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THE DISTRIBUTION OF MUTUAL FUND SHARES— RECENT DEVELOPMENTS IN SEC REGULATION

Section 22(d) of the Investment Company Act of 1940¹ (Investment Company Act) prohibits the sale of mutual fund shares to the public "except at a current public offering price described in the prospectus."² Congress enacted this requirement, commonly known as the retail price maintenance³ provision, to control a number of inequitable and disrupt-

1. 15 U.S.C. §§ 80a-1 to -52 (1970) [hereinafter cited as Investment Company Act].

2. 15 U.S.C. § 80a-22(d) (1970) (emphasis added) states in full:

No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, *except at a current public offering price described in the prospectus*. Nothing in this subsection shall prevent a sale made (i) pursuant to an offer of exchange permitted by section 80a-11 of this title including any offer made pursuant to section 80a-11(b) of this title; (ii) pursuant to an offer made solely to all registered holders of the securities, or of a particular class or series of securities issued by the company proportionate to their holdings or proportionate to any cash distribution made to them by the company (subject to appropriate qualifications designed solely to avoid issuance of fractional securities); or (iii) in accordance with rules and regulations of the Commission made pursuant to subsection (b) of section 80a-12 of this title.

3. The term "retail price maintenance," when used in reference to the pricing uniformity required by § 22(d), differs from its use in reference to the pricing of other items. Generally, retail price maintenance permits a producer to establish a uniform sales price to which retailers must adhere when selling to the public. See Bowman, *The Prerequisites and Effects of Resale Price Maintenance*, 22 U. CHI. L. REV. 825 (1955); Note, *The Impending Demise of Resale Price Maintenance*, 1970 WASH. U.L.Q. 68. Section 22(d), by prohibiting sales except at a uniform price, requires that a uniform price be set (presumably by the fund, adviser, or underwriter) in the prospectus and

five practices in the distribution of mutual fund shares.⁴ Developments since its enactment have cast doubt on the continued necessity of section 22(d). Many of the abuses to which the section was initially addressed have been corrected,⁵ and the provision, with its anti-competitive impact,⁶ has come to be viewed as a cause of "inequities and inefficiencies."⁷

The Securities and Exchange Commission (SEC) has responded to these changed conditions by taking a number of steps "intended to reduce or eliminate many of the inequities and inefficiencies" of the mutual fund distribution system "while at the same time avoiding the dangers of a sudden abolition of retail price maintenance."⁸ This Note

followed by retailers. See *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. 732, 838-39 (1969) [hereinafter cited as *Survey*]. Since other sections of the Investment Company Act provide for the computation of a uniform price in relation to the fund's net assets, see note 15 *infra*, only the sales charge is "maintained" by § 22(d). See notes 16-18 *infra* and accompanying text.

The pricing requirement of § 22(d) has also been termed "resale price maintenance," Greene, *The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940*, 37 U. DET. L.J. 369, 369 (1959) [hereinafter cited as Greene], and "uniform price maintenance," Simpson & Hodes, *The Continuing Controversy Surrounding the Uniform Price Maintenance Provisions of the Investment Company Act of 1940*, 44 NOTRE DAME LAW. 718, 718 (1969) [hereinafter cited as Simpson & Hodes].

The term "retail price maintenance" is used by the Securities and Exchange Commission (SEC) and has been adopted herein.

4. Part II of this Note discusses the debate over the purposes for which § 22(d) was enacted. See notes 40-54 *infra* and accompanying text (disruption of the distribution system and discrimination in pricing among investors); notes 55-76 *infra* and accompanying text (dilution of investors' interest resulted from backward pricing system which offered insiders an opportunity for riskless trading).

5. Reforms since the enactment of § 22(d) include "forward pricing," see notes 74-75 *infra*, and twice-daily pricing, see note 74 *infra*.

6. Unlike state fair trade laws, § 22(d) requires rather than permits the fixing of a price at which a fund's shares are sold to the public, thus precluding competition between dealers retailing shares of the same fund. This requirement is an exception to the general national policy against price fixing expressed in the Sherman Act § 1, 15 U.S.C. § 1 (1970). Cf. notes 263-84 *infra* and accompanying text.

7. Letter of transmittal from Ray Garret, Chrm. of SEC, to Sen. John Sparkman, Chrm. of Senate Comm. on Banking, Housing and Urban Affairs, undated, *reprinted in SEC, MUTUAL FUND DISTRIBUTION AND SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940*, at v (1974) [hereinafter cited as *Transmittal Letter*].

8. *Transmittal Letter v.* The letter further stated:

The Commission has concluded that price competition at the retail level is a desirable goal. It appears to us, however, that the immediate abolition of Section 22(d) would serve the interests of neither the public nor the [mutual fund] industry.

Id. at iv.

will discuss the recent changes in SEC regulation of mutual fund distribution and assess the consequences that may arise from these modifications.

I. THE MUTUAL FUND DISTRIBUTION SYSTEM

An "open-end investment company,"⁹ or mutual fund, invests capital, derived from the sale of its own equity securities, in the securities of other corporations. The fund's "investment adviser" selects the investments,¹⁰ controls the activities of the fund,¹¹ and typically serves as

9. For purposes of the Investment Company Act, §§ 3-5 define open-end investment companies, which are also known colloquially as mutual funds. 15 U.S.C. §§ 80a-3 to -5 (1970). Section 3(a) defines an "investment company" as

any issuer which (1) is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities; (2) is engaged or proposes to engage in the business of issuing face amount certificates of the installment type . . . ; or (3) is engaged . . . in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets

15 U.S.C. § 80a-3(a) (1970). See 15 U.S.C. § 80a-3(b) (1970) (exemptions from § 3(a)(3)).

Section 4 divides investment companies into three classes: face-amount certificate companies, 15 U.S.C. § 80a-4(1) (1970) (issuer of "face-amount certificates of the installment type"); unit investment trusts, 15 U.S.C. § 80a-4(2) (1970) (organized under trust indenture; no board of directors; issues only redeemable securities representing undivided interest in group of specified securities); and management companies, 15 U.S.C. § 80a-4(3) (1970) (any other investment company).

Section 5(a) classifies management companies as "open-end" and "close-end" as follows:

(1) "Open-end company" means a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer.

(2) "Close-end company" means any management company other than an open-end company.

15 U.S.C. § 80a-5(a)(1970). The factor that distinguishes open-end from close-end companies is the redeemable character of the securities issued. Shares in close-end companies are not redeemable; an investor who owns shares in an open-end investment company (a mutual fund) may redeem his shares at any time, see note 22 *infra*, for their "net asset value," see note 23 *infra*.

In July 1974, 798 mutual fund issues were available. 40 SEC ANN. REP. 153 (1974). The 197 available issues of close-end company shares are similar to equity securities of publicly-held corporations, and are traded on exchanges or over-the-counter. *Id.*

10. The Investment Company Act refers to an investment adviser as an "advisory board," defined as

a board . . . distinct from the board of directors . . . of an investment company . . . composed solely of persons who do not serve such company in any other capacity . . . [which] has advisory functions as to investments but has no power to determine that any security or other investment shall be purchased or sold by such company.

underwriter for the distribution of the mutual fund's shares.¹²

Section 22¹³ of the Investment Company Act regulates the distribution of mutual fund shares. Specifically, subsection (d) requires that the total price paid by public purchasers be uniform.¹⁴ This "public offering price" includes the price of the naked share¹⁵ and a sales

15 U.S.C. § 80a-2(a)(1) (1970). See SEC, REPORT ON THE POTENTIAL ECONOMIC IMPACT OF A REPEAL OF SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940 at 12 (1972) [hereinafter cited as 1972 STUDY]:

Mutual funds are seldom managed along conventional corporate lines by their own officers and directors. The typical fund is said to be "externally managed." This means that most or even all of its work is done for it not by its own officers or employees, but by a separate company.

See also S. REP. No. 184, 91st Cong., 1st Sess. 5 (1969); Werner, *Protecting the Mutual Fund Investor: The SEC Reports on the SEC*, 68 COLUM. L. REV. 1, 8-10, 17 (1968) [hereinafter cited as Werner].

11. "The adviser presides over the fund's birth and generally remains in control of it throughout its life." 1972 STUDY 13. See *Survey* 750 ("the adviser is . . . the ringmaster and the mutual fund is the seal"); Note, *Mutual Funds and Their Advisers: Strengthening Disclosure and Shareholder Control*, 83 YALE L.J. 1475 (1974); Note, *The Mutual Fund and Its Management Company: An Analysis of Business Incest*, 71 YALE L.J. 137 (1961).

12. 1972 STUDY 13. Mutual funds compensate their adviser-underwriters for both advisory and underwriting services. Because new sales may increase the advisory fee, see note 26 *infra*, "in a substantial number of cases advisory income [is] used to subsidize the underwriting function." SEC, MUTUAL FUND DISTRIBUTION AND SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940 at 4 (1974) [hereinafter cited as 1974 REPORT]. For no-load funds, the advisory fee is the only compensation. See notes 300-01 *infra* and accompanying text.

13. 15 U.S.C. § 80a-22 (1970). Subsection (a) gives the National Association of Securities Dealers (NASD) the authority to regulate pricing and the time of calculation "for the purpose of eliminating . . . any dilution of the value of other outstanding securities . . ." See notes 57-63 *infra*. Subsection (b) allows the NASD to prohibit "an excessive sales load [allowing] for reasonable compensation for sales personnel . . . and for reasonable sales loads to investors." See notes 210-17 *infra*. Subsection (c) provides that the SEC may supersede the authority that subsection (a) grants the NASD. Subsection (d) imposes the retail price maintenance requirement. Subsection (e) limits the conditions under which the right of redemption may be suspended. See note 22 *infra*. Subsection (f) requires disclosure of restrictions on the transferability of shares, and gives the SEC authority to adopt rules limiting such restrictions. Subsection (g) prohibits the sale of mutual fund shares in return for services or property other than cash or securities.

14. Investment Company Act § 22(d), 15 U.S.C. § 80a-22(d) (1970), quoted in note 2 *supra*.

15. A mutual fund share, like any equity security, represents a fractional undivided property interest in the net assets of the fund. Since the assets of the fund are invested in securities whose value is readily calculable, the value of the interest represented by a share is readily ascertainable. Since the underlying securities fluctuate in value, however, the value and therefore the price of mutual fund shares change accordingly.

charge, or "load."¹⁶ The Investment Company Act requires that the price of naked shares in a fund be fixed by calculating a pro rata share of the fund's current net assets.¹⁷ Since the total price of shares must be uniform, and the only other payment made by an investor is the sales load,¹⁸ section 22(d), in effect, requires that the sales load charged for sales of shares in a particular fund be uniform. Consequently, this uniformity prevents price competition among retail dealers selling shares in the same fund.¹⁹

The accounting methods used to value the net assets of the fund and the timing of the calculation are regulated by the NASD pursuant to authority granted in § 22(a), 15 U.S.C. § 80a-22(a) (1970). The SEC oversees this NASD regulation. 15 U.S.C. § 80a-22(c) (1970). See note 23 *infra*.

16. The Investment Company Act § 2(a)(35) defines "sales load" as the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer

15 U.S.C. § 80a-2(a)(35) (1970).

The phrase "and invested or held for investment by the issuer" in the definition accounts for those funds that employ their own sales forces and sell directly to the public. While the "price . . . to the public" equals the "portion . . . received . . . by the issuer" (leaving no "difference" to be the sales load), not all of that price is invested. Some portion pays sales costs. By definition, the fund adds none of the sales load to its assets; it is "purely a payment for selling effort." 1972 STUDY 3 n.2.

The sales load, calculated as a percentage of the total price, see note 32 *infra*, is typically 8.5%. Largely because of discounts on large purchases, see notes 175-78 *infra* and accompanying text, sales loads on mutual fund sales in 1970 averaged only 5.7%. 1974 REPORT 23 n.5.

The division of the sales load between the underwriter and dealer is another important economic feature of the distribution system. On a typical load of 8.5%, the dealer retains 7.0%. 1974 REPORT 30. In some instances, underwriters have permitted dealers to retain the entire load. *Id.* at 31-32. In these cases the underwriter is compensated solely by the advisory fee. See note 12 *supra*.

Some funds, called "no-load funds," charge no load on sales. They have grown from 5.1% of industry assets in mid-1966, 1974 REPORT 19, to 13.8% in mid-1974, 40 SEC ANN. REP. 153 (1974). No-load funds accounted for 19% of all mutual fund sales in the three years from 1971 through 1973. 1974 REPORT 21. The advisory fee compensates no-load fund underwriters. For a discussion of the lack of retail dealer compensation for the sale of no-loads and the resultant problems, see notes 300-01 *infra* and accompanying text.

17. See notes 15 *supra* & 23 *infra*.

18. See note 16 *supra* (sales load defined as purchase price minus amount invested).

19. Although § 22(d) precludes price competition between retailers, it does not prevent competition between funds for a larger share of the market. This competition would seem to encourage funds to lower their sales loads to attract investors. To the contrary, however, the mutual fund industry believes that investors respond to sales efforts by retailers rather than low sales loads. Therefore, to encourage retailers to devote more effort to selling shares of their fund, funds raise the sales load to increase retailer compensation. *Hearings on S. 1659 Before the Senate Comm. on Banking &*

Except for the retail price maintenance requirement, mutual fund shares are distributed in a manner similar to shares of any equity security:²⁰ the fund, as issuer, sells shares to the public through an underwriter and a network of retail dealers. Mutual fund distributions, however, differ significantly from equity security distributions in several respects. First, a mutual fund shareholder may redeem his shares²¹ at any time²² for his proportionate share of the fund's net assets;²³ to balance these redemptions, funds distribute new shares continuously.²⁴ Second, if sales exceed redemptions, the net assets of the fund tend to increase.²⁵ Moreover, the advisory fee paid to the adviser-underwriter traditionally is calculated as a percentage of the net assets.²⁶ Since an

Currency, 90th Cong., 1st Sess., pt. 1, at 143 (1967); *Survey* 836; text accompanying note 31 *infra*.

20. Because mutual fund shares are securities, their sale is subject to the applicable federal securities laws. Although the Securities Act § 5, 15 U.S.C. § 77e (1970), requires the registration of the distribution of securities, mutual funds register their sales differently. Section 24(a) of the Investment Company Act, 15 U.S.C. § 80a-24(a) (1970), provides that "in lieu of . . . the information and documents specified in schedule A of [15 U.S.C. § 77aa (1970)]," funds may file a registration statement containing the information that funds are required to file under Investment Company Act §§ 8, 29, 15 U.S.C. §§ 80a-8, 80a-29 (1970).

21. By definition, the shares of an open-end investment company are redeemable; that is, an investor may sell them back to the fund. Investment Company Act § 5(a)(1), 15 U.S.C. § 80a-5(a)(1) (1970). *See* note 9 *supra*.

22. Section 22(e) of the Investment Company Act protects the investor's right of redemption from suspension or postponement for more than seven days except under unusual circumstances, such as a SEC order or inability of the company to determine the value of its assets. 15 U.S.C. § 80a-22(e) (1970). *See* SEC Investment Company Act Release No. 5571 (Dec. 20, 1968); *Survey* 834 n.633; Note, *Investment Companies and Restricted Securities: Pearls or Perils?*, 43 S. CAL. L. REV. 516, 530-34 (1970).

23. The "net asset value" of a share is computed by dividing the value of the net assets of the fund by the number of its outstanding shares. Section 22(a)(1) authorizes the NASD to adopt rules assuring redemption pricing in "relation to the current net asset value . . ." 15 U.S.C. § 80a-22(a)(1) (1970). Further, a mutual fund share is a "redeemable security," defined by the Investment Company Act § 2(a)(32) as

any security . . . under the terms of which the holder . . . is entitled . . . to receive approximately his *proportionate share* of the issuer's current net assets

. . . .
15 U.S.C. § 80a-2(a)(32) (1970) (emphasis added).

24. Shares issued by the fund are somewhat analogous to treasury shares bought and sold by a corporation. Whether the shares are termed "new" or viewed as redeemed shares being "reissued" is of no practical importance.

25. Two other variables affect the net assets of a fund: fluctuations in the value of securities in which the fund has invested its assets and services for which the fund must pay.

26. The advisory fee is paid to the fund adviser for "externalized services" such as the selection and management of investments and, frequently, almost all other aspects of

increase in net assets results in a commensurate increase in the advisory fee, adviser-underwriters attempt to maximize their funds' sales-to-redemption ratio²⁷ by selling as many shares as possible. This continuous process of sale and redemption, coupled with the increased compensation from a high rate of sales, makes the distribution system an integral part of the operation of any mutual fund.

Third, to sell as many shares as possible, adviser-underwriters compete for the favor of retail dealers.²⁸ Section 22(d) requires that the fund set,²⁹ and dealers adhere to,³⁰ a fixed sales load. The confluence of these two requirements results in

what has been described as "perverse competition" [between adviser-underwriters] because it is cost-raising rather than cost-lowering. It is a competition for the favor and services of fund dealers and salesmen

the fund's operation. Werner, *supra* note 10, at 8-10. It is typically calculated as one-half of one percent of fund assets per year. 1974 REPORT 24-25 (chart III, note 2).

27. S. REP. No. 184, 91st Cong., 1st Sess. 7 (1969):

[T]his underwriting function . . . may be performed at cost or even at a loss. The real financial return to the underwriter . . . in these instances is the management [adviser's] fee which increases automatically as the fund grows in size.

There is no economic necessity that mutual funds always maintain sales in excess of redemptions. Although the industry experienced "net redemptions" (*i.e.*, redemptions exceeded sales) in 1972 and 1973, 1974 REPORT 21 (Table I; load and no-load funds), these amounts were not a threat when measured against the total industry assets. While the "possibility of ruinous redemption" is recognized by many, *Survey* 834-35, it does not justify the statement that "it is important that sales *always* exceed redemptions lest the company be required to liquidate its holdings . . ." Hodes, *Current Developments Under Section 22(d) of the Investment Company Act*, 13 B.C. IND. & COMM. L. REV. 1061, 1063 n.8 (1972) (emphasis added) [hereinafter cited as Hodes].

It should be noted, however, that the industry's fear of a high rate of redemptions is based on more than a desire to maintain the size of the advisory fee. A high rate of turnover, whether redemptions or new sales, requires the fund to hold an increased portion of its assets in liquid or readily liquidable assets, such as cash or short-term notes. Since such assets yield a diminished or no return, the performance of the fund is impaired, a result that fund advisers legitimately fear.

28. 1974 REPORT 5 n.5; 1972 STUDY, *supra* note 10, at 14; *Survey, supra* note 3, at 836.

29. Obviously, either the mutual fund or the adviser-underwriter must set the sales load in order to guarantee uniformity. Since funds are controlled by their adviser-underwriters, *see* notes 10-11 *supra* and accompanying text, the adviser-underwriters actually set sales loads and determine the portion to be retained by retail dealers.

30. "[N]o dealer shall sell any such [redeemable] security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price . . ." 15 U.S.C. § 80a-22(d) (1970). The Investment Company Act § 48 provides for maximum penalties of \$10,000 fine and two years imprisonment, 15 U.S.C. § 80a-48 (1970).

rather than the conventional form of competition for the favor of investors. This vigorous competition for dealer interest results in powerful upward pressures on selling compensation and sales loads and because of Section 22(d), the countervailing [downward] pressures of retail price competition cannot operate.³¹

As a result, sales loads, calculated as a percentage of the total share price,³² have risen from an average of 5 percent in 1940³³ to a typical 8.5 percent today.³⁴

Reasoning that the high level of sales loads is symptomatic of problems within the mutual fund distribution system,³⁵ the SEC "concluded that price competition at the retail level is a desirable goal."³⁶ In so concluding, the SEC rejected retail price maintenance, exercised its administrative authority to introduce limited variations in the pricing structure of sales loads,³⁷ and suggested replacement or amendment of section 22(d).³⁸

II. LEGISLATIVE HISTORY OF SECTION 22(d)

The debate over section 22(d) has sparked renewed interest in its legislative history.³⁹ Commentators have attempted to identify the problems that compelled its passage in order to determine whether section 22(d) is still necessary.

The "traditional" justification⁴⁰ for the retail price maintenance provi-

31. *Hearings on H.R. 9510, H.R. 9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 90th Cong., 1st Sess., pt. 1, at 110 (1967).

32. By calculating the sales load as a percentage of the total price, rather than the share, the figure appears to be smaller. For example, an \$8.50 sales load calculated as a percentage of a total purchase of \$100.00 equals 8.5%. If that same \$8.50 sales load is computed as a percentage of the investor's initial interest in the fund's assets (\$91.50), the sales load would equal 9.3%.

33. 1974 REPORT 30.

34. *Id.*

35. See text accompanying notes 80-85 *infra*.

36. Transmittal Letter, *supra* note 7, at iv. See 1974 REPORT, *supra* note 12, at 10-11.

37. SEC Investment Company Act Release No. 8570, 5 S.E.C. Dock. 423 (1974).

38. *Id.* See 1974 REPORT 115-21; notes 318-24 *infra* and accompanying text.

39. See, e.g., Heffernan & Jordan, *Section 22(d) of the Investment Company Act of 1940—Its Original Purpose and Present Function*, 1973 DUKE L.J. 975, 975-98 [hereinafter cited as Heffernan & Jordan]; Hodes, *supra* note 27; North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAW. 677, 680-84 (1969); Simpson & Hodes, *supra* note 3, at 719; *Survey* 804-05.

40. Immediately following passage of the Investment Company Act, the retail price

sion is that Congress passed it to "insure the orderly distribution" of mutual fund shares,⁴¹ to "prevent discrimination" in pricing by dealers selling shares to the public,⁴² and to avoid "cut-price competition"⁴³ with the primary distribution system by "bootleg"⁴⁴ broker-dealers.

The threat to orderly distribution and the cut-price competition resulted from the so-called "bootleg" market maintained by broker-dealers not under contract with the mutual fund's underwriter.⁴⁵ Sales contracts between underwriters and retailers required retail dealers to surrender a part of their sales load to the underwriter.⁴⁶ Noncontract or "bootleg" broker-dealers purchased shares from the public at slightly more than net asset (redemption) value, sold them at slightly less than the public offering price, and retained the entire difference.⁴⁷ Since

maintenance provision of § 22(d) received remarkably little attention. *See, e.g., Jaretzki, The Investment Company Act of 1940*, 26 WASH. U.L.Q. 303, 330-32 (1941) (discussing § 22 without reference to § 22(d)). In 1959, Lawrence M. Greene, then Assistant Director of the Division of Corporate Regulation of the SEC, outlined his interpretation of the purposes of § 22(d). Greene, *supra* note 3. Greene first stated that "[a]lthough the reasons for section 22(d) were not articulated by its proponents at the legislative hearings, the objectives were well known in the industry and to the Commission." *Id.* at 371. In support of the three "well-known" purposes, Greene cited only two industry memoranda written in 1958. *Id.* at 371 n.10, citing NASD Memorandum 2-4, February 5, 1958, SEC File No. 57-170-1, Proposal to Adopt Rule 22d-1; N.A.I.C. Memorandum 1-2, June 24, 1958, SEC File No. 57-170-1. It seems unlikely that the congressional purposes that prompted passage of § 22(d) could be "well-known" and yet escape exposition for eighteen years.

41. Greene 371. *See* 1 L. LOSS, SECURITIES REGULATION 404-05 (2d ed. 1961).

42. Greene 371. *See* 1 L. LOSS, SECURITIES REGULATION 404-05 (2d ed. 1961).

43. Greene 371.

44. In the primary distribution system of mutual funds, the fund issues the shares and sells them to the public through an underwriter and a network of retail dealers under contract with the underwriter. *See* text accompanying and following note 20 *supra*. When their sales contracts permitted, retail dealers often functioned as brokers. They established a secondary market in which investors could trade in the shares of that fund, paying a brokerage fee equal to the sales load. This secondary trading posed little threat to the primary distribution system because the brokerage compensation paid to a member of the primary distribution system could be substituted for the sales load revenues that were lost. The "bootleg" market, on the other hand, disrupted the established sales load because bootleg dealers charged a brokerage fee lower than the sales load and diverted revenue from the primary distribution system of which bootleg dealers were not a part.

45. *See* SEC, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES 850-65 (1940) [hereinafter cited as 1940 REPORT].

46. *Id.* at 855. Out of a hypothetical \$100 purchase, including a 6% sales load, the fund typically received \$94, the underwriter \$2, leaving the dealer \$4 as compensation.

47. For example, suppose a fund share sold for \$100, including a sales load of 6%, and was at the same time redeemable for \$94. A bootleg dealer could attract sellers by

noncontract broker-dealers surrendered nothing to the underwriter, they were able to underprice contract dealers and still receive comparable or greater compensation for sales than contract dealers.⁴⁸ This competition diverted revenues from the primary distribution system, and threatened to destroy it.⁴⁹ Supporters of section 22(d) argue that retail price maintenance remains necessary to prevent such price cutting by noncontract broker-dealers.⁵⁰

"Discrimination" in the sale of mutual fund shares is a more abstract problem. Since section 22(d) permits no variation in purchase price,⁵¹ one commentator concluded that "the provisions of section 22(d) on their face indicate a purpose to avoid discrimination in the distribution of redeemable securities"⁵² consistent with "the fundamental declaration of policy" of the Investment Company Act.⁵³ The notion of discrimination, however, without determining against whom there is discrimination, is paradoxical when applied to the sale of mutual fund shares. While the uniform sales load requirement protects investors from discriminatory variations in price, the requirement discriminates against those public purchasers who are forced to pay retailers for sales services they neither desire nor receive. Generally, variations in price that reflect differences in costs or services are not considered discriminatory.⁵⁴

buying at \$95 (one dollar higher than redemption value), attract buyers by selling at \$99 (one dollar lower than fund's offering price), and retain the \$4 difference.

48. 1940 REPORT 856-57, 865. See notes 46 & 47 *supra*.

49. 1940 REPORT 324-25, 850-65; Greene 371-72; Hodes 1062-63.

50. 1974 REPORT 51, quoting Written comment of Investment Company Institute; Simpson & Hodes 728-30. See notes 271-77 *infra* and accompanying text (SEC interpretation that § 22(d) is not applicable to noncontract broker-dealers).

51. See notes 14-19 *supra* and accompanying text.

52. Greene 372. See Hodes 1063; Simpson & Hodes 719.

53. Greene 372. The Investment Company Act's "fundamental declaration of policy" states in part:

[T]he national public interest and the interest of investors are adversely affected—

. . . .
(2) when investment companies are organized, operated, [or] managed . . . in the interest of [insiders, affiliates, or others] rather than in the interest of all classes of such companies' security holders;

(3) when investment companies issue securities containing *inequitable or discriminatory provisions*, or fail to protect the preferences and privileges of the holders of their outstanding securities

Investment Company Act § 1(b), 15 U.S.C. § 80a-1(b) (1970) (emphasis added).

54. 1974 REPORT 93 (variations in price in group purchase context):

[T]here would be no unjust discrimination among investors because differences

Commentators recently⁵⁵ have questioned whether section 22(d) was intended to prevent discrimination in price among investors and negate the disruption caused by the bootleg market. One concluded:

[T]he requirement of a uniform sales load was a compromise provision designed primarily as a device to curb *abuses resulting in dilution* of the value of mutual fund shares, and *possibly* to impose some limitations on the activities of "non-contract" dealers. Only incidentally . . . did the section entail the "price-fixing" aspects which are now assumed by many to be its *raison d'être*.⁵⁶

The "dilution abuses" were possible because of the pricing system that existed in 1940. The price at which funds sell their shares is based on the market value of the securities in each fund's portfolio. As the portfolio securities fluctuate in value, so does the value, and therefore the price, of the fund share. In the pre-1940 market, funds calculated the value of their portfolios at the close of the market.⁵⁷ That valuation set the price at which shares were sold during the following day. By waiting until late afternoon, an investor could predict the closing prices for the securities in the fund's portfolio and accurately predict the next day's price for shares of the fund.⁵⁸

Insiders were able to take advantage of this riskless opportunity to choose between the present price and the next day's predicted price because they had a reduced or no sales load to overcome⁵⁹ and had rapid access to the information necessary to make an accurate prediction.⁶⁰ Average investors, because they paid a full sales load⁶¹ and had

in sales charges would relate to differences in both costs and services.

See Transmittal Letter, *supra* note 7, at iv.

55. Heffernan & Jorden 975; *Survey* 732.

56. Heffernan & Jorden 978 (emphasis added) (footnote omitted).

57. 1940 REPORT 860. This system, known as "backward pricing," continued until abolished in 1968. See notes 74-76 *infra* and accompanying text; *Survey* 804-05. During the 1940 congressional hearings, the practice was defended on the ground that the industry needed a firm price. *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 2, 514-34, 672-74 (1940)* [hereinafter cited as *1940 Senate Hearings*]. See generally Greene 373-75; Heffernan & Jorden 979.

58. See Heffernan & Jorden 980 & n.20.

59. *1940 Senate Hearings* pt. 1, at 142; *id.*, pt. 2, at 842 (insiders paid a price "close to net asset value"). See *Survey* 791.

60. 1940 REPORT 852; *Survey* 791.

61. Since the prevailing sales load in 1940 was between four and five percent, it was necessary for the per-share value of the fund's portfolio to appreciate at least four or five

no rapid access to the necessary information, could not take advantage of this "two-price" system. Thus, the "backward"⁶² pricing system offered a continuous opportunity for riskless profit-taking by insiders. Since insider purchases increased the number of shares on days when a profit was earned by the fund, the profit was distributed among more shares, or diluted.⁶³

The 1940 congressional hearings on the Investment Company Act emphasized the asset-diluting problems of riskless trading under the two-price system.⁶⁴ It was at these abuses that section 22 of the Investment Company act was aimed.⁶⁵ Section 22 of the original bill⁶⁶ contained a provision that would have required shares to be priced as of the first portfolio valuation *after* the order to buy or sell was received.⁶⁷ This "forward pricing" requirement would have eliminated the two-price opportunity.

percent before an investor could break even. Short-term fluctuations of this magnitude were uncommon, and this hurdle, coupled with the investor's inability to secure the requisite information quickly, *see* text accompanying note 60 *supra*, made it impossible for average investors to take advantage of the two-price system. *Survey* 791.

62. *See* notes 57-58 *supra* and accompanying text.

63. This exaggerated example will illustrate the effect of dilution on the value of outstanding shares:

On day 1, the Fund has 10 shares outstanding and total assets of \$100. Each share is worth \$10.

On day 2, the Fund's portfolio appreciates a dramatic 50%. If no sales or redemptions take place, the Fund would have 10 shares outstanding and total assets of \$150. Each share would be worth \$15.

The picture changes, however, if an insider, noting the rise in the Funds portfolio securities by late afternoon of day 2, buys 10 shares. The price calculated at the end of day 1 (\$10) is still in effect. At the close of day 2, the Fund has 20 shares and total assets of \$250. Each share is worth \$12.50. The insider has taken no risk and profited at the expense of the Fund's shareholders. *Survey* 790-91.

64. *1940 Senate Hearings* 140-45, 151-56, 844-46. One article published soon after passage of the Investment Company Act noted the problem of dilution. Jaretzki, *supra* note 40, at 330-32. *But see* Tolins, *The Investment Company Act of 1940*, 26 *CORNELL L.Q.* 77, 84-92 (1940) (discussion of Act with no mention of dilution).

65. Heffernan & Jordan 978; *Survey, supra* note 3, at 849-51.

66. H.R. 8935, S. 3580, 76th Cong., 3d Sess. (1940).

67. Heffernan & Jordan 986 & n.42.

[H]ad [forward pricing] been adopted at the time of the enactment of the 1940 Act, the principal abuses which section 22(d) was designed to curb would have been eliminated, and [section 22(d)] would probably not have been enacted, or, if enacted, would have been addressed more specifically to the problems generated by the activities of "non-contract" dealers.

Id. at 981.

Rather than requiring forward pricing,⁶⁸ Congress adopted the section 22(d) requirement that all sales take place at a uniform price. In response to industry opposition,⁶⁹ Congress replaced the proposed forward pricing provision with subsections (a), (c), and (d) of section 22 of the Investment Company Act.⁷⁰ Subsections (a) and (c) permit the adoption of rules "for the purpose of eliminating . . . any dilution of the value of outstanding securities."⁷¹ Subsection (d), by requiring all purchasers, including insiders, to pay the same sales load, prevented quick profit-taking by insiders because they too had to overcome the sales load before realizing a profit.⁷²

Those who argue that section 22(d) should be repealed maintain that subsequent reforms sufficiently preclude the dilution abuses that existed in 1940.⁷³ Funds now sell their shares at the first price calculated *after* an order to buy or sell is received.⁷⁴ The adoption of forward pricing in 1968⁷⁵ abolished the two-price system that had enabled insiders to trade at the expense of other investors.⁷⁶ Absent any potential for the abuses that section 22(d) was designed to prevent, the continuation of retail price maintenance appears unjustified.

68. The industry had suggested that "no securities issued by an investment company . . . be sold to insiders or anyone other than an underwriter or dealer except on the same terms as are offered to other investors." *1940 Senate Hearings, supra* note 57, at 526, 548-56, 859. Rather than devise a more specific means to insure insider purchases "on the same terms" as public purchases, Congress chose retail price maintenance.

69. Heffernan & Jorden 968-95.

70. *Id.* at 968-95; Greene, *supra* note 3, at 373 n.20.

71. Section 22(a) permits a registered securities association (the NASD) to adopt rules

for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities

15 U.S.C. § 80a-22(a) (1970). Section 22(c) gives the SEC authority to adopt rules "for the accomplishment of the same ends as are prescribed" in § 22(a), 15 U.S.C. § 80a-22(c) (1970).

72. Requiring insiders to pay a full sales load, however, did not prevent them from using the two-price system. Insiders could still use the two-price system by timing their transactions to maximize profit or minimize loss. *See* note 61 *supra*.

73. Heffernan & Jorden, *supra* note 39, at 1007; *Survey* 805, 848-51.

74. SEC rule 22c-1, 17 C.F.R. § 270.22c-1 (1975). Additionally, shares are now valued twice daily. NASD Rules of Fair Practice, Art. III, § 26(c) (1974).

75. SEC Rule 22c-1, 17 C.F.R. § 270.22c-1 (1975). *See* SEC Investment Company Act Release No. 5519 (Oct. 16, 1968).

76. *See* notes 57-63 *supra* and accompanying text.

III. THE SEC PROGRAM

After extensive study,⁷⁷ the SEC concluded that the retail price maintenance requirement "has produced a distribution system that can and should be improved."⁷⁸ In its report, *Mutual Fund Distribution and Section 22(d) of the Investment Company Act of 1940*⁷⁹ (1974 Report), issued in November, 1974, the SEC determined that section 22(d) was an unnecessary exception to the national policy against price-fixing;⁸⁰ that purchasers were paying for selling services they neither wanted, needed, nor received;⁸¹ that the present regulatory structure discouraged the use of economical marketing practices;⁸² and that the high level of sales loads⁸³ and the recent extended period of net redemptions reflected these shortcomings.⁸⁴ As summarized by then-Chairman Garrett of the SEC:

The mutual fund industry's historic reliance upon high fixed sales charges to induce salesmen to "push" fund shares, besides being expensive for investors, is simply not working today.⁸⁵

The SEC analyzed three approaches to reforming the distribution process.⁸⁶ First, the SEC considered retaining retail price maintenance and simply requiring the NASD to exercise its authority under section

77. The SEC and associated institutions have produced seven reports dealing with mutual fund distribution. SEC, INSTITUTIONAL INVESTOR STUDY, H.R. DOC. NO. 64, 92d Cong., 1st Sess. (1971); SEC, THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as 1966 REPORT]; SEC, SPECIAL STUDY OF THE SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. (1963); SECURITIES RESEARCH UNIT, WHARTON SCHOOL OF THE UNIV. OF PA., A STUDY OF MUTUAL FUNDS, H.R. DOC. NO. 2274, 87th Cong., 2d Sess. (1962); 1974 REPORT, *supra* note 12; 1972 STUDY, *supra* note 10; NASD, AN ECONOMIC STUDY OF THE DISTRIBUTION OF MUTUAL FUNDS AND VARIABLE ANNUITIES (1972).

78. Transmittal Letter, *supra* note 7, at iv.

79. 1974 REPORT, *supra* note 12.

80. *Id.* at 76-77. See note 6 *supra*.

81. 1966 REPORT 221; 1972 STUDY 7.

82. 1974 REPORT 86; Transmittal Letter iv.

83. 1974 REPORT 80:

The fund industry's virtually total reliance upon incentives to "sell" fund shares has not forestalled a state of extended net redemptions; and there are no clear signs that the situation is likely to improve under the present marketing strategy.

84. 1974 REPORT 19, 21-22, 80.

85. Transmittal Letter iv.

86. 1974 REPORT 76-83.

22(b) to establish a maximum permissible sales load.⁸⁷ The SEC rejected this alternative because

[i]t would perpetuate the inefficiencies and inequities of the current distribution system, and it would be based upon a presumption that [a] maximum sales charge rule . . . would be an appropriate substitute for increased price competition, a presumption contrary to our own analysis⁸⁸

Second, the SEC considered the immediate abolition of retail price maintenance,⁸⁹ through either congressional repeal of section 22(d) or SEC administrative action.⁹⁰ The SEC, expressing fear that an immediate move to negotiated sales loads might further decrease sales of new shares,⁹¹ declined to move precipitously to a fully competitive environment.⁹² Moreover, the SEC admitted that the marketing problems of the mutual fund industry were partly the regulator's fault:

[T]he present regulatory system . . . has inhibited the development of a demand 'pull' by prohibiting the fund industry from using the marketing devices relied upon by most other businesses: lower prices, effective advertising, and mass marketing techniques such as group discounts.⁹³

Reasoning that the repeal of section 22(d) must be preceded by this "development of a demand 'pull,'" ⁹⁴ the SEC adopted its third alterna-

87. *Id.* at 76-77. The 1974 REPORT described this alternative as involving no major modifications of the law presently governing fund distribution except implementation of a meaningful maximum sales load rule; the mutual fund distribution system's basic reliance upon fixed sales loads . . . would remain unchanged.

Id. at 76. It would seem that Congress mandated some action in this direction when it amended § 22(b) in 1970. See notes 210-17 *infra* and accompanying text.

88. 1974 REPORT 76.

89. *Id.* at 78-81.

90. See notes 318-24 *infra* and accompanying text.

91. 1974 REPORT 79.

92. *Id.* See *id.* at 72, quoting Testimony of Dr. Donald Farrar, Professor of Economics, U.C.L.A.: "There are some very serious problems which are an accumulation of an evolutionary process"

93. *Id.* at 79. The mutual fund industry has traditionally relied upon high sales compensation to encourage retailers to sell ("push") mutual fund shares. At the same time, SEC regulation has prevented the use of mass marketing techniques to develop a large purchasing population. If a large purchasing population were developed, it would exert a demand (a "pull") for shares. However, the industry is reluctant to move in this direction. Mutual fund representatives continue to argue that extensive selling efforts are necessary. *Id.* at 53. Because the industry has continued to rely upon individual salesmen as its primary selling technique, no significant "pull" has developed and extensive selling efforts continue to be necessary.

94. *Id.* at 79.

tive, the gradual modification of the mutual fund distribution system.⁹⁵

The recommended program, now partly implemented, includes seven major changes. Less restrictive regulation of advertising allows a wider "cultivation of public demand."⁹⁶ A new group purchase rule now permits a wider variety of groups to aggregate mutual fund purchases to qualify for quantity discounts.⁹⁷ Underwriters may provide "open seasons" during which investors of record may purchase additional shares at reduced or no load.⁹⁸ The SEC will consider exemptions from section 22(d) when retailers sell mutual fund shares in combination with other financial products.⁹⁹ The SEC is also encouraging secondary trading in mutual fund shares.¹⁰⁰ The SEC approved the new NASD maximum sales load rule limiting sales loads to 8½ percent.¹⁰¹ Finally, proposed legislation will be sent to Congress to clarify the SEC's authority to introduce more competition into the mutual fund distribution system.¹⁰² Although these modifications are aimed at "allowing the industry voluntarily to move toward price competition,"¹⁰³ the SEC is considering "more far reaching administrative actions"¹⁰⁴ that "could go as far as prohibiting retail maintenance."¹⁰⁵

This comprehensive revision has met substantial opposition.¹⁰⁶ The

95. *Id.* at 81-82. The recent modifications in SEC regulations under § 22(d) are intended to encourage transition "to a stage where [the industry] might be able to adjust to full price competition . . ." *Id.* at 82. See note 93 *supra*.

One industry representative found fault with gradual modification:

[A] partial repeal [of § 22(d)] with the end objective of total repeal would overhang the industry like a sword of Damocles. Nobody would want to buy today because prices may be reduced later.

1974 REPORT 57, quoting Written comment of Union Service Corp.

96. Transmittal Letter vi. See 1974 REPORT 84-88; notes 134-74 *infra* and accompanying text.

97. 1974 REPORT, *supra* note 12, at 89-93. See notes 187-206 *infra* and accompanying text.

98. 1974 REPORT 93-97. See notes 238-52 *infra* and accompanying text.

99. 1974 REPORT 97-101. See notes 253-58 *infra* and accompanying text.

100. 1974 REPORT 104-09. See notes 259-99 *infra* and accompanying text.

101. 1974 REPORT 122-29. See notes 207-37 *infra* and accompanying text.

102. 1974 REPORT 115-21. See Transmittal Letter vii; notes 318-24 *infra* and accompanying text.

103. Transmittal Letter vii.

104. *Id.*

105. *Id.*

106. The SEC held hearings on all proposed modifications before writing the 1974 Report containing the recommended program. See generally 1974 REPORT 51-75. The hearings were designed to "accommodate, to the extent possible, the interests of both investors and the industry." *Id.* at 76. Fifty-six of the 59 participants who testified

mutual fund industry generally has opposed any modifications other than a loosening of restrictions on advertising.¹⁰⁷ Full retail price competition, the industry fears, will drive smaller dealers out of business¹⁰⁸ and reduce both sales and personalized services.¹⁰⁹ Moreover, the industry believes that the opportunity for secondary trading,¹¹⁰ increased eligibility for group discounts,¹¹¹ and the maximum sales load rule¹¹² will further reduce sales compensation, while liberalized advertising regulations¹¹³ will only partially compensate for this reduction.¹¹⁴ Since retailers "have consistently sold products which pay the most money,"¹¹⁵ the industry argues that any net decrease in sales compensation would cause "further reductions in sales and further increases in losses or alternatively, a discontinuance of active selling efforts."¹¹⁶

The most convincing argument raised by members of the mutual fund industry is that they have come to rely on the uniform price requirement of section 22(d).¹¹⁷ This reliance has been so great that the industry maintains:

were members of, or affiliated with, the mutual fund industry. One investor testified. *Id.* at Appendix VI. See North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAW. 677, 697 (1969) ("During the course of the ninety-first Congress we may witness a repetition of the industry-government cooperative endeavors which produced the original Act").

107. 1974 REPORT 51-60.

108. *Id.* at 55.

109. *Id.* at 54-55. See *id.* at 55, quoting Written comment of the Putnam Management Co.:

[P]rice competition will cause dealers' profit margins to shrink, in turn causing the quality of the sales effort to decline. Mutual funds must be sold properly if the investor is to be sold funds and programs suitable to his needs.

110. 1974 REPORT 104-09. See notes 259-99 *infra* and accompanying text.

111. See notes 187-206 *infra* and accompanying text.

112. See notes 207-37 *infra* and accompanying text.

113. See notes 134-74 *infra* and accompanying text.

114. "[A]dvertising alone will not get the job done." 1974 REPORT 53, quoting Written comment of Phillip C. Smith, Chairman of the Board, National Securities Research Corp.

115. 1974 REPORT 23, quoting Written comment of Seaboard Corp.

116. 1974 REPORT 55, quoting Statement of Franklin R. Johnson, Keystone Custodian Funds, Inc.

117. 1974 REPORT 55. See Heffernan & Jorden, *supra* note 39, at 1007:

Any legislative or administrative action taken in this area, however, must consider that the mutual fund business has accommodated itself to section 22(d). If the slate were clean, there might be no economic justification [for] such a sweeping exception to the antitrust laws; but the continued vitality of the huge mutual fund industry, if truly dependent upon such a pricing structure, may dictate the continued existence of at least some form of price maintenance.

[T]hose who would propose regulatory changes which would . . . affect the system of distributing mutual fund shares to the public have a heavy burden to establish that the proposal on balance will serve the public interest.¹¹⁸

The SEC response consisted of four major arguments. First, the SEC noted, investors as well as the mutual fund industry deserve the protection of SEC regulation.¹¹⁹ Second, gradual modification under administrative supervision can minimize disruption of the distribution system.¹²⁰ Third, the SEC argued, more specific regulation can control the harmful effects of the abolition of retail price maintenance.¹²¹ Finally, exemption,¹²² reform of rules,¹²³ and increased opportunities for less costly distribution¹²⁴ can cushion any financial difficulties experienced by the industry.

Other parties concerned with the modifications concentrated on specific proposals relating to their particular interests. The No-Load Mu-

118. 1974 REPORT 51, quoting Statement of Robert Augenblick, President, Investment Company Institute.

119. Although much of the 1974 Report appears to be an effort to accommodate or refute arguments of the mutual fund industry, the basic import of the recommended program is to reduce inefficiencies, which require higher costs to be passed on to the investor, and to eliminate inequities in the sale of shares to investors. See 1974 REPORT 76. *But cf.* note 106 *supra*.

120. Transmittal Letter, *supra* note 7, at vii-viii. See 1974 REPORT 81-82, 115-21.

121. See, e.g., notes 259-99 *infra* and accompanying text (the more specific but less restrictive regulation of brokered transactions).

122. 15 U.S.C. § 80a-6(c) (1970):

The Commission . . . may conditionally or unconditionally exempt any person, security, or transaction . . . from any provision of this [Act] or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this [Act].

The phrase, "consistent with . . . the purposes fairly intended by the policy and provisions of this [Act]," makes an identification of the purposes of § 22(d), see notes 39-76 *supra* and accompanying text, an essential element of the granting of exemptions.

123. 15 U.S.C. § 80a-37(a) (1970):

The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred [by this Act] For the purposes of its rules or regulations the Commission may classify persons, securities, and other matters . . . and prescribe different requirements for different classes

See 1974 REPORT 82.

124. These "increased opportunities," which primarily liberalized advertising regulations and expanded eligibility for group sales, represent a compromise intended to accommodate the industry. See 1974 REPORT 88-89.

tual Fund Association¹²⁵ was principally concerned "with the still archaic and inhibiting" advertising regulations.¹²⁶ The American Life Insurance Association¹²⁷ successfully argued that variable annuities,¹²⁸ although "redeemable securities,"¹²⁹ should be exempted from section 22(d) and regulated apart from mutual fund shares.¹³⁰ The Justice

125. See note 16 *supra*. The interest of no-load funds in sales charges "is indirect at most," 1974 REPORT, *supra* note 12, at 60, since they charge none.

126. 1974 REPORT 60, quoting Statement of Donald Samuel, No-Load Mutual Fund Association.

127. Life insurance companies distribute most of the variable annuities offered. 1972 STUDY, *supra* note 10, at 60.

128. A variable annuity entitles its owner to a payment that fluctuates according to the value of a pro rata share of the underlying portfolio of securities. Although variable annuities include a longevity factor, they are distinguishable from fixed annuities. They substitute variable payments for fixed amounts and shift the investment risk from the insurer to the owner. See SEC v. United Beneficial Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 77-80 (1959) (Brennan, J., concurring).

129. "Redeemable security" is defined by the Investment Company Act § 2(a)(32) as

any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer . . . is entitled . . . to receive approximately his proportionate share of the issuer's current net assets

15 U.S.C. § 80a-2(a)(32) (1970). Variable annuities may be redeemed during the "redemption stage," an initial period the length of which is determined by the variable annuity contract. 1972 STUDY 62. Variable annuities are therefore a "redeemable security" within the meaning of the Investment Company Act, and must be sold at a "uniform public offering price" as required by § 22(d).

130. Prior to 1940, the sale of variable annuities was plagued by neither riskless trading nor a secondary market. 1974 REPORT 102, 103 n.2. Before 1975, the continued inclusion of variable annuities under § 22(d) was probably the result of the sale of most variable annuities by insurance companies' "captive" sales forces, in effect a single retailer, who will stipulate a uniform price even if variable annuities are exempted from § 22(d). 1974 REPORT 102; 1972 STUDY 60.

Accepting the recommendation of the 1974 Report, the SEC proposed new rule 22d-3, SEC Investment Company Act Release No. 8775, 6 S.E.C. Dock. 814 (1975), and adopted the rule with minor amendments, SEC Investment Company Act Release No. 8878, 7 S.E.C. Dock. 528 (1975). The rule provides:

[Any seller of variable annuities] shall . . . be exempted from Section 22(d) to the extent necessary to permit the sale of [variable annuities] at prices which reflect variations in the sales load . . . ; *Provided, however*, that (a) the prospectus discloses as precisely as possible the amount of the variations . . . , and (b) any such variations reflect differences in costs or services and are not unfairly discriminatory against any person.

SEC Rule 22d-3, 40 Fed. Reg. 33970 (1975) (emphasis original). The second requirement used the word "reflect" because "variations in . . . purchase payments need not precisely equal variations in costs." SEC Investment Company Act Release No. 8878, 7 S.E.C. Dock. 528, 529 (1975).

This exemptive rule was little more than a codification of the many exemptions

Department unsuccessfully urged the SEC to adopt its second alternative,¹³¹ the immediate abolition of retail price maintenance, in order to eliminate the unjustifiable anticompetitive effects of section 22(d).¹³²

Having considered both the need to introduce retail competition and the extent of industry dependence on section 22(d), the SEC has begun to move the industry gradually toward a competitive pricing structure. In transmitting the *1974 Report*, the SEC described the program as one intended to reduce or eliminate many of the inequities and inefficiencies of the present fund distribution system while, at the same time, avoiding the dangers of a sudden abolition of retail price maintenance.¹³³

A. Advertising

Personal labor is one of the major costs of mutual fund distribution. This characteristic is partially attributable to the extensive restrictions the SEC has imposed on mutual fund advertising.¹³⁴ The SEC has recently modified these restrictions¹³⁵ to allow more informative advertising calculated to increase public understanding of mutual funds. Investor familiarity with funds should reduce the need for extensive sales presentations and lead to lower overall distribution costs.¹³⁶

The Securities Act of 1933 (Securities Act)¹³⁷ and its restrictions on sales literature apply to the sale of mutual fund shares.¹³⁸ Although

granted in the past. 1974 REPORT 103 n.1. Since variable annuities are sold by "captive" sales forces and have already been exempted extensively, exemption from § 22(d) should have little impact on their distribution.

131. See notes 89-93 *supra* and accompanying text.

132. 1974 REPORT 69-71.

133. Transmittal Letter, *supra* note 7, at v.

134. SEC Investment Company Act Release No. 8571, 5 S.E.C. Dock. 425 (1974); SEC Investment Company Act Release No. 8568, 5 S.E.C. Dock. 418 (1974). See 1974 REPORT 84-88. Some members of the industry have argued that the complexity of mutual funds accounts for their high sales cost. See, e.g., *Conference on Mutual Funds*, 115 U. PA. L. REV. 669, 777 (1967):

PROFESSOR MUNDHEIM: . . . If you could have expanded advertising, could you get your story across to the public more cheaply, and therefore be able to make your sales at a lower over-all cost?

MR. RAYMOND GRANT: I don't think so, because we have found that the mutual fund, being the complex investment medium that it is, has to be sold by salesmen.

135. SEC Investment Company Act Release No. 8571, 5 S.E.C. Dock. 425 (1974).

136. *Id.* See 1974 REPORT 84-88.

137. 15 U.S.C. §§ 77a-77aa (1970).

138. Although the Investment Company Act § 24, 15 U.S.C. § 80a-24 (1970), partly supersedes the Securities Act § 5 registration requirement, 15 U.S.C. § 77e (1970), by

other kinds of corporations occasionally sell securities, mutual funds continuously¹³⁰ offer securities for sale, and therefore are continuously subject to the Securities Act's restrictions on publicity.¹⁴⁰ Section 5(b)(1) of the Securities Act¹⁴¹ prohibits the use of any "prospectus" that fails to meet the extensive requirements of section 10.¹⁴² Section 2(10) defines "prospectus" as "any advertisement . . . which offers any security for sale"¹⁴³ other than a tombstone advertisement excluded by section 2(10)(b)¹⁴⁴ or a communication accompanied or preceded by a statutory prospectus.¹⁴⁵ Thus, advertising by a mutual fund is illegal unless (1) it is a section 10 prospectus; (2) it is accompanied by a section 10 prospectus; or (3) it is a tombstone advertisement that meets the requirements of section 2(10)(b).

Section 2(10)(b) excludes the familiar tombstone advertisement from the definition of a prospectus.¹⁴⁶ A tombstone may include only limited information listed in that section and in rule 134.¹⁴⁷ In 1972, the SEC amended rule 134 to permit inclusion of "a general description

providing a form of continuous registration for mutual fund shares, the other provisions of the Securities Act are applicable, including the prospectus requirement of § 5(b), 15 U.S.C. § 77e(b) (1970). See 1 L. LOSS, SECURITIES REGULATION 317 n.2 (2d ed. 1961).

139. See notes 24, 27, 29 *supra*.

140. Generally stated, § 5(b)(1), 15 U.S.C. § 77e(b)(1) (1970), requires that "offers" to sell securities be made only by means of a statutory prospectus. Virtually all publicity is deemed an "offer" in the statutory sense, because it may precondition the market and lead investors to make a decision before receiving the prospectus.

141. 15 U.S.C. § 77e(b)(1) (1970).

142. 15 U.S.C. § 77j (1970) (information required in prospectus).

143. Securities Act § 2(10), 15 U.S.C. § 77b(10) (1970):

The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale

144. Securities Act § 2(10)(b), 15 U.S.C. § 77b(10)(b) (1970), *quoted in* note 146 *infra*

145. Securities Act § 2(10)(a), 15 U.S.C. § 77b(10)(a) (1970).

146. Securities Act § 2(10)(b), 15 U.S.C. § 77b(10)(b) (1970), excludes from the § 2(10) definition of prospectus any

notice, circular, advertisement, letter, or communication [stating] from whom a written [statutory] prospectus . . . may be obtained, and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission . . . may permit.

147. SEC Rule 134, 17 C.F.R. § 230.134 (1975), is an explanation of the "other information" that "the Commission . . . may permit" under the § 2(10)(b), 15 U.S.C. § 77b(10)(b) (1970), "tombstone" advertisement exemption from the definition of a prospectus.

of an investment company including its general attributes, method of operation, and services offered."¹⁴⁸

The *1974 Report* recommended,¹⁴⁹ and the SEC adopted,¹⁵⁰ a further liberalization of rule 134. Now, tombstone advertisements also may include information about the particular fund,¹⁵¹ such as its age,¹⁵² investment objectives,¹⁵³ principal officers,¹⁵⁴ aggregate net asset value,¹⁵⁵ and any illustration from the prospectus "not involving performance figures."¹⁵⁶ Advertisements including the new information must

148. SEC Rule 134(a)(3)(iii), 17 C.F.R. § 230.134(a)(3)(iii) (1972). See SEC Securities Act Release No. 5248 (May 9, 1972) (amendment adopted); SEC Securities Act Release No. 5213 (Dec. 1, 1971) (amendment proposed). These liberalizations were limited to permitting advertisements that described mutual funds in general. The SEC at that time believed that educating the public about mutual funds in general would generate sufficient public understanding to decrease sales costs and reverse the trend of net redemptions. SEC Securities Act Release No. 5248 (May 9, 1972). For a discussion of the industry response, see note 174 *infra*.

149. 1974 REPORT, *supra* note 12, at 84-85.

150. SEC Securities Act Release No. 5536, 5 S.E.C. Dock. 388 (1974).

151. *Compare* notes 152-56 *infra* (information about particular fund) with SEC Securities Act Release No. 5248 (May 9, 1972) (information restricted to description of typical fund).

152. SEC Rule 134(a)(3)(iii)(C), 17 C.F.R. § 230.134(a)(3)(iii)(C) (expressed by date of incorporation).

153. While rule 134(a)(3)(iii) previously permitted a statement of "whether in the selection of investments emphasis is placed on income or growth characteristics," the amended rule permits a more specific "description of such company's investment objectives and policies . . ." SEC Rule 134(a)(3)(iii)(A), 17 C.F.R. § 230.134(a)(3)(iii)(A) (1975). See Dahlberg, *From Mattress and Cashbox to Speculative Securities: The Investor and His Mutual Fund*, 24 Sw. L.J. 473 (1970).

154. SEC Rule 134(a)(3)(iii)(B), 17 C.F.R. § 230.134(a)(3)(iii)(B) (1975). The term "principal officers" is defined in the rule to mean officers, vice presidents "in charge of a principal business function," and "any other person who performs similar policy making functions for the company on a regular basis." SEC Rule 134(a)(3)(iii)(H), 17 C.F.R. § 230.134(a)(3)(iii)(H) (1975). The term replaced a proposed amendment which would have permitted identification of "fund directors and key personnel of the fund adviser." SEC Securities Act Release No. 5357 (Jan. 17, 1973). The change was made to avoid "the possibility that this provision might lend itself to abuse through appointments to boards of directors of celebrities with no investment expertise." SEC Securities Act Release No. 5536, 5 S.E.C. Dock. 388, 388 (1974).

155. SEC Rule 134(a)(3)(iii)(D-E), 17 C.F.R. § 230.134(a)(3)(iii)(D-E) (1975). The aggregate net assets may be either those of the fund, or those of all funds managed by a single adviser-underwriter, or both.

156. SEC Rule 134(a)(3)(iii)(F), 17 C.F.R. § 230.134(a)(3)(iii)(F) (1975). The SEC described this as a "logical extension" of the attention-getting headline interpretation," SEC Securities Act Release No. 5536, 5 S.E.C. Dock. 388 (1974), that first appeared in SEC Securities Act Release No. 5248 (May 9, 1972) (adoption of rule

contain a strengthened instruction cautioning the investor to obtain and read the statutory prospectus.¹⁵⁷

134(a)(3)(iii) codifying earlier interpretations permitting headlines). The attention that the headline attracts must be directed to announcement of the offering, not to the securities themselves. See note 161 *infra* and accompanying text.

Although the rule as amended does not permit tombstone advertisements to include performance figures since "such information might constitute a selling argument," SEC Securities Act Release No. 5536, 5 S.E.C. Dock. 388, 389 (1974), the SEC indicated it will continue to study the problem, *id.*, and has amended the Statement of Policy to allow sales literature to contain two new kinds of charts, see notes 163-69 *infra*.

157. As amended in June 1975, SEC Rule 134(a)(3)(iii)(G), 40 Fed. Reg. 27442 (1975), requires that rule 134 communications contain the following legend:

For more complete information about (Name of Company) including charges and expenses (get) (obtain) (send for) a prospectus (from (Name and Address)) (by sending this coupon). Read it carefully before you invest or (pay) (forward funds) (send money).

To ensure that investors see the legend, rule 134 requires that it be printed "in a size type at least as large as, and of a style different from, but at least as prominent as, that used in the major portion of the advertisement . . ." SEC Rule 134(a)(3)(iii)(G)(1), 40 Fed. Reg. 27443 (1975).

This legend requirement, as finally adopted, is much weaker than several legends that the SEC previously considered. In SEC Securities Act Release No. 5357 (Jan. 17, 1973), the SEC proposed to require the expanded tombstone to contain a statement of advisory fees, administrative charges, sales loads, and redemption charges, and a coupon that could be mailed for a prospectus. The coupon would have had to contain, in twelve point bold-face type, the legend, "Make no payment at this time." *Id.*

In SEC Securities Act Release No. 5536, 5 S.E.C. Dock. 388 (1974), the SEC adopted an amendment to rule 134, 39 Fed. Reg. 39869 (1974), that required a longer but less specific legend:

For more complete information about (Name of Company), including sales charges, management fees, and other expenses, see our prospectus. It is important to read the prospectus carefully before you decide to invest. A copy of the prospectus may be obtained from your securities dealer or by writing to (Distributor's Address). Send no money.

Id. This formulation of the legend is significant in two respects. First, it dropped the requirement that expenses, fees, and charges be stated in the advertisement. See *Conference on Mutual Funds*, 115 U. PA. L. REV. 669, 773-74 (1967). However, it strengthened the final admonition to a single instruction to "[s]end no money."

In SEC Securities Act Release No. 5566, 6 S.E.C. Dock. 211 (1975), the SEC announced its intention to amend again the legend requirement of rule 134 "to permit greater utilization of Rule 134 Communications" and to "shorten the wording of the legend." The proposed amendment would have required a legend stating:

A prospectus containing more complete information about (Name of Company) including all *charges and expenses* may be obtained from your securities dealer or from (Name and Address of Distributor). Read it carefully before you invest. Send no money.

Id. at 212 (emphasis added). This revision deleted the specific list of possible charges and consequently rendered the legend less effective in developing investor awareness of the costs involved in securities dealings.

The deletion was retained by rule 134 as amended. 40 Fed. Reg. 27442 (1975); SEC

The release announcing the amendments to rule 134¹⁵⁸ cautioned that advertisements must not attempt to sell the security.¹⁵⁹ The SEC noted the

significant difference . . . crucial in terms of the legal requirements . . . between selling a product from the face of an advertisement and attracting the readers' attention and stimulating his interest in obtaining the legally-sanctioned selling document, the statutory prospectus.¹⁶⁰

Although the modifications of rule 134 are designed to permit advertisements to generate interest in the prospectus, not in the shares,¹⁶¹ the distinction is probably less clear in the investor's mind than it is in legal theory.

Securities Act Release No. 5591, 7 S.E.C. Dock. 187 (1975). The final amendments to the rule 134 legend requirement also substituted a weakened admonition for the formerly strong directive to "[s]end no money."

The SEC imposed the legend requirement to ensure that tombstone advertisements did not become vehicles for selling the security. As the amount of information contained in the tombstone increases, the need increases for instructions to "read the prospectus" and "send no money." SEC Rule 134(a)(3)(iii)(A-G), *as amended*, 40 Fed. Reg. 27442 (1975), now allows tombstones to contain more information than ever. Yet, at the same time, the SEC has regrettably weakened the cautioning legend.

158. SEC Securities Act Release No. 5536, 5 S.E.C. Dock. 388 (1974).

159. Written "offers" by means other than a statutory prospectus are generally prohibited by § 5(b)(1) of the Securities Act, 15 U.S.C. § 77e(b)(1) (1970). "Offer" is defined to include "every attempt or offer to dispose of, or solicitation of an offer to buy . . ." Securities Act § 2(3), 15 U.S.C. § 77(b)(3) (1970). *See* notes 138, 142-43 *supra*.

See BNA SEC. REG. & L. REP. No. 334, at A-1, A-2 (March 17, 1976) (speech by Anne P. Jones, Director, SEC Division of Investment Management Regulation, to Annual Mutual Funds and Investment Management Conference):

Wondering whether the existing [advertising] rules are themselves really necessary, Ms. Jones conjectured that perhaps all that is really necessary is a rule prohibiting fraud in advertising and a requirement that investors receive a prospectus prior to investing.

Such a statement ignores the restrictions which the Securities Act places upon the advertising of securities. *See Conference on Mutual Funds*, 115 U. PA. L. REV. 669, 777 (1967). The Securities Act, rather than an SEC rule or release, restricts such advertising. Even if such authority were delegated to the SEC, its wisdom is questionable. *See Note, The Investment Company Act of 1940*, 41 COLUM. L. REV. 269, 286 (1940):

[T]he expertness of the [mutual fund] managers was evidenced chiefly by the way in which their literature safely skirted the borderlines of fraudulent misrepresentation

160. SEC Securities Act Release No. 5536, 5 S.E.C. Dock. 388, 389 (1974). *See* notes 138, 142-43 *supra*.

161. SEC Securities Act Release No. 5536, 5 S.E.C. Dock. 388, 389 (1974).

The various "anti-fraud" provisions of the Securities Act,¹⁶² which prohibit false or misleading statements, also apply to mutual fund sales. In 1950, the SEC adopted a Statement of Policy¹⁶³ which describes how the past performance of a mutual fund may be portrayed without being misleading. The Statement of Policy was amended in 1974¹⁶⁴ to allow two new charts portraying fund performance to be included in mutual fund sales literature.¹⁶⁵

Sample Chart E, by the use of a mountain graph, presents "a continuous record of the results of an investment" over a ten-year period.¹⁶⁶ Along with the mutual fund's record, the chart must include a market index¹⁶⁷ "to demonstrate the effect of fluctuations in the securities markets on fund investment results."¹⁶⁸ Sample Chart F displays the same data as Sample Chart E, but uses a bar graph format to emphasize annual variations in the rate of investment return.¹⁶⁹

Whether this liberalization in advertising will enable funds to cultivate a demand for mutual fund shares¹⁷⁰ and thus reduce the costs of

162. Securities Act §§ 11, 12(2), 17(a), 15 U.S.C. §§ 77k, 77l(2), 77q(a) (1970). Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 77j(b) (1970), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1975), are also applicable, if "in connection with [a] purchase or sale"

163. SEC Investment Company Act Release No. 1503 (Aug. 11, 1950). The Statement of Policy is based on the premise that any implication that an investor will receive a return on his investment is misleading, and thus illegal unless expressly permitted. Any portrayal of past performance, because it must of necessity either summarize or be confusing, and because it implies a continuation of past trends, falls into the same category. The amended Statement of Policy expressly permits the use of charts based on the "text, graphic detail and arrangement" of certain "sample charts." SEC Statement of Policy § (j)(1)(i), in SEC Securities Act Release No. 5537, 5 S.E.C. Dock. 390, 393 (1974).

164. SEC Securities Act Release No. 5537, 5 S.E.C. Dock. 390 (1974). See SEC Investment Company Act Release No. 7475 (Nov. 3, 1972) (amendment proposed).

165. SEC Securities Act Release No. 5537, 5 S.E.C. Dock. 390, 391-92 (1974).

166. *Id.* at 391. The use of a uniform period is intended "to promote comparison," and to "minimize the possibility of distortion" because of the selection of a more favorable period. *Id.*

167. The Standard & Poor's Composite Index of 500 Stocks was selected, and must be used by all funds. *Id.* at 391, 392 n.2. Footnote 3 of Chart E explains to investors the purpose of the market index. *Id.* at 398-99.

168. *Id.* at 391, 392 n.2.

169. *Id.* at 392:

Presentation of annual variations in the fund's return should assist investors in distinguishing the average [variable] rate of return for a mutual fund . . . from the constant return available from a savings account

170. See notes 93-94 *supra* and accompanying text (repeal of § 22(d) must be preceded by development of demand "pull").

distribution remains to be seen. The advertising liberalization of 1972¹⁷¹ appears to have been little help to the industry.¹⁷² The 1974 liberalizations, however, permit the inclusion of information about particular funds,¹⁷³ thus giving each fund an incentive to engage in more extensive advertising.¹⁷⁴

B. *Group Purchases*

Although section 22(d) speaks of "a . . . price,"¹⁷⁵ the SEC has always permitted discounted sales loads on large purchases if the discount was described in the prospectus and equally available to all investors.¹⁷⁶ An investor qualifies for quantity discounts if his purchase exceeds a given quantity (a "breakpoint"), typically set by the fund between \$10,000 and \$25,000.¹⁷⁷ Since the discounted sales load applies to the entire purchase, some larger purchases include a far smaller sales cost than smaller purchases.¹⁷⁸

171. See note 148 *supra*.

172. The value of the assets of active mutual funds declined from \$64.7 billion in mid-1972, 38 SEC ANN. REP. 152 (1972), to \$54.4 billion in mid-1973, 39 SEC ANN. REP. 149 (1973), to \$46.1 billion in mid-1974, 40 SEC ANN. REP. 153 (1974). Although part of this decline in assets is attributable to a decline in the stock market, the mutual industry believes itself less susceptible to such declines than the market in general. Furthermore, funds also experienced a decrease in the number of investors. 1974 REPORT 21-22.

173. See notes 151-56 *supra* and accompanying text.

174. The 1972 advertising liberalization was directed toward educating the public about mutual funds in general, see note 148 *supra*. To justify advertising, a fund had to conclude that encouraging investors to select *some* mutual fund would yield a sufficient increase in purchases of the *particular* fund to cover the expense. The 1974 liberalization, however, since it permits advertising about the particular fund, may be more acceptable to funds.

175. 15 U.S.C. § 80a-22(d) (1970).

176. SEC Investment Company Act Release No. 89 (Mar. 13, 1941) (Opinion of SEC General Counsel). The fact pattern that prompted the opinion included a specified load on purchases up to \$25,000 and a discount, at the *option* of the underwriter, on larger sales. The opinion stated that, although the discretion delegated to the underwriter could result in discrimination between inside and public purchasers and was therefore prohibited by § 22(d), the variation in load for larger purchases was permissible so long as it was available to all purchasers on a nondiscriminatory basis. *Id.* See 1 L. LOSS, SECURITIES REGULATION 406 (2d ed. 1961); Greene, *supra* note 3, at 375-76.

177. 1974 REPORT 90; 1972 STUDY, *supra* note 10, at 101-03. Approximately half of the funds have \$10,000 as their first breakpoint. Subsequent breakpoints entitle purchasers to greater discounts in the sales load. *Id.* at 101.

178. 1972 STUDY 83 n.1:

[U]nder the typical mutual fund sales charge schedule a \$9,500 purchase would bear a sales load of \$807.50, while the sales load on a \$10,000 purchase would be \$750.00 and on a \$10,500 purchase, \$787.50.

Groups often aggregate the purchases of their individual members to qualify for quantity discounts. To be eligible to do so, a group must qualify as a "person" within the meaning of section 22(d).¹⁷⁹ If the group is not a "person," the SEC will look beyond the group to the individual investors. Since the individuals' purchases would not qualify for the quantity discount, a reduced sales load would be an illegal deviation from the uniform public offering price required by section 22(d).¹⁸⁰

The Investment Company Act contains few restrictions on "grouping." Section 2(a)(28) and 2(a)(8)¹⁸¹ define "person" broadly. Under these definitions, groups formed for the sole purpose of aggregating purchases could qualify for discounts.¹⁸²

In 1958, in response to industry pressure,¹⁸³ the SEC restricted the eligibility of groups for quantity discounts by promulgating rule 22d-1.¹⁸⁴ Paragraph (a) of the rule contained a specific "antigrouping" provision which prohibited quantity discounts to groups "of individuals whose funds are combined, directly or indirectly, for the purpose" of mutual fund shares.¹⁸⁵ By defining "person," as used in section 22(d), more narrowly than the Investment Company Act, the SEC satisfied industry objections but restricted the use of an important and efficient technique of mass marketing.¹⁸⁶

179. 1974 REPORT 89. See SEC Rule 22d-1(a), 17 C.F.R. § 270.22d-1(a) (1971).

180. 15 U.S.C. § 80a-22(d) (1970). See note 2 *supra*.

181. Section 22(d) requires a uniform price for sales to "any person." 15 U.S.C. § 80a-22(d) (1970). The Investment Company Act defines "person" as "a natural person or a company," 15 U.S.C. § 80a-2(a)(28) (1970), and defines "company" as

a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy or similar official or any liquidating agent for any of the foregoing, in his capacity as such.

Investment Company Act § 2(a)(8), 15 U.S.C. § 80a-2(a)(8) (1970).

182. Greene 379; Simpson & Hodes, *supra* note 3, at 720-21. In some instances, dealers and salesmen encouraged the formation of groups. 1 L. LOSS, SECURITIES REGULATION 407 (2d ed. 1961); Greene 379.

183. Greene 379. Competition between funds to organize and offer discounts to groups threatened the industry's desire to avoid price-cutting. SEC Investment Company Act Release No. 2798 (Dec. 2, 1958). See Hodes, *supra* note 27, at 1064.

184. SEC Investment Company Act Release No. 2798 (Dec. 2, 1958) (adopted); SEC Investment Company Act Release No. 2718 (May 29, 1958) (proposed). See 1 L. LOSS, SECURITIES REGULATION 406-07 (2d ed. 1961).

185. SEC Rule 22d-1(a)(3), 17 C.F.R. § 270.22d-1(a)(3) (1971).

186. 1974 REPORT, *supra* note 12, at 92.

The SEC has recently amended rule 22d-1 to permit funds, at their option,¹⁸⁷ to either offer discounts only to those groups that qualify as a "person" under the old paragraph (a), or to elect the expanded eligibility provisions of new paragraph (b) which permits quantity discounts to any "purchaser."¹⁸⁸ The term "purchaser" includes all individuals and families;¹⁸⁹ all groups eligible under paragraph (a);¹⁹⁰ and all groups that (1) have been in existence for six months,¹⁹¹ (2) have a purpose other than the aggregation of purchases for discount,¹⁹² and (3) are able to satisfy uniform criteria, relating to economies of scale, established by the fund.¹⁹³

The mutual fund industry generally opposed the expansion of group

187. SEC Investment Company Act Release No. 8569, 5 S.E.C. Dock. 420, 420 (1974). By giving funds the option of retaining the old restriction or taking advantage of the expanded definition, the SEC hopes to encourage a degree of voluntary competition and to cushion any adverse impact on specific dealers. See 1974 REPORT 90 n.2.

188. SEC Investment Company Act Release No. 8569, 5 S.E.C. Dock. 420, 420 (1974).

189. *Id.* See Greene 376-77 (family purchase always viewed as "single transaction").

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191. *Id.*

192. The requirement that groups have a "purpose other than to purchase redeemable securities of a registered investment company at a discount," SEC Rule 22d-1(b)(3)(ii)(B), 17 C.F.R. § 270.22(d)-1(b)(3)(ii)(B) (1975), is more than a vestige of the anti-grouping provision enacted in 1958. See notes 183-85 *supra*. It is a compromise intended to allay industry fears that "the broad availability of relatively low group prices might discourage retailers from making an effort to sell fund shares on an individual basis." 1974 REPORT 90. The strongest objections of the industry had been aimed at discounts to groups with no "unrelated purpose." See Hodes 1065 ("ad hoc buying cooperatives"); Ratner, *Regulation of the Compensation of Securities Dealers*, 55 CORNELL L. REV. 348, 380 n.192 (1970) [hereinafter cited as Ratner].

Consistent with this rationale, the rule further restricts eligibility by expressly excluding four groups having a weak organizational nexus:

[T]he term "purchaser" shall not include any group of individuals whose sole organizational nexus is that the participants are credit cardholders of a company; policyholders of an insurance company; customers of either a bank or broker-dealer; or clients of an investment adviser.

SEC Rule 22d-1(b)(3)(ii)(C), 17 C.F.R. § 270.22d-1(b)(3)(ii)(C) (1975). The SEC noted, however, that "[t]his listing may be narrowed or expanded by further amendment to the rule if experience shows that it would be appropriate." SEC Investment Company Act Release No. 8569, 5 S.E.C. Dock. 420, 420 (1974).

193. SEC Investment Company Act Release No. 8569, 5 S.E.C. Dock. 420 (1974). Other than the reduced sales effort generally supposed to accompany group sales, the SEC gave as an example "the payment by the purchaser of record-keeping and other administrative charges . . ." *Id.* Funds may also find it possible to institute "cost-saving modifications" in "paperwork procedures." 1974 REPORT 90 n.1; see SEC Investment Company Act Release No. 8514, 7 S.E.C. Dock. 201 (1974).

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eligibility.¹⁹⁴ The 1974 Report, which recommended the expansion, noted:

Members of the industry cite problems of suitability, discrimination, and "disorderly distribution." However, we believe that the core of the industry's objections is a fear that the broad availability of relatively low group prices might discourage retailers from making an effort to sell fund shares on an individual basis.¹⁹⁵

Furthermore, the industry noted, although investors would receive a discount, extensive group purchasing would require them to sacrifice some or all individual investment advice.¹⁹⁶

As adopted, the eligibility provisions and their optional nature clearly are a compromise intended to take into account the objections raised. Even though it is a compromise, however, the amendment will not diminish present suitability requirements.¹⁹⁷ Yet, these requirements do not "necessarily include an obligation on sellers . . . to assure that individual purchasers make use of all group purchase opportunities."¹⁹⁸

194. 1974 REPORT 90.

195. *Id.* But see note 192 *supra* (requirement of unrelated purposes).

196. The SEC has presumed that any investor "who feels he needs individual services . . . would not buy through a group." 1974 REPORT 91. The group, however, must have a purpose not related to investment, see note 192 *supra*, for which the individual probably joined the group. Limiting the qualifications of the group will not achieve the desired investor protection. Rather, it must be achieved by "full and fair disclosure of the character of securities sold . . ." Securities Act, Preamble, 48 Stat. 74 (1933).

197. SEC Investment Company Act Release No. 8569, 5 S.E.C. Dock. 420, 421 (1974). Generally stated, the suitability doctrine is "an obligation on the part of the dealer to recommend only securities that are suitable to the needs of the particular customer." 6 L. LOSS, SECURITIES REGULATION 3708 (Supp. 1969). The doctrine was directed against "the evils of high pressure selling." *Id.* See Best Securities, Inc., 39 S.E.C. 931, 933 (1960) ("intensive campaign of selling"). The doctrine was incorporated into the NASD Rules of Fair Practice, Art. III, § 2, and in more limited form in SEC Rule 15c2-5, 17 C.F.R. § 240.15c2-5 (1975) (governing sales of "equity funding programs"). See generally Fishman, *Broker-Dealer Obligations to Customers—The NASD Suitability Rule*, 51 MINN. L. REV. 233 (1966); Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869, 897-905 (1972); Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445; Note, *A Symptomatic Approach to Securities Fraud: The SEC's Proposed Rule 15c2-6 and the Boiler Room*, 72 YALE L.J. 1411 (1963). The suitability requirement raises two problems when mutual fund shares are sold at a discount to members of a group. See notes 198-99 *infra*.

198. SEC Investment Company Act Release No. 8569, 5 S.E.C. Dock. 420, 421 (1974). Industry members were concerned that the suitability requirement would

Moreover, rule 22d-1 speaks of sales to a "purchaser" (the group) rather than sales to the members of the group. Based upon the language of this rule, it is consistent to extend the seller's suitability obligation only to the "purchaser."¹⁹⁹ Since rule 22d-1 still limits eligibility to "bona fide" groups, there should be no disruption of the distribution process.²⁰⁰ Those funds that experience a disturbing decline in sales to individuals may simply choose to eliminate the discounts granted to groups that do not qualify under the more restrictive paragraph (a).²⁰¹

The expansion of group eligibility, tied to actual economies of scale²⁰² and affecting only those funds that opt to use it, is a reasonable approach. Calling the expansion an "experiment,"²⁰³ the SEC nonetheless has indicated that "[i]n the future . . . it may be appropriate to provide quantity discounts to any group"²⁰⁴ Although it acknowledged some disclosure and suitability problems inherent in group sales,²⁰⁵ the SEC concluded that "in the long run, this [expansion of

require them to ascertain if a purchaser, proposing to buy individually, would be eligible to participate in a group purchase. Such a duty would have benefited investors by increasing the use of quantity discounts, but would have hindered dealers by requiring additional work and decreasing the resulting sales revenues.

The Release, however, did not completely waive the requirement that sellers advise purchasers of group purchase opportunities; it said only that dealers need not "assure that individual purchasers make use of *all* group purchase opportunities." *Id.* (emphasis added). In some instances, dealers may still be obliged to recommend that an individual purchase through a group.

199. In the group purchase context, it is unclear whether the seller may simply determine that the recommended fund is a suitable investment for the group, rather than assessing the investment needs of each individual. Neither the 1974 Report nor SEC Investment Company Act Release No. 8569, 5 S.E.C. Dock. 420 (1974), considered this problem. Article III, § 2 of the NASD Rules of Fair Practice speaks of an obligation to ensure the suitability of securities recommended "to a customer." SEC Rule 15c2-5, 17 C.F.R. § 240.15c2-5 (1975), speaks of sales to a "person." If "customer" and "person" mean "group," then dealers need only assess the investment situation of the group.

This interpretation of the suitability requirements seems reasonable. The discount for group purchases is premised on the notion that the group functions as a purchasing entity. In addition, the SEC has encouraged group sales because they are a mass marketing technique that reduces selling costs. To require dealers to ensure the suitability of the investment for each individual would severely reduce the usefulness of this sales technique.

200. 1974 REPORT 90.

201. *Id.* at 90 n.2.

202. See note 193 *supra* and accompanying text.

203. 1974 REPORT 90. See SEC Investment Company Act Release No. 8659, 5 S.E.C. Dock. 420 (1974) (list may be narrowed or expanded).

204. 1974 REPORT 91 n.1.

205. *Id.* at 90.

eligibility] should result in wider, more economical and efficient distribution of mutual fund shares."²⁰⁶

C. Regulation of the Level of Sales Loads

The SEC views the high level of sales loads as an unnecessary cost to investors²⁰⁷ and fears that the disproportionately high compensation will influence broker-dealers to recommend mutual fund shares rather than other investments.²⁰⁸ Accordingly, the SEC has sought the authority to reduce sales loads.²⁰⁹ Before 1970, section 22(b)²¹⁰ granted the National Association of Securities Dealers (NASD) authority, with SEC supervision, to prohibit only "unconscionable or grossly excessive" sales loads.²¹¹ This language, the NASD and SEC believed, effectively put most high sales loads beyond the reach of any regulation.²¹² In 1966, the SEC urged Congress to place a five percent maxi-

206. *Id.* at 92.

207. *Id.* at 82. See S. REP. NO. 184, 91st Cong., 1st Sess. 8 (1969):

Mutual fund sales charges are much higher than . . . elsewhere in the securities industry. The basic New York Stock Exchange commission is about 1 percent Over-the-counter securities transactions, when executed on an agency basis, are the same as stock exchange commissions. When the dealer acts as principal the commission is usually between 2 and 3 percent

208. Transmittal Letter, *supra* note 7, at ii. See Survey 833 ("Wearing as he does the two hats of investor adviser and breadwinner, the potential for conflicts of interest is clear").

The debate over the high level of mutual fund sales loads should not be confused with the debate over the need for competition in the industry. The first is primarily a question of statistics, the second an issue of public policy. Nor should it be supposed that the repeal of § 22(d) in itself will necessarily reduce sales loads. See 1972 STUDY, *supra* note 10, at vi. Further, placing a price ceiling on sales loads may have the effect of dampening competition. But see notes 232-34 *infra* and accompanying text.

209. As an outgrowth of the 1966 REPORT, *supra* note 77, the SEC proposed that § 22(b) be amended to provide a five percent maximum sales load, with SEC authority to alter the sales load if conditions required. 1966 REPORT 223. The proposal was incorporated into S. 1659, 90th Cong., 1st Sess. § 12 (1967), as originally drafted. The proposed maximum was vigorously challenged by the industry, deleted, and replaced. For a review of SEC efforts to have § 22(b) amended, see North, *The Investment Company Amendments Act of 1970*, 46 NOTRE DAME LAW. 712 (1971); North, *supra* note 106. See also Survey, *supra* note 3, at 844-48.

210. Act of Aug. 22, 1940, ch. 686, § 22(b), 54 Stat. 823.

211. "[T]he price at which such security is offered or sold to the public shall not include an unconscionable or grossly excessive sales load". *Id.* (emphasis added).

212. 1974 REPORT 4; 1966 REPORT 218. The congressional deliberations also evince a belief that the pre-1970 statutory standard was insufficiently stringent. See S. REP. NO. 184, 91st Cong., 1st Sess. 8 (1969) (emphasis added):

mum on sales loads.²¹³ Congress, however, declined, and instead amended section 22(b) in 1970 to allow the NASD to prohibit "excessive" sales loads.²¹⁴ To prevent unreasonable limitation, the section as amended also provides that mutual fund distributors should be allowed "reasonable compensation."²¹⁵

Whether the amendment of section 22(b) was a prerequisite to regulation of the high level of sales loads is open to question.²¹⁶ Nevertheless, the NASD and SEC felt restrained by the more permissive "unconscionable or grossly excessive" standard, and they interpreted the 1970 amendment as a mandate to reduce sales loads through more restrictive regulation.²¹⁷

This committee believes there is a need to improve the protections afforded mutual fund investors in the sales commission area since existing regulatory controls provide only for the prohibition of *unconscionable or grossly excessive* sales loads.

See also Hearings on S. 1659 Before the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess., pt. 1, at 174 (1967).

213. *Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency, 91st Cong., 1st Sess., 18-19, 29 (1969).*

214. Act of Dec. 14, 1970, Pub. L. No. 91-547, § 12(a), 84 Stat. 1422, amending 15 U.S.C. § 80a-22(b) (1964). The relevant part of the section, as amended, provides:

[T]he price at which such security is offered or sold to the public shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors.

Investment Company Act § 22(b)(1), 15 U.S.C. § 80a-22(b)(1) (1970). *See generally* H.R. REP. NO. 1631, 91st Cong., 2d Sess. 28 (1970) (conference report); H.R. REP. NO. 1382, 91st Cong., 2d Sess. 3-4 (1970); S. REP. NO. 184, 91st Cong., 1st Sess. 7-8, 17-18 (1969); Manges, *The Investment Company Amendments Act of 1970*, 26 BUS. LAW. 1311 (1971); North, *The Investment Company Amendments Act of 1970*, 46 NOTRE DAME LAW. 712 (1971).

215. 15 U.S.C. § 80a-22(b)(1) (1970). As introduced in the House, H.R. 14737, 91st Cong., 1st Sess. (1969), provided that sales personnel should have "reasonable compensation . . ." H.R. REP. NO. 1382, 91st Cong., 2d Sess. 4 (1970). The conference committee agreed to follow the Senate version, and also adopted a House provision that gave the SEC authority to exempt smaller companies. H.R. REP. NO. 1631, 91st Cong., 2d Sess. 28 (1970) (conference report). This "smaller companies" provision is now the last sentence of § 22(b)(1), 15 U.S.C. § 80a-22(b)(1) (1970).

216. Although the wording of the standards is admittedly different, and the old standard connotes a higher permissible sales load, this difference is arguably semantic. *But see Survey 840:*

The assumption under which the SEC operates in this regard is that Congress has itself stated what an unconscionable sales load is. In section 27(a)(1) [15 U.S.C. § 80a-27(a)(1) (1970)], the Seventy-sixth Congress provided that loads on sales of contractual plans could not exceed nine per cent of the offering price.

217. 1974 REPORT 122.

Pursuant to this perception of increased authority, the NASD adopted²¹⁸ and the SEC approved²¹⁹ a rule setting a variable maximum on sales loads. A maximum load of 8.5 percent may be charged only by those funds providing three discount opportunities in their price structure: dividend reinvestment at no load,²²⁰ rights of accumulation,²²¹ and quantity discounts.²²²

The rule assigns each discount opportunity a percentage value (a "penalty") by which the maximum permissible load is reduced if the variation is not offered.²²³ Since each of the price variations eliminates an opportunity for the underwriter and retailer to receive a commission, the rule allows a higher load to be charged when income-reducing variations are offered. As the NASD explained,

[The] penalties are intended to correct the imperfections which the NASD perceived in the mutual fund pricing structure in order that it

218. SEC Securities Exchange Act Release No. 11593, 7 S.E.C. Dock. 570 (1975). In its letter filing the proposed rule, the NASD stated:

The purpose of the amendments is to establish a structure of maximum sales charges which will give effect to . . . the amount of the purchase and special investor privileges of benefits associated with a particular mutual fund

The [NASD] believes that the [rule is] necessary . . . to implement the provisions of Section 22(b) of the Investment Company Act [as amended].

Id. at 572, quoting Letter from NASD to SEC proposing amendment of NASD Rules of Fair Practice, Art. III, § 26 (July 16, 1975).

219. SEC Securities Exchange Act Release No. 11725, 8 S.E.C. Dock. 66 (1975). The rule amended NASD Rules of Fair Practice, Art. III, §§ 26, 29.

220. The reinvestment of dividends resembles a savings account from which interest payments are not withdrawn; the interest becomes part of the principal and itself begins to draw interest. The imposition of sales loads on the reinvestment of dividends has been called an "anomolous practice," 1966 REPORT 223, because the reinvestment of dividends involves no sales effort which would justify the load. The SEC termed the practice "one of the more flagrant deficiencies of the present load structure . . ." 1974 REPORT 127. Not all funds charge a sales load on reinvestment, however, and one fund sought and was granted permission to allow its investors to reinvest dividends at no load in any of seven funds managed by a common adviser-underwriter. SEC Investment Company Act Release No. 9003, 8 S.E.C. Dock. 308 (1975). See also SEC Investment Company Act Release No. 9048, 8 S.E.C. Dock. 574 (1975) (exemption requested).

221. A fund that offers rights to accumulation gives an investor a quantity discount when the value of his current holdings in the fund, including his immediate purchase, total more than a breakpoint in the sales load scale. 1974 REPORT 123. Funds that do not offer rights of accumulation give a quantity discount only when the amount of a single purchase exceeds a breakpoint.

222. See notes 175-206 *supra* and accompanying text. The rule allows funds to select \$10,000 or \$15,000 as their first breakpoint.

223. Data collected by Booz, Allen & Hamilton for the NASD provided the basis for the valuation of these variations. NASD, AN ECONOMIC STUDY OF THE DISTRIBUTION OF MUTUAL FUNDS AND VARIABLE ANNUITIES (1974) [hereinafter cited as NASD STUDY].

correspond more fully to a pricing structure which would exist under a system of effective competition.²²⁴

The *1974 Report* argued that a fourth variation, an exchange privilege, should also be required of funds charging the maximum sales load.²²⁵ This privilege allows investors to exchange shares of one fund for the equivalent value of shares of another fund without payment of a sales load.²²⁶ Approximately 90 percent of the industry now offers some exchange privilege, almost always between funds managed by the same adviser-underwriter.²²⁷ The NASD omitted exchange privileges because of the burden it would place on that 10 percent of the industry composed of "single-fund underwriters," who manage no other fund with which they could offer an exchange without loss of assets.²²⁸

The *1974 Report*, however, argued that the value of the privilege to investors overrode the potential hardship to these few underwriters.²²⁹ Further, the *1974 Report* noted that the privilege deprives distributors of an alternative source of income. Since fund distributors who offer an exchange privilege receive no compensation on exchanges, they should be permitted to charge a higher initial sales charge,²³⁰ a result identical to that which a competitive price structure would produce. Such an addition to the rule would be consistent with the policy of regulating sales loads in order to make them "correspond more fully to a pricing structure which would exist under a system of effective competition."²³¹

The SEC views the NASD rule as only "an interim measure which adds some rationality to the sales load structure."²³² Although the rule functions by imposing a ceiling on prices, the ceiling resembles a competitive pricing structure and is intended to establish the preconditions

224. 1974 REPORT, *supra* note 12, at 123.

225. *Id.* 128-29.

226. Section 11 of the Investment Company Act, 15 U.S.C. § 80(a)-11 (1970), permits such exchanges.

227. 1974 REPORT 128, *citing* NASD STUDY, pt. 3, at 32.

228. 1974 REPORT 128. Although the requirement that funds offer an exchange privilege could be viewed as favoring advisers who manage more than one fund, the *1974 Report* noted that "single fund underwriters might be able to avoid penalties by arranging exchange privileges with another [fund] complex . . ." *Id.* The *Report* gave no consideration to the view that this 10 percent of the industry contains a significant number of companies which, in a competitive market, might offer increased competition.

229. *Id.*

230. *Id.*

231. *Id.* at 123.

232. *Id.* at 127.

necessary for effective price competition.²³³ The SEC believes it “more important in the long run to attempt to establish greater opportunities for competition than to impose a more restrictive regulatory pattern.”²³⁴ Thus, the introduction of more detailed price regulation is merely a means to introduce competitive characteristics into the pricing structure and is not inconsistent with the overall policy of developing a competitive environment.

If other competitive variations are introduced, and if investors become more sensitive to differences in sales loads, normal market forces may begin to exert the downward pressures on prices that the rule is intended to supply.²³⁵ At that point, prescribed maximum sales loads may be replaced by a prohibition of “excessive” sales loads.²³⁶ Although such a rule will be sufficient after the introduction of competitive market forces is complete, the certainty of a “definite ceiling”²³⁷ is necessary during the present period of regulatory modification. The rule, as an interim measure, appears to be the best way to reconcile the competing needs of investors and the industry until a more competitive environment is established.

D. *Unsolicited Purchases*

At first glance, it seems unreasonable to impose a full sales load on purchases by an unadvised and unsolicited investor, because the retailer incurs no cost in securing the purchase. This argument, however, ignores the possibility that an investor might receive advice from one dealer, then purchase through another dealer, and thus appear to be an unsolicited investor.²³⁸ The *1974 Report* concluded that

the likelihood that dealers could be deprived of compensation for their services, and that fund distribution might thus be impaired, outweighs

233. *Id.* at 82. Given this purpose for the maximum sales load rule, the SEC could be expected to argue for additional variations in the future. Beyond the argument involving exchange privileges, however, there has been no indication that the SEC will do so.

234. *Id.* at 125.

235. Whether investors will develop the sensitivity to price variations that the SEC expects is open to doubt. *See id.* at 19 (price inelasticity is still a key characteristic of mutual fund merchandising).

236. *Id.* at 127.

237. *See id.*

238. *Id.* at 93-94.

the argument in favor of providing price reductions for genuinely unsolicited new investors.²³⁹

Although it was unable to formulate a workable rule that would permit unsolicited new investors to receive discounts "reflecting the absence of selling efforts with respect to their purchases,"²⁴⁰ the SEC did indicate a willingness to consider exemptions from section 22(d) if a fund was able to design a program that dealt with the practical difficulties of identifying genuinely unsolicited new investors.²⁴¹

The unsolicited "repeat" investor can be, and has been, distinguished from the unsolicited new investor.²⁴² The SEC has formulated what it believes to be a manageable rule²⁴³ to "allow underwriters [at their option] to provide for periodic 'open seasons,'"²⁴⁴ during which the sales load charged to repeat investors may be reduced. The rule reflects a balance between the desire to eliminate unjustified loads paid by repeat investors, and the danger of discouraging followup sales by depriving dealers of commissions on those sales.²⁴⁵ The opportunity to purchase "open season" shares must (1) be limited to purchasers who are holders of record "for at least a specified period," probably one year;²⁴⁶ (2) allow each investor to purchase only "an amount not in excess of the amount of shares already owned,"²⁴⁷ (3) be disclosed through notice to shareholders and a description of the process in the prospectus,²⁴⁸ and (4) not entail suspension of regular selling efforts.²⁴⁹

239. *Id.* at 96.

240. *Id.* at 93.

241. *Id.* at 97.

242. *Id.* at 93-94.

243. *Id.* at 94. The SEC is particularly conscious of the possibility that its modifications in regulation may discourage sales, compounding the problem of extended net redemptions the industry has recently experienced. See note 172 *supra*. "A salesman who has no opportunity for additional commissions from follow-up sales may decide that the 'one-shot' earnings from an initial sale do not justify an extensive effort." 1974 REPORT 94. The SEC concluded, however, that the discouragement would be "minimal" because "sales loads are high enough to provide salesmen with reasonable compensation for each sale." *Id.* at 94-95.

244. 1974 REPORT 94. The SEC intended that the choice given to the adviser-underwriter would cushion any adverse impact that "open seasons" might have, and would introduce another variation into the mutual fund pricing structure. *Id.*

245. *Id.* at 94.

246. *Id.*

247. *Id.* at 95. Should experience show that a limitation is unnecessary, the SEC may delete the limitation from the rule. Funds will still probably be permitted to set a maximum at their discretion. *Id.* at 95 n.1.

248. *Id.* at 95. The "open season" rule was formulated as an exemption to § 22(d).

As described in the *1974 Report*, the "open season" is similar to the privilege of reinvesting dividends at no load, because the retailer expends no sales effort to secure either purchase.²⁵⁰

The rule arguably has one shortcoming; it does not include a provision for underwriters who may wish to compensate retailers for the deprivation of an opportunity to make followup sales. The *1974 Report* reasoned that

if salesmen receive enough compensation from a sale, it should not be necessary to offer the salesman the prospect of additional unrelated and perhaps unearned compensation from future purchases by the customer.²⁵¹

While such reasoning is consistent with the SEC's desire to encourage mass marketing techniques,²⁵² commissions from followup sales may be a major source of compensation for fund sales organizations. Experience with "open seasons" may show that the deprivation is not appreciable, or that the opportunity to participate in "open seasons" is sufficiently limited to protect the salesman's legitimate interest in followup sales.

E. *Combination Sales*

Mutual fund retailers often sell a wide variety of competing financial products along with mutual fund shares.²⁵³ Since the commissions from competing products may pay a portion of the cost of mutual fund distribution,²⁵⁴ the *1974 Report* concluded that it would be "desirable to recognize such cost savings and allow fund distributors to pass them along to investors."²⁵⁵

The requirement that the reduction be stated in the prospectus, however, would permit the argument that it is a "public offering price described in the prospectus" as required by § 22(d), 15 U.S.C. § 80a-22(d) (1970).

249. 1974 REPORT 96 n.1.

250. *Id.*

251. *Id.* at 95.

252. Transmittal Letter, *supra* note 7, at iv. See 1974 REPORT 11.

253. 1974 REPORT 23-26. These products include insurance, real estate investment trusts, fixed annuities, discretionary accounts, and cash management plans. *Id.*

254. *Id.* at 97:

A considerable portion of the sales charge . . . covers the cost of initially soliciting the customer . . . and counseling him [I]f a retailer sells . . . to an investor to whom he has previously or contemporaneously sold some other financial product, . . . much of the necessary solicitation and financial counseling will already have taken place and need not be repeated

255. *Id.* (footnote omitted).

Acknowledging its lack of experience in regulating combination purchases,²⁵⁶ the SEC declined to propose a comprehensive rule. Instead, the SEC indicated its willingness to consider exemptions from section 22(d)

where the investor (1) previously or contemporaneously purchased (2) from the same retailer (3) certain other types of investment products . . . (4) which are available at a separately stated price, and which are (5) distributed by the same underwriter or a company affiliated with such underwriter.²⁵⁷

The administrative problems inherent in granting discounts on combination sales are great. If the competing product is insurance, extensive state regulation may be encountered. Products that are insufficiently separated may create problems of "tie-in" sales.²⁵⁸ Nonetheless, the new approach has the potential for passing actual savings to investors, providing distributors the opportunity to experiment with new distribution strategies, and tying the distribution of mutual funds to more equitable and economical means.

F. *Secondary Trading*

At present, virtually all trading in mutual fund shares is accomplished through the issuance of new shares and the redemption of outstanding shares. Contractual restraints placed on broker-dealers by underwriters²⁵⁹ and the uniform price requirement of section 22(d)²⁶⁰ have

256. SEC Investment Company Act Release No. 8570, 5 S.E.C. Dock. 423, 424 (1974). See 1974 REPORT, *supra* note 12, at 93 & n.3.

257. *Id.* at 98-99. In announcing this policy, the SEC omitted the limitation on the kinds of investment products, and the requirement that the products be available separately. SEC Investment Company Act Release No. 8570, 5 S.E.C. Dock. 423, 424 (1974). It is doubtful that these omissions were for reasons other than brevity.

258. [A] tying arrangement may be described as an agreement to sell one product but only on the condition that the buyer also purchase a different (or tied) product

Northern Pac. Ry. v. United States, 356 U.S. 1, 5-6 (1958) (footnotes omitted). Because they tend to restrain competition for the tied product, tie-ins may violate § 1 of the Sherman Act, 15 U.S.C. § 1 (1970). See Turner, *The Validity of Tying Arrangements Under the Antitrust Laws*, 72 HARV. L. REV. 50 (1958); 1975 WASH. U.L.Q. 495, 497-98 & nn. 10-11. Unless the seller offers the tied product "on the condition" that the buyer also purchase the tied product, there is no tie-in. *Northern Pacific Ry. v. United States*, *supra*, at 5. Thus, so long as the financial products in the package are also available separately, as suggested by the 1974 Report, the tie-in problem will not arise.

259. 1974 REPORT 104.

260. The extent to which § 22(d) is responsible for the absence of secondary trading is difficult to ascertain. Because the section arguably applied to secondary trading, it is

hampered the development of a secondary market in which investors could buy and sell shares through a broker acting as agent.

Secondary trading in mutual fund shares might take place in three ways: a purchase and sale between two individuals; a transaction arranged by an independent, or noncontract, broker-dealer; or a transaction arranged by a broker-dealer under contract to sell shares issued by the fund. Exchanges between individuals are rare because of the practical difficulties of a purchaser and seller locating each other. Therefore, transactions arranged by contract and noncontract broker-dealers are the only practical possibilities.

Retail dealers have consistently either refrained from brokering secondary transactions or charged a broker's fee on the secondary transaction equal to the sales load required by their contracts with the funds' underwriters.²⁶¹ Underwriters impose the first restriction to prevent brokers from filling buy orders except with shares purchased through the underwriter, thus guaranteeing the underwriter a commission on every purchase of fund shares. The second restriction prevents the broker-dealer from cutting prices to attract purchasers and sellers.²⁶²

The Department of Justice recently brought suit²⁶³ alleging that, in imposing these contractual restrictions, the NASD and members of the mutual fund industry²⁶⁴ had violated federal antitrust law.²⁶⁵ The

likely that some broker-dealers concluded that § 22(d) prohibited them from brokering transactions and therefore refrained.

261. 1974 REPORT 104.

262. See notes 46-47 *supra* and accompanying text.

263. *In re Mutual Fund Sales Antitrust Litigation*, 374 F. Supp. 95 (D.D.C. 1973). The suit was a consolidation of the government action, *United States v. NASD*, Civil No. 338-73, and two private actions, *Haddad v. Crosby Corp.*, Civil No. 2454-72, and *Gross v. NASD*, Civil No. 426-73. After dismissal, the two private parties appealed to the Court of Appeals for the District of Columbia Circuit. The appeals were stayed pending resolution of *United States v. NASD*, 422 U.S. 694 (1974). *Gross* filed a petition for certiorari, which was denied, *Gross v. NASD*, 419 U.S. 843 (1974).

Fifty other private suits premised on similar theories were filed in other federal courts. The Judicial Panel on Multidistrict Litigation ordered the suits consolidated in the District Court for the District of Columbia, *In re Mutual Fund Sales Antitrust Litigation*, 374 F. Supp. 95, 97 n.4 (D.D.C. 1974). The district court stayed all activity in the cases. *Id.*

264. Other than the NASD, the suit involved three mutual funds, three underwriters, and nine broker-dealers. 422 U.S. at 701 nn. 7-9.

265. The Department of Justice alleged violation of § 1 of the Sherman Act, 15 U.S.C. § 1 (1970) ("Every contract . . . or conspiracy, in restraint of trade or commerce . . . is . . . illegal"). As explained by the district court, 374 F. Supp. at 97, the "gist of the complaint" was that defendants, through their sales contracts, inhibited

district court dismissed the action,²⁶⁶ holding²⁶⁷ that the mutual fund distribution system was immune from the antitrust laws. On expedited appeal,²⁶⁸ the Supreme Court affirmed the dismissal²⁶⁹ on different grounds.²⁷⁰

the growth of a secondary market in fund shares, causing public purchasers to pay "artificial and non-competitive sales loads."

266. 374 F. Supp. at 114.

267. The district court based its holding on two alternative grounds. The court first reasoned that

competition in the sale of a single fund's shares is effectively precluded by the 1940 Act which was intended, via § 22(d), to prevent the sale of fund shares at a price less than that fixed in the current prospectus.

Id. at 108. The district court relied upon two arguments to support this ground for its holding. First, the court found that § 22(d) was intended to prohibit the secondary trading that defendants were accused of restraining, 374 F. Supp. at 106, *citing* Greene, *supra* note 3, at 371. *Compare* notes 40-54 *supra* with notes 55-76 *supra*. Second, the court noted that when Congress had considered repealing § 22(d), the SEC had offered testimony which, as interpreted by the district court, indicated that § 22(d) prohibited price cutting in the secondary trading market. Congress' acceptance of this testimony, evidenced by Congress' declining to amend or repeal § 22(d), convinced the court that Congress intended § 22(d) to apply to transactions in the secondary market. 374 F. Supp. at 106-07. To reach this ground for its holding, the district court rejected the defendants' argument distinguishing "brokers" from "dealers." *See* notes 273-76 *infra* and accompanying text.

This broad holding, if affirmed, would have prohibited secondary trading by contract and noncontract broker-dealers unless the public offering price, including the sales load set by the underwriter, was maintained. It would also have prohibited any SEC action introducing secondary trading at negotiated rates. The SEC found it necessary to take issue with this holding when introducing its program to encourage the development of a secondary market. *See* 1974 REPORT 104-05; notes 285-92 *infra*.

The district court's alternative ground for its holding, however, would not have impinged on SEC regulatory control over secondary trading. Noting the "pervasive regulatory scheme" established by the Investment Company Act, the district court found a "Congressional intent to immunize the investment company industry from the impact of the antitrust laws." 374 F. Supp. at 110. Because the Supreme Court ruled that it is the "pervasive regulatory scheme" that shields mutual fund trading restrictions from antitrust liability, the SEC clearly has the authority to modify that regulatory scheme to make it more competitive.

268. Because the United States was complainant, and the case alleged violation of the federal antitrust laws, the Expediting Act, ch. 646, § 17, 62 Stat. 989, required the government to appeal directly to the Supreme Court. Because *Gross* and *Crosby* did not involve the United States as complainant, appeal from the dismissal in those cases was to the Court of Appeals for the District of Columbia Circuit.

269. *United States v. NASD*, 422 U.S. 694 (1975) (5-4 decision), *affirming In re Mutual Fund Sales Antitrust Litigation*, 374 F. Supp. 95 (D.D.C. 1973). The impact of the decision on antitrust law is treated in Note, *SEC Regulation as a Pervasive Regulatory Scheme—Implied Repeal of the Antitrust Laws with Respect to National Securities Exchanges and the NASD*, 44 *FORD L. REV.* 355 (1975).

270. The Court began its analysis by framing the issues:

The SEC, as *amicus curiae*, argued to the Supreme Court that section 22(d) is inapplicable to secondary trading. The section states that “no dealer shall sell . . . except at a current offering price,”²⁷¹ and the SEC urged the Court to distinguish between “brokers” and “dealers.”²⁷² The Investment Company Act treats the terms separately,²⁷³ defining a broker as “any person . . . effecting transactions in securities for the account of others,”²⁷⁴ and a dealer as “any person . . . buying and selling securities for his own account.”²⁷⁵ Since a broker-dealer arranging secondary transactions acts only as the agent of the buyer and seller,²⁷⁶ the SEC argued that the broker-dealer acts as a statutory “broker” and therefore is not covered by the section 22(d) requirement.²⁷⁷

The questions presented require us to determine whether § 22(d) *obligates* appellees to engage in the [restriction of secondary trading] and thus necessarily confers antitrust immunity for them. If not, we must determine whether such practices are *authorized* by § 22(f) and, if so, whether they are immune from antitrust sanction.

422 U.S. at 705 (emphasis added).

271. Investment Company Act § 22(d), 15 U.S.C. § 80a-22(d) (1970), *quoted in note 2 supra*.

272. The Investment Company Act § 2(a)(11) defines “dealer” as “any person regularly engaged in the business of buying and selling securities for his own account, through a broker or otherwise” 15 U.S.C. § 80a-2(a)(11) (1970) (emphasis added). A “broker” is “any person engaged in the business of effecting transactions in securities for the account of others” Investment Company Act § 2(a)(6), 15 U.S.C. § 80a-2(a)(6) (1970) (emphasis added).

273. *See* 422 U.S. at 712 & n.22.

274. Investment Company Act § 2(a)(6), 15 U.S.C. § 80a-2(a)(6) (1970).

275. Investment Company Act § 2(a)(11), 15 U.S.C. § 80a-2(a)(11) (1970).

276. [T]he most apparent distinction between a broker and a dealer is that the former effects transactions for the account of others and the latter buys and sells securities for his own account. . . . [T]he terms of the Act [do not] compel the conclusion that a broker-dealer acting in a brokerage capacity would be bound by the § 22(d) dealer mandate.

422 U.S. at 713. The Department of Justice had argued that since the word “regularly” appears in the definition of “dealer,” *see note 272 supra*,

any person who purchases and sells securities with sufficient regularity to qualify as a statutory dealer is thereafter bound by all dealer restrictions, regardless of the nature of the particular transaction in question.

422 U.S. at 712-13. The Court, reasoning that “the critical distinction relates to their transactional capacity,” *id.* at 713, rejected this argument.

277. The SEC had adopted this interpretation well before the decision by the Supreme Court. *See* 1974 REPORT 104 & n.3, *citing* Oxford Co., Inc., 21 S.E.C. 681 (1946), Investment Company Act Release No. 87 (March 14, 1941), Letter from Director, Division of Corporate Regulation, to Edward J. Esap (March 18, 1966), and Letter from Chief Counsel, Division of Investment Management Regulation, to George A. Bailey, Jr. (April 24, 1973). The Supreme Court reasoned that the SEC interpretation was “entitled to considerable weight.” *United States v. NASD*, 422 U.S. 694, 719 (1975).

The Court accepted this argument, which the district court had rejected,²⁷⁸ and thus found it necessary to rely upon the second holding of the district court:²⁷⁹ section 22(f)²⁸⁰ grants mutual funds the power to restrict, and the SEC the power to regulate, the transferability of fund shares. The Court held that section 22(f) established a "pervasive regulatory scheme"²⁸¹ that immunized contractual restrictions on transferability from the antitrust laws.²⁸² This rationale left the SEC, unhampered by section 22(d)²⁸³ or the antitrust laws,²⁸⁴ to use its regulatory authority under section 22(f) to introduce secondary trading gradually.

Even before the Supreme Court's decision, the *1974 Report* recommended the gradual elimination of restraints on brokered transactions.²⁸⁵ The SEC, having decided that section 22(d) was inapplicable

278. 422 U.S. at 720. The district court clearly begged the question in stating: "This argument, however, ignores the price maintenance purpose of § 22(d) . . ." 374 F. Supp. at 104.

279. 422 U.S. at 720.

280. Investment Company Act § 22(f), 15 U.S.C. § 80a-22(f) (1970):

No registered open-end company shall restrict the transferability of any security of which it is the issuer except in conformity with the statements with respect thereto contained in its registration statement nor in contravention of such rules and regulations as the Commission may prescribe. . . .

281. 422 U.S. at 735.

282. Here implied repeal of the antitrust laws is "necessary to make the [regulatory scheme] work." [W]e have implied immunity . . . to assure that the federal agency entrusted with regulation . . . could carry out that responsibility free from the disruption of conflicting judgments that might be voiced by courts exercising jurisdiction under the antitrust laws.

Id. at 734, quoting *Silver v. New York Stock Exchange*, 373 U.S. 341, 357 (1963).

283. Had the Court found § 22(d) applicable to secondary trading, no significant amount of brokerage would have developed. The secondary market that existed before 1940 depended upon the broker's ability to purchase and sell shares at slightly better prices than the fund offered, *see* note 47 *supra*. If § 22(d) required brokers to sell only at the offering price set by the fund, they would have no way to attract the number of purchasers needed to maintain a secondary market.

284. As recommended by the *1974 Report*, the SEC wished to introduce secondary trading gradually. 1974 REPORT 104-07. The contractual and transferability restrictions would have been unenforceable if the Supreme Court had found the antitrust laws applicable. This sudden establishment of secondary trading, the SEC feared, would have disrupted the entire mutual fund distribution system. 1974 REPORT 105. As introduced, the secondary market is subject to discretionary regulation by the SEC and NASD. *See* notes 289-93 *infra* and accompanying text.

285. *See* 1974 REPORT 105-09 (elimination of restraints recommended); SEC Investment Company Act Release No. 8570, 5 S.E.C. Dock. 423, 424-25 (1974) (intention to eliminate restraints announced).

to secondary trading,²⁸⁶ prompted the NASD to amend its Rules of Fair Practice to prohibit such contractual restrictions.²⁸⁷ If funds attempt to circumvent this prohibition by restricting the transferability of their shares or imposing excessive transfer fees, the SEC will adopt a rule under section 22(f) prohibiting such restrictions.²⁸⁸

The SEC will continue to regulate the brokered market in mutual fund shares. The NASD rule allows funds to "impose a reasonable flat service fee" upon the transfer of shares.²⁸⁹ The reasonableness of the fee depends upon two factors: the cost of recording the transfer,²⁹⁰ and the sales load of which the underwriter is deprived through brokerage rather than redemption and sale.²⁹¹ Although the underwriter does not participate in the brokered transaction, compensation for him is allowed "to help ensure that all shareholders . . . bear a fair share of mutual fund distribution costs."²⁹² If secondary trading of a fund's shares becomes "extensive," the rule allows the NASD to exempt the fund from the prohibition on restrictive transfer fees.²⁹³

The SEC has admitted the difficulty of predicting the impact bro-

286. 1974 REPORT 104.

287. SEC Investment Company Act Release No. 8570, 5 S.E.C. Dock. 423, 424 (1974).

288. Section 22(f) prohibits funds from restricting "the transferability or negotiability" of their shares "in contravention of" SEC rules. 15 U.S.C. § 80a-22(f) (1970). See 1974 REPORT 105.

289. 1974 REPORT 105-06. The NASD rule will probably both require funds to calculate the fee as a percentage of the redemption value (net asset value) of the shares traded, and limit the fee to a maximum of one percent. Cf. *id.* at 106 n.1.

290. Since transfer fees must not be so high that they discourage secondary trading, the rule will probably require funds to show that the fee is related to costs actually incurred. *Id.*

291. See *id.*

It may be argued that the services performed by the underwriters do not directly benefit investors who purchase shares from other individuals through a broker. However, mutual fund offerings . . . are continuous; therefore, persons who buy and sell shares do benefit indirectly from the underwriter's services . . . in that the underwriter helps to create the continuous demand which is basic to the functioning of such a market [T]hey should help pay the cost of such services.

292. *Id.* The "service fee" is intended "to help neutralize any adverse impact upon the fund's primary distribution system, and to help ensure that transactions in a brokered market do not injure existing shareholders." *Id.* at 105.

293. The 1974 Report recommended that the SEC permit funds to restrict the transferability of their shares

if the fund could show that such a market . . . had become so extensive and price-competitive as to present a significant threat to the fund's primary distribution system.

Id. at 108.

kered transactions will have on the primary distribution system.²⁹⁴ The industry has argued that such a market will divert a substantial amount of sales compensation from the distribution system, discouraging new sales and resulting in net redemptions.²⁹⁵ This fear of net redemptions fails to recognize that shares involved in brokered transactions are not redeemed, but remain outstanding. Although sales may decrease, redemptions should decrease at a commensurate rate.²⁹⁶ Further, the decrease in sales load revenues should be balanced by lowered distribution costs,²⁹⁷ the transfer fee paid to the underwriter,²⁹⁸ and the reduced need for distribution.²⁹⁹ The development is a sound one and should be welcomed by investors as a long overdue reform.

G. *Broker's Fees for Sales of No-Loads*

The principal method of compensating dealers for the sale of no-load shares has been through the use of reciprocal brokerage practices³⁰⁰ and

294. *Id.* at 105.

295. New sales would be discouraged if the cost of the overall sales effort remained constant while the number of shares sold and the amount of sales load revenue declined. Although overall sales revenues will decline, so will the need to sell new shares and the cost incurred in distributing them.

296. In other words, for every sales load of which an underwriter is deprived because a prospective purchaser bought his shares in a secondary market, a similar number of redemptions must be avoided as a result of the investor's sale in the secondary market.

297. The SEC expects that the introduction of more effective advertising and mass marketing techniques will reduce distribution costs significantly. 1974 REPORT 88; Transmittal Letter, *supra* note 7, at i. Compare Statement of Robert Loeffler of Investors Diversified Services, Inc., *quoted in* 1974 REPORT 60, with Written comment of Philip C. Smith of National Securities and Research Corp., *quoted in* 1974 REPORT 53.

298. See notes 289-90 *supra*.

299. See notes 295-96 *supra* and accompanying text.

300. See generally Fogel v. Chestnut, 533 F.2d 731 (2d Cir. 1975); Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971), *noted in* 13 WM. & MARY L. REV. 530 (1971); Miller & Carlson, *Recapture of Brokerage Commissions by Mutual Funds*, 46 N.Y.U.L. REV. 35 (1971); Note, *The Use of Brokerage Commissions to Promote Mutual Fund Sales*, 68 COLUM. L. REV. 334 (1968); Note, *Conflict of Interest in the Allocation of Mutual Fund Brokerage Business*, 80 YALE L.J. 372 (1970). When executing a trade in portfolio securities, the adviser may place the order (and therefore the brokerage commission) with a broker-dealer who also retails shares of the fund. This practice, permissible as long as patronage is not given *in return* for the sale of fund shares, is limited in a number of ways. First, fund officers, including the adviser, have a fiduciary duty to the fund and its shareholders "to see the most favorable execution of portfolio transactions . . ." Delaware Mgmt. Co., 43 S.E.C. 392, 395 (1967). Second, if the reciprocity practice is followed regularly, it may constitute an anticompetitive practice in violation of § 1 of the Sherman Act, 15 U.S.C. § 1 (1970). See *United States v. General Dynamics Corp.*, 258 F. Supp. 36 (S.D.N.Y. 1966); Ratner 383.

“dealer-directed give-ups.”³⁰¹ The recent prohibition of such practices, however, eliminated this compensation.³⁰² Dealers are now faced with the prospect of marketing securities for which they receive no direct, and diminished indirect, compensation. The SEC has proposed to remove this resultant “disincentive”³⁰³ by permitting brokers, acting independently of the fund,³⁰⁴ to charge a fee for the sale of no-load fund shares “somewhat comparable” to the fee charged on other investments.³⁰⁵

This approach presents two problems. First, the no-load label is misleading if a fee is charged for the sale of the shares.³⁰⁶ Second, the resulting variation in purchase price appears to violate the uniform price requirement of section 22(d).³⁰⁷ The SEC has attempted to avoid these problems by reasoning that if the broker’s charge is “separate and apart from the price of the fund share,”³⁰⁸ it can be distinguished from a sales load. Thus, the purchaser pays a uniform purchase price that does not include a sales load, but then pays a separate fee to his broker for services rendered in connection with the sale. Arguably, such an arrangement would maintain the uniformity of purchase price and the truth of the no-load label.

301. A “give up” is the practice of a customer (the fund) directing the broker with which a transaction is placed to split the commission with other brokers whom the fund wishes to reward. In 1968, amendment of the exchanges’ rules or constitutions prohibited the practice. *See, e.g.*, NYSE Const. art. XV, § 1; AMEX Const. art. VI, § 1. *See* 1966 REPORT, *supra* note 77, at 172; Ratner, *supra* note 192, at 357-58; Romanski, *The Role of Advertising in the Mutual Funds Industry*, 13 B.C. IND. & COMM. L. REV. 959, 972-75 (1972). Some techniques resembling the “give-up” have persisted. Romanski, *supra*, at 975-76.

302. *See* notes 300-01 *supra*.

303. 1974 REPORT 110. This “disincentive” is not only harmful to the industry because it reduces sales, but also because discrepancies in sales compensation may “unduly influence” broker-dealers’ advice to investors. 1966 REPORT 221.

304. *See* notes 308-12 *infra* and accompanying text.

305. 1974 REPORT 110.

306. This was the SEC position until 1974. *See* SEC Investment Company Act Release No. 7475 (Nov. 3, 1972):

The imposition of any charge for recommending the shares or for effecting the purchase of such a fund, especially if the fund encourages or has knowledge of the practice, has been viewed as an impermissible deviation from the prospectus representation as to no-load status

The NASD argued that funds should not be allowed to maintain their “no-load” label if additional charges are levied. 1974 REPORT 111, *quoting* Written comment of NASD.

307. Since two brokers might charge different amounts, the deviations from the no-load “public offering price described in the prospectus” would clearly violate § 22(d), 15 U.S.C. § 80a-22(d) (1970). *See* SEC Investment Company Act Release No. 7475 (Nov. 3, 1972).

308. 1974 REPORT 112-13.

For the broker's charge to "be viewed as separate and apart," there must be no formal or informal distribution agreement between the fund and the dealer,³⁰⁹ the entire fee must be retained by the broker,³¹⁰ the fund must not encourage brokers to charge such a fee,³¹¹ and the fee may cover only services not offered by the fund.³¹² Additionally, the retailer must disclose to investors that shares are available at no load from other dealers,³¹³ the prospectus must disclose the possibility of such a fee,³¹⁴ and the fee must be reasonable.³¹⁵

This new approach to the sale of no-load shares, although laudable in its attempt to introduce a more competitive environment, presents a number of difficult complications. The rationale that brokers' fees can be separated from the purchase price of the share would seem to apply with equal force to all fund sales—and the SEC has admitted the statutory barrier that section 22(d) presents to such action. Notwithstanding disclosure in the prospectus that a broker's fee may be charged on the sale, the "no-load" label inaccurately connotes that no sales charge will be imposed. The label should be removed.³¹⁶ It is difficult to imagine a dealer selling fund shares without at least an "informal agreement" with the fund or its underwriter, yet the opportunity to charge a fee for the sale of no-loads requires that there be no agree-

309. *Id.* But see note 316 *infra* and accompanying text.

310. 1974 REPORT 112. None of the service charge may be surrendered to the underwriter because the costs are all incurred by the dealer and because the underwriter represents the fund as its external management. See notes 10-11 *supra*.

311. 1974 REPORT 113.

312. *Id.* at 113 n.1. Expenses or fees that are "properly chargeable to sales or promotional activities" are included in the definition of sales load. Investment Company Act § 2(a)(35), 15 U.S.C. § 80a-2(a)(35) (1970). If the fund offered the selling services, and the broker charged for them independently, the result would be a variation in the sales load which is impermissible under § 22(d).

313. Disclosure would guarantee that "the fee would be one which the customer would pay voluntarily to a third person in order to compensate him for certain selling services." 1974 REPORT 113.

314. *Id.*

315. The reasonableness of the fee will be determined "considering the size of the transaction and the extent of the services provided." 1974 REPORT 114. The SEC contemplates that the competitive factors of negotiability of the charge and availability of shares at no load will keep brokers' fees at a reasonable level. *Id.* at 114 n.1.

316. See note 306 *supra*. See also 1974 REPORT 111, quoting Written comment of NASD:

[T]he designation of "no-load" constitutes the backbone of the marketing strategies for those funds. If broker-dealers were allowed to make a charge for "recommending and effecting" a sale, it would be misleading to characterize such a fund as "no-load."

ment.³¹⁷ Further, disclosure of the possibility of such a charge in the prospectus would appear to suggest, if not encourage, that brokers charge such a fee. Finally, rather than responding to interpretive requests, the SEC should formulate and adopt a rule clearly outlining the contemplated exemption.³¹⁸ In the absence of such a rule, the distinction between "purchase price" (including a sales load) and "purchase price" plus "broker's fee" is too fine to avoid confusion for investors and challenge in court.

IV. LEGISLATIVE PROPOSAL

The optional variations in the pricing structure of mutual fund distribution have been introduced by the SEC pursuant to its power to promulgate rules and grant exemptions from the provisions of the Investment Company Act. The SEC will need additional authority if it becomes necessary to make the variations mandatory, or if retail price competition is to be further introduced. As part of its program, the SEC will forward to Congress legislation that would increase SEC authority in two ways.³¹⁹

First, the legislation would grant the SEC "increased administrative discretion to deal flexibly with mutual fund pricing in the future."³²⁰ The 1974 Report recommended that the legislation be "analogous"³²¹ to a provision of the National Securities Market System Act³²² that gives the SEC authority to

conditionally or unconditionally exempt any security or transaction or any class of securities or transactions from any such prohibition if the Commission deems such exemption consistent with the public interest, the protection of investors, and the maintenance of fair and orderly markets.³²³

317. See text accompanying note 309 *supra*.

318. Cf. text accompanying note 237 *supra*.

319. 1974 REPORT, *supra* note 12, at 115-18. As of April 19, 1976, the SEC had not forwarded any proposed legislation to Congress.

320. *Id.* at 121.

321. *Id.* at 116 n.1.

322. 15 U.S.C. § 78k-1(c)(3)(A) (Supp. V 1975).

323. *Id.* Compare S. REP. NO. 93-865, 93d Cong., 2d Sess. 17 (1974) ("In light of the possibility that the fears expressed by the NYSE and others may be realized . . . the SEC should be vested with flexible and effective power . . ."), with 1974 REPORT 116-18 ("Obviously, a precise determination of what actions should be taken in the future can only be based upon the facts appearing at that time . . .").

Since it is difficult to predict the impact each newly introduced variation in the pricing structure will have, the SEC clearly needs the desired authority and flexibility.

Second, amendment of section 22(d) would clarify congressional approval of the course of regulation selected by the SEC.³²⁴ The introduction of variations in the pricing of mutual funds is a departure from the traditional requirements of section 22(d). Amendment or replacement of the section would not only remove any doubt about the legality of the current program of voluntary price variation, but would also ensure that retail price competition is reached with legislative endorsement.

V. CONCLUSION

The retail price maintenance requirement of section 22(d) has produced an inequitable and inefficient mutual fund distribution system. The recent period of net redemptions and the high level of sales loads were symptomatic of these problems. The recent modifications in SEC regulations, to the extent that they are intended to revitalize sales and reduce sales loads, should alleviate many of the problems.

Some of these modifications, however, have been made at the expense of basic principles of federal securities law. The tombstone advertisement, originally intended to permit announcement of an offering, now

The form this legislation will take is, however, open to some question. In a speech before the Annual Mutual Funds and Investment Management Conference, Anne P. Jones, Director of the Division of Investment Management Regulation of the SEC, recommended that § 22(d) be amended to be a "fair trade" law, *see* note 3 *supra*, under which funds, at their option, could fix sales loads. *See* BNA SEC. REG. & L. REP. No. 334, at A-1, A-2 (March 17, 1976):

The Director advocated that the necessary legislation be structured so that the SEC be given the authority to reinstitute compulsory fixed loads should [a] "fair trade" system threaten the mutual fund industry's distribution system. Should competitive loads function well, the Commission might consider requiring price competition. Ms. Jones stressed that this was her own personal view

Notwithstanding Ms. Jones' disclaimer, this position represents a significant recantation of the 1974 Report's commitment to move the industry toward a competitive pricing structure.

[A]n exaggerated fear of disorderly distribution should not be permitted to form a pretext for avoiding the introduction of price competition which, while perhaps difficult and even unprofitable for particular funds and their underwriters . . . would be to the benefit of investors and the fund industry generally.

1974 REPORT 115.

324. 1974 REPORT 115; Transmittal Letter, *supra* note 7, at vii.

looks like a medium capable of selling securities rather than provoking interest in prospectuses.³²⁵ The retention of the "no-load" label by funds for which a brokerage fee is charged is misleading.³²⁶ The SEC should reassess these modifications, not in light of the condition of mutual funds, but rather in light of the federal securities laws.

The SEC program, in general, is a long overdue reform. The inequitable and disruptive practices to which section 22(d) was addressed are now controlled by more specific measures. The mutual fund industry is now threatened, not by the dilution abuses that existed in 1940, but rather by its reliance on the inefficient selling system that retail price maintenance produced. The gradual change in regulation should be accompanied by a changed selling system. Competitive variations in sales loads are a welcome development.

325. See notes 149-61 *supra* and accompanying text.

326. See notes 306, 308, 316 *supra* and accompanying text.