SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 239, and 274

[Release No. 33–7197; IC–21221; FR–46; S7–22–94]

RIN 3235–AF94

Payment for Investment Company Services With Brokerage Commissions

AGENCY: Securities and Exchange Commission.

ACTION: Final amendments to rules and forms.

SUMMARY: The Securities and Exchange Commission is adopting rule and form amendments relating to the reporting of expenses by investment companies. The amendments require an investment company to reflect as expenses in its statement of operations and in other financial information certain liabilities of the company paid by broker-dealers in connection with allocation of the company's brokerage transactions to the broker-dealers and liabilities reduced by certain expense offset arrangements. In addition, the amendments require an investment company to disclose the average commission rate it paid in connection with the purchase and sale of portfolio securities, subject to a *de minimis* exception. The amendments are intended to enhance the information provided to investors so that they may be better able to assess and compare investment company expenses and yield information.

DATES: *Effective Date:* The amendments are effective September 1, 1995.

Compliance Dates: Proxy statements and shareholder reports filed with the Commission and quotations of yield by investment companies in advertisements or sales literature published or distributed on or after December 1, 1995 must comply with the amendments. Required compliance for financial information appearing in registration statements is staggered to reflect the affected investment companies' annual updating schedules. A more detailed discussion of the compliance dates appears in section of this release.

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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") today is adopting amendments to:

(1) Rule 6–07 of Regulation S–X [17 CFR 210.6–07]; and

(2) Form N–1A [17 CFR 239.15A, 274.11A], Form N–2 [17 CFR 239.14, 274.11a–1], Form N–3 [17 CFR 239.17a, 274.11b], and Form N–4 [17 CFR 239.17b, 274.11c] under the Securities Act of 1933 [15 U.S.C. 77a *et seq.*] ("1933 Act") and the Investment Company Act of 1940 [15 U.S.C. 80a–1 *et seq.*] ("1940 Act").

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I. Background

Some investment companies enter into arrangements under which a broker-dealer agrees to pay the cost of certain products or services provided to the investment company in exchange for fund brokerage ("brokerage/service arrangements"). Under a typical brokerage/service arrangement, a broker agrees to pay a fund's custodian fees or transfer agency fees and, in exchange, the fund agrees to direct a minimum amount of brokerage to the broker. The fund usually negotiates the terms of the contract with the service provider, which is paid directly by the broker.[1]

By entering into a brokerage/service arrangement, a fund can reduce expenses reported to shareholders in its statement of operations, fee table, and expense ratio and can increase its reported yield. A fund is able to decrease expenses and increase yield under these arrangements because the costs paid on behalf of the fund by the broker are embedded in the brokerage commissions the fund pays.[2] Brokerage commissions are reflected in the cost basis of the purchased securities or as a reduction of the proceeds from the sale of securities.

On August 11, 1994, the Commission proposed for public comment amendments to its accounting rules that would require fund financial data to reflect amounts the fund would have paid to its service providers if a broker-dealer or any affiliate of the broker-dealer had not paid or agreed to pay those service providers on behalf of the fund in connection with a brokerage/service arrangement.[3] As proposed, the amendments would require that the adjusted expenses be reflected in a fund's fee table and financial highlights table included in the fund's prospectus, and in the yield quotations in the fund's advertisements and sales literature. In addition, the proposed amendments would require that the financial highlights table disclose the average commission rate paid by the fund.

The Commission received comments on the Proposing Release from 104 commenters.[4] Commenters that addressed the substance of the Commission's proposals generally expressed support for the proposed amendments.[5] These commenters expressed their belief that the proposals would enhance the information

[1] Brokerage/service arrangements are structurally similar to the more common research soft dollar arrangements under which an investment adviser uses client commission dollars to obtain research services. In a research soft dollar arrangement, however, the receipt of a benefit by an adviser through the use of its clients' commission dollars raises conflict of interest concerns addressed by the safe harbor provisions of section 28(e) of the Securities Exchange Act of 1934 ("1934 Act") [15 U.S.C. 78bb(e)]. These concerns generally are not raised by brokerage/service arrangements, which typically involve use of a fund's commission dollars to obtain services that directly and exclusively benefit the fund.

[2] The staff has stated that the safe harbor provided by section 28(e) of the 1934 Act does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions, *i.e.,* when a broker buys or sells securities for or from its own account. U.S. Department of Labor (pub. avail. July 25, 1990). Because brokerage/service arrangements do not rely on the Section 28(e) safe harbor, a fund may use principal as well as agency transactions to accumulate credits with brokers for the payment of fund expenses. Therefore, references in this release to "commissions" or "commission dollars" rather than "spreads" or "mark-ups" are not intended to indicate otherwise.

[3] Investment Company Act Release No. 20472 (Aug. 11, 1994) [59 FR 42187 (Aug. 17, 1994)] ("Proposing Release").

[4] The Commission received a total of 108 comment letters, as four commenters provided two letters each. The comment letters and a summary of comments prepared by the Commission's staff are available for public inspection and copying in the Commission's public reference room in File No. S7–22–94.

[5] Seventy-one of the 104 commenters, however, limited their comments to the issue of whether the Commission should require funds to include as expenses the cost of research services provided by brokers. *See infra* section.