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THE CONTINUING CONTROVERSY SURROUNDING THE UNIFORM PRICE MAINTENANCE PROVISIONS OF THE INVESTMENT COMPANY ACT OF 1940*

*Murray L. Simpson*** and Scott Hodes****

I. Introduction and Scope

The dust of battle has yet to settle on recent attacks made on Section 22(d), the uniform price maintenance provisions of the Investment Company Act of 1940[1] [hereinafter cited as the "1940 Act"], by the Securities and Exchange Commission[2] and by Senators John Sparkman of Alabama[3] and Thomas J. McIntyre of New Hampshire.[4] Basically, Section 22(d) of the 1940 Act requires that any sale of a redeemable security issued by any investment company registered[5] under the 1940 Act, by its principal underwriter or any dealer, be made to "any person" (except a dealer) only "at a current public offering price described in the prospectus."[6] In other words, the retail offering price of a mutual fund share must be uniform to retail purchasers.

This article will examine the background and content of Section 22(d) and the SEC's Rule 22d-1, and then consider the proposed amendment to that rule and the above mentioned legislative attacks on Section 22(d) itself. Throughout, the authors will demonstrate the reasons why Rule 22d-1 should not be amended as proposed and why Section 22(d) should not be repealed.

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* This article was completed on April 8, 1969.

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1 15 U.S.C. § 80a-22(d) (1964).

2 SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 21 (1966) [hereinafter cited as the SEC 1966 REPORT]. *See also* SEC Investment Company Act Release No. 5507 (Oct. 7, 1968).

3 S. 34, 91st Cong., 1st Sess. § 12(c) (1969).

4 S. 296, 91st Cong., 1st Sess. § 12(a) (1969).

5 15 U.S.C. § 80a-8 (1964).

6 Section 22(d), 15 U.S.C. § 80a-22(d) (1964), reads as follows:

> 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: *Provided, however,* That nothing in this subsection shall prevent a sale made (i) pursuant to an offer of exchange permitted by section 11 hereof including any offer made pursuant to clause (1) or (2) of section 11 (b); (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 12.

II. Pre-1940

While the legislative history of the Investment Company Act of 1940 is relatively silent on the reasons for the passage of Section 22(d), the purposes underlying the provisions of this section have been alluded to as being (1) to prevent discrimination among purchasers, (2) to provide for an orderly distribution of mutual fund shares, and (3) to prevent "cut-throat" competition between those dealers who were under contract with a principal underwriter and those who were not.[7]

Prior to the enactment of Section 22(d) investment dealers who had entered into distribution agreements with principal underwriters or registered investment companies were placed at a competitive disadvantage by dealers who were selling these shares without any contractual restrictions. Dealers who had contracts with a principal underwriter were obligated to offer shares in a mutual fund subject to a predetermined sales charge, while non-contractual dealers could offer the same shares subject to any sale charge they chose to set. Moreover, non-contractual dealers could take advantage of large underwriting spreads by purchasing shares directly from investors or from an over-the-counter trading market at prices somewhat lower than the prices being paid by contract dealers, thereby being in a position to offer these shares at different prices.[8] As a result of this market environment, dealers were cancelling their contracts with principal underwriters, thus creating a disruption in the orderly and continuous system of distributing mutual fund shares. The advocates of enacting Section 22(d) sought to curtail this type of competition in order to prevent discrimination among purchasers and to insure the orderly distribution essential for a security having the unique feature of continuous redeemability. The passage of Section 22(d) was the legislative antidote.

III. The Aftermath: 1940-1958

Operating under the mandate of Section 22(d) — orderly distribution and prevention of price discrimination — the SEC issued an interpretive release in 1941 making it clear that the charging of varying prices for varying amounts of securities based on a "uniform scale of sales loads" is permissible if the "current offering price" is readily ascertainable by a reading of the prospectus.[9] Since the purpose of the disclosure of the "current offering price" is to prevent "discrimination among investors," it was therefore established shortly after the enactment of the 1940 Act that "at least one of the purposes" of Section 22(d) was to assure uniform non-discriminatory treatment of purchasers of mutual fund shares. In interpreting the meaning of "current offering price"[10] to allow varying prices for varying amounts, *i.e.*, quantity discounts, this release dealt only

7 SEC 1966 REPORT 219. Investors Diversified Services, Inc., 39 S.E.C. 829, 831 (1960). For a thorough discussion of Section 22(d) from its enactment through 1959, see Greene, *The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940,* 37 U. DET. L.J. 369 (1960).

8 The pre-1940 trading market is described in SEC, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, pt. 2, at 324-25 (1940).

9 SEC Investment Company Act Release No. 89 (March 13, 1941).

10 *Id.*

with a "single investment" of a specified sum. Relying on the SEC's acquiescence in quantity discounts in this situation, many investment companies soon became liberal in their interpretation of what would be considered a "single investment" or a "single transaction" for purposes of obtaining a quantity discount, and as a direct result, allowed such discounts for "single" purchases by a trustee, fiduciary, or custodian acting for, or on behalf of, more than one account.[11] Investment companies considered the fiduciary or other representative making the purchases as a "single purchaser," thus coming within the purview of "any person" under the provisions of Section 22(d). The practice of aggregating purchases by "any person" as a "single transaction" soon led to the wholesale formation of hybrid group purchase arrangements to take advantage of the quantity discount.

Even those companies that were not so liberal in their interpretation of a "single transaction" received favorable responses from the SEC when they asked permission to give a discount for aggregated transactions. Examples can be found in two opinions issued by the SEC in 1950. In *Investors Diversified Services, Incorporated,* the Commission approved a cumulative volume discount which entitled an investor to a reduction in sales load for the current purchase when his aggregate purchases to date reached or passed a sales breakpoint.[12] In *Axe Houghton Fund, Incorporated,* the SEC approved a volume discount for the aggregate purchase of shares in more than one mutual fund distributed by the same principal underwriter.[13] (While volume discounts and varying sales loads based on the quantity of shares sold does enhance price discrimination between different investors based on their financial ability to make a larger dollar commitment, a recent judicial attack alleging that such practices created price discrimination in violation of the Robinson-Patman Act was thwarted when the United States District Court for the Northern District of Illinois held that "the system of cumulative quantity discounts in the sale of mutual fund shares is governed exclusively by the SEC under the Investment Company Act, and is immune from attack under the Robinson-Patman Act.")[14]

In short, the widespread practice of freely interpreting a "single transaction" to obtain a group discount caused concern among both the industry and the SEC over the uniform price standard requirement of Section 22(d). A former SEC official, in commenting on the development of these practices, stated that:

> [I]t soon became obvious from the widespread and increasing number of group plans that they were not being devised spontaneously by astute investors but were receiving their inspiration from specialists. Industry leaders and organizations, alarmed by the inroads being made upon the uniform

11 Some investment companies did obtain specific SEC exemptive relief for such "discounts" pursuant to Section 6(c) of the 1940 Act, 15 U.S.C. § 80a-6(c) (1964). Greene, *supra* note 7, at 377.

12 SEC Investment Company Act Release No. 1504 (Aug. 15, 1950). It is interesting to note that the SEC has recently suspended part of a brokerage firm's mutual fund sales activities where sales were made close to, but under, a sales charge breakpoint on the basis that salesmen are "duty bound" to advise customers of the breakpoint. Paine, Webber, Jackson & Curtis, SEC Securities Exchange Act Release No. 8501 (Jan. 22, 1969).

13 SEC Investment Company Act Release No. 1505 (Aug. 17, 1950).

14 Baum v. Investors Diversified Services, Inc., 286 F. Supp. 914 (N.D. Ill. 1968), *appeal docketed,* No............., 7th Cir., ...

price standard, appealed to the Commission to stem what appeared to be evasions of the statute.[15] (Footnote omitted.)

The Commission's response is next considered.

IV. The Era of Rule 22d-1

The Commission soon concluded that the industry practice of allowing quantity discounts to various groups of investors was undesirable because (1) some members of these groups were not being furnished with a prospectus of the fund and (2) discrimination contrary to the intent of Section 22(d) was being practiced since reduced group prices were not being granted to individual members of the public on the basis of the quantity purchased but rather to numerous individuals comprising so-called selected "classes" of persons. These abuses were further compounded by the cooperative attitude of certain investment companies, which were soliciting or encouraging group purchases contrary to the spirit and intent of Section 22(d).[16]

After notice and public hearings on these abusive industry practices, the SEC promulgated Rule 22d-1,[17] which became effective on April 30, 1959.

15 Greene, *supra* note 7, at 379.

16 SEC Investment Company Act Release No. 2718 (May 28, 1958).

17 SEC Investment Company Act Release No. 2798 (Dec. 2, 1958); 17 C.F.R. § 270.22d-1 (1967). Rule 22d-1 provides in part as follows:

> A registered investment company which is the issuer of redeemable securities, a principal underwriter of such securities or a dealer therein shall be exempted from the provisions of Section 22(d) to the extent necessary to permit the sale of such securities by such persons at prices which reflect reductions in, or eliminations of, the sales load under any of the following circumstances:
>
> (a) In accordance with a scale of reducing sales load varying with the quantity of securities purchased by any person. The quantity entitling any person to any such reduced sales load may be computed on any of the following bases, and may include redeemable securities of other registered investment companies having the same principal underwriter as the issuer of such securities: (1) the aggregate quantity of securities being purchased at any one time; (2) the aggregate quantity of securities previously purchased or acquired and then owned plus the securities being purchased; or (3) the aggregate quantity of securities purchased by any person within a period of no more than 13 months from the date of and pursuant to a written statement of his intention, accepted by the underwriter, which provides that the purchaser intends, but is not obligated, to purchase securities within such period in a specified aggregate amount which would entitle the purchaser to a quantity discount if purchased at one time, and which further provides that each purchase made pursuant to the statement shall be made either (i) at the price applicable to the quantity of securities being purchased in each separate transaction until at least a sufficient quantity of securities has been purchased to qualify for a discount pursuant to the statement, or until the aggregate quantity specified therein has been purchased, whereupon a retroactive price adjustment for all purchases theretofore made under the statement to reflect the quantity discount to which the purchaser is then entitled pursuant to the statement shall be made by the underwriter and the dealer involved, if any, or (ii) at the price applicable to the intended aggregate quantity of securities specified by the purchaser, provided that an amount of the securities purchased shall be retained by the underwriter or held by a bank escrow agent pursuant to terms and conditions which will reasonably assure that the full applicable sales load will be charged if the purchaser does not complete the intended purchases. The statement of intention may also provide that, if the total purchases made within the period covered by the statement exceed the amount specified by the purchaser as his expected aggregate purchases, and equal an aggregate amount which would, if purchased at a single time, qualify for an additional quantity discount, a retroactive price adjustment shall be made by the underwriter and the dealer involved, if any, for all purchases made under the statement to reflect the quantity discount applicable to the aggregate amount of such purchases.

This rule codified certain previous administrative interpretations of Section 22(d) which allowed variations in the sales load to "any person." Previous Commission policy, as reflected by both exemptions and permissive industry practices, permitted groupings of purchases for quantity discounts where such groupings were voluntarily arranged without inducement by the issuer or the sales representative. However, by adopting Rule 22d-1, the SEC restricted the definition of "any person" in the statute so that group purchases, whether made directly or indirectly through a trustee, agent, custodian or other representative, could no longer qualify as a single purchase under Section 22(d). The term "any person" entitled to a quantity discount was specifically limited to include only (1) an individual together with his spouse and their minor children purchasing for his own or their own account and (2) a trustee or other fiduciary purchasing for a single trust estate or single fiduciary account (including a pension, profit sharing, or other employee benefit trust created pursuant to a plan qualified under section 401 of the Internal Revenue Code) although more than one beneficiary was involved.[18]

In effect, Rule 22d-1 departs from the "single transaction" theory and focuses upon the phrase "any person" as being the true statutory test. According to one legal authority, Rule 22d-1 "has done much to bring order and stability into the pricing methods of the mutual funds and uniformity to the form of prospectus disclosures made."[19] In further enforcing the mandate of Section 22(d) and the intent of its rule promulgated thereunder, the Commission, in 1960, denied an exemption request by an investment company which sought to continue the practice of selling to certain organizations of professional people at reduced sales loads based upon aggregating the purchases of all members of the particular organization. In denying the requested exemption, a unanimous Commission held that "[t]he purposes of the Section [22(d)] are to prevent discrimination among purchasers and to provide for an orderly distribution of such shares by preventing their sale at a price less than that fixed in the prospectus."[20]

The next critical examination of Section 22(d) developed from the SEC's attack on the overall level of sales charges. The SEC, in its *1966 Report,* stated that the growth and size of the mutual fund industry had reached the point

The scale of reducing sales load and the method of computation utilized shall be specifically described in the prospectus and shall be applicable to sales to all persons.

As used in this paragraph (a) the term "any person" shall include (i) an individual, or an individual, his spouse and their children under the age of 21, purchasing securities for his or their own account, and (ii) a trustee or other fiduciary purchasing securities for a single trust estate or single fiduciary account (including a pension, profit-sharing, or other employee benefit trust created pursuant to a plan qualified under Section 401 of the Internal Revenue Code) although more than one beneficiary is involved: *Provided, however,* That the term "any person" shall not include a group of individuals whose funds are combined, directly or indirectly, for the purchase of redeemable securities of a registered investment company jointly or through a trustee, agent, custodian, or other representative, nor shall it include a trustee, agent, custodian, or other representative of such a group of individuals.

18 For a more complete analysis of Rule 22d-1, *see* 1 L. Loss, Securities Regulation 406-10 (1961). For commentary concerning the rationale for inclusion of certain allowable reductions in sales charges, *see* Note, *The SEC Ruling Forbidding Quantity Discounts on Group Purchases from Mutual Investment Companies,* 43 Minn. L. Rev. 1212 (1959).

19 Greene, *supra* note 7, at 387.

20 Investors Diversified Services, Inc., 39 S.E.C. 829, 831 (1960).

where sales loads involved in the purchase of mutual fund shares should be re-examined. According to this same report,

> [m]ore than a quarter of a century of experience shows that the sort of competition which in fact generally prevails, i.e., competition among principal underwriters for the favor of retail dealers rather than price competition among retail dealers, has had the effect of raising rather than lowering prices to the investor.[21]

The SEC then concluded, arbitrarily we believe, that mutual fund sales charges should be lowered. It noted that one of the methods it had considered to achieve this objective would be the removal of the retail price maintenance provisions of Section 22(d), which it felt "would enable retail dealers to attract customers by offering lower prices."[22] After further analysis, however, the SEC conceded that removal of the retail price maintenance provisions of Section 22(d) would create certain "disadvantages" including:

> (1) The introduction of free competition might at least temporarily favor captive organizations that are the sole distributors of the fund shares they sell. While indirect competition resulting from public awareness of lower sales charges for shares of other mutual funds would in all probability eventually force captive organizations to reduce their prices, captive organizations would for a time enjoy an unwarranted disparity in sales compensation. They might be able to attract salesmen away from independent dealers who would be subject to direct price competition. Many principal underwriters might abandon distribution through independent dealers in favor of captive sales organizations. Thus, if the Act be amended to permit price competition in the sale of mutual fund shares, the Commission should be authorized to adopt rules designed to bring the captives' charges into line with sales charges paid by purchasers of dealers' distributed fund shares.
>
> (2) Retail price competition would permit knowledgeable investors to purchase mutual fund shares at sales loads substantially lower than those now prevailing, but others — among them those most in need of protection — might save little or nothing. This disadvantage is mitigated by the likelihood that dealers, rather than risking their good business reputation, would charge the same prices to all of their customers who invest the same amount in shares of a particular fund.[23]

As a consequence of these findings, the SEC concluded that Section 22(d) should be maintained but that a fixed maximum sales charge not to exceed five percent of the net asset value per share at the time of sale be adopted. At the same time the Commission asked Congress for express statutory authority to alter the maximum sales charge by rule or regulation when, in its sole discretion, the public interest or investor protection was involved.[24]

The *SEC 1966 Report* sheds little light on the legal and/or economic justification for a five per cent maximum sales load, and there is no assurance that the

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21 SEC 1966 REPORT 221.
22 *Id.* at 222.
23 *Id.*
24 *Id.* at 223. *See also Hearings Before the Senate Comm. on Banking and Currency on S. 1659,* 90th Cong., 1st Sess. pt. 1, at 154-55 (1967) [hereinafter cited as *1967 Senate Hearings*]. *But cf.* Simpson, *Costs in the Distribution of Mutual Fund Shares,* CONFERENCE ON MUTUAL FUNDS 101-10 (CCH 1967).

elaborate law-making machinery of Congress would not soon have to be reactivated to correct this rather arbitrary means of rate fixing. It is interesting to note that while in 1967 the SEC was asking for a fixed maximum sales charge, in 1940, when the passage of the Investment Company Act was under consideration, the SEC's chief spokesman testified that the principal reason for the SEC's reluctance to recommend the imposition of a statutory maximum on sales load was the fear that "immediately the maximum would become the minimum in every case."[25]

During the 1967-68 legislative session, companion bills were introduced in the Senate (S. 1659)[26] and the House of Representatives (H.R. 9510)[27] to implement the recommendations contained in the *SEC 1966 Report.* Although the ninetieth Congress did not enact any legislation amending the 1940 Act, the Senate did pass an amended version of S. 1659 which provided that the National Association of Securities Dealers, Inc. [the "NASD"] may prescribe rules to prevent "excessive" sales loads, but at any time after eighteen months from the date of enactment of the legislation the SEC would have the power to alter or supplement any such rules adopted by the NASD.[28]

V. Proposed Amendment to Rule 22d-1

While there was still debate concerning the unsuccessful 1967 proposed mutual fund legislation, on October 7, 1968, in *Release Number 5507* under the 1940 Act, the Commission announced its proposal to amend Rule 22d-1 to delete the present prohibition against certain group purchases for quantity discounts on investment company securities.[29] The proposed amendment to Rule 22d-1 specifically deletes the present language of the rule which excludes group purchases from the definition of the term "any person," and substitutes therefor the definition of the word "person" as set forth in Section 2(a)(27) of the 1940 Act.[30] Curiously enough, this proposal came less than one month after the House Interstate and Foreign Commerce Committee voted to adjourn debate on the pending mutual fund legislation (H.R. 9510) for the remainder of the congressional session, which vote immediately followed the decision of the House Subcommittee on Commerce and Finance not to consider further the mutual fund bill passed by the Senate (S. 3724). Apparently, however, the Commission did not consider the refusal of Congress to pass legislation affecting sales charges as the final decision on the matter.

25 *Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency on S. 3580,* 76th Cong., 3d Sess., pt. 1, at 290 (1940).

26 S. 1659, 90th Cong., 1st Sess. (1967).

27 H.R. 9510, 90th Cong., 1st Sess. (1967).

28 Senator John Sparkman (D. Ala.), Chairman of the Senate Committee on Banking and Currency, on January 10, 1969, introduced new mutual fund legislation in the ninety-first Congress (*see* note 3 *supra*) which is virtually identical to S. 3724 (S. 1659, as amended) passed by the Senate in 1968.

29 SEC Investment Company Act Release No. 5507 (Oct. 7, 1968) [hereinafter cited as Release Number 5507].

30 Section 2(a) (27) of the 1940 Act, 15 U.S.C. § 80a-2(a)(27) (1964), states that " 'person' means a natural person or a company." The word "company" is further defined in Section 2(a)(8) of the 1940 Act, 15 U.S.C. § 80a-2(a)(8) (1964), to mean "a corporation . . . or any organized group of persons whether incorporated or not."

A. Expanding the "Any Person" Concept

The scope of the Commission's proposed amendment to Rule 22d-1 [hereinafter sometimes referred to as the "proposed amended rule"] appears to be in conflict with the statute itself. The statute, in effect, provides that the retail offering price of the shares of any mutual fund shall be uniform to all purchasers of that fund making the same dollar investment. However, the proposed amended rule would allow purchasers of the same mutual fund to pay different offering prices at the same time, depending upon the ability of their broker-dealer to organize a group large enough to warrant a reduction in the applicable sales charge for that fund. Consequently, the proposed amended rule would discriminate between customers in the sale of mutual fund shares by allowing an individual to purchase the same mutual fund share at a different price depending upon the size of the "group" of which the individual is a "member."[31]

While the volume discount concept which developed since the 1940 Act may have a rational basis founded upon economies generated through volume purchases, for such a volume discount to work on a non-discriminatory basis and to assure price uniformity, there must be some criteria of eligibility for the discount. As presently constituted, the definition of "any person" contained in Rule 22d-1 is designed to achieve this purpose by restricting the availability of the volume discount to a single customer investing his own money or funds which he controls.

In adopting Rule 22d-1 in 1958, the Commission criticized industry practices which had developed over the years involving discounts to groups, observing that such groupings violated the "purpose and intent" of Section 22(d) because price discrimination was involved. The Commission stated that it

> is therefore of the opinion that there is no sufficient basis for exempting such group purchases in the rule and has included in the rule an interpretive definition of "any person" which makes clear that group purchases, whether directly or through a trustee or agent, cannot qualify as a single purchase for pricing purposes under Section 22(d).[32]

The proposed amended rule goes beyond merely reversing the Commission's previous position on group purchases. By allowing for the aggregation of unrelated purchases by unrelated persons the proposed amended rule would, in effect, be repealing by administrative action the statutory requirement of price uniformity. As an example, individual investors who do not have access to a large brokerage firm or who, for various reasons, decide to deal with a small brokerage firm, are discriminated against if the smaller brokerage firm is not in a position to obtain the same quantity discount as a larger brokerage firm, due solely to the latter's ability to organize a larger "group" of purchasers at any given time. The proposed amended rule would not only create discrimination among purchasers, but also among broker-dealers, since broker-dealers having a greater clientele would be in a position to place larger "group orders" with a

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31 *Cf.* text accompanying note 20 *supra.*
32 SEC Release No. 2798, *supra* note 17.

mutual fund at any specific time, and thereby receive a distinct and unfair advantage over smaller broker-dealers.

While the Commission stated in *Release Number 5507* that such revised group discounts can be offered on a uniform and non-discriminatory basis, we believe such variations in sales charges must somehow be tied to either the economies of distribution, a factor which was not even mentioned in the Release, or to some other valid basis of classification not alluded to by the Commission. Thus, built into the mechanics of the proposed amended rule are capricious classifications and discriminations between customers and broker-dealers that have no rational basis, or at least none that can be discerned in the Commission's Release.

B. Prejudicing the Fund's Stockholders?

Another form of discrimination which could evolve from the proposed amended rule affects the existing stockholders of the mutual fund. "In order to avoid problems under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940," the Commission noted in its *Release Number 5507* that "all group purchases would be required to be handled in a manner substantially similar to ordinary brokerage transactions." This means that where limitations are imposed on the rights of an individual participant, or special charges are made, a separate security might possibly be created which would be required to be registered under the Securities Act of 1933. In turn, the issuer of this separate security might also become an investment company required to register under the Investment Company Act of 1940.[33] To avoid creating a separate security and investment company, no special fees or charges can be imposed on the participants under the "group purchases."[34] We therefore question who would bear the possible additional costs incurred by the transfer agent of the investment company in processing the individual accounts of each participant under a "single group purchase." It would appear to be unfair and discriminatory to the existing stockholders if such additional costs are paid by the fund.

C. What Is the "Current Offering Price"?

A further area of conflict between the proposed amended rule and Section 22(d) is that the latter provides that the current public offering price must be described in the prospectus. In the 1941 opinion of the Commission's General Counsel, it was stated that:

> [I]t is permissible to charge varying prices for varying amounts of redeemable securities based on a *uniform* scale of sales loads for different amounts

33 For example, such problems would arise if:
(1) sums were accumulated for material periods of time before investment; (2) special fees or charges, such as a front end load, were imposed; (3) limitations were imposed on the right of participants to withdraw securities held in custody; or (4) limitations were imposed on the rights and privileges of participants as shareholders.
SEC Release No. 5507.

34 *Id.*

> purchased. But, in my opinion, section 22(d) requires the "current offering price" to be one *readily ascertainable* by a reading of the prospectus. Therefore, I believe that the charging of varying prices is not permissible unless the prospectus definitely sets forth the price which a purchaser of any specific amount of redeemable securities will have to pay.[35] (Emphasis added.)

Since the amount of quantity discounts available under the proposed amended rule would depend upon the size of the group, a prospective investor will not know at any given time by a reading of the prospectus what discount he is entitled to for his own purchase, and therefore, the "current offering price" cannot be "readily ascertainable by a reading of the prospectus." This uncertainty in knowing the price of the mutual fund shares a customer is currently purchasing clearly seems to be contrary to the statutory requirements as previously interpreted by the Commission.

D. Suitability Problems

The proposed amended rule also leads to problems in the area of "suitability,"[36] since unlike the present limitations in Rule 22d-1, the proposed amended rule would encourage the formation of groups which have no purpose other than to qualify their "members" for discounts. Not only is it possible that a particular mutual fund security purchased by a single "group" might not be a suitable investment vehicle for each member, but the broker-dealer offering the security might not be able to meet the requirements of knowing his customer's "financial situation and needs."

E. Other Problems

Release Number 5507 also states that the proposed amended rule would not relax the obligations imposed by the Securities Act of 1933 on broker-dealers and other distributors of mutual fund shares to provide a prospectus to all persons who are solicited. Allowing quantity discounts to large groups, such as medical, dental or other professional associations, could present serious problems in compliance with the prospectus delivery requirements of the Securities Act of 1933.[37] Furthermore, since the offer of the quantity discount would obviously have to be made to all members of such an association, in order to avoid problems of discrimination, the securities of the mutual fund would have to meet the Blue Sky requirements of each state in which a member of such an association resides. Most states require registration or qualification of the mutual fund

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35 SEC Release No. 89, *supra* note 9.

36 Article III, Section 2 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc., requires that:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, REPRINT OF THE MANUAL ¶ 2152 (CCH 1968). *See also* Wilson, *Interpretation of NASD's Suitability Requirements in Sales of Mutual Fund Shares*, CONFERENCE ON MUTUAL FUNDS 21-27 (CCH 1967).

37 15 U.S.C. § 77e(b)(2) (1964).

shares even if the offer to purchase such shares is solicited in the state by a broker-dealer outside the state. In addition, the soliciting broker-dealer might have to register as a "broker-dealer" in each state in which solicited members of the association reside.

F. Conclusion

The obvious conflicts between the proposed amended rule and Section 22(d) as discussed above present sufficient support for the conclusion that this amendment should not be adopted. Furthermore, although quantity discounts are offered by investment companies on a voluntary basis, adoption of the proposed amended rule would leave the investment company industry no choice other than to compete in price-cutting for the favor of such group purchases even though this, in turn, could disrupt the orderly distribution of mutual fund shares and lower the standards of selling — all in contradiction of the spirit of the 1940 Act.

VI. Section 22(d): To Maintain or Repeal?

Despite the Commission's own reluctance, as expressed in its *1966 Report,* to recommend legislation repealing Section 22(d),[38] on January 16, 1969, Senator Thomas J. McIntyre introduced legislation which included the following reference to Section 22(d):

> Section 22(d) of the Investment Company Act of 1940 . . . is repealed.[39]

In our opinion, the repeal of Section 22(d) would re-create the chaos and abuses which Congress had hoped to eliminate in the passage of the 1940 Act.

It is well recognized by both the SEC and the investment company industry that the present retail price maintenance provisions of Section 22(d) assure an orderly and continuous system of distribution which would not otherwise exist. Such continuous distribution is essential because of the unique redeemability feature inherent in mutual funds. Although mutual funds generally have sufficient cash or liquid assets to meet current redemptions, the major source of funds for this purpose is the new money obtained through the continuous sale of its shares to new or existing shareholders. In the absence of a continuous cash flow, the mutual fund might have to keep a degree of liquidity which might not be consistent with the fund's investment appraisal of the market at any particular time.

The repeal of Section 22(d) would produce other consequences which it is believed would have an adverse effect on the public interest. Undoubtedly, a secondary market in mutual fund shares would develop with such shares being traded in much the same way and by the same firms that handle over-the-counter securities generally. Various trading firms would then "make-markets" in mutual fund shares, and over-the-counter retailers would acquire shares from these

38 SEC 1966 REPORT 223.
39 S. 296, 91st Cong., 1st Sess. § 12(a) (1969).

market-makers to meet specific customer demand. Consequently, dealers would not tend to specialize in the retail sale of mutual fund shares since the salesmen's income would be highly unstable because other dealers not so specializing would be able to offer the same shares at a lower price—a discriminatory situation which Section 22(d) was primarily designed to prevent. No dealer would promote and sell this form of long-term investment in the same manner as a growth stock, since it is the sales charge that compensates the salesman for the time and effort essential to the sale of this type of security.

It has been argued that the over-the-counter market cannot support a wide distribution of mutual fund shares. If this is true, a negative cash flow to the funds based on higher redemptions than sales, particularly in periods of market stress, may develop. This poses the question as to whether the public interest is best served by encouraging short-term trading in individual issues at the expense of the long-term investment objectives of most mutual funds.[40] Advocates of repealing Section 22(d) argue that the growth of a secondary market in mutual fund shares which would follow the repeal of Section 22(d) would soften the redemption problem since an investor desiring to sell would likely find a buyer in the firms making a market in the particular mutual fund shares. However, pre-1940 history has demonstrated that the development of a secondary market, with bargain-basement price competition, would only stimulate an excess of redemptions over sales. A former president of the Investment Company Institute has appropriately commented:

> In periods of financial stress when some increase in redemptions might be expected, the secondary market-making activities of the trading houses which have no obligation to continue trading would tend to dry up and the mutual funds would have to honor their own guarantee of redemption.[41]

Another reason advanced for the repeal of Section 22(d) is that since 1940 price competition at the retail sales level has been allegedly hampered by the price maintenance provisions of the 1940 Act.[42] We believe that this contention is without merit since Section 22(d) does not require that all mutual funds impose the same sales charge, but rather that the shares of any one mutual fund be offered at a uniform offering price. In fact, the sales charges of more than four hundred publicly offered mutual funds range from no sales charge at all to those charging a maximum of approximately eight and one-half per cent. Professor Louis Loss, in supporting the mandate of Section 22(d), stated:

> Very likely this uniform price system has been a material factor in the dramatic growth of the mutual funds. And it does not seem to have stifled competition, to judge from the number and variety of new entries into the industry as well as the range of sales charges, which run from 9 percent of the offering price down to 2 percent or, in the case of a few companies, zero.[43]

40 *See 1967 Senate Hearings, supra* note 24, at 321.
41 Statement of Dorsey Richardson, Former President of Investment Company Institute, September 12, 1966, at 15 (on file at the Library of the Securities and Exchange Commission, Washington, D. C.).
42 *See 1967 Senate Hearings, supra* note 24, at 152.
43 1 L. Loss, *supra* note 18, at 410.

In connection with attempts to create price competition on the retail level, consideration must be given to the potential deterioration in the quality of salesmen and the result this would have on the necessary services provided to the customer. It is generally recognized that the mutual fund industry imposes self-regulatory burdens unlike most other industries dealing with the public. Accordingly, securities firms are becoming increasingly selective in hiring salesmen because of the costs of their training and supervising. Retail price-cutting is obviously not conducive to budgeting for this type of self-regulation, and firms would likely be under increased economic pressures to lower standards in recruiting and training new salesmen.

It could also be argued that the repeal of Section 22(d) may lead salesmen who are not under proper supervision increasingly to sell mutual funds as speculative trading vehicles, thus making portfolio management more difficult. The management of the fund would therefore be under increased pressures to show quick, spectacular performances to discourage salesmen from switching customers to another mutual fund. Furthermore, to the extent that this trading pattern develops, funds not performing well at a given moment would be faced with increased redemptions, which in itself would probably complicate portfolio management.

The 1963 *Special Study of the SEC* expressed concern over "switching" of mutual fund shares and made a specific recommendation that the Commission exercise its rule-making power to curtail recommendations of switches from one mutual fund to another.[44] The sale of mutual funds without the protection of Section 22(d) could create a climate which would encourage salesmen to recommend switching, and this would clearly not be in accord with the philosophy underlying this *Special Study* recommendation.

In our opinion, the sale of mutual fund shares through direct dealer competition with no uniformity in sales charges for the same mutual fund shares would be a totally unrealistic approach for an industry which requires and demands "suitability" as the prime consideration in the purchase and sale of securities. We therefore believe that the repeal of Section 22(d) would tend to create the potential for:

(1) discriminatory pricing in favor of large volume purchasers who are generally in a position to arrive at ad hoc prices by negotiation;

(2) speculative market trading rather than long-term investing; and

(3) the impairment and withdrawal of the professional services needed in the distribution of mutual fund shares.

VII. Conclusion

Although the dust of battle has not yet settled on the recent attacks made on Section 22(d), and there may be still other attacks to follow, it is our contention that the assaults launched by Senator McIntyre, Senator Sparkman and the Securities and Exchange Commission are unrealistic in view of their possible

44 *Report of Special Study of Securities Markets of the Securities and Exchange Commission,* H.R.Doc. No. 95, 88th Cong., 1st Sess., pt. 4, at 164-65, 206-09, 212 (1963).

adverse effects on the effective distribution of mutual fund shares.

It should be apparent that Senator McIntyre's proposal to repeal Section 22(d) will force the investment company industry to endure the chaos and disorder that characterized the distribution of mutual fund shares prior to the enactment of the 1940 Act. On the other hand, Senator Sparkman's bill takes into account the wisdom of preserving the uniform price maintenance provisions, but it attempts to enlarge the administrative jurisdiction of the SEC by allowing the Commission to prevent an "excessive sales load"[45] in lieu of an "unconscionable or grossly excessive sales load" which the SEC now has the power to regulate.[46] Is Senator Sparkman's proposed amendment to Section 22(d) based on the premise, as stated by the SEC in its *1966 Report,* that current sales charges are in fact excessive? If Senator Sparkman's proposal *is* based on this premise, which we believe to be arbitrary and unsupportable, then we question whether the enactment of his proposed amendent would not in fact lead to the adoption of rules by both the NASD and the SEC fixing a scale of sales charges based on a fictitious congressional fiat that the present structure includes "excessive sales loads."[47]

With respect to the proposed amendment to Rule 22d-1, the SEC is, in effect, emasculating the spirit and purpose of Section 22(d) by allowing investment companies to encourage group purchases at quantity discounts which, we believe, will engender price discrimination among both mutual fund purchasers and dealers. The President of the Investment Company Institute, in commenting to the Commission on the proposed amended rule, stated that:

> [L]arge broker-dealers with their many branches would be impelled to regard their unrelated customers, the butcher from Los Angeles, the baker from Santa Fe, the candlestick maker from Tallahassee, as an "organized group" of customers, for purposes of a quantity discount, with the result that the emphasis in selling would very likely be on discount rather than suitability of the security.[48]

In the absence of conclusive evidence to the contrary, the present methods employed by investment companies assure an orderly and continuous distribution of mutual fund shares, with full disclosure and freedom of choice to the investing public in furtherance of the mandate of the 1940 Act. When the dust of battle finally does settle, we trust that Section 22(d) and the present rules promulgated thereunder will emerge intact.

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45 S. 34, 90th Cong., 1st Sess. § 12(b) (1969).

46 Section 22(b) of the 1940 Act, 15 U.S.C. § 80a-22(b) (1964). *See* Rappaport, *The SEC's Report on Public Policy Implications of Investment Company Growth,* 1967 SECURITIES LAWS AND REGULATIONS INSTITUTE AT UNIVERSITY OF MIAMI LAW CENTER 177.

47 *See* remarks of Gordon D. Henderson regarding difficulties in justifying particular sales load limitations, printed in *The Financing of Sales of Mutual Fund Shares,* 115 U. PA. L. REV. 768, 798-99 (1967).

48 Letter from Robert L. Augenblick, to the Securities and Exchange Commission, Nov. 27, 1968 (on file at the Library of the Securities and Exchange Commission, Washington, D. C.).