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THE DISTRIBUTION OF MUTUAL FUND SHARES—
RECENT DEVELOPMENTS IN SEC REGULATION

Section 22(d) of the Investment Company Act of 19401 (Investment Company Act) prohibits the sale of mutual fund shares to the public "except at a current public offering price described in the prospectus."2 Congress enacted this requirement, commonly known as the retail price maintenance3 provison, to control a number of inequitable and disrup-

2. 15 U.S.C. § 80a-22(d) (1970) (emphasis added) states in full:
   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. 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.
3. The term "retail price maintenance," when used in reference to the pricing uniformity required by § 22(d), differs from its use in reference to the pricing of other items. Generally, retail price maintenance permits a producer to establish a uniform sales price to which retailers must adhere when selling to the public. See Bowman, The Prerequisites and Effects of Resale Price Maintenance, 22 U. Chi. L. Rev. 825 (1955); Note, The Impending Demise of Resale Price Maintenance, 1970 Wash. U.L.Q. 68. Section 22(d), by prohibiting sales except at a uniform price, requires that a uniform price be set (presumably by the fund, adviser, or underwriter) in the prospectus and
tive practices in the distribution of mutual fund shares.\textsuperscript{4} Developments since its enactment have cast doubt on the continued necessity of section 22(d). Many of the abuses to which the section was initially addressed have been corrected,\textsuperscript{6} and the provision, with its anti-competitive impact,\textsuperscript{6} has come to be viewed as a cause of "inequities and inefficiencies."\textsuperscript{7}

The Securities and Exchange Commission (SEC) has responded to these changed conditions by taking a number of steps "intended to reduce or eliminate many of the inequities and inefficiencies" of the mutual fund distribution system "while at the same time avoiding the dangers of a sudden abolition of retail price maintenance."\textsuperscript{8} This Note


The term "retail price maintenance" is used by the Securities and Exchange Commission (SEC) and has been adopted herein.

4. Part II of this Note discusses the debate over the purposes for which § 22(d) was enacted. \textit{See} notes 40-54 \textit{infra} and accompanying text (disruption of the distribution system and discrimination in pricing among investors); notes 55-76 \textit{infra} and accompanying text (dilution of investors' interest resulted from backward pricing system which offered insiders an opportunity for riskless trading).

5. Reforms since the enactment of § 22(d) include "forward pricing," \textit{see} notes 74-75 \textit{infra}, and twice-daily pricing, \textit{see} note 74 \textit{infra}.

6. Unlike state fair trade laws, § 22(d) requires rather than permits the fixing of a price at which a fund's shares are sold to the public, thus precluding competition between dealers retailing shares of the same fund. This requirement is an exception to the general national policy against price fixing expressed in the Sherman Act § 1, 15 U.S.C. § 1 (1970). \textit{Cf.} notes 263-84 \textit{infra} and accompanying text.


8. Transmittal Letter v. The letter further stated:

\textit{The Commission has concluded that price competition at the retail level is a desirable goal. It appears to us, however, that the immediate abolition of Section 22(d) would serve the interests of neither the public nor the [mutual fund] industry.}

\textit{Id. at iv.}
will discuss the recent changes in SEC regulation of mutual fund distribution and assess the consequences that may arise from these modifications.

I. THE MUTUAL FUND DISTRIBUTION SYSTEM

An "open-end investment company," or mutual fund, invests capital, derived from the sale of its own equity securities, in the securities of other corporations. The fund's "investment adviser" selects the investments, controls the activities of the fund, and typically serves as

9. For purposes of the Investment Company Act, §§ 3-5 define open-end investment companies, which are also known colloquially as mutual funds. 15 U.S.C. §§ 80a-3 to -5 (1970). Section 3(a) defines an "investment company" as any issuer which (1) is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities; (2) is engaged or proposes to engage in the business of issuing face amount certificates of the installment type . . . ; or (3) is engaged . . . in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets . . . .


Section 5(a) classifies management companies as "open-end" and "close-end" as follows:

(1) "Open-end company" means a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer.

(2) "Close-end company" means any management company other than an open-end company.

15 U.S.C. § 80a-5(a)(1970). The factor that distinguishes open-end from close-end companies is the redeemable character of the securities issued. Shares in close-end companies are not redeemable; an investor who owns shares in an open-end investment company (a mutual fund) may redeem his shares at any time, see note 22 infra, for their "net asset value," see note 23 infra.

In July 1974, 798 mutual fund issues were available. 40 SEC ANN. REP. 153 (1974). The 197 available issues of close-end company shares are similar to equity securities of publicly-held corporations, and are traded on exchanges or over-the-counter. Id.

10. The Investment Company Act refers to an investment adviser as an "advisory board," defined as a board . . . distinct from the board of directors . . . of an investment company . . . composed solely of persons who do not serve such company in any other capacity . . . [which] has advisory functions as to investments but has no power to determine that any security or other investment shall be purchased or sold by such company.
underwriter for the distribution of the mutual fund’s shares.12

Section 2213 of the Investment Company Act regulates the distribution of mutual fund shares. Specifically, subsection (d) requires that the total price paid by public purchasers be uniform.14 This “public offering price” includes the price of the naked share15 and a sales


Mutual funds are seldom managed along conventional corporate lines by their own officers and directors. The typical fund is said to be “externally managed.” This means that most or even all of its work is done for it not by its own officers or employees, but by a separate company.

See also S. REP. No. 184, 91st Cong., 1st Sess. 5 (1969); Werner, Protecting the Mutual Fund Investor: The SEC Reports on the SEC, 68 COLUM. L. REV. 1, 8-10, 17 (1968) [hereinafter cited as Werner].


12. 1972 STUDY 13. Mutual funds compensate their adviser-underwriters for both advisory and underwriting services. Because new sales may increase the advisory fee, see note 26 infra, “in a substantial number of cases advisory income [is] used to subsidize the underwriting function.” SEC, MUTUAL FUND DISTRIBUTION AND SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940 at 4 (1974) [hereinafter cited as 1974 REPORT]. For no-load funds, the advisory fee is the only compensation. See notes 300-01 infra and accompanying text.

13. 15 U.S.C. § 80a-22 (1970). Subsection (a) gives the National Association of Securities Dealers (NASDAQ) the authority to regulate pricing and the time of calculation “for the purpose of eliminating . . . any dilution of the value of other outstanding securities . . .” See notes 57-63 infra. Subsection (b) allows the NASD to prohibit “an excessive sales load [allowing] for reasonable compensation for sales personnel . . . and for reasonable sales loads to investors.” See notes 210-17 infra. Subsection (c) provides that the SEC may supersede the authority that subsection (a) grants the NASD. Subsection (d) imposes the retail price maintenance requirement. Subsection (e) limits the conditions under which the right of redemption may be suspended. See note 22 infra. Subsection (f) requires disclosure of restrictions on the transferability of shares, and gives the SEC authority to adopt rules limiting such restrictions. Subsection (g) prohibits the sale of mutual fund shares in return for services or property other than cash or securities.


15. A mutual fund share, like any equity security, represents a fractional undivided property interest in the net assets of the fund. Since the assets of the fund are invested in securities whose value is readily calculable, the value of the interest represented by a share is readily ascertainable. Since the underlying securities fluctuate in value, however, the value and therefore the price of mutual fund shares change accordingly.
charge, or "load." The Investment Company Act requires that the price of naked shares in a fund be fixed by calculating a pro rata share of the fund's current net assets. Since the total price of shares must be uniform, and the only other payment made by an investor is the sales load, section 22(d), in effect, requires that the sales load charged for sales of shares in a particular fund be uniform. Consequently, this uniformity prevents price competition among retail dealers selling shares in the same fund.


The Investment Company Act § 2(a)(35) defines "sales load" as the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer.


The phrase "and invested or held for investment by the issuer" in the definition accounts for those funds that employ their own sales forces and sell directly to the public. While the "price . . . to the public" equals the "portion . . . received . . . by the issuer" (leaving no "difference" to be the sales load), not all of that price is invested. Some portion pays sales costs. By definition, the fund adds none of the sales load to its assets; it is "purely a payment for selling effort." 1972 STUDY 3 n.2.

The sales load, calculated as a percentage of the total price, see note 32 infra, is typically 8.5%. Largely because of discounts on large purchases, see notes 175-78 infra and accompanying text, sales loads on mutual fund sales in 1970 averaged only 5.7%. 1974 REPORT 23 n.5.

The division of the sales load between the underwriter and dealer is another important economic feature of the distribution system. On a typical load of 8.5%, the dealer retains 7.0%. 1974 REPORT 30. In some instances, underwriters have permitted dealers to retain the entire load. Id. at 31-32. In these cases the underwriter is compensated solely by the advisory fee. See note 12 supra.

Some funds, called "no-load funds," charge no load on sales. They have grown from 5.1% of industry assets in mid-1966, 1974 REPORT 19, to 13.8% in mid-1974, 40 SEC ANN. REP. 153 (1974). No-load funds accounted for 19% of all mutual fund sales in the three years from 1971 through 1973. 1974 REPORT 21. The advisory fee compensates no-load fund underwriters. For a discussion of the lack of retail dealer compensation for the sale of no-loads and the resultant problems, see notes 300-01 infra and accompanying text.

See notes 15 supra & 23 infra.

18. See note 16 supra (sales load defined as purchase price minus amount invested).

19. Although § 22(d) precludes price competition between retailers, it does not prevent competition between funds for a larger share of the market. This competition would seem to encourage funds to lower their sales loads to attract investors. To the contrary, however, the mutual fund industry believes that investors respond to sales efforts by retailers rather than low sales loads. Therefore, to encourage retailers to devote more effort to selling shares of their fund, funds raise the sales load to increase retailer compensation. Hearings on S. 1659 Before the Senate Comm. on Banking &
Except for the retail price maintenance requirement, mutual fund shares are distributed in a manner similar to shares of any equity security: if the fund, as issuer, sells shares to the public through an underwriter and a network of retail dealers. Mutual fund distributions, however, differ significantly from equity security distributions in several respects. First, a mutual fund shareholder may redeem his shares at any time for his proportionate share of the fund's net assets; to balance these redemptions, funds distribute new shares continuously. Second, if sales exceed redemptions, the net assets of the fund tend to increase. Moreover, the advisory fee paid to the adviser-underwriter traditionally is calculated as a percentage of the net assets. Since an

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Currency, 90th Cong., 1st Sess., pt. 1, at 143 (1967); Survey 836; text accompanying note 31 infra.


22. Section 22(e) of the Investment Company Act protects the investor's right of redemption from suspension or postponement for more than seven days except under unusual circumstances, such as a SEC order or inability of the company to determine the value of its assets. 15 U.S.C. § 80a-22(e) (1970). See SEC Investment Company Act Release No. 5571 (Dec. 20, 1968); Survey 834 n.633; Note, Investment Companies and Restricted Securities: Pearls or Perils?, 43 S. Cal. L. Rev. 516, 530-34 (1970).

23. The "net asset value" of a share is computed by dividing the value of the net assets of the fund by the number of its outstanding shares. Section 22(a)(1) authorizes the NASD to adopt rules assuring redemption pricing in "relation to the current net asset value . . . ." 15 U.S.C. § 80a-22(a)(1) (1970). Further, a mutual fund share is a "redeemable security," defined by the Investment Company Act § 2(a)(32) as any security . . . under the terms of which the holder . . . is entitled . . . to receive approximately his proportionate share of the issuer's current net assets . . . . 15 U.S.C. § 80a-2(a)(32) (1970) (emphasis added).

24. Shares issued by the fund are somewhat analogous to treasury shares bought and sold by a corporation. Whether the shares are termed "new" or viewed as redeemed shares being "reissued" is of no practical importance.

25. Two other variables affect the net assets of a fund: fluctuations in the value of securities in which the fund has invested its assets and services for which the fund must pay.

26. The advisory fee is paid to the fund adviser for "externalized services" such as the selection and management of investments and, frequently, almost all other aspects of
increase in net assets results in a commensurate increase in the advisory fee, adviser-underwriters attempt to maximize their funds’ sales-to-redemption ratio by selling as many shares as possible. This continuous process of sale and redemption, coupled with the increased compensation from a high rate of sales, makes the distribution system an integral part of the operation of any mutual fund.

Third, to sell as many shares as possible, adviser-underwriters compete for the favor of retail dealers. Section 22(d) requires that the fund set, and dealers adhere to, a fixed sales load. The confluence of these two requirements results in

what has been described as “perverse competition” [between adviser-underwriters] because it is cost-raising rather than cost-lowering. It is a competition for the favor and services of fund dealers and salesmen

the fund’s operation. Werner, supra note 10, at 8-10. It is typically calculated as one-half of one percent of fund assets per year. 1974 REPORT 24-25 (chart III, note 2).


[T]his underwriting function . . . may be performed at cost or even at a loss. The real financial return to the underwriter . . . in these instances is the management [adviser’s] fee which increases automatically as the fund grows in size.

There is no economic necessity that mutual funds always maintain sales in excess of redemptions. Although the industry experienced “net redemptions” (i.e., redemptions exceeded sales) in 1972 and 1973, 1974 REPORT 21 (Table I; load and no-load funds), these amounts were not a threat when measured against the total industry assets. While the “possibility of ruinous redemption” is recognized by many, Survey 834-35, it does not justify the statement that “it is important that sales always exceed redemptions lest the company be required to liquidate its holdings . . . .” Hodes, Current Developments Under Section 22(d) of the Investment Company Act, 13 B.C. IND. & COMM. L. REV. 1061, 1063 n.8 (1972) (emphasis added) [hereinafter cited as Hodes].

It should be noted, however, that the industry’s fear of a high rate of redemptions is based on more than a desire to maintain the size of the advisory fee. A high rate of turnover, whether redemptions or new sales, requires the fund to hold an increased portion of its assets in liquid or readily liquidable assets, such as cash or short-term notes. Since such assets yield a diminished or no return, the performance of the fund is impaired, a result that fund advisers legitimately fear.

28. 1974 REPORT 5 n.5; 1972 STUDY, supra note 10, at 14; Survey, supra note 3, at 836.

29. Obviously, either the mutual fund or the adviser-underwriter must set the sales load in order to guarantee uniformity. Since funds are controlled by their adviser-underwriters, see notes 10-11 supra and accompanying text, the adviser-underwriters actually set sales loads and determine the portion to be retained by retail dealers.

rather than the conventional form of competition for the favor of investors. This vigorous competition for dealer interest results in powerful upward pressures on selling compensation and sales loads and because of Section 22(d), the countervailing [downward] pressures of retail price competition cannot operate.  31

As a result, sales loads, calculated as a percentage of the total share price, 32 have risen from an average of 5 percent in 1940 33 to a typical 8.5 percent today. 34

Reasoning that the high level of sales loads is symptomatic of problems within the mutual fund distribution system, 35 the SEC "concluded that price competition at the retail level is a desirable goal." 36 In so concluding, the SEC rejected retail price maintenance, exercised its administrative authority to introduce limited variations in the pricing structure of sales loads, 37 and suggested replacement or amendment of section 22(d). 38

II. LEGISLATIVE HISTORY OF SECTION 22(d)

The debate over section 22(d) has sparked renewed interest in its legislative history. 39 Commentators have attempted to identify the problems that compelled its passage in order to determine whether section 22(d) is still necessary.

The "traditional" justification 40 for the retail price maintenance provi-

32. By calculating the sales load as a percentage of the total price, rather than the share, the figure appears to be smaller. For example, an $8.50 sales load calculated as a percentage of a total purchase of $100.00 equals 8.5%. If that same $8.50 sales load is computed as a percentage of the investor's initial interest in the fund's assets ($91.50), the sales load would equal 9.3%.
34. Id.
35. See text accompanying notes 80-85 infra.
38. Id. See 1974 Report 115-21; notes 318-24 infra and accompanying text.
40. Immediately following passage of the Investment Company Act, the retail price competition still held sway.
sion is that Congress passed it to “insure the orderly distribution” of mutual fund shares, to “prevent discrimination” in pricing by dealers selling shares to the public, and to avoid “cut-price competition” with the primary distribution system by “bootleg” broker-dealers.

The threat to orderly distribution and the cut-price competition resulted from the so-called “bootleg” market maintained by broker-dealers not under contract with the mutual fund’s underwriter. Sales contracts between underwriters and retailers required retail dealers to surrender a part of their sales load to the underwriter. Noncontract or “bootleg” broker-dealers purchased shares from the public at slightly more than net asset (redemption) value, sold them at slightly less than the public offering price, and retained the entire difference. Since

maintenance provision of § 22(d) received remarkably little attention. See, e.g., Jaretzki, The Investment Company Act of 1940, 26 WASH. U.L.Q. 303, 330-32 (1941) (discussing § 22 without reference to § 22(d)). In 1959, Lawrence M. Greene, then Assistant Director of the Division of Corporate Regulation of the SEC, outlined his interpretation of the purposes of § 22(d). Greene, supra note 3. Greene first stated that “[a]lthough the reasons for section 22(d) were not articulated by its proponents at the legislative hearings, the objectives were well known in the industry and to the Commission.” Id. at 371. In support of the three “well-known” purposes, Greene cited only two industry memoranda written in 1958. Id. at 371 n.10, citing NASD Memorandum 2-4, February 5, 1958, SEC File No. 57-170-1, Proposal to Adopt Rule 22d-1; N.A.I.C. Memorandum 1-2, June 24, 1958, SEC File No. 57-170-1. It seems unlikely that the congressional purposes that prompted passage of § 22(d) could be “well-known” and yet escape exposition for eighteen years.


In the primary distribution system of mutual funds, the fund issues the shares and sells them to the public through an underwriter and a network of retail dealers under contract with the underwriter. See text accompanying and following note 20 supra. When their sales contracts permitted, retail dealers often functioned as brokers. They established a secondary market in which investors could trade in the shares of that fund, paying a brokerage fee equal to the sales load. This secondary trading posed little threat to the primary distribution system because the brokerage compensation paid to a member of the primary distribution system could be substituted for the sales load revenues that were lost. The “bootleg” market, on the other hand, disrupted the established sales load because bootleg dealers charged a brokerage fee lower than the sales load and diverted revenue from the primary distribution system of which bootleg dealers were not a part.

5. See SEC, Report on Investment Trusts and Investment Companies 850-65 (1940) [hereinafter cited as 1940 Report].
6. Id. at 855. Out of a hypothetical $100 purchase, including a 6% sales load, the fund typically received $94, the underwriter $2, leaving the dealer $4 as compensation.
7. For example, suppose a fund share sold for $100, including a sales load of 6%, and was at the same time redeemable for $94. A bootleg dealer could attract sellers by
noncontract broker-dealers surrendered nothing to the underwriter, they were able to underprice contract dealers and still receive comparable or greater compensation for sales than contract dealers.\textsuperscript{48} This competition diverted revenues from the primary distribution system, and threatened to destroy it.\textsuperscript{49} Supporters of section 22(d) argue that retail price maintenance remains necessary to prevent such price cutting by noncontract broker-dealers.\textsuperscript{50}

“Discrimination” in the sale of mutual fund shares is a more abstract problem. Since section 22(d) permits no variation in purchase price,\textsuperscript{61} one commentator concluded that “the provisions of section 22(d) on their face indicate a purpose to avoid discrimination in the distribution of redeemable securities”\textsuperscript{62} consistent with “the fundamental declaration of policy” of the Investment Company Act.\textsuperscript{63} The notion of discrimination, however, without determining against whom there is discrimination, is paradoxical when applied to the sale of mutual fund shares. While the uniform sales load requirement protects investors from discriminatory variations in price, the requirement discriminates against those public purchasers who are forced to pay retailers for sales services they neither desire nor receive. Generally, variations in price that reflect differences in costs or services are not considered discriminatory.\textsuperscript{64}

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\textsuperscript{48} 1940 REPORT 856-57, 865. See notes 46 & 47 supra.
\textsuperscript{49} 1940 REPORT 324-25, 850-65; Greene 371-72; Hodes 1062-63.
\textsuperscript{50} 1974 REPORT 51, quoting Written comment of Investment Company Institute; Simpson & Hodes 728-30. See notes 271-77 infra and accompanying text (SEC interpretation that § 22(d) is not applicable to noncontract broker-dealers).
\textsuperscript{51} See notes 14-19 supra and accompanying text.
\textsuperscript{52} Greene 372. See Hodes 1063; Simpson & Hodes 719.
\textsuperscript{53} Greene 372. The Investment Company Act’s “fundamental declaration of policy” states in part:

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

\[2\] when investment companies are organized, operated, [or] managed \ldots in the interest of [insiders, affiliates, or others] rather than in the interest of all classes of such companies’ security holders;

(3) when investment companies issue securities containing \textit{inequitable or discriminatory provisions}, or fail to protect the preferences and privileges of the holders of their outstanding securities \ldots . . .


\textsuperscript{54} 1974 REPORT 93 (variations in price in group purchase context):

There would be no unjust discrimination among investors because differences
Commentators recently\textsuperscript{55} have questioned whether section 22(d) was intended to prevent discrimination in price among investors and negate the disruption caused by the bootleg market. One concluded:

[The requirement of a uniform sales load was a compromise provision designed primarily as a device to curb \emph{abuses resulting in dilution} of the value of mutual fund shares, and \emph{possibly} to impose some limitations on the activities of "non-contract" dealers. Only incidentally \ldots{} did the section entail the "price-fixing" aspects which are now assumed by many to be its \emph{raison d'etre}.\textsuperscript{56}

The "dilution abuses" were possible because of the pricing system that existed in 1940. The price at which funds sell their shares is based on the market value of the securities in each fund's portfolio. As the portfolio securities fluctuate in value, so does the value, and therefore the price, of the fund share. In the pre-1940 market, funds calculated the value of their portfolios at the close of the market.\textsuperscript{57} That valuation \textbf{set} the price at which shares were sold during the following day. By waiting until late afternoon, an investor could predict the closing prices for the securities in the fund's portfolio and accurately predict the next day's price for shares of the fund.\textsuperscript{58}

Insiders were able to take advantage of this riskless opportunity to choose between the present price and the next day's predicted price because they had a reduced or no sales load to overcome\textsuperscript{59} and had rapid access to the information necessary to make an accurate prediction.\textsuperscript{60} Average investors, because they paid a full sales load\textsuperscript{61} and had

\begin{itemize}
  \item in sales charges would relate to differences in both costs and services.
\end{itemize}
See Transmittal Letter, supra note 7, at iv.
\textsuperscript{55} Heffernan & Jorden 975; Survey 732.
\textsuperscript{56} Heffernan & Jorden 978 (emphasis added) (footnote omitted).
\textsuperscript{57} 1940 REPORT 860. This system, known as "backward pricing," continued until abolished in 1968. See notes 74-76 infra and accompanying text; Survey 804-05. During the 1940 congressional hearings, the practice was defended on the ground that the industry needed a firm price. \textit{Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency}, 76th Cong., 3d Sess., pt. 2, 514-34, 672-74 (1940) [hereinafter cited as 1940 Senate Hearings]. See generally Greene 373-75; Heffernan & Jorden 979.
\textsuperscript{58} See Heffernan & Jorden 980 & n.20.
\textsuperscript{59} 1940 Senate Hearings pt. 1, at 142; \textit{id}., pt. 2, at 842 (insiders paid a price "close to net asset value"). See Survey 791.
\textsuperscript{60} 1940 REPORT 852; Survey 791.
\textsuperscript{61} Since the prevailing sales load in 1940 was between four and five percent, it was necessary for the per-share value of the fund's portfolio to appreciate at least four or five
no rapid access to the necessary information, could not take advantage of this "two-price" system. Thus, the "backward"\(^{62}\) pricing system offered a continuous opportunity for riskless profit-taking by insiders. Since insider purchases increased the number of shares on days when a profit was earned by the fund, the profit was distributed among more shares, or diluted.\(^ {63}\)

The 1940 congressional hearings on the Investment Company Act emphasized the asset-diluting problems of riskless trading under the two-price system.\(^ {64}\) It was at these abuses that section 22 of the Investment Company act was aimed.\(^ {65}\) Section 22 of the original bill\(^ {66}\) contained a provision that would have required shares to be priced as of the first portfolio valuation after the order to buy or sell was received.\(^ {67}\) This "forward pricing" requirement would have eliminated the two-price opportunity.

percent before an investor could break even. Short-term fluctuations of this magnitude were uncommon, and this hurdle, coupled with the investor's inability to secure the requisite information quickly, see text accompanying note 60 supra, made it impossible for average investors to take advantage of the two-price system. \textit{Survey} 791.

62. \textit{See} notes 57-58 supra and accompanying text.

63. This exaggerated example will illustrate the effect of dilution on the value of outstanding shares:

On day 1, the Fund has 10 shares outstanding and total assets of $100. Each share is worth $10.

On day 2, the Fund's portfolio appreciates a dramatic 50\%. If no sales or redemptions take place, the Fund would have 10 shares outstanding and total assets of $150. Each share would be worth $15.

The picture changes, however, if an insider, noting the rise in the Funds portfolio securities by late afternoon of day 2, buys 10 shares. The price calculated at the end of day 1 ($10) is still in effect. At the close of day 2, the Fund has 20 shares and total assets of $250. Each share is worth $12.50. The insider has taken no risk and profited at the expense of the Fund's shareholders. \textit{Survey} 790-91.


67. Heffernan & Jorden 986 & n.42.

[\(H\)ad \(f\)orward pricing] been adopted at the time of the enactment of the 1940 Act, the principal abuses which section 22(d) was designed to curb would have been eliminated, and [section 22(d)] would probably not have been enacted, or, if enacted, would have been addressed more specifically to the problems generated by the activities of "non-contract" dealers.

\textit{Id}. at 981.
Rather than requiring forward pricing, Congress adopted the section 22(d) requirement that all sales take place at a uniform price. In response to industry opposition, Congress replaced the proposed forward pricing provision with subsections (a), (c), and (d) of section 22 of the Investment Company Act. Subsections (a) and (c) permit the adoption of rules "for the purpose of eliminating . . . any dilution of the value of outstanding securities." Subsection (d), by requiring all purchasers, including insiders, to pay the same sales load, prevented quick profit-taking by insiders because they too had to overcome the sales load before realizing a profit.

Those who argue that section 22(d) should be repealed maintain that subsequent reforms sufficiently preclude the dilution abuses that existed in 1940. Funds now sell their shares at the first price calculated after an order to buy or sell is received. The adoption of forward pricing in 1968 abolished the two-price system that had enabled insiders to trade at the expense of other investors. Absent any potential for the abuses that section 22(d) was designed to prevent, the continuation of retail price maintenance appears unjustified.

68. The industry had suggested that "no securities issued by an investment company . . . be sold to insiders or anyone other than an underwriter or dealer except on the same terms as are offered to other investors." 1940 Senate Hearings, supra note 57, at 526, 548-56, 859. Rather than devise a more specific means to insure insider purchases "on the same terms" as public purchases, Congress chose retail price maintenance.

69. Heffernan & Jorden 968-95.
70. Id. at 968-95; Greene, supra note 3, at 373 n.20.
71. Section 22(a) permits a registered securities association (the NASD) to adopt rules for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities . . . .
72. Requiring insiders to pay a full sales load, however, did not prevent them from using the two-price system. Insiders could still use the two-price system by timing their transactions to maximize profit or minimize loss. See note 61 supra.
73. Heffernan & Jorden, supra note 39, at 1007; Survey 805, 848-51.
76. See notes 57-63 supra and accompanying text.
III. THE SEC PROGRAM

After extensive study,\textsuperscript{77} the SEC concluded that the retail price maintenance requirement "has produced a distribution system that can and should be improved."\textsuperscript{78} In its report, \textit{Mutual Fund Distribution and Section 22(d) of the Investment Company Act of 1940}\textsuperscript{79} (1974 Report), issued in November, 1974, the SEC determined that section 22.(d) was an unnecessary exception to the national policy against price-fixing;\textsuperscript{80} that purchasers were paying for selling services they neither wanted, needed, nor received;\textsuperscript{81} that the present regulatory structure discouraged the use of economical marketing practices;\textsuperscript{82} and that the high level of sales loads\textsuperscript{83} and the recent extended period of net redemptions reflected these shortcomings.\textsuperscript{84} As summarized by then-Chairman Garrett of the SEC:

The mutual fund industry's historic reliance upon high fixed sales charges to induce salesmen to "push" fund shares, besides being expensive for investors, is simply not working today.\textsuperscript{85}

The SEC analyzed three approaches to reforming the distribution process.\textsuperscript{86} First, the SEC considered retaining retail price maintenance and simply requiring the NASD to exercise its authority under section


\textsuperscript{78} Transmittal Letter, supra note 7, at iv.
\textsuperscript{79} 1974 REPORT, supra note 12.
\textsuperscript{80} \textit{Id.} at 76-77. See note 6 supra.
\textsuperscript{81} 1966 REPORT 221; 1972 Study 7.
\textsuperscript{82} 1974 REPORT 86; Transmittal Letter iv.
\textsuperscript{83} 1974 REPORT 80:
The fund industry's virtually total reliance upon incentives to "sell" fund shares has not forestalled a state of extended net redemptions; and there are no clear signs that the situation is likely to improve under the present marketing strategy.
\textsuperscript{84} 1974 REPORT 19, 21-22, 80.
\textsuperscript{85} Transmittal Letter iv.
\textsuperscript{86} 1974 REPORT 76-83.

https://openscholarship.wustl.edu/law_lawreview/vol1975/iss5/1
22(b) to establish a maximum permissible sales load. The SEC rejected this alternative because

[i]t would perpetuate the inefficiencies and inequities of the current distribution system, and it would be based upon a presumption that [a]

maximum sales charge rule . . . would be an appropriate substitute for increased price competition, a presumption contrary to our own analy-
sis . . . .

Second, the SEC considered the immediate abolition of retail price maintenance, through either congressional repeal of section 22(d) or SEC administrative action. The SEC, expressing fear that an immediate move to negotiated sales loads might further decrease sales of new shares, declined to move precipitously to a fully competitive environment. Moreover, the SEC admitted that the marketing problems of the mutual fund industry were partly the regulator's fault:

[T]he present regulatory system . . . has inhibited the development of a demand 'pull' by prohibiting the fund industry from using the marketing devices relied upon by most other businesses: lower prices, effective advertising, and mass marketing techniques such as group discounts.

Reasoning that the repeal of section 22(d) must be preceded by this "development of a demand 'pull,'" the SEC adopted its third alterna-

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87. Id. at 76-77. The 1974 REPORT described this alternative as involving no major modifications of the law presently governing fund distribution except implementation of a meaningful maximum sales load rule; the mutual fund dis-

tribution system's basic reliance upon fixed sales loads . . . would remain un-

changed.

Id. at 76. It would seem that Congress mandated some action in this direction when it amended § 22(b) in 1970. See notes 210-17 infra and accompanying text.

88. 1974 REPORT 76.
89. Id. at 78-81.
90. See notes 318-24 infra and accompanying text.
91. 1974 REPORT 79.
92. Id. See id. at 72, quoting Testimony of Dr. Donald Farrar, Professor of Eco-

nomics, U.C.L.A.: "There are some very serious problems which are an accumulation of an evolutionary process . . . ."

93. Id. at 79. The mutual fund industry has traditionally relied upon high sales compensation to encourage retailers to sell ("push") mutual fund shares. At the same time, SEC regulation has prevented the use of mass marketing techniques to develop a large purchasing population. If a large purchasing population were developed, it would exert a demand (a "pull") for shares. However, the industry is reluctant to move in this direction. Mutual fund representatives continue to argue that extensive selling efforts are necessary. Id. at 53. Because the industry has continued to rely upon individual salesmen as its primary selling technique, no significant "pull" has developed and extensive selling efforts continue to be necessary.

94. Id. at 79.
tive, the gradual modification of the mutual fund distribution system.95

The recommended program, now partly implemented, includes seven
major changes. Less restrictive regulation of advertising allows a wider
"cultivation of public demand."96 A new group purchase rule now
permits a wider variety of groups to aggregate mutual fund purchases
to qualify for quantity discounts.97 Underwriters may provide "open
seasons" during which investors of record may purchase additional shares
at reduced or no load.98 The SEC will consider exemptions from
section 22(d) when retailers sell mutual fund shares in combination
with other financial products.99 The SEC is also encouraging second-
ary trading in mutual fund shares.100 The SEC approved the new
NASD maximum sales load rule limiting sales loads to 8½ percent.101
Finally, proposed legislation will be sent to Congress to clarify the SEC's
authority to introduce more competition into the mutual fund distribu-
tion system.102 Although these modifications are aimed at "allowing
the industry voluntarily to move toward price competition,"103 the SEC
is considering "more far reaching administrative actions"104 that "could
go as far as prohibiting retail maintenance."105

This comprehensive revision has met substantial opposition.106 The

95. Id. at 81-82. The recent modifications in SEC regulations under § 22(d) are
intended to encourage transition "to a stage where [the industry] might be able to adjust
to full price competition . . . ." Id. at 82. See note 93 supra.

One industry representative found fault with gradual modification:
[A] partial repeal of § 22(d)] with the end objective of total repeal would
overhang the industry like a sword of Damocles. Nobody would want to buy
today because prices may be reduced later.

1974 REPORT 57, quoting Written comment of Union Service Corp.

96. Transmittal Letter vi. See 1974 REPORT 84-88; notes 134-74 infra and accom-
panying text.

97. 1974 REPORT, supra note 12, at 89-93. See notes 187-206 infra and accompan-
ing text.

98. 1974 REPORT 93-97. See notes 238-52 infra and accompanying text.


100. 1974 REPORT 104-09. See notes 259-99 infra and accompanying text.


102. 1974 REPORT 115-21. See Transmittal Letter vii; notes 318-24 infra and accom-
panying text.


104. Id.

105. Id.

106. The SEC held hearings on all proposed modifications before writing the 1974
Report containing the recommended program. See generally 1974 REPORT 51-75. The
hearings were designed to "accommodate, to the extent possible, the interests of both
investors and the industry." Id. at 76. Fifty-six of the 59 participants who testified
mutual fund industry generally has opposed any modifications other than a loosening of restrictions on advertising.\textsuperscript{107} Full retail price competition, the industry fears, will drive smaller dealers out of business\textsuperscript{108} and reduce both sales and personalized services.\textsuperscript{109} Moreover, the industry believes that the opportunity for secondary trading,\textsuperscript{110} increased eligibility for group discounts,\textsuperscript{111} and the maximum sales load rule\textsuperscript{112} will further reduce sales compensation, while liberalized advertising regulations\textsuperscript{113} will only partially compensate for this reduction.\textsuperscript{114} Since retailers "have consistently sold products which pay the most money,"\textsuperscript{116} the industry argues that any net decrease in sales compensation would cause "further reductions in sales and further increases in losses or alternatively, a discontinuance of active selling efforts."\textsuperscript{116}

The most convincing argument raised by members of the mutual fund industry is that they have come to rely on the uniform price requirement of section 22(d).\textsuperscript{117} This reliance has been so great that the industry maintains:

\begin{quote}
were members of, or affiliated with, the mutual fund industry. One investor testified. \textit{Id.} at Appendix VI. \textit{See} North, \textit{A Brief History of Federal Investment Company Legislation}, \textit{44 Notre Dame Law.} 677, 697 (1969) ("During the course of the ninety-first Congress we may witness a repetition of the industry-government cooperative endeavors which produced the original Act").
\end{quote}

\begin{quote}
\begin{itemize}
\item \textsuperscript{107} \textit{1974 Report} 51-60.
\item \textsuperscript{108} \textit{Id.} at 55.
\item \textsuperscript{109} \textit{Id.} at 54-55. \textit{See id.} at 55, \textit{quoting} Written comment of the Putnam Management Co.: 
\begin{quote}
\textit{P}rice competition will cause dealers' profit margins to shrink, in turn causing the quality of the sales effort to decline. Mutual funds must be sold properly if the investor is to be sold funds and programs suitable to his needs.
\end{quote}
\item \textsuperscript{110} \textit{1974 Report} 104-09. \textit{See} notes 259-99 \textit{infra} and accompanying text.
\item \textsuperscript{111} \textit{See} notes 187-206 \textit{infra} and accompanying text.
\item \textsuperscript{112} \textit{See} notes 207-37 \textit{infra} and accompanying text.
\item \textsuperscript{113} \textit{See} notes 134-74 \textit{infra} and accompanying text.
\item \textsuperscript{114} "[A]dvertising alone will not get the job done." \textit{1974 Report} 53, \textit{quoting} Written comment of Phillip C. Smith, Chairman of the Board, National Securities Research Corp.
\item \textsuperscript{115} \textit{1974 Report} 23, \textit{quoting} Written comment of Seaboard Corp.
\item \textsuperscript{116} \textit{1974 Report} 55, \textit{quoting} Statement of Franklin R. Johnson, Keystone Custodian Funds, Inc.
\item \textsuperscript{117} \textit{1974 Report} 55. \textit{See} Heffernan & Jorden, \textit{supra} note 39, at 1007:
\begin{quote}
Any legislative or administrative action taken in this area, however, must consider that the mutual fund business has accommodated itself to section 22(d). If the slate were clean, there might be no economic justification [for] such a sweeping exception to the antitrust laws; but the continued vitality of the huge mutual fund industry, if truly dependent upon such a pricing structure, may dictates the continued existence of at least some form of price mainte-
\end{quote}
\end{itemize}
\end{quote}
Those who would propose regulatory changes which would . . . affect the system of distributing mutual fund shares to the public have a heavy burden to establish that the proposal on balance will serve the public interest.\textsuperscript{118}

The SEC response consisted of four major arguments. First, the SEC noted, investors as well as the mutual fund industry deserve the protection of SEC regulation.\textsuperscript{119} Second, gradual modification under administrative supervision can minimize disruption of the distribution system.\textsuperscript{120} Third, the SEC argued, more specific regulation can control the harmful effects of the abolition of retail price maintenance.\textsuperscript{121} Finally, exemption,\textsuperscript{122} reform of rules,\textsuperscript{123} and increased opportunities for less costly distribution\textsuperscript{124} can cushion any financial difficulties experienced by the industry.

Other parties concerned with the modifications concentrated on specific proposals relating to their particular interests. The No-Load Mu-

\begin{itemize}
\item \textsuperscript{118} 1974 Report 51, quoting Statement of Robert Augenblick, President, Investment Company Institute.
\item \textsuperscript{119} Although much of the 1974 Report appears to be an effort to accommodate or refute arguments of the mutual fund industry, the basic import of the recommended program is to reduce inefficiencies, which require higher costs to be passed on to the investor, and to eliminate inequities in the sale of shares to investors. See 1974 Report 76. But cf. note 106 supra.
\item \textsuperscript{120} Transmittal Letter, supra note 7, at vii-viii. See 1974 Report 81-82, 115-21.
\item \textsuperscript{121} See, e.g., notes 259-99 infra and accompanying text (the more specific but less restrictive regulation of brokered transactions).
\item \textsuperscript{122} 15 U.S.C. § 80a-6(c) (1970):
\begin{quote}
The Commission . . . may conditionally or unconditionally exempt any person, security, or transaction . . . from any provision of this [Act] or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this [Act].
\end{quote}
The phrase, "consistent with . . . the purposes fairly intended by the policy and provisions of this [Act]," makes an identification of the purposes of § 22(d), see notes 39-76 supra and accompanying text, an essential element of the granting of exemptions.
\item \textsuperscript{123} 15 U.S.C. § 80a-37(a) (1970):
\begin{quote}
The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred [by this Act] . . . For the purposes of its rules or regulations the Commission may classify persons, securities, and other matters . . . and prescribe different requirements for different classes . . .
\end{quote}
\textit{See} 1974 Report 82.
\item \textsuperscript{124} These "increased opportunities," which primarily liberalized advertising regulations and expanded eligibility for group sales, represent a compromise intended to accommodate the industry. See 1974 Report 88-89.
\end{itemize}
mutual Fund Association\textsuperscript{125} was principally concerned "with the still archaic and inhibiting" advertising regulations.\textsuperscript{126} The American Life Insurance Association\textsuperscript{127} successfully argued that variable annuities,\textsuperscript{128} although "redeemable securities,"\textsuperscript{129} should be exempted from section 22(d) and regulated apart from mutual fund shares.\textsuperscript{130} The Justice

125. See note 16 supra. The interest of no-load funds in sales charges "is indirect at most," 1974 \textit{Report, supra} note 12, at 60, since they charge none.
127. Life insurance companies distribute most of the variable annuities offered. 1972 \textit{Study, supra} note 10, at 60.
128. A variable annuity entitles its owner to a payment that fluctuates according to the value of a pro rata share of the underlying portfolio of securities. Although variable annuities include a longevity factor, they are distinguishable from fixed annuities. They substitute variable payments for fixed amounts and shift the investment risk from the insurer to the owner. \textit{See SEC v. United Beneficial Life Ins. Co.,} 387 U.S. 202 (1967); SEC \textit{v. Variable Annuity Life Ins. Co.,} 359 U.S. 65, 77-80 (1959) (Brennan, J., concurring).
129. "Redeemable security" is defined by the Investment Company Act § 2(a)(32) as any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer . . . is entitled . . . to receive approximately his proportionate share of the issuer's current net assets . . . .
15 U.S.C. § 80a-2(a)(32) (1970). Variable annuities may be redeemed during the "redemption stage," an initial period the length of which is determined by the variable annuity contract. 1972 \textit{Study} 62. Variable annuities are therefore a "redeemable security" within the meaning of the Investment Company Act, and must be sold at a "uniform public offering price" as required by § 22(d).
130. Prior to 1940, the sale of variable annuities was plagued by neither riskless trading nor a secondary market. 1974 \textit{Report} 102, 103 n.2. Before 1975, the continued inclusion of variable annuities under § 22(d) was probably the result of the sale of most variable annuities by insurance companies' "captive" sales forces, in effect a single retailer, who will stipulate a uniform price even if variable annuities are exempted from § 22(d). 1974 \textit{Report} 102; 1972 \textit{Study} 60.


[Any seller of variable annuities] shall . . . be exempted from Section 22(d) to the extent necessary to permit the sale of [variable annuities] at prices which reflect variations in the sales load . . . . \textit{Provided, however,} that (a) the prospectus discloses as precisely as possible the amount of the variations . . . ., and (b) any such variations reflect differences in costs or services and are not unfairly discriminatory against any person.

This exemptive rule was little more than a codification of the many exemptions
Department unsuccessfully urged the SEC to adopt its second alternative, the immediate abolition of retail price maintenance, in order to eliminate the unjustifiable anticompetitive effects of section 22(d).

Having considered both the need to introduce retail competition and the extent of industry dependence on section 22(d), the SEC has begun to move the industry gradually toward a competitive pricing structure. In transmitting the 1974 Report, the SEC described the program as one intended to reduce or eliminate many of the inequities and inefficiencies of the present fund distribution system while, at the same time, avoiding the dangers of a sudden abolition of retail price maintenance.

A. Advertising

Personal labor is one of the major costs of mutual fund distribution. This characteristic is partially attributable to the extensive restrictions the SEC has imposed on mutual fund advertising. The SEC has recently modified these restrictions to allow more informative advertising calculated to increase public understanding of mutual funds. Investor familiarity with funds should reduce the need for extensive sales presentations and lead to lower overall distribution costs.

The Securities Act of 1933 (Securities Act) and its restrictions on sales literature apply to the sale of mutual fund shares. Although

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granted in the past. 1974 Report 103 n.1. Since variable annuities are sold by "captive" sales forces and have already been exempted extensively, exemption from § 22(d) should have little impact on their distribution.

131. See notes 89-93 supra and accompanying text.
133. Transmittal Letter, supra note 7, at v.

    PROFESSOR MUNDHEIM: . . . If you could have expanded advertising, could you get your story across to the public more cheaply, and therefore be able to make your sales at a lower over-all cost?

    MR. RAYMOND GRANT: I don't think so, because we have found that the mutual fund, being the complex investment medium that it is, has to be sold by salesmen.

other kinds of corporations occasionally sell securities, mutual funds continuously offer securities for sale, and therefore are continuously subject to the Securities Act's restrictions on publicity. Section 5(b)(1) of the Securities Act prohibits the use of any "prospectus" that fails to meet the extensive requirements of section 10. Section 2(10) defines "prospectus" as "any advertisement . . . which offers any security for sale" other than a tombstone advertisement excluded by section 2(10)(b) or a communication accompanied or preceded by a statutory prospectus. Thus, advertising by a mutual fund is illegal unless (1) it is a section 10 prospectus; (2) it is accompanied by a section 10 prospectus; or (3) it is a tombstone advertisement that meets the requirements of section 2(10)(b).

Section 2(10)(b) excludes the familiar tombstone advertisement from the definition of a prospectus. A tombstone may include only limited information listed in that section and in rule 134. In 1972, the SEC amended rule 134 to permit inclusion of "a general description

providing a form of continuous registration for mutual fund shares, the other provisions of the Securities Act are applicable, including the prospectus requirement of § 5(b), 15 U.S.C. § 77e(b) (1970). See 1 L. Loss, SECURITIES REGULATION 317 n.2 (2d ed. 1961).

139. See notes 24, 27, 29 supra.
140. Generally stated, § 5(b)(1), 15 U.S.C. § 77e(b)(1) (1970), requires that "offers" to sell securities be made only by means of a statutory prospectus. Virtually all publicity is deemed an "offer" in the statutory sense, because it may precondition the market and lead investors to make a decision before receiving the prospectus.

The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale . . .

146. Securities Act § 2(10)(b), 15 U.S.C. § 77b(10)(b) (1970), excludes from the § 2(10) definition of prospectus any notice, circular, advertisement, letter, or communication [stating] from whom a written [statutory] prospectus . . . may be obtained, and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission . . . may permit.
of an investment company including its general attributes, method of operation, and services offered.”

The 1974 Report recommended, and the SEC adopted, a further liberalization of rule 134. Now, tombstone advertisements also may include information about the particular fund, such as its age, investment objectives, principal officers, aggregate net asset value, and any illustration from the prospectus “not involving performance figures.” Advertisements including the new information must

contain a strengthened instruction cautioning the investor to obtain and read the statutory prospectus.\footnote{157}

\footnote{157}134(a)(3)(iii) codifying earlier interpretations permitting headlines). The attention that the headline attracts must be directed to announcement of the offering, not to the securities themselves. See note 161 infra and accompanying text.

Although the rule as amended does not permit tombstone advertisements to include performance figures since "such information might constitute a selling argument," SEC Securities Act Release No. 5536, 5 S.E.C. Dock. 388, 389 (1974), the SEC indicated it will continue to study the problem, \textit{id.}, and has amended the Statement of Policy to allow sales literature to contain two new kinds of charts, see notes 163-69 infra.

As amended in June 1975, SEC Rule 134(a)(3)(iii)(G), 40 Fed. Reg. 27442 (1975), requires that rule 134 communications contain the following legend:

For more complete information about (Name of Company) including charges and expenses (get) (obtain) (send for) a prospectus (from (Name and Address)) (by sending this coupon). Read it carefully before you invest or (pay) (forward funds) (send money).

To ensure that investors see the legend, rule 134 requires that it be printed "in a size type at least as large as, and of a style different from, but at least as prominent as, that used in the major portion of the advertisement . . . ." SEC Rule 134(a)(3)(iii)(G)(1), 40 Fed. Reg. 27443 (1975).

This legend requirement, as finally adopted, is much weaker than several legends that the SEC previously considered. In SEC Securities Act Release No. 5357 (Jan. 17, 1973), the SEC proposed to require the expanded tombstone to contain a statement of advisory fees, administrative charges, sales loads, and redemption charges, and a coupon that could be mailed for a prospectus. The coupon would have had to contain, in twelve point bold-face type, the legend, "Make no payment at this time." \textit{Id.}


For more complete information about (Name of Company), including sales charges, management fees, and other expenses, see our prospectus. It is important to read the prospectus carefully before you decide to invest. A copy of the prospectus may be obtained from your securities dealer or by writing to (Distributor's Address). Send no money.

\textit{Id.} This formulation of the legend is significant in two respects. First, it dropped the requirement that expenses, fees, and charges be stated in the advertisement. \textit{See} Conference on Mutual Funds, 115 U. Pa. L. Rev. 669, 773-74 (1967). However, it strengthened the final admonition to a single instruction to "[s]end no money."

In SEC Securities Act Release No. 5566, 6 S.E.C. Dock. 211 (1975), the SEC announced its intention to amend again the legend requirement of rule 134 "to permit greater utilization of Rule 134 Communications" and to "shorten the wording of the legend." The proposed amendment would have required a legend stating:

A prospectus containing more complete information about (Name of Company) including all charges and expenses may be obtained from your securities dealer or from (Name and Address of Distributor). Read it carefully before you invest. Send no money.

\textit{Id.} at 212 (emphasis added). This revision deleted the specific list of possible charges and consequently rendered the legend less effective in developing investor awareness of the costs involved in securities dealings.

The deletion was retained by rule 134 as amended. 40 Fed. Reg. 27442 (1975); SEC
The release announcing the amendments to rule 134\textsuperscript{158} cautioned that advertisements must not attempt to sell the security.\textsuperscript{160} The SEC noted the significant difference . . . crucial in terms of the legal requirements . . . between selling a product from the face of an advertisement and attracting the readers' attention and stimulating his interest in obtaining the legally-sanctioned selling document, the statutory prospectus.\textsuperscript{160}

Although the modifications of rule 134 are designed to permit advertisements to generate interest in the prospectus, not in the shares,\textsuperscript{162} the distinction is probably less clear in the investor's mind than it is in legal theory.

\textsuperscript{158} Securities Act Release No. 5591, 7 S.E.C. Dock. 187 (1975). The final amendments to the rule 134 legend requirement also substituted a weakened admonition for the formerly strong directive to "send no money."

The SEC imposed the legend requirement to ensure that tombstone advertisements did not become vehicles for selling the security. As the amount of information contained in the tombstone increases, the need increases for instructions to "read the prospectus" and "send no money." SEC Rule 134(a)(3)(iii)(A-G), as amended, 40 Fed. Reg. 27442 (1975), now allows tombstones to contain more information than ever. Yet, at the same time, the SEC has regrettably weakened the cautioning legend.


\textsuperscript{160} See BNA SEC. REG. & L. REP. No. 334, at A-1, A-2 (March 17, 1976) (speech by Anne P. Jones, Director, SEC Division of Investment Management Regulation, to Annual Mutual Funds and Investment Management Conference):

Wondering whether the existing [advertising] rules are themselves really necessary, Ms. Jones conjectured that perhaps all that is really necessary is a rule prohibiting fraud in advertising and a requirement that investors receive a prospectus prior to investing.

Such a statement ignores the restrictions which the Securities Act places upon the advertising of securities. See Conference on Mutual Funds, 115 U. Pa. L. Rev. 669, 777 (1967). The Securities Act, rather than an SEC rule or release, restricts such advertising. Even if such authority were delegated to the SEC, its wisdom is questionable. See Note, The Investment Company Act of 1940, 41 Colum. L. Rev. 269, 286 (1940):

[The expertness of the [mutual fund] managers was evidenced chiefly by the way in which their literature safely skirted the borderlines of fraudulent misrepresentation . . . .]


The various "anti-fraud" provisions of the Securities Act,\(^{162}\) which prohibit false or misleading statements, also apply to mutual fund sales. In 1950, the SEC adopted a Statement of Policy\(^ {163}\) which describes how the past performance of a mutual fund may be portrayed without being misleading. The Statement of Policy was amended in 1974\(^ {164}\) to allow two new charts portraying fund performance to be included in mutual fund sales literature.\(^ {165}\)

Sample Chart E, by the use of a mountain graph, presents "a continuous record of the results of an investment" over a ten-year period.\(^ {166}\) Along with the mutual fund's record, the chart must include a market index\(^ {167}\) "to demonstrate the effect of fluctuations in the securities markets on fund investment results."\(^ {168}\) Sample Chart F displays the same data as Sample Chart E, but uses a bar graph format to emphasize annual variations in the rate of investment return.\(^ {169}\)

Whether this liberalization in advertising will enable funds to cultivate a demand for mutual fund shares\(^ {170}\) and thus reduce the costs of

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163. SEC Investment Company Act Release No. 1503 (Aug. 11, 1950). The Statement of Policy is based on the premise that any implication that an investor will receive a return on his investment is misleading, and thus illegal unless expressly permitted. Any portrayal of past performance, because it must of necessity either summarize or be confusing, and because it implies a continuation of past trends, falls into the same category. The amended Statement of Policy expressly permits the use of charts based on the "text, graphic detail and arrangement" of certain "sample charts." SEC Statement of Policy § (j)(1)(i), in SEC Securities Act Release No. 5537, 5 S.E.C. Dock. 390, 393 (1974).


166. Id. at 391. The use of a uniform period is intended "to promote comparison," and to "minimize the possibility of distortion" because of the selection of a more favorable period. Id.

167. The Standard & Poor's Composite Index of 500 Stocks was selected, and must be used by all funds. Id. at 391, 392 n.2. Footnote 3 of Chart E explains to investors the purpose of the market index. Id. at 398-99.

168. Id. at 391, 392 n.2.

169. Id. at 392:

Presentation of annual variations in the fund's return should assist investors in distinguishing the average [variable] rate of return for a mutual fund . . . from the constant return available from a savings account . . . .

170. See notes 93-94 supra and accompanying text (repeal of § 22(d) must be preceded by development of demand "pull").
distribution remains to be seen. The advertising liberalization of 1972\textsuperscript{171} appears to have been little help to the industry.\textsuperscript{172} The 1974 liberalizations, however, permit the inclusion of information about particular funds,\textsuperscript{173} thus giving each fund an incentive to engage in more extensive advertising.\textsuperscript{174}

B. Group Purchases

Although section 22(d) speaks of "a . . . price,"\textsuperscript{175} the SEC has always permitted discounted sales loads on large purchases if the discount was described in the prospectus and equally available to all investors.\textsuperscript{176} An investor qualifies for quantity discounts if his purchase exceeds a given quantity (a "breakpoint"), typically set by the fund between $10,000 and $25,000.\textsuperscript{177} Since the discounted sales load applies to the entire purchase, some larger purchases include a far smaller sales cost than smaller purchases.\textsuperscript{178}

\begin{itemize}
  \item \textsuperscript{171} See note 148 \textit{supra}.
  \item \textsuperscript{172} The value of the assets of active mutual funds declined from $64.7 billion in mid-1972, 38 SEC \textit{Ann. Rep.} 152 (1972), to $54.4 billion in mid-1973, 39 SEC \textit{Ann. Rep.} 149 (1973), to $46.1 billion in mid-1974, 40 SEC \textit{Ann. Rep.} 153 (1974). Although part of this decline in assets is attributable to a decline in the stock market, the mutual industry believes itself less susceptible to such declines than the market in general. Furthermore, funds also experienced a decrease in the number of investors. 1974 \textit{Report} 21-22.
  \item \textsuperscript{173} See notes 151-56 \textit{supra} and accompanying text.
  \item \textsuperscript{174} The 1972 advertising liberalization was directed toward educating the public about mutual funds in general, see note 148 \textit{supra}. To justify advertising, a fund had to conclude that encouraging investors to select some mutual fund would yield a sufficient increase in purchases of the particular fund to cover the expense. The 1974 liberalization, however, since it permits advertising about the particular fund, may be more acceptable to funds.
  \item \textsuperscript{175} 15 U.S.C. § 80a-22(d) (1970).
  \item \textsuperscript{176} SEC Investment Company Act Release No. 89 (Mar. 13, 1941) (Opinion of SEC General Counsel). The fact pattern that prompted the opinion included a specified load on purchases up to $25,000 and a discount, at the option of the underwriter, on larger sales. The opinion stated that, although the discretion delegated to the underwriter could result in discrimination between inside and public purchasers and was therefore prohibited by § 22(d), the variation in load for larger purchases was permissible so long as it was available to all purchasers on a nondiscriminatory basis. \textit{Id.} See 1 L. Loss, \textit{Securities Regulation} 406 (2d ed. 1961); Greene, \textit{supra} note 3, at 375-76.
  \item \textsuperscript{177} 1974 \textit{Report} 90; 1972 \textit{Study}, \textit{supra} note 10, at 101-03. Approximately half of the funds have $10,000 as their first breakpoint. Subsequent breakpoints entitle purchasers to greater discounts in the sales load. \textit{Id.} at 101.
  \item \textsuperscript{178} 1972 \textit{Study} 83 n.1:

Under the typical mutual fund sales charge schedule a $9,500 purchase would bear a sales load of $807.50, while the sales load on a $10,000 purchase would be $750.00 and on a $25,000 purchase $787.50.
Groups often aggregate the purchases of their individual members to qualify for quantity discounts. To be eligible to do so, a group must qualify as a "person" within the meaning of section 22(d). If the group is not a "person," the SEC will look beyond the group to the individual investors. Since the individuals' purchases would not qualify for the quantity discount, a reduced sales load would be an illegal deviation from the uniform public offering price required by section 22(d).

The Investment Company Act contains few restrictions on "grouping." Section 2(a)(28) and 2(a)(8) define "person" broadly. Under these definitions, groups formed for the sole purpose of aggregating purchases could qualify for discounts.

In 1958, in response to industry pressure, the SEC restricted the eligibility of groups for quantity discounts by promulgating rule 22d-1. Paragraph (a) of the rule contained a specific "antigrouping" provision which prohibited quantity discounts to groups "of individuals whose funds are combined, directly or indirectly, for the purpose" of mutual fund shares. By defining "person," as used in section 22(d), more narrowly than the Investment Company Act, the SEC satisfied industry objections but restricted the use of an important and efficient technique of mass marketing.

181. Section 22(d) requires a uniform price for sales to "any person." 15 U.S.C. § 80a-22(d) (1970). The Investment Company Act defines "person" as "a natural person or a company," 15 U.S.C. § 80a-2(a)(28) (1970), and defines "company" as a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy or similar official or any liquidating agent for any of the foregoing, in his capacity as such.
182. Greene 379; Simpson & Hodes, supra note 3, at 720-21. In some instances, dealers and salesmen encouraged the formation of groups. 1 L. Loss, SECURITIES REGULATION 407 (2d ed. 1961); Greene 379.
186. 1974 REPORT, supra note 12, at 92.
The SEC has recently amended rule 22d-1 to permit funds, at their option,187 to either offer discounts only to those groups that qualify as a "person" under the old paragraph (a), or to elect the expanded eligibility provisions of new paragraph (b) which permits quantity discounts to any "purchaser."188 The term "purchaser" includes all individuals and families;189 all groups eligible under paragraph (a);190 and all groups that (1) have been in existence for six months,191 (2) have a purpose other than the aggregation of purchases for discount,192 and (3) are able to satisfy uniform criteria, relating to economies of scale, established by the fund.193

The mutual fund industry generally opposed the expansion of group

187. SEC Investment Company Act Release No. 8569, 5 S.E.C. Dock. 420, 420 (1974). By giving funds the option of retaining the old restriction or taking advantage of the expanded definition, the SEC hopes to encourage a degree of voluntary competition and to cushion any adverse impact on specific dealers. See 1974 Report 90 n.2.


189. Id. See Greene 376-77 (family purchase always viewed as "single transaction").


191. Id.

192. The requirement that groups have a "purpose other than to purchase redeemable securities of a registered investment company at a discount," SEC Rule 22d-1(b)(3)(ii)(B), 17 C.F.R. § 270.22(d)-1(b)(3)(ii)(B) (1975), is more than a vestige of the anti-grouping provision enacted in 1958. See notes 183-85 supra. It is a compromise intended to allay industry fears that "the broad availability of relatively low group prices might discourage retailers from making an effort to sell fund shares on an individual basis." 1974 Report 90. The strongest objections of the industry had been aimed at discounts to groups with no "unrelated purpose." See Hodes 1065 ("ad hoc buying cooperatives"); Ratner, Regulation of the Compensation of Securities Dealers, 55 CORNELL L. REV. 348, 380 n.192 (1970) [hereinafter cited as Ratner].

Consistent with this rationale, the rule further restricts eligibility by expressly excluding four groups having a weak organizational nexus:

[The term "purchaser" shall not include any group of individuals whose sole organizational nexus is that the participants are credit cardholders of a company; policyholders of an insurance company; customers of either a bank or broker-dealer; or clients of an investment adviser. SEC Rule 22d-1(b)(3)(ii)(C), 17 C.F.R. § 270.22(d)-1(b)(3)(ii)(C) (1975). The SEC noted, however, that "this listing may be narrowed or expanded by further amendment to the rule if experience shows that it would be appropriate." SEC Investment Company Act Release No. 8569, 5 S.E.C. Dock. 420, 420 (1974).

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\(^{183}\) Greene 379. Competition between funds to organize and offer discounts to groups threatened the industry's desire to avoid price-cutting. SEC Investment Company Act Release No. 2798 (Dec. 2, 1958). See Hodes, supra note 27, at 1064.


\(^{186}\) 1974 REPORT, supra note 12, at 92.
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eligibility. The 1974 Report, which recommended the expansion, noted:

Members of the industry cite problems of suitability, discrimination, and “disorderly distribution.” However, we believe that the core of the industry’s objections is a fear that the broad availability of relatively low group prices might discourage retailers from making an effort to sell fund shares on an individual basis.

Furthermore, the industry noted, although investors would receive a discount, extensive group purchasing would require them to sacrifice some or all individual investment advice.

As adopted, the eligibility provisions and their optional nature clearly are a compromise intended to take into account the objections raised. Even though it is a compromise, however, the amendment will not diminish present suitability requirements. Yet, these requirements do not “necessarily include an obligation on sellers... to assure that individual purchasers make use of all group purchase opportunities.”

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195. Id. See note 192 supra (requirement of unrelated purposes).
196. The SEC has presumed that any investor “who feels he needs individual services... would not buy through a group.” 1974 Report 91. The group, however, must have a purpose not related to investment, see note 192 supra, for which the individual probably joined the group. Limiting the qualifications of the group will not achieve the desired investor protection. Rather, it must be achieved by “full and fair disclosure of the character of securities sold...” Securities Act, Preamble, 48 Stat. 74 (1933).
198. SEC Investment Company Act release No. 8569, 5 S.E.C. Dock. 420, 421 (1974). Industry members were concerned that the suitability requirement would
Moreover, rule 22d-1 speaks of sales to a "purchaser" (the group) rather than sales to the members of the group. Based upon the language of this rule, it is consistent to extend the seller's suitability obligation only to the "purchaser." Since rule 22d-1 still limits eligibility to "bona fide" groups, there should be no disruption of the distribution process. Those funds that experience a disturbing decline in sales to individuals may simply choose to eliminate the discounts granted to groups that do not qualify under the more restrictive paragraph (a).

The expansion of group eligibility, tied to actual economies of scale and affecting only those funds that opt to use it, is a reasonable approach. Calling the expansion an "experiment," the SEC nonetheless has indicated that "[i]n the future . . . it may be appropriate to provide quantity discounts to any group . . . ." Although it acknowledged some disclosure and suitability problems inherent in group sales, the SEC concluded that "in the long run, this [expansion of

require them to ascertain if a purchaser, proposing to buy individually, would be eligible to participate in a group purchase. Such a duty would have benefited investors by increasing the use of quantity discounts, but would have hindered dealers by requiring additional work and decreasing the resulting sales revenues.

The Release, however, did not completely waive the requirement that sellers advise purchasers of group purchase opportunities; it said only that dealers need not "assure that individual purchasers make use of all group purchase opportunities." Id. (emphasis added). In some instances, dealers may still be obliged to recommend that an individual purchase through a group.

199. In the group purchase context, it is unclear whether the seller may simply determine that the recommended fund is a suitable investment for the group, rather than assessing the investment needs of each individual. Neither the 1974 Report nor SEC Investment Company Act Release No. 8569, 5 S.E.C. Dock. 420 (1974), considered this problem. Article III, § 2 of the NASD Rules of Fair Practice speaks of an obligation to ensure the suitability of securities recommended "to a customer." SEC Rule 15c2-5, 17 C.F.R. § 240.15c2-5 (1975), speaks of sales to a "person." If "customer" and "person" mean "group," then dealers need only assess the investment situation of the group.

This interpretation of the suitability requirements seems reasonable. The discount for group purchases is premised on the notion that the group functions as a purchasing entity. In addition, the SEC has encouraged group sales because they are a mass marketing technique that reduces selling costs. To require dealers to ensure the suitability of the investment for each individual would severely reduce the usefulness of this sales technique.

200. 1974 REPORT 90.
201. Id. at 90 n.2.
202. See note 193 supra and accompanying text.
204. 1974 REPORT 91 n.1.
205. Id. at 90.
eligibility] should result in wider, more economical and efficient distribution of mutual fund shares.\footnote{206}

C. Regulation of the Level of Sales Loads

The SEC views the high level of sales loads as an unnecessary cost to investors\footnote{207} and fears that the disproportionately high compensation will influence broker-dealers to recommend mutual fund shares rather than other investments.\footnote{208} Accordingly, the SEC has sought the authority to reduce sales loads.\footnote{209} Before 1970, section 22(b)\footnote{210} granted the National Association of Securities Dealers (NASD) authority, with SEC supervision, to prohibit only "unconscionable or grossly excessive" sales loads.\footnote{211} This language, the NASD and SEC believed, effectively put most high sales loads beyond the reach of any regulation.\footnote{212} In 1966, the SEC urged Congress to place a five percent maxi-

\footnote{206}{\textit{Id.} at 92.}
\footnote{207}{\textit{Id.} at 82. See S. Rep. No. 184, 91st Cong., 1st Sess. 8 (1969): Mutual fund sales charges are much higher than ... elsewhere in the securities industry. The basic New York Stock Exchange commission is about 1 percent ... Over-the-counter securities transactions, when executed on an agency basis, are the same as stock exchange commissions. When the dealer acts as principal the commission is usually between 2 and 3 percent ...}
\footnote{208}{Transmittal Letter, supra note 7, at ii. See Survey 833 ("Wearing as he does the two hats of investor adviser and breadwinner, the potential for conflicts of interest is clear").}
\footnote{209}{As an outgrowth of the 1966 Report, supra note 77, the SEC proposed that \$ 22(b) be amended to provide a five percent maximum sales load, with SEC authority to alter the sales load if conditions required. 1966 Report 223. The proposal was incorporated into S. 1659, 90th Cong., 1st Sess. \$ 12 (1967), as originally drafted. The proposed maximum was vigorously challenged by the industry, deleted, and replaced. For a review of SEC efforts to have \$ 22(b) amended, see North, \textit{The Investment Company Amendments Act of 1970}, 46 \textit{Notre Dame Law} 712 (1971); North, supra note 106. See also Survey, supra note 3, at 844-48.}
\footnote{210}{Act of Aug. 22, 1940, ch. 686, \$ 22(b), 54 Stat. 823.}
\footnote{211}{[T]he price at which such security is offered or sold to the public shall not include an unconscionable or grossly excessive sales load"... \textit{Id.} (emphasis added).}
\footnote{212}{1974 Report 4; 1966 Report 218. The congressional deliberations also evince a belief that the pre-1970 statutory standard was insufficiently stringent. See S. Rep. No. 184, 91st Cong., 1st Sess. 8 (1969) (emphasis added):}
mum on sales loads.\textsuperscript{213} Congress, however, declined, and instead amended section 22(b) in 1970 to allow the NASD to prohibit “excessive” sales loads.\textsuperscript{214} To prevent unreasonable limitation, the section as amended also provides that mutual fund distributors should be allowed “reasonable compensation.”\textsuperscript{215}

Whether the amendment of section 22(b) was a prerequisite to regulation of the high level of sales loads is open to question.\textsuperscript{216} Nevertheless, the NASD and SEC felt restrained by the more permissive “unconscionable or grossly excessive” standard, and they interpreted the 1970 amendment as a mandate to reduce sales loads through more restrictive regulation.\textsuperscript{217}

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This committee believes there is a need to improve the protections afforded mutual fund investors in the sales commission area since existing regulatory controls provide only for the prohibition of unconscionable or grossly excessive sales loads.

See also Hearings on S. 1659 Before the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess., pt. 1, at 174 (1967).


214. Act of Dec. 14, 1970, Pub. L. No. 91-547, § 12(a), 84 Stat. 1422, amending 15 U.S.C. § 80a-22(b) (1964). The relevant part of the section, as amended, provides: [T]he price at which such security is offered or sold to the public 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.


216. Although the wording of the standards is admittedly different, and the old standard connotes a higher permissible sales load, this difference is arguably semantic. But see Survey 840:

The assumption under which the SEC operates in this regard is that Congress has itself stated what an unconscionable sales load is. In section 27(a)(1) [15 U.S.C. § 80a-27(a)(1) (1970)], the Seventy-sixth Congress provided that loads on sales of contractual plans could not exceed nine per cent of the offering price.

217. 1974 REPORT 122.
Pursuant to this perception of increased authority, the NASD adopted\(^ {218} \) and the SEC approved\(^ {219} \) a rule setting a variable maximum on sales loads. A maximum load of 8.5 percent may be charged only by those funds providing three discount opportunities in their price structure: dividend reinvestment at no load,\(^ {220} \) rights of accumulation,\(^ {221} \) and quantity discounts.\(^ {222} \)

The rule assigns each discount opportunity a percentage value (a "penalty") by which the maximum permissible load is reduced if the variation is not offered.\(^ {223} \) Since each of the price variations eliminates an opportunity for the underwriter and retailer to receive a commission, the rule allows a higher load to be charged when income-reducing variations are offered. As the NASD explained,

[The] penalties are intended to correct the imperfections which the NASD perceived in the mutual fund pricing structure in order that it

\(^ {218} \) SEC Securities Exchange Act Release No. 11593, 7 S.E.C. Dock. 570 (1975). In its letter filing the proposed rule, the NASD stated:

The purpose of the amendments is to establish a structure of maximum sales charges which will give effect to . . . the amount of the purchase and special investor privileges of benefits associated with a particular mutual fund . . . .

The [NASD] believes that the [rule is] necessary . . . to implement the provisions of Section 22(b) of the Investment Company Act [as amended].


\(^ {220} \) The reinvestment of dividends resembles a savings account from which interest payments are not withdrawn; the interest becomes part of the principal and itself begins to draw interest. The imposition of sales loads on the reinvestment of dividends has been called an "anomalous practice," 1966 REPORT 223, because the reinvestment of dividends involves no sales effort which would justify the load. The SEC termed the practice "one of the more flagrant deficiencies of the present load structure . . . ." 1974 REPORT 127. Not all funds charge a sales load on reinvestment, however, and one fund sought and was granted permission to allow its investors to reinvest dividends at no load in any of seven funds managed by a common adviser-underwriter. SEC Investment Company Act Release No. 9003, 8 S.E.C. Dock. 308 (1975). See also SEC Investment Company Act Release No. 9048, 8 S.E.C. Dock. 574 (1975) (exemption requested).

\(^ {221} \) A fund that offers rights to accumulation gives an investor a quantity discount when the value of his current holdings in the fund, including his immediate purchase, total more than a breakpoint in the sales load scale. 1974 REPORT 123. Funds that do not offer rights of accumulation give a quantity discount only when the amount of a single purchase exceeds a breakpoint.

\(^ {222} \) See notes 175-206 supra and accompanying text. The rule allows funds to select $10,000 or $15,000 as their first breakpoint.

\(^ {223} \) Data collected by Booz, Allen & Hamilton for the NASD provided the basis for the valuation of these variations. NASD, AN ECONOMIC STUDY OF THE DISTRIBUTION OF MUTUAL FUNDS AND VARIABLE ANNUITIES (1974) [hereinafter cited as NASD STUDY].
correspond more fully to a pricing structure which would exist under a system of effective competition.\textsuperscript{224}

The 1974 Report argued that a fourth variation, an exchange privilege, should also be required of funds charging the maximum sales load.\textsuperscript{226} This privilege allows investors to exchange shares of one fund for the equivalent value of shares of another fund without payment of a sales load.\textsuperscript{226} Approximately 90 percent of the industry now offers some exchange privilege, almost always between funds managed by the same adviser-underwriter.\textsuperscript{227} The NASD omitted exchange privileges because of the burden it would place on that 10 percent of the industry composed of "single-fund underwriters," who manage no other fund with which they could offer an exchange without loss of assets.\textsuperscript{228}

The 1974 Report, however, argued that the value of the privilege to investors overrode the potential hardship to these few underwriters.\textsuperscript{229} Further, the 1974 Report noted that the privilege deprives distributors of an alternative source of income. Since fund distributors who offer an exchange privilege receive no compensation on exchanges, they should be permitted to charge a higher initial sales charge,\textsuperscript{230} a result identical to that which a competitive price structure would produce. Such an addition to the rule would be consistent with the policy of regulating sales loads in order to make them "correspond more fully to a pricing structure which would exist under a system of effective competition."\textsuperscript{231}

The SEC views the NASD rule as only "an interim measure which adds some rationality to the sales load structure."\textsuperscript{232} Although the rule functions by imposing a ceiling on prices, the ceiling resembles a competitive pricing structure and is intended to establish the preconditions

\textsuperscript{224} 1974 \textit{Report}, supra note 12, at 123.
\textsuperscript{225} \textit{Id.} 128-29.
\textsuperscript{228} 1974 \textit{Report} 128. Although the requirement that funds offer an exchange privilege could be viewed as favoring advisers who manage more than one fund, the 1974 Report noted that "single fund underwriters might be able to avoid penalties by arranging exchange privileges with another [fund] complex ... ." \textit{Id.} The Report gave no consideration to the view that this 10 percent of the industry contains a significant number of companies which, in a competitive market, might offer increased competition.
\textsuperscript{229} \textit{Id.}
\textsuperscript{230} \textit{Id.}
\textsuperscript{231} \textit{Id.} at 123.
\textsuperscript{232} \textit{Id.} at 127.
necessary for effective price competition.\textsuperscript{233} The SEC believes it “more important in the long run to attempt to establish greater opportunities for competition than to impose a more restrictive regulatory pattern.”\textsuperscript{234} Thus, the introduction of more detailed price regulation is merely a means to introduce competitive characteristics into the pricing structure and is not inconsistent with the overall policy of developing a competitive environment.

If other competitive variations are introduced, and if investors become more sensitive to differences in sales loads, normal market forces may begin to exert the downward pressures on prices that the rule is intended to supply.\textsuperscript{235} At that point, prescribed maximum sales loads may be replaced by a prohibition of “excessive” sales loads.\textsuperscript{236} Although such a rule will be sufficient after the introduction of competitive market forces is complete, the certainty of a “definite ceiling”\textsuperscript{237} is necessary during the present period of regulatory modification. The rule, as an interim measure, appears to be the best way to reconcile the competing needs of investors and the industry until a more competitive environment is established.

D. Unsolicited Purchases

At first glance, it seems unreasonable to impose a full sales load on purchases by an unadvised and unsolicited investor, because the retailer incurs no cost in securing the purchase. This argument, however, ignores the possibility that an investor might receive advice from one dealer, then purchase through another dealer, and thus appear to be an unsolicited investor.\textsuperscript{238} The 1974 Report concluded that

the likelihood that dealers could be deprived of compensation for their services, and that fund distribution might thus be impaired, outweighs

\textsuperscript{233} Id. at 82. Given this purpose for the maximum sales load rule, the SEC could be expected to argue for additional variations in the future. Beyond the argument involving exchange privileges, however, there has been no indication that the SEC will do so.

\textsuperscript{234} Id. at 125.

\textsuperscript{235} Whether investors will develop the sensitivity to price variations that the SEC expects is open to doubt. See id. at 19 (price inelasticity is still a key characteristic of mutual fund merchandising).

\textsuperscript{236} Id. at 127.

\textsuperscript{237} See id.

\textsuperscript{238} Id. at 93-94.
the argument in favor of providing price reductions for genuinely unsolicited new investors.\textsuperscript{239}

Although it was unable to formulate a workable rule that would permit unsolicited new investors to receive discounts "reflecting the absence of selling efforts with respect to their purchases,"\textsuperscript{240} the SEC did indicate a willingness to consider exemptions from section 22(d) if a fund was able to design a program that dealt with the practical difficulties of identifying genuinely unsolicited new investors.\textsuperscript{241}

The unsolicited "repeat" investor can be, and has been, distinguished from the unsolicited new investor.\textsuperscript{242} The SEC has formulated what it believes to be a manageable rule\textsuperscript{243} to "allow underwriters [at their option] to provide for periodic 'open seasons,'"\textsuperscript{244} during which the sales load charged to repeat investors may be reduced. The rule reflects a balance between the desire to eliminate unjustified loads paid by repeat investors, and the danger of discouraging followup sales by depriving dealers of commissions on those sales.\textsuperscript{245} The opportunity to purchase "open season" shares must (1) be limited to purchasers who are holders of record "for at least a specified period," probably one year;\textsuperscript{246} (2) allow each investor to purchase only "an amount not in excess of the amount of shares already owned,"\textsuperscript{247} (3) be disclosed through notice to shareholders and a description of the process in the prospectus;\textsuperscript{248} and (4) not entail suspension of regular selling efforts.\textsuperscript{249}

\textsuperscript{239} Id., at 96.
\textsuperscript{240} Id. at 93.
\textsuperscript{241} Id. at 97.
\textsuperscript{242} Id. at 93-94.
\textsuperscript{243} Id. at 94. The SEC is particularly conscious of the possibility that its modifications in regulation may discourage sales, compounding the problem of extended net redemptions the industry has recently experienced. See note 172 supra. "A salesman who has no opportunity for additional commissions from follow-up sales may decide that the 'one-shot' earnings from an initial sale do not justify an extensive effort." 1974 REPORT 94. The SEC concluded, however, that the discouragement would be "minimal" because "sales loads are high enough to provide salesmen with reasonable compensation for each sale." Id. at 94-95.
\textsuperscript{244} 1974 REPORT 94. The SEC intended that the choice given to the adviser-underwriter would cushion any adverse impact that "open seasons" might have, and would introduce another variation into the mutual fund pricing structure. Id.
\textsuperscript{245} Id. at 94.
\textsuperscript{246} Id.
\textsuperscript{247} Id. at 95. Should experience show that a limitation is unnecessary, the SEC may delete the limitation from the rule. Funds will still probably be permitted to set a maximum at their discretion. Id. at 95 n.1.
\textsuperscript{248} Id. at 85. The "open season" rule was formulated as an exemption to § 22(d).
As described in the 1974 Report, the "open season" is similar to the privilege of reinvesting dividends at no load, because the retailer expends no sales effort to secure either purchase.250

The rule arguably has one shortcoming; it does not include a provision for underwriters who may wish to compensate retailers for the deprivation of an opportunity to make followup sales. The 1974 Report reasoned that

if salesmen receive enough compensation from a sale, it should not be necessary to offer the salesman the prospect of additional unrelated and perhaps unearned compensation from future purchases by the customer.251

While such reasoning is consistent with the SEC's desire to encourage mass marketing techniques,252 commissions from followup sales may be a major source of compensation for fund sales organizations. Experience with "open seasons" may show that the deprivation is not appreciable, or that the opportunity to participate in "open seasons" is sufficiently limited to protect the salesman's legitimate interest in followup sales.

E. Combination Sales

Mutual fund retailers often sell a wide variety of competing financial products along with mutual fund shares.253 Since the commissions from competing products may pay a portion of the cost of mutual fund distribution,254 the 1974 Report concluded that it would be "desirable to recognize such cost savings and allow fund distributors to pass them along to investors."255

The requirement that the reduction be stated in the prospectus, however, would permit the argument that it is a "public offering price described in the prospectus" as required by § 22(d), 15 U.S.C. § 80a-22(d) (1970).

249. 1974 REPORT 96 n.1.
250. Id.
251. Id. at 95.
253. 1974 REPORT 23-26. These products include insurance, real estate investment trusts, fixed annuities, discretionary accounts, and cash management plans. Id.
254. Id. at 97:

A considerable portion of the sales charge . . . covers the cost of initially soliciting the customer . . . and counseling him . . . [I]f a retailer sells . . . to an investor to whom he has previously or contemporaneously sold some other financial product, . . . much of the necessary solicitation and financial counseling will already have taken place and need not be repeated . . . .

255. Id. (footnote omitted).
Acknowledging its lack of experience in regulating combination purchases,\textsuperscript{256} the SEC declined to propose a comprehensive rule. Instead, the SEC indicated its willingness to consider exemptions from section 22(d) where the investor (1) previously or contemporaneously purchased (2) from the same retailer (3) certain other types of investment products . . . (4) which are available at a separately stated price, and which are (5) distributed by the same underwriter or a company affiliated with such underwriter.\textsuperscript{257}

The administrative problems inherent in granting discounts on combination sales are great. If the competing product is insurance, extensive state regulation may be encountered. Products that are insufficiently separated may create problems of "tie-in" sales.\textsuperscript{258} Nonetheless, the new approach has the potential for passing actual savings to investors, providing distributors the opportunity to experiment with new distribution strategies, and tying the distribution of mutual funds to more equitable and economical means.

F. Secondary Trading

At present, virtually all trading in mutual fund shares is accomplished through the issuance of new shares and the redemption of outstanding shares. Contractual restraints placed on broker-dealers by underwriters\textsuperscript{259} and the uniform price requirement of section 22(d)\textsuperscript{260} have


\textsuperscript{257} \textit{Id.} at 98-99. In announcing this policy, the SEC omitted the limitation on the kinds of investment products, and the requirement that the products be available separately. SEC Investment Company Act Release No. 8570, 5 S.E.C. Dock. 423, 424 (1974). It is doubtful that these omissions were for reasons other than brevity.

\textsuperscript{258} [A] tying arrangement may be described as an agreement to sell one product but only on the condition that the buyer also purchase a different (or tied) product . . .

Northern Pac. Ry. v. United States, 356 U.S. 1, 5-6 (1958) (footnotes omitted). Because they tend to restrain competition for the tied product, tie-ins may violate \textsection{1} of the Sherman Act, 15 U.S.C. \textsection{1} (1970). \textit{See} Turner, \textit{The Validity of Tying Arrangements Under the Antitrust Laws}, 72 \textsc{Harv. L. Rev.} 50 (1958); 1975 Wash. U.L.Q. 495, 497-98 & nn. 10-11. Unless the seller offers the tied product "on the condition" that the buyer also purchase the tied product, there is no tie-in. Northern Pacific Ry. v. United States, supra, at 5. Thus, so long as the financial products in the package are also available separately, as suggested by the \textit{1974 report}, the tie-in problem will not arise.

\textsuperscript{259} 1974 \textit{report} 104.

\textsuperscript{260} The extent to which \textsection{22(d)} is responsible for the absence of secondary trading is difficult to ascertain. Because the section arguably applied to secondary trading, it is
hampered the development of a secondary market in which investors could buy and sell shares through a broker acting as agent.

Secondary trading in mutual fund shares might take place in three ways: a purchase and sale between two individuals; a transaction arranged by an independent, or noncontract, broker-dealer; or a transaction arranged by a broker-dealer under contract to sell shares issued by the fund. Exchanges between individuals are rare because of the practical difficulties of a purchaser and seller locating each other. Therefore, transactions arranged by contract and noncontract broker-dealers are the only practical possibilities.

Retail dealers have consistently either refrained from brokering secondary transactions or charged a broker's fee on the secondary transaction equal to the sales load required by their contracts with the funds' underwriters. Underwriters impose the first restriction to prevent brokers from filling buy orders except with shares purchased through the underwriter, thus guaranteeing the underwriter a commission on every purchase of fund shares. The second restriction prevents the broker-dealer from cutting prices to attract purchasers and sellers.

The Department of Justice recently brought suit alleging that, in imposing these contractual restrictions, the NASD and members of the mutual fund industry had violated federal antitrust law. The

likely that some broker-dealers concluded that § 22(d) prohibited them from brokering transactions and therefore refrained.

261. 1974 REPORT 104.
262. See notes 46-47 supra and accompanying text.

Fifty other private suits premised on similar theories were filed in other federal courts. The Judicial Panel on Multidistrict Litigation ordered the suits consolidated in the District Court for the District of Columbia, In re Mutual Fund Sales Antitrust Litigation, 374 F. Supp. 95, 97 n.4 (D.D.C. 1974). The district court stayed all activity in the cases. Id.

264. Other than the NASD, the suit involved three mutual funds, three underwriters, and nine broker-dealers. 422 U.S. at 701 nn. 7-9.
265. The Department of Justice alleged violation of § 1 of the Sherman Act, 15 U.S.C. § 1 (1970) ("Every contract . . . or conspiracy, in restraint of trade or commerce . . . is . . . illegal"). As explained by the district court, 374 F. Supp. at 97, the "gist of the complaint" was that defendants, through their sales contracts, inhibited
district court dismissed the action, holding that the mutual fund distribution system was immune from the antitrust laws. On expedited appeal, the Supreme Court affirmed the dismissal on different grounds.  

the growth of a secondary market in fund shares, causing public purchasers to pay "artificial and non-competitive sales loads."

266. 374 F. Supp. at 114.

267. The district court based its holding on two alternative grounds. The court first reasoned that

competition in the sale of a single fund's shares is effectively precluded by the 1940 Act which was intended, via § 22(d), to prevent the sale of fund shares at a price less than that fixed in the current prospectus.

ld. at 108. The district court relied upon two arguments to support this ground for its holding. First, the court found that § 22(d) was intended to prohibit the secondary trading that defendants were accused of restraining, 374 F. Supp. at 106, citing Greene, supra note 3, at 371. Compare notes 40-54 supra with notes 55-76 supra. Second, the court noted that when Congress had considered repealing § 22(d), the SEC had offered testimony which, as interpreted by the district court, indicated that § 22(d) prohibited price cutting in the secondary trading market. Congress' acceptance of this testimony, evidenced by Congress' declining to amend or repeal § 22(d), convinced the court that Congress intended § 22(d) to apply to transactions in the secondary market. 374 F. Supp. at 106-07. To reach this ground for its holding, the district court rejected the defendants' argument distinguishing "brokers" from "dealers." See notes 273-76 infra and accompanying text.

This broad holding, if affirmed, would have prohibited secondary trading by contract and noncontract broker-dealers unless the public offering price, including the sales load set by the underwriter, was maintained. It would also have prohibited any SEC action introducing secondary trading at negotiated rates. The SEC found it necessary to take issue with this holding when introducing its program to encourage the development of a secondary market. See 1974 REPORT 104-05; notes 285-92 infra.

The district court's alternative ground for its holding, however, would not have impinged on SEC regulatory control over secondary trading. Noting the "pervasive regulatory scheme" established by the Investment Company Act, the district court found a "Congressional intent to immunize the investment company industry from the impact of the antitrust laws." 374 F. Supp. at 110. Because the Supreme Court ruled that it is the "pervasive regulatory scheme" that shields mutual fund trading restrictions from antitrust liability, the SEC clearly has the authority to modify that regulatory scheme to make it more competitive.

268. Because the United States was complainant, and the case alleged violation of the federal antitrust laws, the Expediting Act, ch. 646, § 17, 62 Stat. 989, required the government to appeal directly to the Supreme Court. Because Gross and Crosby did not involve the United States as complainant, appeal from the dismissal in those cases was to the Court of Appeals for the District of Columbia Circuit.


270. The Court began its analysis by noting the issues:
The SEC, as amicus curiae, argued to the Supreme Court that section 22(d) is inapplicable to secondary trading. The section states that "no dealer shall sell . . . except at a current offering price," and the SEC urged the Court to distinguish between "brokers" and "dealers." The Investment Company Act treats the terms separately, defining a broker as "any person . . . effecting transactions in securities for the account of others," and a dealer as "any person . . . buying and selling securities for his own account." Since a broker-dealer arranging secondary transactions acts only as the agent of the buyer and seller, the SEC argued that the broker-dealer acts as a statutory "broker" and therefore is not covered by the section 22(d) requirement.

The questions presented require us to determine whether § 22(d) obligates appellees to engage in the [restriction of secondary trading] and thus necessarily confers antitrust immunity for them. If not, we must determine whether such practices are authorized by § 22(f) and, if so, whether they are immune from antitrust sanction.
The Court accepted this argument, which the district court had rejected,\(^{278}\) and thus found it necessary to rely upon the second holding of the district court:\(^{279}\) section 22(f)\(^{280}\) grants mutual funds the power to restrict, and the SEC the power to regulate, the transferability of fund shares. The Court held that section 22(f) established a "pervasive regulatory scheme"\(^{281}\) that immunized contractual restrictions on transferability from the antitrust laws.\(^{282}\) This rationale left the SEC, unhampered by section 22(d)\(^{283}\) or the antitrust laws,\(^{284}\) to use its regulatory authority under section 22(f) to introduce secondary trading gradually.

Even before the Supreme Court's decision, the 1974 Report recommended the gradual elimination of restraints on brokered transactions.\(^ {285}\) The SEC, having decided that section 22(d) was inapplicable

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\(^{278}\) 422 U.S. at 720. The district court clearly begged the question in stating: "This argument, however, ignores the price maintenance purpose of § 22(d) . . . ." 374 F. Supp. at 104.

\(^{279}\) 422 U.S. at 720.


No registered open-end company shall restrict the transferability of any security of which it is the issuer except in conformity with the statements with respect thereto contained in its registration statement nor in contravention of such rules and regulations as the Commission may prescribe. . . .

\(^{281}\) 422 U.S. at 735.

\(^{282}\) Here implied repeal of the antitrust laws is "necessary to make the [regulatory scheme] work." [W]e have implied immunity . . . to assure that the federal agency entrusted with regulation . . . could carry out that responsibility free from the disruption of conflicting judgments that might be voiced by courts exercising jurisdiction under the antitrust laws.


\(^{283}\) Had the Court found § 22(d) applicable to secondary trading, no significant amount of brokerage would have developed. The secondary market that existed before 1940 depended upon the broker's ability to purchase and sell shares at slightly better prices than the fund offered, see note 47 supra. If § 22(d) required brokers to sell only at the offering price set by the fund, they would have no way to attract the number of purchasers needed to maintain a secondary market.

\(^{284}\) As recommended by the 1974 Report, the SEC wished to introduce secondary trading gradually. 1974 REPORT 104-07. The contractual and transferability restrictions would have been unenforceable if the Supreme Court had found the antitrust laws applicable. This sudden establishment of secondary trading, the SEC feared, would have disrupted the entire mutual fund distribution system. 1974 REPORT 105. As introduced, the secondary market is subject to discretionary regulation by the SEC and NASD. See notes 289-93 infra and accompanying text.

to secondary trading, 286 prompted the NASD to amend its Rules of Fair Practice to prohibit such contractual restrictions. 287 If funds attempt to circumvent this prohibition by restricting the transferability of their shares or imposing excessive transfer fees, the SEC will adopt a rule under section 22(f) prohibiting such restrictions. 288

The SEC will continue to regulate the brokered market in mutual fund shares. The NASD rule allows funds to “impose a reasonable flat service fee” upon the transfer of shares. 289 The reasonableness of the fee depends upon two factors: the cost of recording the transfer, 290 and the sales load of which the underwriter is deprived through brokerage rather than redemption and sale. 291 Although the underwriter does not participate in the brokered transaction, compensation for him is allowed “to help ensure that all shareholders . . . bear a fair share of mutual fund distribution costs.” 292 If secondary trading of a fund’s shares becomes “extensive,” the rule allows the NASD to exempt the fund from the prohibition on restrictive transfer fees. 293

The SEC has admitted the difficulty of predicting the impact bro-

286. 1974 REPORT 104.
289. 1974 REPORT 105-06. The NASD rule will probably both require funds to calculate the fee as a percentage of the redemption value (net asset value) of the shares traded, and limit the fee to a maximum of one percent. Cf. id. at 106 n.1.
290. Since transfer fees must not be so high that they discourage secondary trading, the rule will probably require funds to show that the fee is related to costs actually incurred. Id.
291. See id.
292. Id. The “service fee” is intended “to help neutralize any adverse impact upon the fund’s primary distribution system, and to help ensure that transactions in a brokered market do not injure existing shareholders.” Id. at 105.
293. The 1974 Report recommended that the SEC permit funds to restrict the transferability of their shares if the fund could show that such a market . . . had become so extensive and price-competitive as to present a significant threat to the fund’s primary distribution system.
Brokered transactions will have on the primary distribution system. The industry has argued that such a market will divert a substantial amount of sales compensation from the distribution system, discouraging new sales and resulting in net redemptions. This fear of net redemptions fails to recognize that shares involved in brokered transactions are not redeemed, but remain outstanding. Although sales may decrease, redemptions should decrease at a commensurate rate. Further, the decrease in sales load revenues should be balanced by lowered distribution costs, the transfer fee paid to the underwriter, and the reduced need for distribution. The development is a sound one and should be welcomed by investors as a long overdue reform.

G. Broker's Fees for Sales of No-Loads

The principal method of compensating dealers for the sale of no-load shares has been through the use of reciprocal brokerage practices and

294. Id. at 105.
295. New sales would be discouraged if the cost of the overall sales effort remained constant while the number of shares sold and the amount of sales load revenue declined. Although overall sales revenues will decline, so will the need to sell new shares and the cost incurred in distributing them.
296. In other words, for every sales load of which an underwriter is deprived because a prospective purchaser bought his shares in a secondary market, a similar number of redemptions must be avoided as a result of the investor's sale in the secondary market.
297. The SEC expects that the introduction of more effective advertising and mass marketing techniques will reduce distribution costs significantly. 1974 REPORT 88; Transmittal Letter, supra note 7, at i. Compare Statement of Robert Loeffler of Investors Diversified Services, Inc., quoted in 1974 REPORT 60, with Written comment of Philip C. Smith of National Securities and Research Corp., quoted in 1974 REPORT 53.
298. See notes 289-90 supra.
299. See notes 295-96 supra and accompanying text.
300. See generally Fogel v. Chestnut, 533 F.2d 731 (2d Cir. 1975); Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971), noted in 13 WM. & MARY L. REV. 530 (1971); Miller & Carlson, Recapture of Brokerage Commissions by Mutual Funds, 46 N.Y.U.L. REV. 35 (1971); Note, The Use of Brokerage Commissions to Promote Mutual Fund Sales, 68 COLUM. L. REV. 334 (1968); Note, Conflict of Interest in the Allocation of Mutual Fund Brokerage Business, 80 YALE L.J. 372 (1970). When executing a trade in portfolio securities, the adviser may place the order (and therefore the brokerage commission) with a broker-dealer who also retails shares of the fund. This practice, permissible as long as patronage is not given in return for the sale of fund shares, is limited in a number of ways. First, fund officers, including the adviser, have a fiduciary duty to the fund and its shareholders "to see the most favorable execution of portfolio transactions . . . ." Delaware Mgmt. Co., 43 S.E.C. 392, 395 (1967). Second, if the reciprocity practice is followed regularly, it may constitute an anticompetitive practice in violation of § 1 of the Sherman Act, 15 U.S.C. § 1 (1970). See United States v. General Dynamics Corp., 385 F. Supp. 36 (S.D.N.Y. 1974); Rainer 383.
“dealer-directed give-ups.” The recent prohibition of such practices, however, eliminated this compensation. Dealers are now faced with the prospect of marketing securities for which they receive no direct, and diminished indirect, compensation. The SEC has proposed to remove this resultant “disincentive” by permitting brokers, acting independently of the fund, to charge a fee for the sale of no-load fund shares “somewhat comparable” to the fee charged on other investments.

This approach presents two problems. First, the no-load label is misleading if a fee is charged for the sale of the shares. Second, the resulting variation in purchase price appears to violate the uniform price requirement of section 22(d). The SEC has attempted to avoid these problems by reasoning that if the broker’s charge is “separate and apart from the price of the fund share,” it can be distinguished from a sales load. Thus, the purchaser pays a uniform purchase price that does not include a sales load, but then pays a separate fee to his broker for services rendered in connection with the sale. Arguably, such an arrangement would maintain the uniformity of purchase price and the truth of the no-load label.

301. A “give up” is the practice of a customer (the fund) directing the broker with which a transaction is placed to split the commission with other brokers whom the fund wishes to reward. In 1968, amendment of the exchanges’ rules or constitutions prohibited the practice. See, e.g., NYSE Const. art. XV, § 1; AMEX Const. art. VI, § 1. See 1966 REPORT; supra note 77, at 172; Ratner, supra note 192, at 357-58; Romanski, The Role of Advertising in the Mutual Funds Industry, 13 B.C. IND. & COMM. L. REV. 959, 972-75 (1972). Some techniques resembling the “give-up” have persisted. Romanski, supra, at 975-76.

302. See notes 300-01 supra.

303. 1974 REPORT 110. This “disincentive” is not only harmful to the industry because it reduces sales, but also because discrepancies in sales compensation may “unduly influence” broker-dealers’ advice to investors. 1966 REPORT 221.

304. See notes 308-12 infra and accompanying text.

305. 1974 REPORT 110.

306. This was the SEC position until 1974. See SEC Investment Company Act Release No. 7475 (Nov. 3, 1972):

The imposition of any charge for recommending the shares or for effecting the purchase of such a fund, especially if the fund encourages or has knowledge of the practice, has been viewed as an impermissible deviation from the prospectus representation as to no-load status. . . .

The NASD argued that funds should not be allowed to maintain their “no-load” label if additional charges are levied. 1974 REPORT 111, quoting Written comment of NASD.

For the broker's charge to "be viewed as separate and apart," there must be no formal or informal distribution agreement between the fund and the dealer, the entire fee must be retained by the broker, the fund must not encourage brokers to charge such a fee, and the fee may cover only services not offered by the fund. Additionally, the retailer must disclose to investors that shares are available at no load from other dealers, the prospectus must disclose the possibility of such a fee, and the fee must be reasonable.

This new approach to the sale of no-load shares, although laudable in its attempt to introduce a more competitive environment, presents a number of difficult complications. The rationale that brokers' fees can be separated from the purchase price of the share would seem to apply with equal force to all fund sales—and the SEC has admitted the statutory barrier that section 22(d) presents to such action. Notwithstanding disclosure in the prospectus that a broker's fee may be charged on the sale, the "no-load" label inaccurately connotes that no sales charge will be imposed. The label should be removed. It is difficult to imagine a dealer selling fund shares without at least an "informal agreement" with the fund or its underwriter, yet the opportunity to charge a fee for the sale of no-loads requires that there be no agree-

309. Id. But see note 316 infra and accompanying text.
310. 1974 REPORT 112. None of the service charge may be surrendered to the underwriter because the costs are all incurred by the dealer and because the underwriter represents the fund as its external management. See notes 10-11 supra.
311. 1974 REPORT 113.
312. Id. at 113 n.1. Expenses or fees that are "properly chargeable to sales or promotional activities" are included in the definition of sales load. Investment Company Act § 2(a)(35), 15 U.S.C. § 80a-2(a)(35) (1970). If the fund offered the selling services, and the broker charged for them independently, the result would be a variation in the sales load which is impermissible under § 22(d).
313. Disclosure would guarantee that "the fee would be one which the customer would pay voluntarily to a third person in order to compensate him for certain selling services." 1974 REPORT 113.
314. Id.
315. The reasonableness of the fee will be determined "considering the size of the transaction and the extent of the services provided." 1974 REPORT 114. The SEC contemplates that the competitive factors of negotiability of the charge and availability of shares at no load will keep brokers' fees at a reasonable level. Id. at 114 n.1.
316. See note 306 supra. See also 1974 REPORT 111, quoting Written comment of NASD:
[T]he designation of "no-load" constitutes the backbone of the marketing strategies for those funds. If broker-dealers were allowed to make a charge for "recommending and effecting" a sale, it would be misleading to characterize such a fund as "no-load."
Further, disclosure of the possibility of such a charge in the prospectus would appear to suggest, if not encourage, that brokers charge such a fee. Finally, rather than responding to interpretive requests, the SEC should formulate and adopt a rule clearly outlining the contemplated exemption. In the absence of such a rule, the distinction between "purchase price" (including a sales load) and "purchase price" plus "broker's fee" is too fine to avoid confusion for investors and challenge in court.

IV. LEGISLATIVE PROPOSAL

The optional variations in the pricing structure of mutual fund distribution have been introduced by the SEC pursuant to its power to promulgate rules and grant exemptions from the provisions of the Investment Company Act. The SEC will need additional authority if it becomes necessary to make the variations mandatory, or if retail price competition is to be further introduced. As part of its program, the SEC will forward to Congress legislation that would increase SEC authority in two ways.

First, the legislation would grant the SEC "increased administrative discretion to deal flexibly with mutual fund pricing in the future." The 1974 Report recommended that the legislation be "analogous" to a provision of the National Securities Market System Act that gives the SEC authority to conditionally or unconditionally exempt any security or transaction or any class of securities or transactions from any such prohibition if the Commission deems such exemption consistent with the public interest, the protection of investors, and the maintenance of fair and orderly markets.

317. See text accompanying note 309 supra.
318. Cf. text accompanying note 237 supra.
319. 1974 REPORT, supra note 12, at 115-18. As of April 19, 1976, the SEC had not forwarded any proposed legislation to Congress.
320. Id. at 121.
321. Id. at 116 n.1.
323. 1974 REPORT, supra note 116-18 ("Obviously, a precise determination of what actions should be taken in the future can only be based upon the facts appearing at that time . . .").
Since it is difficult to predict the impact each newly introduced variation in the pricing structure will have, the SEC clearly needs the desired authority and flexibility.

Second, amendment of section 22(d) would clarify congressional approval of the course of regulation selected by the SEC. The introduction of variations in the pricing of mutual funds is a departure from the traditional requirements of section 22(d). Amendment or replacement of the section would not only remove any doubt about the legality of the current program of voluntary price variation, but would also ensure that retail price competition is reached with legislative endorsement.

V. Conclusion

The retail price maintenance requirement of section 22(d) has produced an inequitable and inefficient mutual fund distribution system. The recent period of net redemptions and the high level of sales loads were symptomatic of these problems. The recent modifications in SEC regulations, to the extent that they are intended to revitalize sales and reduce sales loads, should alleviate many of the problems.

Some of these modifications, however, have been made at the expense of basic principles of federal securities law. The tombstone advertisement, originally intended to permit announcement of an offering, now

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The form this legislation will take is, however, open to some question. In a speech before the Annual Mutual Funds and Investment Management Conference, Anne P. Jones, Director of the Division of Investment Management Regulation of the SEC, recommended that § 22(d) be amended to be a "fair trade" law, see note 3 supra, under which funds, at their option, could fix sales loads. See BNA SEC. REG. & L. REP. No. 334, at A-1, A-2 (March 17, 1976):

The Director advocated that the necessary legislation be structured so that the SEC be given the authority to reinstitute compulsory fixed loads should [a] "fair trade" system threaten the mutual fund industry's distribution system. Should competitive loads function well, the Commission might consider requiring price competition. Ms. Jones stressed that this was her own personal view... . . .

Notwithstanding Ms. Jones' disclaimer, this position represents a significant recantation of the 1974 Report's commitment to move the industry toward a competitive pricing structure.

[A]n exaggerated fear of disorderly distribution should not be permitted to form a pretext for avoiding the introduction of price competition which, while perhaps difficult and even unprofitable for particular funds and their underwriters... . . . would be to the benefit of investors and the fund industry generally.

looks like a medium capable of selling securities rather than provoking interest in prospectuses.\textsuperscript{325} The retention of the “no-load” label by funds for which a brokerage fee is charged is misleading.\textsuperscript{326} The SEC should reassess these modifications, not in light of the condition of mutual funds, but rather in light of the federal securities laws.

The SEC program, in general, is a long overdue reform. The inequitable and disruptive practices to which section 22(d) was addressed are now controlled by more specific measures. The mutual fund industry is now threatened, not by the dilution abuses that existed in 1940, but rather by its reliance on the inefficient selling system that retail price maintenance produced. The gradual change in regulation should be accompanied by a changed selling system. Competitive variations in sales loads are a welcome development.

\textsuperscript{325} See notes 149-61 \textit{supra} and accompanying text.
\textsuperscript{326} See notes 306, 308, 316 \textit{supra} and accompanying text.