with the Commission's encouragement of simplified prospectuses.

I. Background

Both the multiple class and masterfeeder structures may benefit shareholders and fund sponsors. These structures may increase investor choice, result in efficiencies in the distribution of fund shares, and allow fund sponsors to tailor products more closely to different investor markets. Fund sponsors assert that multiple classes may enable funds to attract larger asset bases, permitting them to spread fixed costs over more shares, qualify for discounts in advisory fees ("breakpoints"), and otherwise experience economies of scale, resulting in lower fees and expenses. They also state that multiple classes avoid the need to create "clone" funds, which require duplicative portfolio and fund management expenses. Furthermore, fund sponsors state that a larger asset base permits greater portfolio liquidity and diversification.

Master-feeder funds may achieve similar benefits of economies of scale, thus potentially lowering expenses, and also allow several different small funds access to the same management and compliance personnel. The masterfeeder structure allows a fund sponsor to offer feeder funds that invest in specialized portfolios, even though the sponsor's expected asset base may not justify organizing a stand-alone fund for that market or market segment. Sponsors also use this structure to offer off-shore and other unregistered feeder funds.³

Investor understanding of sales and service charges in both arrangements, however, has been a subject of concern to the Commission.⁴ Some commentators have asserted that the complexity generated by these arrangements may confuse many investors, who often may not understand them or the effect that fees have upon performance.⁵

⁴ See, e.g., Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds, Investment Company Act Release No. 19955 (Dec. 15, 1993), 58 FR 68074 (Dec. 23, 1993) [hereinafter Proposing Release].

⁵ See Proposing Release, 58 FR at 68082 n.59; see also Jeff Kelly, A Fine Mess, Morningstar Mutual

On December 15, 1993, the Commission proposed for public comment rule 18f-3 and related amendments to rule 12b-1 under the Investment Company Act and advertising and prospectus disclosure requirements.⁶ Among other things, rule 18f-3 would have allowed funds to issue multiple classes of shares without the need to apply for and receive an exemption from the Commission and largely would have codified the exemptive orders. The proposal also would have made consistent the disclosure requirements of Form N-1A for multiple class and master-feeder funds by imposing disclosure requirements based on those in the multiple class exemptive orders. These requirements would have included a prominent legend following the fee table disclosing the availability of other classes or feeder funds not offered in that prospectus, and an undertaking to provide investors with additional information about other classes or feeder funds. They also would have required full cross-disclosure in the prospectus about any other classes or feeder funds that were offered or made available through the same broker, dealer, bank, or other financial intermediary, and permitted investors to choose among alternative arrangements for sales and related charges. The proposal also would have required a line graph comparing the hypothetical value of holdings of the classes or feeder funds described in the prospectus upon redemption at the end of each year during a ten-year period. The proposal would have made conforming changes to advertising and sales literature rules and Form N-14. A related amendment to rule 12b-1 would have clarified that a rule 12b–1 plan must treat each class separately and required separate director and shareholder approval.

II. Discussion

The Commission received 24 comments on the proposal.⁷ Most of the commenters were fund groups, law firms, and trade associations. Although all commenters favored a rule allowing

⁷The comment letters, as well as a comment summary dated Dec. 21, 1994 prepared by the Commission's staff, are available for public inspection and copying at the Commission's public reference room in File No. S7–32–93.

multiple class structures without the need for exemptive orders, most strongly opposed the proposed disclosure requirements. The Commission is adopting rule 18f-3 and related prospectus disclosure requirements with modifications that address the comments received. Rule 18f-3 allows funds flexibility in tailoring many aspects of their multiple class structures, overseen by the board of directors, while preserving investor protection conditions based on the exemptive orders and derived from the concerns underlying section 18. The Commission has reconsidered the disclosure aspects of the proposal in light of the strong opposition of the commenters, and is adopting much less extensive requirements than proposed. The rule and form amendments will give investors the means to obtain information about certain other classes or other feeder funds investing in the same master fund, but do not require extensive cross-disclosure in prospectuses and advertisements.

A. Rule 18f-3

The Commission is adopting rule 18f– 3 to create a limited exemption from sections 18(f)(1) and 18(i) ⁸ for funds that issue multiple classes of shares with varying arrangements for the distribution of securities and provision of services to shareholders. Multiple class funds relying on existing exemptive orders would be allowed to use the rule but would not be required to do so.⁹ The Commission has made several modifications to the rule in view of the comments received.

The rule largely codifies the exemptive order approach of addressing

9 Funds currently relying on exemptive orders that choose to operate instead under the new rule must first prepare plans under paragraph (d) of the rule and file copies of the plans with the Commission as exhibits to their registration statements under new Item 24(b)(18) of Form N-1A. Provided that no changes are made to arrangements and expense allocations under an existing order, paragraph (d) does not require board approval of the plan. A fund choosing to rely on an existing exemptive order, including one providing an exemption for "future classes," may continue to do so, provided it complies with all of the conditions in the order (including the disclosure conditions); in addition, such a fund would also be subject to the disclosure requirements adopted today. See discussion at II.A.5. regarding the adoption of a multiple class plan under the rule.

³ P.W. Coolidge, Business Applications of the Hub and Spoke® Structure, 1993 Mutual Funds & Investment Management Conference X–3 (Mar. 11, 1993); R.M. Phillips and C.E. Plaza, Hub & Spoke® Mutual Funds, 26 Securities & Commodities Regulation 137 (Aug. 1993). See also "Hub-and-Spoke" Funds: A Report Prepared by the Division of Investment Management, submitted with letter from Richard C. Breeden, Chairman, SEC, to John D. Dingell, Chairman, House Comm. on Energy and Commerce (Apr. 15, 1992).

Funds, Nov. 25, 1994, at S1; Carole Gould, *Brokers' New Pitch; Level Load on Funds*, N.Y. Times, May 7, 1994, at 37 ("If investors are confused about which pricing method is best for them, it's no wonder"); Vanessa O'Connell, *Mastering the ABCs of Fund Shares*, Money, Sept. 1993 ("Counting A, B and C shares, analysts now predict that the number of fund options could double to a mindnumbing 8,000 within the next 18 months").

⁶Proposing Release, *supra* note 4.

⁸15 U.S.C. § 80a–18(f)(1) and –(i). Section 18(f)(1) generally makes it "unlawful for any registered open-end company to issue any class of senior security." Section 18(g) defines senior security to include any stock of a class having a priority over any other class as to distribution of assets or payment of dividends. Section 18(i) requires that every share of stock issued by a registered investment company be voting stock, with the same voting rights as every other outstanding voting stock.