amendments to Form N–1A.<sup>16</sup> Because different methods of collecting load payments could carry different potential tax consequences for investors,<sup>17</sup> funds also would be required to disclose those consequences briefly in the prospectus.<sup>18</sup>

## B. Deferred Load Calculation

Rule 6c–10 sets two requirements for calculating a deferred sales load. Under the first requirement, a CDSL must be based on the lesser of the net asset value (the "NAV") at the time of purchase or the NAV at the time of redemption.19 The 1988 proposal would have required the "lesser of" standard for all deferred loads paid at redemption, but would have allowed deferred loads paid other than at redemption (such as installment payments) to be based at a fund's option either on the NAV at the time of purchase or on the lesser of the NAV at the time of purchase or the NAV at the time the load was paid. The mandatory "lesser of" standard for loads paid at redemption was designed to eliminate any impediment to redemption in a falling market that might be created by the load. The second requirement prescribes the method for load calculation in a partial redemption.20

17 One commenter on the 1988 proposal, for example, pointed out that paying installments out of dividend distributions would mean that a shareholder would incur dividend income, yet not actually receive the portion of that income that was used to pay the installment. ICI comment letter supra note 7, at 2, 9. Payment through automatic redemptions, on the other hand, would mean that a shareholder might incur a capital gain or loss on each such redemption; if additional shares then were purchased by the shareholder within 30 days of the automatic redemption, any capital loss might be disallowed under the "wash sale" rule contained in the Internal Revenue Code. Id. at 9; IDS Financial comment letter, supra note 7, at 1; NYLIFE comment letter, supra note 8, at 3.

According to another commenter, installment loads could present potential difficulties for taxprivileged investors, such as retirement plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA") Simpson Thacher comment letter, supra note 15, at 1-8. Automatic redemptions to pay installment loads, for example, might result in the mutual fund's being deemed a fiduciary of the investor for purposes of ERISA, the redemption's being deemed a prohibited transaction under ERISA, and the investor's losing its tax-exempt status. Id. This commenter noted, however, that a fund could seek to obtain a favorable ruling from the Internal Revenue Service on these issues. Simpson Thacher comment letter, supra note 15, at 5-6. A fund also could choose not to offer installment loads to its tax-privileged investors.

 $^{18}$  See infra section III.B (discussing staff Guide 30 to Form N–1A).

<sup>19</sup>17 CFR 270.6c–10(a)(1).

<sup>20</sup> 17 CFR 270.6c–10(a)(3). A fund must treat as if redeemed first shares or amounts representing shares not subject to a load, and treat other shares or amounts representing shares as if redeemed in the order they were purchased. In a partial redemption, this method would allow a This requirement was intended to allow shareholders the maximum benefit from shares in their deferred load accounts that carried no load.

Commenters on the 1988 proposal generally argued that neither requirement is necessary as long as deferred loads are subject to the limits of the NASD Sales Charge Rule and properly disclosed.<sup>21</sup> None of the commenters addressed the concern about an impediment to redemption associated with the "lesser of" requirement, nor any benefits or drawbacks of the order of load calculation. Some commenters suggested, however, that allowing, but not requiring, the "lesser of" method would make it easier for fund sponsors to obtain financing to pay commissions to brokers by eliminating the risk of NAV fluctuation.<sup>22</sup> One commenter also argued that eliminating the "lesser of" requirement would eliminate the need to build a cushion into the load structure to account for the risk of a lower NAV.23 This commenter suggested that the "lesser of" standard may cause fund sponsors to set the load at a higher percentage amount than they otherwise would in order to allow a margin for a possible decline in the NAV.

The Commission is proposing to eliminate the two load calculation requirements from rule 6c-10. Under the proposed amendments, paragraph (a)(1) would allow a deferred load to be a specified percentage of the NAV at the time of purchase, redemption, or the payment of an installment, but would not otherwise limit load calculation.<sup>24</sup> Paragraph (a)(2) would require the terms of a deferred load to be subject to the NASD Sales Charge Rule.

The Commission requests comment on whether paragraph (a)(1) should

<sup>21</sup> ABA Subcommittee comment letter, *supra* note 7, at 6; ICI comment letter, *supra* note 7, at 2; IDS comment letter, *supra* note 7, at 2.

<sup>22</sup> Deutsche Bank December 13, 1993 comment letter, *supra* note 7, at 5; ICI June 14, 1994 comment letter, *supra* note 10, at 5.

<sup>23</sup> Deutsche Bank December 13, 1993 comment letter, *supra* note 7, at 5.

<sup>24</sup> This provision also would allow funds to base a deferred sales load on a combination of these standards, such as on the lesser of, or the higher of, the NAV at the time of purchase or redemption, provided the standard is disclosed and is consistent with any applicable provisions in the NASD Sales Charge Rule. A "higher of" standard, for instance, currently is not allowed under the NASD Sales Charge Rule for mutual funds without an assetbased sales charge, because the Rule limits the sales loads for these funds to a set percentage of the offering price. NASD, Rules of Fair Practice, Art. III, Sec. 26(d)(1)(A). provide for a deferred load to be based on the offering price either instead of, or in addition to, the NAV at the time of purchase. The fee table appearing in mutual fund prospectuses calls for deferred loads to be expressed, where applicable, as a percentage of the original purchase price. This disclosure provides easier comparability with front-end sales loads, which are expressed as a percentage of the offering price.

The requirement in paragraph (a)(1) that the load be a "specified percentage" stated in the prospectus would allow investors to know at the time of purchase the maximum percentage amount of the load.25 Under the revised prospectus disclosure requirements, funds also would have to disclose in the fee table, and explain elsewhere in the prospectus, the manner in which the load is calculated.<sup>26</sup> In addition, funds would have to disclose the method by which they would calculate a deferred load in a partial redemption. The requirement in paragraph (a)(2) that the terms of a deferred load be covered by the NASD Sales Charge Rule would subject all deferred sales loads to the NASD's limits on maximum sales charges.<sup>27</sup> Such an approach is consistent with that currently taken with front-end sales charges assessed on mutual fund shares. The Commission requests comment on the proposed elimination of the load calculation restrictions and the reliance on revised prospectus disclosure requirements and the NASD Sales Charge Rule for deferred sales charges.

26 See infra sections III.A and B.  $^{\rm 27}$  The NASD Sales Charge Rule in its current form governs only deferred loads paid at redemption. The Rule applies to, among other things, "deferred sales charges," which it defines, in relevant part, as "a sales charge that is deducted from the proceeds of the redemption of shares by an investor." NASD, Rules of Fair Practice, Art. III, Sec. 26(b)(8)(B). To the extent deferred loads would be allowed to be paid other than upon redemption (e.g., installment loads), they would fall outside the current definition and would not be covered by the Rule. The proposed amendments to rule 6c-10 contemplate the NASD's amending its Sales Charge Rule to address deferred loads paid other than upon redemption. The Commission's staff has requested the NASD to review its Sales Charge Rule in light of the proposed amendments.

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<sup>&</sup>lt;sup>16</sup> See infra section III.B.

shareholder, in effect, to delay the payment of the deferred sales charge. In a full redemption, no particular order of load calculation would have affected the amount of a deferred sales charge due.

<sup>&</sup>lt;sup>25</sup> The requirement that the load be a "specified percentage" does not mean that the amount must be fixed and may not decrease or increase over time. Rather, it requires only that the percentage amount of the load to be charged at a given time be disclosed in the prospectus. Therefore, the phrase "the same or a lower percentage" in paragraph (a)(1) as adopted for CDSLs has been deleted from the proposed text. Funds would be able to show in the prospectus fee table the range of any deferred load that changes over time, as well as a schedule of any installment load payments. *See infra* section III.A.