funds" would include "master-feeder" funds. NASD Regulation requests comment on whether it would be practical for a "master-feeder" fund to calculate a remaining amount. Should the proposed definition of "fund of funds" exclude "master-feeder" funds? In addition, the proposed definition of "fund of funds" is limited to investment companies that invest their assets "principally" in the securities of other mutual funds or unit investment trusts.[14] Is this test sufficient to ensure that funds will not invest in the securities of another mutual fund or unit investment trust simply to avoid the cumulative cap on asset-based fees?

b. Installment Loads

NASD Regulation proposes to amend the Investment Company Rule to permit new types of deferred sales charges, such as installment loads.

Prior to the SEC's 1996 amendments to Rule 6c-10, the only deferred loads permitted under Rule 6c-10 were CDSLs, which are paid at redemption but decline to zero if shares are held for a stated period of time. The amendments to Rule 6c-10 permit a variety of deferred sales charges, including loads paid upon redemption that do not decline to zero (back-end loads), loads paid after purchase during the term of a shareholder's investment (installment loads) and deferred loads on reinvested dividends.[15]

NASD Regulation proposes to 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").[16] Such an amendment would provide funds with greater flexibility to structure their deferred sales load arrangements, subject to the sales charge limits imposed by the Investment Company Rule.[17] Conforming the definitions also would minimize any confusion or compliance burdens that could result from the application of inconsistent SEC and NASD requirements to the same transaction.[18]

c. Loads on Reinvested Dividends

NASD Regulation proposes to amend the Investment Company Rule to prohibit loads on reinvested dividends, including front-end loads (which the rule currently permits) and deferred loads (which the rule prohibits but SEC Rule 6c-10 now permits).

While the Investment Company Rule permits front-end loads on reinvested dividends, NASD Regulation understands that few, if any, funds currently charge such loads.[19] Front-end loads on reinvested dividends were more common before funds were permitted to assess asset-based sales charges under Rule 12b-1. Deferred loads on reinvested dividends have never been permitted under the Investment Company Rule.

NASD Regulation proposes to amend the Investment Company Rule to prohibit *all* loads on reinvested dividends because these charges will typically cause an investor to pay a charge twice on the same assets, and could exceed the appropriate sales charge limits. For example, an investor who invests in a load fund at a time when a portion of the fund's net asset value includes undistributed income or capital gains will pay a charge based, in part, on the undistributed earnings. When those earnings are distributed and reinvested, the investor will pay a second charge on those assets. Amending the Investment Company Rule to prohibit loads on reinvested dividends would ensure that investors are not subject to the imposition of these duplicative loads.

d. CDSL Calculations

NASD Regulation proposes to amend the Investment Company Rule to reinstate redemption order (first-in-first-out or FIFO) requirements for shares subject to CDSLs that were eliminated by the SEC's Rule 6c-10 amendments.

NASD Regulation is proposing to amend the Investment Company Rule to prohibit members from selling fund shares that carry CDSLs 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. Before the SEC's amendments to Rule 6c-10, the rule had required that in a partial redemption a CDSL must be calculated as if shares not subject to a load are redeemed first and then the other shares are redeemed in the order purchased (the FIFO method). (Rule 6c-10 did permit any other order of redemption that results in the redeeming shareholder paying a lower CDSL.) Because a CDSL declines over the period of a shareholder's investment, the redemption order requirement generally ensured that transactions were subject to the lowest applicable CDSL.

The Rule 6c-10 amendments eliminated the FIFO requirement.[20] A fund thus may use a last-in-first-out (the LIFO method) of calculation, which could cause investors to incur the *highest* applicable sales charge on each transaction. For example, an investor who bought shares subject to a CDSL in 1988 for $10,000, invested another $10,000 subject to the CDSL in 1997, and then redeemed shares for $10,000 later in 1997 would pay the maximum deferred load charged by the fund under a LIFO method, but no load under a FIFO method (assuming that the CDSL declines to $0 within nine years, which is typical).[21] The FIFO method of CDSL calculation currently used by most investment companies better reflects the purpose of the CDSL, to encourage long-term investing and ensure that the mutual fund's distribution costs are recouped through the asset-based sales charges. At the same time, the FIFO method ensures that investors incur only the lowest applicable CDSL.

The proposed amendment to the Investment Company Rule, however, would expressly provide that if a redemption order other than FIFO would result in a redeeming shareholder paying a lower CDSL, the other method may be used.[22] For example, an investor who invested $10,000 in a fund in January 1996 and $10,000 in November 1996 and redeemed $10,000 in December 1996 may benefit if the fund used a LIFO calculation. A LIFO calculation could result in a lower CDSL if the investor redeems additional shares in 1997, based on the longer holding period for the shares purchased in January 1996.

e. Prospectus Disclosure

NASD Regulation proposes to amend the Investment Company Rule to eliminate the prospectus disclosure requirement regarding the long-term effect of Rule 12b-1 plans.

The Investment Company Rule 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.[23] The SEC recently proposed for public comment significant revisions to the prospectus disclosure requirements for mutual funds.[24] Included in the proposal was an amendment that would require prospectuses of funds with asset-based sales charges to disclose that:

• the fund has a Rule 12b-1 plan that allows the fund to pay fees for the sale and distribution of its shares; and

• since these fees are paid out of the fund's assets on an ongoing basis, over time these fees will increase the cost of an investment and may cost the investor more than paying other types of sales loads.

In the release proposing the prospectus disclosure revisions, the SEC stated that if the amendment is adopted, it would discuss with the NASD the NASD's disclosure requirements so that similar disclosure is not required to be repeated in the prospectus.[25] In light of the SEC's proposal concerning disclosure of the effect of asset-based sales charges, NASD Regulation proposes to eliminate the similar disclosure requirement in the Investment Company Rule.

2. Variable Contracts Rule

NASD Regulation proposes to amend the Variable Contracts Rule to eliminate the maximum sales charge limitations.

a. Background

Prior to the 1996 Amendments, insurance companies selling variable insurance contracts had been treated under the 1940 Act as periodic payment plan sponsors and were limited in the types of fees that could be deducted under the contracts. Variable insurance contracts had been treated as periodic plan certificates and were limited in the amount, manner and timing of sales loads that could be charged.[26] The 1996 Amendments fundamentally changed the way sales charges for variable insurance contracts are regulated by the SEC by eliminating specific limits on fees and imposing a reasonableness standard on aggregate fees. The Variable Contracts Rule, however, continues to impose specific limits on the payment of sales charges for the sale of variable annuity contracts. The Variable Contracts Rule does not impose sales charge limits in connection with the sale of variable life contracts. The NASD determined that specific limits on variable life products would not be meaningful since sales charges and commissions generally are paid from sources other than deductions from premium or purchase payments.

b. Sales Charge Limits

The Variable Contracts Rule prohibits members from participating in the offer or sale of variable annuity contracts if the charges stated in the prospectus exceed 8.5 percent of total payments to be made under a contract, determined over a maximum period of 12 years. For variable annuity contracts providing for a single payment, the Variable Contracts

Rule provides sales charge limits on a decreasing scale from 8.5 percent for a purchase payment at or below $25,000 to 6.5 percent for payments over $50,000. The Variable Contracts Rule, however, does not define "sales charge."

The Variable Contracts Rule was last amended in 1976 and the current provisions relating to sales charges do not reflect the changes in the distribution and fee structures in variable insurance products over the last 20 years.[27] For example, variable annuity contracts typically do not deduct sales loads from purchase payments. Instead, distribution expenses are paid by the issuer. In funding these expenses, the issuer may use amounts realized from surrender charges and profits realized from other charges under the contract.

c. Jurisdictional Issues

NASD Regulation has the authority to prohibit excessive sales charges in connection with the distribution of variable insurance products under Section 22(b) of the 1940 Act.[28] Effective regulation of sales charges by NASD Regulation is problematic without clear jurisdiction to impose specific limits on insurance charges, however, for the same reason that SEC regulation in this area was problematic prior to the 1996 Amendments. Moreover, while the fund of funds provisions in the 1996 Amendments specifically deferred to the NASD sales charge rules, the Amendments concerning the aggregate fees charged for variable insurance contracts refer only to SEC rulemaking authority. Therefore, the imposition by NASD Regulation of specific limits on the sales charge component of variable insurance contracts under the Variable Products Rule appears to be impractical and inconsistent with congressional intent. For these reasons, NASD Regulation proposes to eliminate the sales charge limitations in the rule by deleting paragraphs (c)(1) to (3) in Rule 2820.[29]

d. Possible Limitations on Sales Charges of Underlying Funds

The Variable Products Rule provides that it "shall apply exclusively (and in lieu of [the Investment Company Rule]), to the activities of members in connection with variable contracts, to the extent such activities are subject to regulation under the federal securities laws." Consequently, the Underlying Fund in a variable insurance contract would not be subject to sales charge limitations under NASD Regulation's proposal.[30] NASD Regulation could amend the Investment Company Rule to provide that it applies to Underlying Funds. Such an amendment, however, would not impose an overall limit on variable contract charges, and thus may not be particularly effective.

NASD Regulation requests comment on whether the Investment Company Rule should be amended to provide that its sales charge limitations apply to Underlying Funds.

Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley
Secretary
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Text Of Proposed Amendments

(Note: New text is underlined; deletions are bracketed. Text from pending amendments to revise existing rules in accordance with pending non-cash compensation proposals are not included. Rule 2830 paragraphs (e)-(n) are not included; no amendments to those paragraphs are proposed.)

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 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) 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 therefor 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 it may be considered to have been received for the risk of the purchaser when actually received.

(e) 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) Selling Agreement

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) 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 rules 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 managed account 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] <u>1940 Act</u>) 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] <u>1940 Act</u>.

(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] <u>any amount properly chargeable to sales or promotional expenses that is paid by a shareholder after purchase but before or upon redemption</u>.

(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] <u>1940 Act</u>.

(11) <u>A "fund of funds" is an investment company that invests its assets principally in the securities of registered open-end investment companies or registered unit investment trusts, and that limits its other investments to Government securities or short term paper</u>.

(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] <u>1940 Act</u> 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) 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)](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 [(B)](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)](B)(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)](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)] *(C)(i)* are met.

b. 7.25% of offering price if [the provisions of subparagraph (B)(i) are met but] the provisions of subparagraph [(C)]*(B)*(i) 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 subparagraph (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 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 subparagraph (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 subparagraph (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 share 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 described in subparagraph (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 (as those terms are defined in Section 12(d)(1)(G)of the 1940 Act) in a fund of funds structure has an asset-based sales charge, the maximum aggregate front-end and/or deferred sales charges that may be imposed by the acquiring company and the acquired company, as described in the prospectus of the acquiring company, shall not exceed the limits provided in paragraph (d)(1).

(B) If an acquiring company or acquired company in a fund of funds structure has an asset-based sales charge, the maximum aggregate asset-based sales charge and/or service fee imposed by the acquiring company and the acquired company, as described in the prospectus of the acquiring company, shall not exceed the limits provided in paragraphs (d)(2)(E)(i) and (d)(5). The maximum aggregate front-end or deferred sales charge shall be 7.25% of the amount invested, or 6.25% if either company pays a service fee.

[(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 whose 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 front-end or deferred sales charge imposed on shares, or amounts representing shares, that are purchased through the reinvestment of dividends; or

(B) 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, however, that another order of redemption may be used if such order would result in the redeeming shareholder paying a lower contingent deferred sales load.

Endnotes:

[1]Pub. L. No. 104-290, 110 Stat. 3416 (1996).

[2]The legislation defines a "group of investment companies" as two or more funds that hold themselves out to the public as being related for purposes of investment or investor services.

[3]Section 27(a) limited issuers of variable annuity contracts to a load not to exceed nine

percent of total premium payments. 15 U.S.C. 80a-27(a). Rule 27a-1 under the Act limited sales loads to nine percent of total payments to be made under a contract, determined over a maximum period of 12 years. 17 CFR 270.27a-1. Section 26(a)(2)(C) required administrative fees to be reasonable, as determined by the SEC. 15 U.S.C. 80a-26(a) Rule 26a-1 defined reasonable administrative expenses for a separate account funding a variable annuity. 17 CFR 270.26a-1. Rules 6e-2 and 6e-3(T) limited sales loads assessed under variable life contracts to nine percent of total premiums paid or expected to be paid over the lesser of 20 years or the life expectancy of the insured. 17 CFR 270.6e-2, 6e-3(T).

[4]*See Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management, United States Securities and Exchange Commission, May 1992 (Protecting Investors) pp. 373 - 419.

[5]*Id.* at 394.

[6]15 U.S.C. 80a-26(e)(4).

[7]*Id. See also* H.R. Rep. No. 622, 104th Cong. 2d Sess. at 45 (1996) (the House Report). The House Report clarifies that aggregate charges include all fees and charges imposed for any purpose and in any manner, including marketing, sales and distribution, advisory services, and insurance charges imposed directly on the contract holder or on the assets of the separate account. *Id.* at 46.

[8]17 CFR 270.6c-10.

[9]Investment Company Act Release No. 22202 (September 9, 1996). The Investment Company Rule currently permits front-end loads on reinvested dividends.

[10]Rule 12b-1 permits the use of fund assets to pay for distribution of fund shares. 17 CFR 270.12b-1.

[11]*See* Letter from Heidi Stam, Associate Director, Division of Investment Management, SEC, to Gary Hughes, Chief Counsel, American Counsel of Life Insurance, Paul Schott Stevens, General Counsel, Investment Company Institute, and Mark J. Mackey, President & CEO, National Association for Variable Annuities (May 7, 1996).

[12]Section 22(b) of the 1940 Act authorizes the NASD to prohibit excessive sales loads. 15 U.S.C. 80a-22(b).

[13]Long-term investors in many funds with asset-based sales charges can be expected to pay more than the economic equivalent of the maximum cap. Unless a fund has experienced net redemptions or few new sales over an extended period, it is unlikely that the fund would deplete its remaining amount since new sales replenish the remaining amount. Some multiple class funds, however, offer shares that automatically convert after a predetermined number of years to shares that do not impose asset-based sales charges. Investors in funds with such a feature might not pay more than the maximum cap.

[14]*Cf.* Investment Company Act Release No. 22528 (February 27, 1997) (proposing to amend Form N-1A, Item 4 to require disclosure of a fund's "principal investment strategies, including the particular type or types of securities in which the Fund principally invests or will invest").

[15]The amendments do not require any particular method of collecting deferred loads. For example, the loads could be paid out of distributions, by automatic redemptions, or through separate billing of a shareholder's account. The choice of a particular method likely would have tax consequences for investors.

[16]The current definition of "deferred sales charge" in the Investment Company Rule expressly excludes certain nominal charges for services in connection with a redemption or to discourage short-term trading that are credited to the net assets of the fund. The proposed definition of "deferred sales charge" would apply only to amounts chargeable to sales or promotional expenses, so there no longer would be a need for an express exclusion for nominal charges that are not sales related.

[17]The Investment Company Rule prohibits members from describing a fund as "no-load" or as having "no sales charge" if the fund has a deferred sales charge. In the release adopting amendments to Rule 6c-10, the SEC stated, "[I]f the NASD amends the [Investment Company] Rule to permit installment loads, the Commission anticipates the NASD would address the applicability of its 'no-load' labeling policy to funds whose shares are subject to such loads." If, as recommended above, the definition of "deferred sales charge" is conformed to the Rule 6c-10 definition, the NASD's "no-load" labeling policy would apply to all deferred loads by its terms.

[18]The Investment Company Institute (ICI) recently recommended certain changes to the Investment Company Rule to implement the Rule 6c-10 amendments. See Letter from Craig Tyle, Senior Vice President, ICI, to Thomas M. Selman, Director, Advertising/Investment Companies Regulation, NASDR (December 5, 1996). The ICI suggested that the NASD Regulation implement each of the relevant SEC amendments to Rule 6c-10. The ICI specifically recommended that the NASDR conform the definition of "deferred sales charge" in the Investment Company Rule to the Rule 6c-10 definition, thereby permitting funds to charge a wider variety of deferred loads and reducing compliance burdens that could result from inconsistent definitions. NASD Regulation's proposal is in accord with this recommendation. The ICI also recommended amending the Investment Company Rule to permit deferred loads on reinvested dividends and stated that it did not believe that there is a need for NASD Regulation to restrict the manner in which CDSLs are calculated. For the reasons discussed below, these positions have not been accepted into the proposal.

[19]The Investment Company Rule subjects funds that do not offer reinvestment of dividends at net asset value (*i.e.*, that impose sales loads on reinvested dividends) to lower sales charge limits than funds that do.

[20]The SEC also eliminated the requirement that a CDSL be based on the "lesser of" net asset value (NAV) of a fund's shares at the time of purchase or NAV at the time of redemption. As amended, Rule 6c-10 per-

mits any deferred load in an amount not greater than a specified percentage of NAV at the time of purchase, subject to the limits in the Investment Company Rule.

[21] In addition to paying the maximum deferred load on the redeemed shares, such an investor probably would pay Rule 12b-1 fees on the initial investment for nine years.

[22] Moreover, the proposed amendment, which would concern only the manner in which a fund may calculate the CDSL, should not affect a shareholder's ability to identify for tax purposes which shares have been redeemed.

[23] Rule 2830(d)(2)(4).

[24] *See* Investment Company Act Release No. 22528 (February 27,1997).

[25] The proposing release also states that the SEC intends to discuss other NASD prospectus disclosure requirements with the goal of streamlining disclosure requirements in SEC documents consistent with the SEC's initiatives to improve fund disclosure.

[26] Before the 1940 Act limited sales charges for periodic payment plans, investors typically would incur a sales load calculated as a percentage of the total amount invested over the life of the plan, rather than as a percentage of each individual payment. Proportionately higher loads charged on early payments left little for actual investment, and if a plan was terminated before completion of planned payments, investors paid a sales load on a larger amount than was actually invested. *See Protecting Investors*, pp. 382-384.

[27] Prior to the 1996 Amendments, which changed the regulatory standards for variable insurance contracts, NASD Regulation issued *Notice to Members 96-52* (August 1996) soliciting members' comment on revisions to the Variable Contracts Rule, including a new definition of "sales charge." The amendments proposed today would supercede the proposals regarding sales charge limits in *Notice to Members 96-52*. Also in 1996, NASD Regulation published *Notice to Members 96-86* to remind members that sales of variable contracts are subject to NASD suitability requirements.

[28] 15 U.S.C. 80a-22(b).

[29] Of course, the NASD's suitability requirements would continue to apply to variable insurance contracts. An NASD member offering these products must consider, among other factors, the amount of premium that a customer would be obligated to pay and the customer's financial ability to meet such an obligation. See *Notice to Members 96-86.*

[30] We understand that due to provisions in the Internal Revenue Code, in the vast majority of cases Underlying Funds are not offered both to separate accounts and to the public as mutual funds. If an Underlying Fund is offered in both distribution channels, however, the exclusivity provision would not prevent the Investment Company Rule sales charge provisions from applying to the public mutual fund sales because such sales are not "in connection with [a] variable contract."