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CURRENT DEVELOPMENTS UNDER SECTION 22(d) OF THE INVESTMENT COMPANY ACT†

SCOTT HODES*

For the time being, at least, Section 22(d) of the Investment Company Act of 1940¹ (1940 Act) is alive and well. However, some diagnoses reveal that the section may be experiencing the effects of regulatory overexertion and legislative fatigue. Section 22(d) was enacted to require a registered investment company, its principal underwriter or a dealer in its shares to sell such shares to any person (except a dealer) only at a current offering price described in the fund's prospectus. The provision, which effectively prevents any price competition among dealers selling the shares of a particular fund, was adopted in order to insure the orderly distribution of fund shares and to prevent discrimination among purchasers of such shares. The anticompetitive aspects of section 22(d), however, have become so controversial that during recent congressional hearings some legislators advocated its repeal;² others recommended amending it to give the Securities and Exchange Commission (SEC) jurisdiction over the magnitude of the sales loads charged;³ while still others proposed that section 22(d) should not be changed until the implications of any proposal for change had been studied in depth.⁴ The conservatives emerged victorious in

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¹ 15 U.S.C. §§ 80a-1 to 80a-52 (1970). Section 22(d), 15 U.S.C. § 80a-22d (1970) provides:

(d) No registered investment company shall sell any redeemable security issued by it to any person except 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.

² S. 296, 91st Cong., 1st Sess. § 12(a) (1969).

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

⁴ After extensive hearings on S. 296 and S. 34, a "clean" bill (S. 2224) was reported to the Senate. S. 2224, 91st Cong., 1st Sess. § 12(c) (1969).

the Investment Company Amendments Act of 1970⁵ and section 22(d) remained untouched—although perhaps slightly tarnished.

The genesis of section 22(d) of the 1940 Act has been well charted in other law review articles and a summary is presented here only as an introduction to discussion of current regulatory and legislative developments.⁶ As the reader proceeds it should become apparent to him that congressional advocates of conflicting interests within the mutual fund industry continue to weigh the future of section 22(d). For the present, no one interest has been able to tip the scale and the ultimate fate of section 22(d) hangs in balance.

I. REGULATORY DEVELOPMENTS SINCE 1940

Prior to enactment of the 1940 Act, open-end investment company shares were distributed by two networks of dealers. One network was composed of "contract" dealers, those who had entered into contracts with investment companies to offer the latter's shares to the public at an established offering price. The other network was composed of noncontract dealers, those who were under no contractual obligation to sell investment company shares at the specified public offering price. As a consequence, the noncontract dealers were able to trade fund shares for their own account by purchasing shares from other noncontract dealers or from public shareholders at a price somewhat higher than the authorized *redemption price*, and then offering them for sale at a price somewhat lower than the *published sales price* being charged by contract dealers. This technique permitted noncontract dealers to undercut the prices of shares offered by the contract dealers while allowing them to retain substantial selling commissions.⁷ The resulting disruption in the distribution and pricing systems of the investment companies caused many contract dealers, who were prohibited from trading in the above fashion, to cancel their contracts with principal underwriters. It soon became apparent to the industry that, if restrictions were not imposed on noncontract dealers, the fund

⁵ Act of Dec. 14, 1970, Pub. L. No. 91-547, 84 Stat. 1413 [hereinafter cited as 1970 Act]. The legislative history of the 1970 Act is discussed in detail in North, *The Investment Company Amendments Act of 1970*, 46 *Notre Dame Lawyer* 712 (1971), which is a sequel to North, *A Brief History of Federal Investment Company Legislation*, 44 *Notre Dame Lawyer* 677 (1969).

⁶ See Greene, *The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940*, 37 *U. Det. L.J.* 369 (1960); Simpson and Hodes, *The Continuing Controversy Surrounding the Uniform Price Maintenance Provision of the Investment Company Act of 1940*, 44 *Notre Dame Lawyer* 718 (1969); *The Mutual Fund Industry: A Legal Survey*, 44 *Notre Dame Lawyer* 732, 833-51 (1969).

⁷ SEC, *Report on Investment Trusts and Investment Companies* pt. 3, at 850-64 (1940).

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industry would be in the untenable situation of having redemptions exceed sales.⁸

As noted, in promulgating section 22(d), Congress sought to eliminate discrimination among purchasers by requiring that mutual fund shares be sold to the public at the offering price described in the prospectus.⁹ Although this approach is vulnerable to the charge that it sanctions protective pricing practices, its underlying rationale is consistent with a competing national policy set forth in the Declaration of Policy of the Investment Company Act:

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

- (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. . . .¹⁰

After the passage of 22(d), an interpretative release issued by the General Counsel of the SEC indicated that section 22(d) required that sales charges be specifically set forth in the prospectus. The release further indicated that a single investment was entitled to a volume discount if it was based on a nondiscriminatory uniform scale of sales loads charged to all purchasers.¹¹ According to the release,

⁸ Since by statute a mutual fund is required to redeem any security it has issued, 15 U.S.C. § 80a-22(e) (1970), it is important that sales always exceed redemptions lest the company be required to liquidate its holdings to pay for the tendered shares. The cancelling of contracts by contract dealers, or, in fact, any disruption in the distribution process, is likely to cause a decline in sales and thus risk the possibility that funds will be forced into liquidation.

⁹ Typically, shares of a fund are purchased through authorized dealers who have entered into sales agreements with the distributor or underwriter of the shares of the fund. Shares are offered at net asset value plus a reducing sales load for quantity purchases. Set forth below are typical "break-points," the points at which a reduction takes place:

Amount of Sale	Total Sales Charge	Dealer Concession
Less than \$15,000	8.75%	8.00%
\$15,000, but less than \$25,000	8.00%	7.50%
\$25,000, but less than \$50,000	7.00%	6.25%
\$50,000, but less than \$125,000	5.00%	4.25%
\$125,000, but less than \$250,000	3.00%	2.25%
\$250,000, and over	2.00%	1.40%

¹⁰ 15 U.S.C. § 80a-1(b)(3) (1970).

¹¹ SEC Investment Company Act Release No. 89 (Mar. 13, 1941). The SEC recently called attention to the fact that the sales charges set forth in the prospectus and the "real" sales charge may in effect differ:

this uniformity was essential because section 22(d) prohibited discrimination among investors. Yet, in the wake of this opinion and two companion releases of the SEC, which approved cumulative volume discounts¹² and discounts based on the total sales of several related funds made to one investor at the same time,¹³ investment companies proceeded to interpret the single investment requirement in such a way as to permit an artificial grouping of investors. Such interpretations of course resulted in various groups of individuals receiving discriminatory discounts. At the same time, the SEC was granting numerous exemptions from the prohibitions of section 22(d), under section 6(c).¹⁴ It was soon perceived that, unless further steps were taken to clarify the situation, section 22(d) would be interpreted or exempted out of existence, thus returning the industry to a pre-1940 situation.

A. Rule 22d-1

In view of the increasing number of interpretations permitting artificial groupings, the SEC considered whether volume discounts to artificially created groups constituted price discrimination among customers. In concluding that the grouping of investors to achieve volume discounts was contrary to the statutory purpose of section 22(d),¹⁵ the SEC adopted Rule 22d-1,¹⁶ which prohibits groups (with the exception of a close family group, a single trust, or single fiduciary account and certain pension and profit sharing plans) from taking advantage of volume discounts. This prohibition was accomplished by

[T]he practice of compensating broker-dealers for mutual fund sales by assigning them commission business violates the long accepted precept in investment company regulation that an investor is entitled to know how much was paid to those who sell him an investment. This practice puts the investment company in the position of issuing a prospectus which purports to specify the sales compensation but fails to quantify the additional compensation paid to the customer's broker-dealer in the form of commission business awarded on the basis of success in selling investment company shares.

SEC Policy Statement, *The Future Structure of the Securities Markets* 42-43 (Feb. 3, 1972).

¹² *Investors Diversified Services, Inc.*, SEC Investment Company Act Release No. 1504 (Aug. 15, 1950).

¹³ *Axe Houghton Fund, Inc.*, SEC Investment Company Act Release No. 1505 (Aug. 17, 1950).

¹⁴ Section 6(c) of the 1940 Act, 15 U.S.C. § 80a-6(c) (1970), provides that the Commission by rule, regulation or order may exempt any person or transaction or any class of persons or transactions from any provision of the Act if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and purposes fairly intended by the policy and provisions of the Act. According to Greene, *supra* note 6, at 377-79, most funds considered aggregate purchases to be single transactions and thus automatically qualifying for a quantity discount without need for an exemptive order under § 6(c).

¹⁵ 17 C.F.R. § 270.22d-1 (1971).

¹⁶ SEC Investment Company Act Release No. 2798 (Dec. 2, 1958).

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limiting volume discounts to "any person" and, subject to the specified exceptions, specifically providing 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.¹⁷

In discussing this restrictive provision, the SEC observed that recognition of such artificial groupings violated the purpose and intent of section 22(d) because of the resultant price discrimination.¹⁸ In determining whether such groupings were entitled to discounts, however, the SEC apparently did not consider whether the dealer provided sales services such as advertising, the distribution of sales literature and other selling efforts; rather, the SEC focused on the composition of the groups. By including the definition of "any person" within the Rule, the SEC, in effect, decided that ad hoc buying cooperatives did not qualify.

Since the adoption of Rule 22d-1, the SEC on a number of occasions has reaffirmed its stand against discrimination among purchasers of investment company shares.¹⁹ In denying an application for an exemption from section 22(d) based on an artificial grouping of insurance purchasers, the SEC stated:

The general role of this Commission under the statutes we administer is to secure for public investors maximum protections in the purchase and sale of securities, and it might seem that it is not in furtherance of that role for us to prevent an issuer of securities which desires to permit some investors to obtain its securities without sales charges or with low charges from doing so. An important objective of section 22(d), the provisions of which were first suggested by members of the industry, is to prevent discrimination or preferential treatment in prices.²⁰

Continued SEC intent to prevent price discrimination was evidenced by the failure of the SEC to adopt a proposed revision of Rule 22d-1 that would have substituted for the above quoted definition of "any person" the definition set forth in Section 2(a)(28) of the

¹⁷ 17 C.F.R. § 270.22d-1(a) (1971).

¹⁸ SEC Investment Company Act Release No. 2718 (May 29, 1958).

¹⁹ See, e.g., Midamerica Mutual Fund, Inc., SEC Investment Company Act Release No. 3612 (Jan. 11, 1963). See also Investors Diversified Services, Inc., 39 S.E.C. 829 (1960).

²⁰ Midamerica Mutual Fund, Inc., SEC Investment Company Act Release No. 3612 at 3 (Jan. 11, 1963).

1940 Act.²¹ Under this section, the proposed definition would have included a "company," a term defined in Section 2(a)(8) of the 1940 Act as including "any organized group of persons whether incorporated or not."²² A stated purpose of this proposed revision was to "afford quantity discounts to groups of individuals."²³ Apparently, the SEC was hesitant to encourage the formation of buying cooperatives organized for the express purpose of purchasing mutual fund shares. It should be recognized, however, that such groups remain eligible for a section 6(c) exemption based on reduced selling efforts.

B. Rule 22d-1(h)

Current SEC approval of the purposes behind section 22(d) is evidenced by a recently adopted amendment to Rule 22d-1(h) which restricts the class of persons entitled to a reduction or elimination of sales charges.²⁴ Prior to the amendment, Rule 22d-1(h) permitted the reduction or elimination of sales loads for several classes of persons both related and unrelated to the functions of the company, its investment adviser or principal underwriter.²⁵ This amendment, which was adopted "[i]n view of the proliferation of insurance companies and

²¹ SEC Investment Company Act Release No. 5507 (Oct. 7, 1968). See SEC "no action" letter to Westfield Growth Fund, Inc., (May 21, 1971), where a co-mingled trust account having a substantial amount of other investments was allowed to purchase fund shares at reduced sales charges for quantity purchases. This letter was written in connection with Release No. 5507, according to which the term "any person" would have been modified so as not to include a trustee or the participants in a co-mingled trust account. [A summary copy of this letter, prepared by the Investment Co. Institute, is on file in the office of the Boston College Industrial & Commercial Law Review].

²² Section 2(a)(28) of the 1940 Act, 15 U.S.C. § 80a-2(a)(28) (1970), provides that "[p]erson" means a natural person or a company." "Company" is defined in § 2(a)(8) of the 1940 Act, 15 U.S.C. § 80a-2(a)(8) (1970), as including "a corporation . . . a fund, or any organized group of persons whether incorporated or not."

²³ SEC Investment Company Act Release No. 5507, at 1 (Oct. 7, 1968).

²⁴ SEC Investment Company Act Release No. 6347 (Feb. 8, 1971).

²⁵ Prior to promulgation of SEC Release No. 6347, *id.*, a liberal application of Rule 22d-1(h) was given by the SEC in several cases. In Transamerica Capital Fund, SEC Investment Company Act Release Nos. 5730 (July 1, 1969), and 5751 (July 25, 1969), the SEC permitted special pricing for almost 23,000 persons employed by the Transamerica conglomerate, without issuing an opinion providing the reasons for its decision. It is doubtful that any investment company purpose was served by providing special prices to persons who were employed by over 100 subsidiaries of Transamerica. See also Travelers Equities Fund, Inc., SEC Investment Company Act Release No. 5948 (Jan. 3, 1970), where an exemption was granted for sales at net asset value, without sales charge, to persons in the following categories: (1) permanent employees of the Travelers Companies having more than one year's service and over the age of 21, and all officers and directors of the Travelers Companies and of the Fund; (2) contract sales representatives of the Travelers Companies; and (3) full-time employees of such representatives serving more than one year and over the age of 21, and any trust, pension or profit-sharing, or any other benefit plan for such persons. After SEC Release No. 6347 was promulgated, the SEC adopted a more restrictive approach in denying the general counsel of an open-end investment company the right to purchase shares of the fund at net asset value. Wisconsin Fund, Inc., 2 CCH Mutual Funds Guide § 9290 (Aug. 3, 1971).

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conglomerate complexes in the investment company industry," serves to limit the availability of fund sales charge discounts to those employees of an adviser and seller who devote, or who may potentially devote, "more than one-half of [their] working time" to the company on whose shares they are obtaining a discount.²⁶ One objection raised to the amendment, but given little serious consideration, involved the difficulty which would arise in determining the manner by which to measure "more than one-half." Another objection focused on the problem that arises where a life insurance company acts as investment adviser and principal underwriter for two or more registered separate accounts or mutual funds; this objection, however, was met by permitting satisfaction of the one-half working time standard in situations in which a person has rendered his services to more than one fund within a complex. In adopting the amended rule the SEC stated:

It is important to note that this rule and the present amendment are necessitated by Section 22(d) of the Act, which was not changed by the recent amendments to the Act in Public Law 91-547.²⁷

It is curious to observe that in proposing to redefine the words "any person" in Rule 22d-1,²⁸ the SEC planned to enlarge the number of groups entitled to volume discounts, while in amending Rule 22d-1(h),²⁹ the SEC reversed itself and restricted the class of persons entitled to a reduction or elimination of the sales charge. In the latter situation, the persons to which the discount is available work directly or indirectly for a common employer, and a reduced or possibly non-existent sales cost should justify a reduction in the sales charge. Obviously, then, it is not the amount of sales effort upon which the SEC *now* relies in affording sales cost reductions, but rather the structure of the group itself. This distinction will be discussed further in relation to recent SEC findings involving Mutual Funds Advisory, Inc.

II. THE DECISION IN MUTUAL FUNDS ADVISORY, INC.

In a recent application for an exemption³⁰ under Section 6(c) of the 1940 Act, Mutual Funds Advisory, Inc. (MFA), a broker-dealer registered with the National Association of Securities Dealers (NASD), proposed to sell to The Fundpack, Inc. (Fundpack), a registered open-end investment company under common control with

²⁶ SEC Investment Company Act Release No. 6347, at 2, 4 (Feb. 8, 1971).

²⁷ *Id.* at 3.

²⁸ See SEC Investment Company Act Release No. 5507 (Oct. 7, 1968).

²⁹ See SEC Investment Company Act Release No. 6347 (Feb. 8, 1971).

³⁰ Mutual Funds Advisory, Inc., SEC Investment Company Act Release No. 6932 (Jan. 12, 1972).

MFA, shares of load mutual funds at MFA's cost—*i.e.*, the net asset value plus the concession to the principal underwriter of the selling fund. Fundpack had invested only in no-load funds, but it proposed to invest in load fund shares and to operate as a fund holding company. Under section 22(d), MFA as a dealer would be prohibited from selling mutual fund shares to Fundpack except at the current public offering price, including a concession for the dealer as a part of the sales load. In order for MFA to sell shares to Fundpack without charging Fundpack the dealer's concession, MFA had to obtain an exemption, pursuant to section 6(c), from the provisions of section 22(d).³¹

Arguments concerning the philosophy and application of section 22(d) were dramatically presented in briefs filed by MFA, the NASD, the Investment Company Institute (ICI) and the SEC's Division of Corporate Regulation (SEC Corp. Reg.).³² MFA argued that the exemption would be in the public interest, because of the resulting economies in portfolio transactions, and that the SEC had consistently taken into account the presence or absence of substantial services performed by the dealer. In this regard, MFA argued that the acquisition of load fund shares for the portfolio of Fundpack would not require MFA to perform the same type of services that it must perform in selling mutual fund shares to the public.³³ If MFA's rationale is accepted, the question arises as to whether a dealer's concession is justified where *any* unsolicited order of investment company shares is involved. It is evident that if an exemption were allowed on the basis of reduced services performed by MFA, the extent of the services performed by any dealer as a prerequisite to a section 22(d) exemp-

³¹ The application by MFA also contained a request for a § 6(c) exemption from the provisions of § 17(a), which prohibits transactions between an investment company and an affiliated person. 15 U.S.C. § 80-17(a) (1970). Section 17(a) was designed to protect mutual funds and their shareholders from overreaching, by prohibiting, among other transactions, the purchase of securities from an affiliate when the affiliate acts as a principal. *Id.*

³² Briefs of Applicant for Mutual Funds Advisory, Inc. (Jan. 27, 1971) [hereinafter cited as MFA Brief]; Brief of the Division of Corporate Regulations (Feb. 5, 1971) [hereinafter cited as SEC Corp. Reg. Brief]; Brief of the Investment Company Institute (Mar. 8, 1971) [hereinafter cited as ICI Brief]; Brief of the National Association of Securities Dealers, Inc. (Mar. 22, 1971) [hereinafter cited as NASD Brief]; Mutual Funds Advisory, Inc., SEC Investment Company Act Release No. 6932 (Jan. 12, 1972). Copies of these Briefs are on file at the Library of the Securities and Exchange Commission, Washington, D.C.

³³ See MFA Brief, *supra* note 32, at 27-30. The NASD, citing Midamerica Mutual Fund, Inc. (SEC Investment Company Release No. 3612, Jan. 11, 1963), took exception to the broad statement made by MFA that the SEC has consistently taken into account the presence or absence of substantial services in ruling on proposed exemptions from § 22(d). NASD Brief, *supra* note 32 at 31.

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tion would probably have to be resolved in a time-consuming case by case analysis.

SEC Corp. Reg., in support of MFA's application, argued that the sale to Fundpack of redeemable securities at a price lower than that which other individuals must pay would not disrupt the distribution channels for particular mutual fund shares. In support of its position, SEC Corp. Reg. alluded to the broad range of exemptive orders which had been granted by the SEC on the basis of reduced or nonexistent sales costs.³⁴ However, SEC Corp. Reg. failed to note that the cases it cited had concerned exemptions granted to the specific funds involved and that the exemptions had benefitted persons directly related to the fund itself; whereas in MFA's situation, one member of a group of dealers selling the shares of a fund was asking for a reduction in the sales load.

In rejecting the MFA and SEC Corp. Reg. positions, the NASD asserted that an exemption would place Fundpack in a preferred position, one not obtainable by any other member of the public, and that it would thus discriminate in favor of one customer—all contrary to the intent of section 22(d). The NASD asserted that "Fundpack or any other institution . . . are 'customers' the same as members of the general public or the so-called 'man in the street' investing only \$10 per month," and that "[t]here is no way the 'man in the street' can purchase mutual fund shares at a lower price other than the ordinary volume discount which is also available to Fundpack without the exemption."³⁵ The NASD claimed that because the exemption was in the interest of only Fundpack or its shareholders, it did not meet the requirement of section 6(c) that it be necessary or in the public interest. The NASD further argued that it was MFA's burden to prove that the granting of the exemption would not disrupt the orderly distribution of fund shares.³⁶ In contrast, SEC Corp. Reg. argued that the SEC has granted exemptions from section 22(d) which permitted discrimination among investors and which did not result in a disruption of the fund distribution system.³⁷

Finally, the ICI in its brief stressed that section 22(d) did not permit the sale of shares of registered investment companies to Fundpack at a discount because Fundpack is an unauthorized grouping of

³⁴ See SEC Corp. Reg. Brief, *supra* note 32, at 13-14. But see Midamerica Mutual Fund, Inc., SEC Investment Company Act Release No. 3612 (Jan. 11, 1963), where the SEC reaffirmed its stand against discrimination among purchasers of mutual fund shares.

³⁵ NASD Brief, *supra* note 32, at 24.

³⁶ *Id.* at 25.

³⁷ SEC Corp. Reg. Brief, *supra* note 32, at 13, n.32.

customers organized in violation of Rule 22d-1.³⁸ This argument was based on the fact that the SEC had failed to adopt a proposed revision of Rule 22d-1 which would have permitted groups of customers to qualify for quantity discounts.³⁹ The ICI argument, however, would deny investors reduced sales loads for quantity purchases when they purchased shares of a fund organized for the purpose of acquiring shares of other funds. The fact that Congress now specifically permits, within certain limitations, the operations of such fund holding companies,⁴⁰ appears to rebut the ICI argument that the grouping of MFA's customers into an investment company entity is artificial and ineligible for a volume discount. The better argument would have been to consider the grouping of MFA's customers as being legitimate, but to interpret section 22(d) as requiring Fundpack to purchase shares of other load funds on the basis of the same quantity discounts granted to other customers.

On January 12, 1972, the SEC denied MFA's application for the exemption.⁴¹ The SEC determined that, because MFA had served as a broker and not a dealer in acquiring the shares of other funds for Fundpack's portfolio, MFA lacked standing to seek an exemption from section 22(d). The opinion indicated that only underwriters of funds whose shares were to be acquired for Fundpack had standing.⁴² The opinion, however, noted that even if the application had properly been brought before the SEC, it would have failed because the purposes of section 22(d) would be defeated.⁴³ In discussing the possible disruption in the distribution of fund shares that could result from the offering of discounts to investors, the SEC showed little sympathy for MFA's contention that Congress had intended to foster the creation of fund holding companies by permitting them to obtain preferential prices in purchasing fund shares for their portfolios.⁴⁴ The opinion also emphasized the fact that dealers selling shares of other funds would soon find themselves at a competitive disadvantage because Fundpack could purchase these same shares at a lower price and then, in effect,

³⁸ See ICI Brief, *supra* note 32, at 10-14.

³⁹ See discussion of SEC Investment Company Act Release No. 5507 (Oct. 7, 1968).

⁴⁰ 15 U.S.C. § 80a-12(d)(1) (1970) prohibits a fund of funds from acquiring more than 3% of the shares of another investment company, confines sales charges imposed upon the public by such funds to 1.5%, and restricts the number of shares of portfolio investment companies that can be redeemed.

⁴¹ Mutual Funds Advisory, Inc., SEC Investment Company Act Release No. 6932 (Jan. 12, 1972).

⁴² *Id.* at 3. The SEC ruled that the concessions or rebates paid to MFA would be subject to 15 U.S.C. § 80a-17(e)(2) (1970), which makes it unlawful for a person affiliated with a registered investment company who is "acting as a broker" in connection with the sale of securities to such company to receive from any source a commission or other remuneration which exceeds 1% of the purchase price. *Id.*

⁴³ *Id.* at 4.

⁴⁴ *Id.*

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offer the investor an indirect discount through sales to him of shares of Fundpack.⁴⁶

MFA's contention that a reduction in selling costs has been the basis for the granting of prior exemptions was summarily dismissed by the SEC on the grounds that "Rule 22d-1 was designed not only to codify but also to eliminate or modify exemptions from Section 22(d) previously granted, and we have since materially restricted the class of persons eligible for preferential prices under the Rule."⁴⁶ Although this statement appears to support the proposition that section 22(d) is primarily concerned with eliminating discrimination among purchasers, the SEC did not go so far as to adopt the NASD contention that the applicant for an exemption has the burden of proving that an exemption would not disrupt the orderly distribution of fund shares.⁴⁷ The opinion indicates that restrictions imposed by section 22(d) should be applied regardless of whether the purchaser is an individual or an entity organized specifically to invest in shares of other funds. An important consequence of this position is that a fund affiliated with a dealer does not gain economic advantage over an unrelated fund since each becomes entitled to a discount only if qualifying dollar purchases are made.⁴⁸

If the SEC had granted an exemption to MFA, it would be difficult to restrain dealers similarly situated from entering into contracts to rebate or give up a part of their dealers' concession to an unrelated fund. Fund holding companies would then purchase shares of funds from only those dealers who would give up the greatest proportion of their dealers' concessions. As a result, the suitability and investment merit of the fund shares purchased would no longer be the prime selling factors—a consequence which would be to the detriment of the shareholders of the holding companies. Eventually, too, by dealing directly with the principal underwriter of the fund, the fund complexes would promote the demise of the dealer; new dealer compensation

⁴⁶ Id.

⁴⁶ Id. at 5.

⁴⁷ NASD Brief, *supra* note 32, at 25.

⁴⁸ In regard to the situation involving the rebate by a mutual fund salesman to his public customers of a portion of the sales load, the SEC has stated:

Moreover, the purposes of Section 22(d) as stated by the Commission "are to prevent discrimination among purchasers and to provide for orderly distribution of such shares by preventing their sale at a price less than that fixed in the prospectus." (citation omitted). Accordingly, while [the salesman's] customers were financially benefitted in their particular purchases from him, Section 22(d) seeks to prevent the adverse effect upon investors generally which would result from discriminatory pricing and disorderly distribution.

Spiro Sideris d/b/a Olympic Insurance and Securities Agency, Securities Exchange Act Release No. 8816 at 2 (Feb. 13, 1970). Article III, § 24 of the NASD Rules of Fair Practice prohibits the granting of a discount by a broker-dealer to a customer. CCH NASD Manual ¶ 2174 (1971).

arrangements would have to be created to encourage sales of the fund of funds to the public shareholder. Whatever the final result, it is safe to predict that most of the problems involving sales charges (except as provided in Section 12(d)(1) of the 1940 Act) would reappear at another level or in another form in the distribution structure.

It is apparent from a close examination of the opinion in the MFA application that the SEC was not about to "rock the boat" until its study concerning the amendment or deletion of section 22(d) had been completed. The SEC realized that the granting of an exemption to MFA would prematurely have precipitated tidal waves throughout the industry. Thus it is not inconceivable that the SEC might have reached an opposite conclusion if its study of section 22(d) had been completed before consideration of the MFA application. In any event, the SEC appropriately decided to wait for congressional action before attempting to modify the retail price maintenance provisions of section 22(d).

III. LEGISLATIVE DEVELOPMENT UNDER THE 1970 ACT AMENDMENTS

It is important to note that Congress did not alter the thrust of section 22(d) in the 1970 Act amendments. Legislative proposals had been made to abolish section 22(d) and to place maximum upper limits on sales loads, but testimony at the hearings convinced Congress that a sufficient study of the consequences of such an amendment had not been made. As a result, the Senate Banking and Currency Committee asked the SEC to review the consequences of deleting section 22(d) from the Act and to report its recommendations to the Committee.⁴⁹

Having thus declined to abolish the retail price maintenance provision of section 22(d), Congress approached the sales charge problem from the sales loads perspective, by passing a series of amendments to section 22(b)—the section which authorizes the NASD to adopt rules regulating sales loads. Prior to the amendments the standard used by the NASD in adopting such rules was one of preventing an "unconscionable or grossly excessive sales load."⁵⁰ Section 22(b) now provides that the public offering price of fund shares must not include an "excessive sales load," with a stipulation that sales loads shall "allow for a reasonable compensation for sales personnel, broker-dealers, and underwriters and for reasonable sales loads to investors."⁵¹ It would

⁴⁹ S. Rep. No. 91-184, 91st Cong., 1st Sess. 8 (1969).

⁵⁰ Act of Aug. 22, 1940, ch. 686 tit. I § 22, 54 Stat. 823.

⁵¹ 15 U.S.C. § 80a-22(b) (1970), § 12(b)(1) of the 1970 Act, amends 22(b) of the 1940 Act. S. Rep. No. 91-184, 91st Cong., 1st Sess. at 18 (1969) indicates that: The provision for "reasonable loads to investors" is intended to assure that the sales loads fixed by the principal underwriters (which continue to be protected

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appear that this provision would sanction higher sales loads in situations where relatively more selling effort is involved.

The amendments to section 22(b) must have been based on the premise, as stated by the SEC in its 1966 Report, that the then current sales charges were excessive, a conclusion perhaps arbitrarily reached.⁵² In a letter to the NASD, dated April 29, 1966, the SEC's Division of Trading and Markets admitted that, with respect to the securities industry generally, there exists "a pressing and unfilled need for additional financial data to assist the Commission as well as the self-regulatory institutions in the performance of their responsibilities."⁵³ The letter further stated that it was impossible for the SEC to discharge its responsibility without the benefit of additional financial data from each firm in the securities industry:

It is well known that there are many interrelationships between the exchange markets, the over-the-counter markets and other aspects of the securities industry, such as underwriting of new issues and the distribution of mutual fund shares. The emphasis placed on each area of activity depends basically on its profitability, on the circumstances of the particular firm, and also upon the applicable regulatory requirements and responsibilities. Without information, there is no means of measuring the impact of changes in regulatory procedures applicable to each of these activities, whether such changes will result in significant changes of emphasis without the industry and whether, if so, this is a good thing, a bad thing, or neither. The problems of the next decade are extremely difficult and mistakes cannot afford to be made or decisions taken randomly [*sic*], under threat of law suit or exercise of economic pressures. The Commission has the responsibility for acting in the public interest; it will also be in the role of arbiter, and neither we nor the self-regulatory organizations can work in a vacuum.⁵⁴

In commenting on this letter, the ICI questioned whether there existed

against price competition by Section 22(d) of the Act) will be established at levels which recognize the interests of investors. These provisions also contemplate that, if warranted, the rules might include provisions for higher sales loads in situations where relatively more selling effort is required. They will also permit flexible treatment of the problem of sales loads on automatic investment of dividends, which involve little or no new effort.

⁵² House Comm. on Interstate and Foreign Commerce, Report of the SEC on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 21 (1966) [hereinafter cited as PPI]. This Report is discussed in Simpson and Hodes, *supra* note 6, at 723.

⁵³ Letter from the SEC's Division of Trading and Markets to NASD, April 29, 1966, quoted at p. 6 of the memorandum attached to letter from Dorsey Richardson, President of ICI, to the SEC, Sept. 12, 1966.

⁵⁴ *Id.*

any reason consistent with the public interest or the protection of investors supporting the adoption of new legislation affecting methods of mutual fund share distribution. ICI further charged that any such legislation altering section 22(d) "would not be based on fact but on theoretical economic concepts."⁵⁵ Today, six years after this exchange of letters, it appears that the SEC is finally collecting the economic data upon which to base its recommendation to the Congress.

IV. CURRENT STUDIES

A. *The NASD Study Pertaining to Section 22(b)*

At present, the NASD is soliciting information from its members which it will evaluate in adopting rules defining and prohibiting excessive sales charges.⁵⁶ In the formulation of rules concerning excessive sales loads, consideration must be given to the nature and quality of services necessary to effect the proper distribution of fund shares to the public. Thus funds which lack their own sales forces must be allowed to make sales commissions attractive in order to encourage fund dealers to sell their shares. These funds are protected to the extent that the SEC, upon application, could grant qualified exemptions from the sales load provisions to smaller companies which experience relatively higher operating costs.⁵⁷ Responsibility for the adoption of rules prohibiting excessive mutual fund sales charges rests with existing self-regulatory machinery (at present the NASD is the only such vehicle), subject to appropriate SEC overview.⁵⁸ Section 22(b)(3), which changes the rule-making authority of the SEC formerly contained in Section 22(c) of the 1940 Act, now provides that eighteen months after

⁵⁵ Letter from Dorsey Richardson to the SEC, Sept. 12, 1966, at p. 7 of attached memorandum.

⁵⁶ On April 30, 1971, the NASD mailed questionnaires to NASD principal underwriters and NASD broker-dealers, and accommodated the SEC by simultaneously mailing the section 22(d) questionnaires prepared by the SEC staff. According to the general instructions which accompanied the NASD questionnaires, the data obtained will be used by NASD consultant Booz, Allen & Hamilton, Inc., in conducting an economic study upon which the NASD may establish, pursuant to the 1970 amendment to Section 22(b) of the Investment Company Act of 1940, guidelines for sales charges on redeemable securities issued by a registered investment company and sold to the public. These guidelines will be intended to insure that the price "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."

⁵⁷ Section 12(a) of the 1970 Act amends Section 22(b)(1) of the 1940 Act by adding protective language in regard to smaller companies.

⁵⁸ The NASD has already established a maximum of 5% on commissions to be charged in over-the-counter transactions, but this rule does not have any application to sales of mutual fund shares. See NASD Rules of Fair Practice, Art. III, § 4, known as the "NASD Mark-up Policy." CCH NASD Manual ¶ 2154 (1971). It has been suggested by the SEC that the 5% policy could be a possible starting point for determining proper sales loads. See PPI, *supra* note 52, at 22. See also *The Mutual Fund Industry: A Legal Survey*, 44 *Notre Dame Lawyer*, 732, 847-48 (1969), for a more detailed discussion.

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the date of its enactment (June 14, 1972) or sooner if the NASD has adopted the required rules, the SEC may supplement or change these NASD rules as authorized by Section 15A(k)(2) of the Securities Exchange Act of 1934.⁵⁹

B. *The SEC Study Pertaining to Section 22(d)*

In the meantime, in an effort to study the impact of a repeal of section 22(d), the SEC has prepared and transmitted questionnaires to broker-dealers, principal underwriters and mutual funds. The SEC inquiry relating to broker-dealers seeks to determine the number of people actually involved in the selling of fund shares and the extent of the salesmen's income attributable to that activity. In addition, the SEC is seeking information from broker-dealer firms regarding the relative importance of mutual fund business to the firms themselves and the expenses attributable to selling fund shares.

The SEC questionnaires also include a list of seventeen funds that have discontinued the public offering of shares and that do not have a current prospectus.⁶⁰ Shares of these funds may be purchased in the over-the-counter market, where the purchase price is not governed by the price maintenance provisions of section 22(d). By eliciting sales information from broker-dealers who handle transactions in either a principal or agency capacity, the SEC is attempting to determine what mark-ups, mark-downs or commissions are charged in a marketplace not regulated by section 22(d). Such information would be revealing if these broker-dealers traded fund shares only over-the-counter; since, however, these same broker-dealers distribute fund shares in accordance with section 22(d), it is questionable whether the over-the-counter operations can be meaningfully segregated and analyzed from a profit standpoint.

The questionnaire sent to the principal underwriters, which posed many of the same questions asked of broker-dealers, also inquired into the number of investment companies the underwriter represented, the number of dealers distributing shares of the fund represented by the underwriter, and the types of investment plans being offered by the underwriter. After the SEC receives this information it will try to determine what comparative effect the abolition of section 22(d) would have on (1) underwriters who confine their operations to wholesaling and who use independent brokers for retailing, and (2) underwriters who have their own retail sales organizations, called "captive sales

⁵⁹ 15 U.S.C. § 80a-22(b)(3) (1970).

⁶⁰ See pages 6-8 of the SEC Broker-Dealer 22(d) Questionnaire, Pt. B (Mar. 1971), where the SEC requests data relating to inventories and transactions in shares of 17 listed funds during the two-week period ending December 31, 1970. A copy of these pages is on file in the office of the Boston College Industrial & Commercial Law Review.

forces." The statistics will probably show that the underwriter employing a captive sales force is not as vulnerable to the vast economic leverage that a large national brokerage firm can wield in negotiating a reduction in the underwriter/wholesaler's sales concession. The result may well be that the large national brokerage firm rather than the underwriter/wholesaler will be in a position to determine the ultimate public offering price of fund shares; this situation, in turn, will create competition for the underwriters owning captive sales forces. Instead of funds and their underwriters offering competitive sales loads to attract shareholders (which is now the case), the abolition of section 22(d) would shift the competition to lower sales charges to the retailers and distributors of fund shares. It is doubtful that the statistics presently being collected will reveal the extent of the financial impact that elimination of section 22(d) would have on fund underwriters.

Finally, the questionnaire sent to the funds focused on the methods used to merchandise fund shares, the extent of redemptions, the magnitude of the sales effort, and the geographical distribution of the shares. In requesting fund sales data, the SEC seeks specific information regarding sales loads charged, dealer concessions offered and the "break-points" designated for varying sales charges. This information should enable the SEC to evaluate the relationship between the size of the purchases and the sales load charged. However, since most funds presently have sales loads of one percent or less on purchases of one million dollars or more,⁶¹ it is doubtful that quantity discounts based on large group purchases will be negotiated at rates substantially less than those now charged even if section 22(d) were eliminated.

CONCLUSION

It is possible that the conclusions of the SEC investigation concerning the impact of deleting section 22(d) and the NASD study of section 22(b) aimed at adopting rules defining and prohibiting sales loads considered "excessive" will conflict. The NASD might adopt guidelines defining excessive sales loads within the framework of section 22(d) while at the same time the SEC might recommend that mutual funds must not be permitted to control the public sale price of their shares. Without the protective pricing practices of section 22(d), dealer price-cutting would likely undermine the NASD sales loads guidelines by forcing many smaller dealers out of business. Such a development would be violative of the mandate of section 22(b), which presently provides that reasonable compensation shall be allowed for sales personnel, broker-dealers, and underwriters.⁶² Moreover, it can be

⁶¹ PPI *supra* note 52, at 210.

⁶² 15 U.S.C. § 80a-22(b) (1970).

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argued that Congress sanctioned protective pricing practices by expressly removing the SEC's authority to shield such practices from possible antitrust attack.

At issue in both the SEC and NASD studies is the extent of the financial loss which would be experienced by the fund industry if section 22(d) were abolished. It is doubtful, however, that the figures which are likely to emerge from these studies will measure accurately the financial repercussions of price competition. Even if meaningful figures do emerge, the statistics will be interpreted in many ways to support a variety of conclusions, especially in a situation where no guidelines have been determined at the outset. It will be interesting to observe whether the statistics which are ultimately presented by the SEC will have any significant effect on the fundamental public policy issue—whether or not there should be competition in the sale of mutual fund shares.

If one takes into consideration the competing interests and the various consequences that might arise from the limitation or expansion of the pertinent sections, it would seem that a comprehensive package plan is necessary. Such a solution would attempt to reach a workable and realistic compromise among the various interest groups. In the opinion of this writer, section 22(d) should be retained in order to insure the continued smooth functioning of the distribution system. As noted above, disruptions in the system jeopardize the viability of mutual funds and ultimately work to the detriment of the investor. Because the very provisions of section 22(d) which protect the purchaser's investment also work to his disadvantage, by precluding the price benefits of open competition, additional measures are necessary to complement section 22(d). A modification of Rule 22d-1 to allow a wider range of investors to become members of groups eligible for volume discounts would be an initial step in this direction. Second, an across-the-board upper limit of 6.5-7.5 percent for sales charges would insure that sales loads remain at least reasonable, if not competitive. Finally, adoption of a new, lower "first break-point" in the range of six percent for purchases exceeding \$7,500 would ease the present high sales load levied on smaller investments.