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June 3 1999

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

Re: File No. SR-NASD-98-14 – Proposed Rule Change by the National Association of Securities Dealers, Inc. Concerning Sales Charge Limitations

Dear Ms. England:

This letter summarizes and responds to comment letters submitted in response to the Securities and Exchange Commission's ("SEC") publication of proposed changes to National Association of Securities Dealers, Inc. ("NASD") Conduct Rules 2820 and 2830.[1] Commenters consist of Battle Fowler LLP ("Battle Fowler"), Cahill Gordon & Reindel ("Cahill Gordon"), Carter, Ledyard & Milburn ("Carter Ledyard"), Chapman and Cutler, Davis Polk & Wardell ("Davis Polk"), the Investment Company Institute ("ICI"), the National Association for Variable Annuities ("NAVA"), and Prudential Securities Incorporated ("Prudential").

1. *Prohibition of Sales Loads on Reinvested Dividends*

Battle Fowler, Carter Ledyard, Chapman and Cutler, Davis Polk, the ICI and Prudential opposed the proposed prohibition of loads on shares purchased through reinvestment of dividends, as that prohibition would apply to sponsors of unit investment trusts ("UITs"). Some commenters asserted that this prohibition is not justified, since a UIT investor does not pay a sales charge twice on the same assets when he or she purchases shares through reinvested dividends. Moreover, some commenters pointed out that unlike mutual funds underwriters, UIT sponsors are not permitted to receive fees

[1] *See* Securities and Exchange Commission Release No. 34-40310 (Aug. 7, 1998), 63 Fed. Reg. 43974 (Aug. 17, 1998).

pursuant to Rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act"), since UITs do not have boards of directors (whose approval is required for Rule 12b-1 plans). Thus, these commenters urged that UIT sponsors should be permitted to recoup their expenses through sales charges imposed on reinvested dividends.

Several commenters asserted that prohibiting such sales charges would be inconsistent with SEC exemptive orders that permit certain UIT sponsors to impose sales charges on reinvested dividends, subject to certain conditions. Battle Fowler and Chapman and Cutler asserted that this prohibition would require certain UITs that offer deferred sales load structures to create multiple classes of shares, which could raise issues under the 1940 Act and the federal tax laws.

Carter Ledyard and Davis Polk argued that the proposed prohibition would require UIT sponsors to reprogram their computer systems to separate reinvestment shares when deferred sales loads are deducted. The SEC has issued a moratorium on the implementation of new SEC rules that require major reprogramming of SEC-regulated entities' computer systems between June 1, 1999 and March 31, 2000, in order to allow these entities to focus their efforts on resolving any Year 2000 computer programming issues.[2] These commenters questioned the SEC's authority to approve this aspect of the proposed rule change in light of its Y2K moratorium.

Response: NASD Regulation continues to believe that loads on reinvested dividends constitute excessive compensation, regardless of the type of investment company that imposes them. We are not persuaded by the arguments that the proposed amendments conflict with certain SEC exemptive orders.

Some comment letters indicated that exemptive relief under the 1940 Act was necessary in order for UIT sponsors to charge installment loads on reinvested dividends, and that the SEC had granted this relief. We have reviewed the exemptive orders and related notices cited by the comment letters. While these orders permitted UIT sponsors to charge installment loads, they do not appear to refer to any dividend reinvestment program. Indeed, we understand that at least two of these orders applied to fixed portfolio UITs that offered only dividend reinvestment into no-load mutual funds.[3] Moreover, the exemptive orders provide relief from the application of certain provisions of the 1940 Act and the SEC rules thereunder. The orders do not address or provide relief from the application of the NASD's Conduct Rules.

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[2] Securities and Exchange Commission Release No. 34-40377 (Aug. 27, 1998), 63 Fed. Reg. 47051 (Sept. 3, 1998).

[3] *Compare, e.g.,* Letter to Jonathan G. Katz, Securities and Exchange Commission from Davis Polk (September 8, 1998) (citing Release Nos. IC-15167 and IC -13848) *with* Letter to R. Clark Hooper, NASD, Inc. from Davis Polk (October 14, 1993) (seeking interpretation that UITs subject to these orders qualify for higher sales charge caps in part because they offer reinvestment into no-load mutual funds).

We also discussed with the SEC staff the issue of whether UITs would have to create multiple classes of shares to comply with the proposed prohibition on loads on reinvested dividends and one commenter's claim that a multiple class structure could cause adverse tax consequences for UITs. We defer to the expertise of the Division of Investment Management on this issue. In our view, however, complying with the proposed amendments should not require UITs to adopt a multiple class structure.

We also do not agree with the offered comparisons to Rule 12b-1 fees. Our determination that loads on reinvested dividends are excessive was unrelated to the question of whether Rule 12b-1 fees may be charged. Thus, for example, the prohibition would apply to mutual funds that have no Rule 12b-1 plan just as it applies to mutual funds that have Rule 12b-1 plans. As amended, Rule 2830(d)(6)(B) would not prohibit UIT sponsors from imposing sales charges on the initial purchase of UIT shares, which UIT sponsors may set at a level that should adequately compensate them for their distribution costs.

Nevertheless, NASD Regulation does recognize that prohibiting sales loads on reinvested dividends could require UIT sponsors to reprogram their computer systems. We further recognize that the SEC's moratorium on the implementation of new rules that require major reprogramming of computer systems may preclude approval of this rule if it were to take effect prior to April 1, 2000. Accordingly, NASD Regulation proposes to revise Rule 2830(d)(6)(B) to delay the effectiveness of the prohibition of loads on reinvested dividends with respect to UITs until April 1, 2000, in order to comply with the Y2K moratorium.

2. "Fund of Funds" Definition

Chapman and Cutler and the ICI both recommended changes to the proposed definition of "fund of funds" in Rule 2830(b)(11). The proposed amendments published by the SEC would have defined "fund of funds" as "an investment company that invests any portion of its assets in the securities of registered open-end investment companies or registered unit investment trusts." Both commenters felt that this language was too broad and may unnecessarily include funds that invest only a small portion of their assets in other funds. The commenters noted that Section 12(d)(1)(A) of the 1940 Act permits an investment company to purchase a limited amount of the total voting stock of another investment company.[4] Chapman and Cutler and the ICI suggested that the definition of "fund of funds" be modified to more closely reflect traditional funds of funds, such as those companies relying on Sections 12(d)(1)(F) and 12(d)(1)(G) of the 1940 Act. Alternatively, the ICI recommended that the definition include only funds whose investments in other funds exceed the limits permitted under Section 12(d)(1)(A).

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[4] In particular, Section 12(d)(1)(A) permits an investment company to invest in up to 3% of the shares of another fund, provided that the value of such shares represents less than 5% of the acquiring fund's total assets, and the acquiring fund's investments in all other funds represent less than 10% of the acquiring fund's total assets.

Response: NASD Regulation proposes to modify the definition of "fund of funds" to include any investment company that acquires securities issued by any other investment company in excess of the amounts permitted under Section 12(d)(1)(A) of the 1940 Act. This definition will exclude from the definition investment companies that invest only a small portion of their assets in other funds' shares.

3. Calculation of Contingent Deferred Sales Loads

The proposed amendments would reinstate requirements previously applicable pursuant to SEC Rule 6c-10 under the 1940 Act concerning the order in which fund shares subject to a contingent deferred sales load ("CDSL") must be redeemed. (See Rule 2830(d)(6)(A).) If a fund has a CDSL that declines over the shareholder's investment period, then the proposed amendments would require the fund to calculate the CDSL as if the shares not subject to the CDSL are redeemed first, and other shares are then redeemed in the order purchased, provided that another order or redemption may be used if it results in the shareholder paying a lower CDSL. Chapman and Cutler commented that some investors for business or tax reasons may want to apply a different order of redemption than the one specified by the rule, and that therefore the rule should be modified to allow investors to dictate a different order of redemption. The ICI commented that, while it does not object to this provision, it believes that it should be modified to specify that it applies to partial redemptions. The ICI also recommended that the rule language be modified to provide that an order of redemption other than first-in-first-out may be used if such an order "could" (rather than "would") result in the shareholder paying a lower CDSL.

Response: NASD Regulation does not believe additional changes are needed to this provision. NASD Regulation is not aware of any significant problems that arose as a result of the identical requirements that were previously imposed on the investment company industry by Rule 6c-10. Moreover, we are concerned that if investors were permitted to consent to a different order of redemption, investment company account agreements could include standard language that effectively allows a fund sponsor to determine the order of redemption. We also do not believe that it is necessary to modify the language of this provision to indicate that it applies only to partial redemptions, since if all shares are redeemed, the issue of redemption order becomes moot.

4. Elimination of Variable Annuity Sales Charge Restrictions

NAVA commented that it strongly supports elimination of the limits in Rule 2820 on variable annuity sales loads. NAVA noted that the National Securities Markets Improvement Act of 1996 ("NSMIA") amended Section 26 of the 1940 Act to exempt variable annuities from the charge restrictions in Sections 26 and 27 of the 1940 Act. NSMIA substituted in their place a requirement that variable contract charges be reasonable in relation to the services rendered. NAVA commented that the imposition of sales charge restrictions on variable annuities would be inconsistent with the purpose and intent of this amendment. NAVA also expressed its support for NASD Regulation's decision not to impose sales charge limits in Rule 2830 on funds underlying variable annuities, again citing the NSMIA amendments to Section 26 of the 1940 Act.

Response: The proposed amendments as revised, like the original proposal, would eliminate the restrictions on variable annuity sales loads and would not impose sales charge limits on funds underlying variable annuities.

Very truly yours,

Thomas M. Selman

Attachment

cc: Kenneth Berman
Division of Investment Management
Securities and Exchange Commission

Christine M. Richardson
Division of Market Regulation
Securities and Exchange Commission

Sales Charge Rule Amendments Chronology

July 19, 1999

At the request of the Division of Market Regulation, the NASD Regulation staff has prepared this chart, which sets forth dates and descriptions of the series of filings that NASD Regulation has made with the SEC in connection with its efforts to amend its Conduct Rules 2820 and 2830, governing the sales charges for investment companies and variable contracts.

The National Securities Markets Improvement Act of 1996 (NSMIA) permitted the creation of so-called "funds of funds," provided that the sales charges imposed by such funds are not excessive under NASD or SEC rules. NASD Regulation had intended that the proposed amendments accommodate this statutory mandate. Today Rule 2830 does not contemplate sales charges imposed by funds of funds.

This chronology also includes the date on which the SEC approved other amendments to Rules 2820 and 2830 relating to non-cash compensation arrangements. This date is included to clarify the timing of the non-cash amendments, relative to the publication of proposed sales charge amendments.

Date	**Event**	**Description**
Feb. 17, 1998	Initial Filing	In response to NSMIA and other developments, NASD Regulation initially submits the proposed changes to the SEC staff. The staff subsequently directs NASD Regulation to submit an amendment that adds a sentence stating that NASD Regulation believes that the proposed changes are consistent with Section 15A(b)(6) of the 1934 Act.
Mar. 12, 1998	Amendment No. 1	NASD Regulation submits an amended filing with the requested language. The SEC staff subsequently provides comments on the rule proposal.

June 11, 1998	Amendment No. 2	NASD Regulation submits an amendment that responds to the SEC staff comments. SEC staff, rather than reviewing the filing as to its substance, subsequently rejects it on the ground that it was insufficient as to form. The SEC staff specifically objects to the fact that the rule changes from the original proposal were italicized, to make it easier for the SEC staff to analyze.
July 13, 1998	Amendment No. 3	NASD Regulation once again files a revised proposed rule change, without the italics.
July 15, 1998	SEC Approves Non-Cash Compensation Amendments	SEC approves amendments to NASD Conduct Rules 2820 and 2830 relating to the regulation of non-cash compensation arrangements for the sale and distribution of variable contracts and investment company securities.
After July 15, 1999	SEC Requests for Technical Changes	The SEC staff requests certain grammatical and technical changes to Amendment No. 3 to the Sales Charge Rule filed on July 13.
Aug. 12, 1998	Amendment No. 4	NASD Regulation files another revised proposed rule change in response to SEC staff's non-substantive comments on Amendment No. 3. This filing does not reflect the unrelated non-cash amendments to Rule 2830.
Aug. 17, 1998	Federal Register Publication of Proposal	SEC staff publishes for comment in the Federal Register the proposed changes to NASD Conduct Rules 2820 and 2830. *See* 63 Fed. Reg. 43974 (Aug. 17, 1998). Proposed changes do not include or refer to rules changes regarding non-cash compensation arrangements.
Sept. 8, 1998	Comment Period Expires	Comment period on sales charge rule proposal expires.

Dec. 17, 1998	Extension No. 1	NASD Regulation submits a letter extending the time for SEC action on the rule proposal to January 30, 1999. Extension requested due to staffing changes in Advertising/Investment Companies Regulation Department.
June 3, 1999	Response to Comments	NASD Regulation files with SEC a letter responding to the comments submitted in response to the SEC's August 1998 publication of the proposed changes to NASD Conduct Rules 2820 and 2830. SEC staff subsequently objects to filing on ground that its "re" line is incorrect. Staff subsequently requests this chronology. Staff subsequently requests clarification of multi-class issue.
July 19, 1999	Amendment No. 5	NASD Regulation files a letter with corrected "re" line, chronology and explanation of multi-class issue; deems filing to be Amendment No. 5.