

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 210, 239, and 274

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

RIN 3235-AF94

### Payment for Investment Company Services With Brokerage Commissions

AGENCY: Securities and Exchange Commission.

ACTION: Final amendments to rules and forms.

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

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

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

**FOR FURTHER INFORMATION CONTACT:** Karen J. Garnett, Attorney, Office of Disclosure and Investment Adviser Regulation, (202) 942-0728, or Anthony Evangelista, Assistant Chief Accountant, (202) 942-0636, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission

("Commission") today is adopting amendments to:

- (1) Rule 6-07 of Regulation S-X [17 CFR 210.6-07]; and
- (2) Form N-1A [17 CFR 239.15A, 274.11A], Form N-2 [17 CFR 239.14, 274.11a-1], Form N-3 [17 CFR 239.17a, 274.11b], and Form N-4 [17 CFR 239.17b, 274.11c] under the Securities Act of 1933 [15 U.S.C. 77a *et seq.*] ("1933 Act") and the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq.*] ("1940 Act").

#### Table of Contents

- I. Background
  - II. Discussion
    - A. Accounting for Expenses
      1. Brokerage/Service Arrangements
      2. Expense Offset Arrangements
      3. Accounting Method
      4. Financial Statement Note Disclosure
    - B. Exception for Research Services
    - C. Fee Table and Financial Highlights Table
    - D. Yield
    - E. Average Commission Rates
    - F. Effective Date
    - G. Compliance Dates
      1. Registration Statements
      2. Yield Information
      3. Proxy Statements and Shareholder Reports
    - H. Filing Requirements for Post-Effective Amendments
  - III. Cost/Benefit Analysis
  - IV. Regulatory Flexibility Analysis
  - V. Statutory Authority
- Text of Rule and Form Amendments

#### I. Background

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

By entering into a brokerage/service arrangement, a fund can reduce

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

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

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

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

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

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

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

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

provided to investors so that they may be better able to assess and compare investment company expenses and performance. The Commission is adopting the proposed amendments with several modifications that reflect the comments received.<sup>6</sup>

## II. Discussion

### A. Accounting for Expenses

#### 1. Brokerage/Service Arrangements

The Commission is adopting, substantially as proposed, amendments to rule 6-07 of Regulation S-X<sup>7</sup> to require that the amounts of various expenses (such as custody fees, transfer agency fees, printing and legal fees, and other miscellaneous fees) listed in a fund's statement of operations be adjusted, or "grossed-up," to include amounts paid with commission dollars.<sup>8</sup> The rule amendments require funds to make adjustments to their statements of operations at the time financial statements are prepared, but do not require daily expense accruals for services paid with commission dollars. The rule amendments do not require funds to adjust amounts in the financial statements other than expenses and the expense ratio.<sup>9</sup>

<sup>6</sup> As discussed in section II.A.2 below, one of these changes requires funds to reflect as expenses liabilities reduced in connection with certain expense offset arrangements.

<sup>7</sup> Article 6 of Regulation S-X specifies the contents of financial statements included in registration statements, proxy statements and shareholder reports of registered investment companies. Rule 6-07 of Regulation S-X sets forth the requirements for investment company statements of operations.

<sup>8</sup> The staff previously has required funds to disclose in footnotes to the fee table, financial highlights table, and financial statements their participation in brokerage/service arrangements and the effect these arrangements may have on the level of brokerage commissions paid to the fund. See Proposing Release, *supra* note 3, at n.2. The amendments to rule 6-07 eliminate the need for this disclosure and therefore the staff will no longer require such footnotes.

<sup>9</sup> The Proposing Release explained that a fund's investment adviser can benefit from brokerage/service arrangements, particularly if a reduction in fund expenses affects the amount of any expense waiver or reimbursement by the adviser. Proposing Release, *supra* note 3, at n.1. Section 17(e)(1) of the 1940 Act [15 U.S.C. 80a-17(e)(1)] makes it unlawful for an affiliated person of a fund (such as its adviser) to accept from any source compensation (other than regular wages) for the purchase or sale of fund shares. The receipt by a fund's adviser of any direct or indirect economic benefit as a result of brokerage/service arrangements would almost certainly violate section 17(e)(1), unless the benefit received fell within the safe harbor provided by section 28(e) of the 1934 Act. See *supra* note 1. However, the Commission believes that if a fund adviser voluntarily imposes a limitation on the fund's expenses or waives its fees, the fund's brokerage/service arrangements would not violate section 17(e)(1). Similarly, if compliance with expense limitations imposed by statute or by contract is measured by reference to the fund's total

A majority of the commenters that addressed the substance of the proposal supported the proposed accounting changes. These commenters agreed that the gross-up adjustment to expenses would accurately reflect the economic effect of these arrangements, would assist investors in comparing expenses among funds, and would be consistent with current industry reporting standards for statements of operations. Fund industry commenters stated that the method proposed for reflecting broker-paid liabilities as fund expenses was appropriate and not burdensome.<sup>10</sup> Some commenters, however, opposed the proposal, asserting that grossing-up fund expenses would not provide meaningful disclosure to investors and could mislead investors about the benefits to the fund of brokerage/service arrangements. Other commenters objected to the proposal arguing that it would cause funds to overstate expenses.

Commenters opposing the proposed amendments asserted, in effect, that comparable commission rates might be paid by funds that choose not to enter into brokerage/service arrangements, and, therefore fund services provided under brokerage/service arrangements should be treated as "free" services and payments by brokers should be ignored. If brokers made these payments to funds in the form of cash, however, fund expenses would not be affected. Thus, it is merely the form these payments take, rather than their substance, that has permitted such payments to reduce fund expenses. To the extent that investors benefit from these arrangements (which the Proposing Release acknowledged they may), the benefit is reflected in overall fund return rather than as a reduction of fund expenses—a result that more accurately reflects these arrangements as a rebate on brokerage.

#### 2. Expense Offset Arrangements

##### a. Fee Reductions. Some funds enter into arrangements that, like brokerage/

expenses (*i.e.*, expenses adjusted to include the cost of services provided under brokerage/service arrangements), a fund's brokerage/service arrangements would not result in a violation of section 17(e)(1).

<sup>10</sup> In the Proposing Release, the Commission requested comment on an alternative accounting method that would require funds to allocate each commission paid between execution cost and payment for fund services, and to present their financial statements based upon those allocations. This method would have required funds to separate commissions into brokerage and expense components, and reflect the expense component as an expense in the financial statements. Commenters that addressed the alternative accounting method were uniformly opposed to it on grounds that it would be impractical, costly, and burdensome for funds to calculate, as well as difficult to audit.

service arrangements, have the effect of reducing reported fund expenses. In these arrangements ("expense offset arrangements"), however, expenses are reduced by foregoing income rather than by recharacterizing them as capital items. For example, a fund may have a "compensating balance" arrangement with its custodian under which the custodian reduces its fees if the fund maintains cash on deposit with the custodian in non-interest or below market interest bearing accounts. Similarly, a fund may enter into a securities lending agreement under which the fund permits the custodian to loan fund securities to third parties (typically unrelated broker-dealers) in exchange for a reduction in custody fees.<sup>11</sup> Expense offset arrangements may involve explicit oral or written agreements regarding the amount of fee reductions. A fund's custody fee may, however, reflect an estimate of the income the custodian expects to derive from an expense offset arrangement, and the resulting fee reduction is not expressly stated in the custodial agreement.

The Commission requested comment whether an adjustment to fund expenses similar to that proposed for brokerage/service arrangements should be required for expense offset arrangements, or whether these arrangements should be addressed in footnotes to the financial statements.<sup>12</sup> In addition, the Commission requested comment whether the amount of any increase in fund expenses to reflect these arrangements should include only amounts that are explicit in the agreement, or should also include amounts implicit in the basic custodian fee.

Most of the commenters addressing this issue supported an adjustment to fund expenses for expense offset arrangements. Commenters generally stated that requiring disclosure for expense offset arrangements would be consistent with requirements relating to brokerage/service arrangements. Commenters were divided, however, on whether the amount of any increase in fund expenses should include only

<sup>11</sup> Securities lending arrangements may raise other issues under the federal securities laws. The Commission is not addressing in this release the merits of any particular securities lending arrangements.

<sup>12</sup> Footnote disclosure of compensating balance arrangements under which the withdrawal or use of cash or cash items is restricted, either legally or as a practical matter, is currently required by rule 6-04.5 of Regulation S-X [17 CFR 210.6-04.5]. In addition, Rule 6-04.11 of Regulation S-X [17 CFR 210.6-04.11] requires fund balance sheets to state the value of securities loaned and to indicate the nature of collateral received as security for the loan.

amounts that are explicit in agreements between the fund and the service provider.

The amendments to rule 6-07 of Regulation S-X, as adopted, require funds to include as expenses the amount of any reduction in fees or expenses arising from expense offset arrangements.<sup>13</sup> A fund's statement of operations must reflect as the cost of services provided the amount that the fund would have paid in the absence of the expense offset arrangement.<sup>14</sup> The requirement only applies to agreements that provide for specified or reasonably ascertainable fee reductions in exchange for use by another person of the fund's assets. It does not apply to fee reductions that are implicit in the service provider's basic fee.

b. *Foregone Income.* The Commission also requested comment whether funds should be required to estimate income foregone under expense offset arrangements and reflect such amounts in fund financial information.<sup>15</sup> The Commission asked commenters to suggest methods for estimating income foregone under these arrangements. Some commenters supported such a requirement, suggesting that funds should make a "reasonable estimate" of foregone income. Other commenters noted the difficulty of estimating lost income and expressed concern that such a requirement could result in misleading financial information. Moreover, one commenter argued that, in order to estimate lost income, a fund would have to assume income, which is inconsistent with generally accepted accounting principles ("GAAP") and could prevent auditors from issuing an unqualified report that fund financial statements are prepared in accordance with GAAP.

The Commission shares certain of these concerns and has therefore decided not to require funds to reflect in fund financial information income foregone as a result of expense offset arrangements. As amended, rule 6-07 requires a fund that enters into an expense offset arrangement to include in a footnote to financial statements a statement that the fund could have invested the assets used by the other

person in an income-producing asset if it had not agreed to a reduction in fees or expenses under an expense offset arrangement.

### 3. Accounting Method

Under rule 6-07, as amended, a fund's total expenses reported in the statement of operations must include expenses paid under brokerage/service and expense offset arrangements.<sup>16</sup> Total expenses are then reduced by the total amount paid under brokerage/service and expense offset arrangements. The remainder appears on the statement of operations as "net expenses."<sup>17</sup> The following example illustrates adjustments to the statement of operations required by the amended rule:

Expenses:	
Management Fee .....	\$50
[Other direct fund expenses] .....	48
Custodian Fee [would include 8 paid by brokers] .....	10
Total Expenses .....	108
Fees Paid Indirectly <sup>18</sup> .....	(8)
Net Expenses .....	100

The increase in "Total Expenses," and the offsetting "Fees Paid Indirectly," reflect the amount that the fund would have paid for services in the absence of brokerage/service and expense offset arrangements. If a fund directly negotiates the service provider's fees, the cost of the services for purposes of making the required adjustments is the amount negotiated, presumably the same amount the fund would have paid for the service in the absence of the arrangement. If the fund cannot readily determine the actual cost of such services, e.g., when a broker arranges for the services or provides them itself or through an affiliate, the fund must make a good-faith estimate of the amount it would have paid if it had contracted for the services directly in an arms-length transaction.<sup>19</sup>

<sup>16</sup> A fund must also use the total expense figure to calculate its expense ratio, its "Other Expenses" listed in the fee table, and its yield. See *infra* sections II.C and II.D.

<sup>17</sup> Because only expenses, and not realized gains/losses or unrealized appreciation/depreciation, are adjusted in the statement of operations, the presentation of "net expenses" is necessary to ensure that net investment income is not affected by the adjustment to expenses.

<sup>18</sup> As amended, rule 6-07 requires funds to include a footnote to the financial statements that states separately the total amount of expenses paid through brokerage/service arrangements and the total amount of expenses paid through expense offset arrangements. See *infra* section II.A.4.

<sup>19</sup> The good-faith estimate may be based upon price quotes for the services obtained by the fund or the amount funds of similar size and having

### 4. Financial Statement Note Disclosure

As proposed, the amendments to rule 6-07 would have required a fund to identify separately in a note to the financial statements any expense that the amendments would require to be increased by five percent or more over the amount of the unadjusted expense.<sup>20</sup> Several commenters urged the Commission to require less detailed note disclosure, arguing that shareholders were not interested in individual expense amounts. In response to these concerns, the amended rule requires a fund to state separately in a note to the financial statements the total of expense increases resulting from brokerage/service and expense offset arrangements (which together should be equal to the amount of the "Fees Paid Indirectly" line item in the statement of operations). The amended rule also requires a fund to state in the footnote each category of expense that is increased by an amount equal to at least five percent of total expenses.<sup>21</sup>

#### B. Exception for Research Services

As proposed, the requirement to adjust reported expenses to include amounts paid with commission dollars excepted the cost of research services (as that term is used in section 28(e) of the 1934 Act) provided by broker-dealers.<sup>22</sup> Most commenters believed that the exception was appropriate. Many pointed out the difficulties of allocating research received by the adviser among accounts when the brokerage of those accounts is used to acquire the research.<sup>23</sup> Some also asserted that it would be difficult to value research services, particularly when combined with brokerage services, while others objected to

similar investment objectives pay for the same services.

<sup>20</sup> Proposing Release, *supra* note 3, at n.12. The amendments, as proposed, would have permitted funds to aggregate amounts that individually were less than five percent of the unadjusted expense and required funds to state the total of these amounts.

<sup>21</sup> The five percent threshold is consistent with an existing provision of rule 6-07 that requires funds to state separately expense items that exceed five percent of the total expenses shown in the statement of operations. Rule 6-07.2(b) [17 CFR 210.6-07.2(b)].

<sup>22</sup> See *supra* note 1. Because research services are typically provided to the adviser, not the fund, the specific exception may be unnecessary. In light of the widespread use of research soft dollar arrangements, however, the Commission is adopting a specific exception.

<sup>23</sup> Twenty commenters expressly opposed allocation of research on an account-specific basis, stating that such a requirement would be burdensome (with no corresponding benefit to investors), costly, arbitrary or impossible.

<sup>13</sup> Rule 6-07.2(g)(2) of Regulation S-X [17 CFR 210.6-07.2(g)(2)]. Under the amendments, expense offset arrangements include arrangements under which a service provider reduces its fees in return for the use of fund assets as well as arrangements under which another person, in return for the use of fund assets, makes payment to a fund service provider which in turn reduces its fees charged to the fund.

<sup>14</sup> Amendments to fund registration forms adopted today incorporate similar requirements for fund prospectuses by reference to rule 6-07.

<sup>15</sup> Proposing Release, *supra* note 3, at section II.D.

making assumptions about the value of research services.

A minority of commenters supported the additional disclosure of research soft dollar practices. These commenters expressed concern that such practices pose the same hidden expense problems as brokerage/service arrangements, and that such practices may be more likely to raise conflicts of interest than brokerage/service arrangements. None of the commenters, however, suggested a feasible approach for valuing<sup>24</sup> or allocating<sup>25</sup> research services for purposes of disclosure. Because of the practical difficulties of valuing and allocating research services, the amendments except the cost of research services from the requirement to gross up fund expenses.<sup>26</sup>

### C. Fee Table and Financial Highlights Table

The Commission also proposed amendments to the instructions to items of fund registration forms that require funds to include in their prospectuses a table presenting the expenses paid by fund shareholders, either directly or out of the assets of the fund (the "fee table").<sup>27</sup> Most commenters supported these amendments and the Commission is adopting them as proposed.

The amended instructions require that expense percentages included in a fund's fee table be based upon total

expenses (i.e., expenses that include amounts paid in connection with brokerage/service arrangements and expense offset arrangements). Similarly, the "ratio of expenses to average net assets" ("expense ratio") in a fund's financial highlights table must reflect total expenses.<sup>28</sup> Funds must also include a footnote to the financial highlights table disclosing the change in the manner in which expenses have been determined.

### D. Yield

The Commission is adopting, substantially as proposed, amendments to the instructions to yield formulas for funds (other than money market funds) that require a fund to include the cost of services paid with brokerage commissions in yield quotations appearing in the fund's registration statement and, as a result, in its advertisements.<sup>29</sup> The amended instructions require funds to estimate amounts paid with commission dollars for the period of the yield quotation.<sup>30</sup> A majority of commenters addressing this proposal expressed support for the requirement. These commenters stated that the proposed requirement would prevent funds from overstating yield and would be consistent with the Commission's objective of enhancing investors' ability to compare expenses and yields among funds.<sup>31</sup>

The amendments do not require funds to adjust yield calculations to reflect expense offset arrangements. Because the formula for calculating yield requires funds to reduce income by expenses,<sup>32</sup> any increase in expenses to reflect expense offset arrangements would require a corresponding increase in income by an estimate of income foregone as a result of the arrangement. As discussed above, the amendments do not require estimates of foregone income in the statement of operations. Moreover, because expense offset arrangements generally reduce both income and expenses by similar amounts, reflection of (or failure to reflect) these arrangements in calculation of fund yield should have a minimal effect on the reported yield.

### E. Average Commission Rates

The Commission proposed to require funds to disclose the average commission rate paid by a fund in the financial highlights table next to the portfolio turnover rate. Brokerage commissions and other costs incurred in connection with the execution of a fund's portfolio transactions are not reflected in the fund's statement of operations, financial highlights table, or fee table because these costs are treated as capital items that increase the cost of securities purchased or reduce the proceeds of securities sold. The Commission was concerned that funds may not provide adequate information about these costs to investors,<sup>33</sup> particularly in light of the fact that these costs can reflect the cost of research and other benefits the fund adviser may receive in connection with its direction of fund brokerage.<sup>34</sup>

Most fund industry commenters opposed the proposal, asserting that disclosure of average commission rates either would not be meaningful or would be confusing for most investors because average commission rates do not reflect spreads and quality of execution. Furthermore, they argued, factors affecting commission rates, such as the size of the order, the market in which the security trades, and the

amortized or discount accreted for the purposes of calculating yield. Only two commenters addressed the question of revising the yield formula for money market funds. Both of these commenters agreed with the Commission's analysis of the effect of brokerage/service arrangements on money market fund yield, and both were opposed to such revisions.

<sup>32</sup> See, e.g., Item 22(b)(ii) of Form N-1A.

<sup>33</sup> A fund is required to disclose in its Statement of Additional Information the aggregate amount of brokerage commissions it paid to fund affiliates during its three most recent fiscal years. Item 17(b) of Form N-1A.

<sup>34</sup> See *supra* notes 1 and 2.

<sup>24</sup> One commenter recommended that fund advisers be required to make a good faith estimate of what soft dollar research would have cost in an arms-length transaction. This approach, however, would require fund advisers to report positive values for unsolicited and unused research, which could distort fund expenses if receipt of the research was incidental to brokerage direction decisions made wholly on the basis of the broker's execution capabilities. In addition, good faith estimates may be difficult to make if the services provided are unlike those available for hard dollars.

<sup>25</sup> One commenter recommended that expenses incurred on behalf of more than one fund be allocated in accordance with written formulas approved by the board of directors of each fund. While it is possible that a board of directors may be in a position to provide guidance to an adviser in allocating the cost or value of research among series of a series fund or among funds having a common board of directors, it is unlikely that a board would be in such a position with respect to other clients of the adviser.

<sup>26</sup> The Commission recently proposed new disclosure requirements for soft-dollar practices. Investment Advisers Act Rel. No. 1469 (Feb. 14, 1995) [60 FR 9750 (Feb. 21, 1995)] ("Adviser Soft Dollar Release"). The Commission requested comment on the valuation issue in the Adviser Soft Dollar Release. If the comments received in response to the Adviser Soft Dollar Release suggest a feasible way to address these issues without imposing burdens that outweigh the benefits of disclosure, the Commission may reconsider the exception for research services provided in the amendments adopted today.

<sup>27</sup> Item 2(a)(i) of Form N-1A, Item 3.1 of Form N-2, Item 3(a) of Form N-3, and Item 3(a) of Form N-4.

<sup>28</sup> Item 3(a) of Form N-1A and Item 4.1 of Form N-2. The Commission did not propose amendments to the per share tables in Forms N-3 and N-4.

<sup>29</sup> Paragraph (e)(1) of rule 482 under the 1933 Act [17 CFR 230.482(e)(1)] requires that yield quotations included in fund advertisements be calculated in accordance with the formulas specified in fund registration forms. The yield formulas are set forth in Item 22(b)(ii) of Form N-1A, Item 25(b)(ii) of Form N-3, and Item 21(b)(ii) of Form N-4.

<sup>30</sup> The amendments to Regulation S-X require funds to adjust expenses at the end of a financial statement period, but generally would not require funds to accrue or otherwise determine at the end of the 30-day period for which yield is calculated the amount of expenses paid with brokerage commissions for that period.

<sup>31</sup> The amendments do not revise the manner in which yield is calculated by money market funds. The money market fund yield formula is based upon the net change in the value of a hypothetical account, and any spread or mark-up paid by a fund is amortized and reflected in that change in value. See, e.g., Item 22(a) of Form N-1A. Therefore, requiring money market funds to include fees paid with commission dollars in the calculation of yield would result in those fees being counted twice. The same double-counting problem does not arise with respect to non-money market funds because the yield formula for those funds generally requires that the amortization of premium and accretion of discount on debt securities be based upon the market value of the security, rather than the initial purchase price. See, e.g., Instruction 1(a) to Item 22(b)(ii) of Form N-1A. The mark-up or spread paid by the fund upon the purchase of a security is not reflected in the security's market value and therefore would not be a part of any premium

nature of the brokerage firm capital commitment to the trade, would preclude any useful comparison between funds. Other commenters expressed concern that requiring funds to disclose average commission rates would induce funds to place undue emphasis on lower commission rates rather than quality of execution.

The Commission believes that disclosure of average commission rates can improve investors' ability to evaluate and compare fund brokerage costs, and is adopting the requirement as proposed. While many factors may affect commission rates, many similar factors affect other fund costs. The Commission believes that a comparison of average commission rates among funds will be a useful bench-mark for investors and therefore is adopting the disclosure requirement substantially as proposed.<sup>35</sup>

One commenter urged the Commission to exclude from the requirement to disclose average commission rates funds that have a *de minimis* amount of transactions on which brokerage commissions are paid. Because commission rate information may have limited value in such circumstances, the Commission has adopted an exclusion for funds that, during any fiscal year, invest on average less than ten percent of their net assets in equity securities on which commissions are charged on trades.<sup>36</sup>

#### F. Effective Date

The amendments are effective September 1, 1995. All funds may elect to comply with the amendments before the effective date or before the compliance dates described below.

#### G. Compliance Dates

##### 1. Registration Statements

a. *Current Registrants.* Registered investment companies must amend their registration statements to comply with the rule amendments no later than

<sup>35</sup> The Commission has added instructions to the various fund registration forms describing the method for calculating average commission rate. Instruction 17 to Item 3 of Form N-1A, and Instruction 19 to Item 4 of Form N-2. The instruction requires funds to compute the average commission rate paid by dividing the total dollar amount of commissions paid during the fiscal year by the total number of shares purchased and sold during the fiscal year for which commissions were charged. Funds must convert commissions paid in foreign currencies into US dollars and cents per share. Mark-ups, Mark-downs, and spreads on shares traded on a principal basis are not included in the average commission rate figure unless they are disclosed on confirmations prepared in accordance with rule 10b-10 under the 1934 Act [17 CFR 240.10b-10].

<sup>36</sup> Instruction 16 to Item 3 of Form N-1A, and Instruction 18 to Item 4 of Form N-2.

the next post-effective amendment updating financial statements pursuant to section 10(a)(3) of the 1933 Act to reflect information for fiscal years *ending* on or after the effective date.<sup>37</sup> Information regarding average commission rates, however, must be provided only for fiscal years *beginning* on or after the effective date.<sup>38</sup>

b. *New Registrants.* Funds with registration statements effective on or after the effective date of these rule amendments must first reflect these rule amendments in financial information contained in post-effective amendments filed thereafter.

##### 2. Yield Information

Yield quotations appearing in fund advertisements or other sales literature published or distributed on or after December 1, 1995 must be calculated in accordance with the rule amendments.

##### 3. Proxy Statements and Shareholder Reports

Financial information covering fiscal years ending on or after the effective date contained in proxy statements and shareholder reports filed with the Commission must comply with the amendments.

#### H. Filing Requirements for Post-Effective Amendments

Post-effective amendments to fund registration statements made for purpose of complying with these rule amendments may be made pursuant to the immediate effectiveness provisions of rule 485(b) under the 1940 Act [17 CFR 230.485(b)], provided that the post-effective amendment otherwise meets the conditions for immediate effectiveness under that rule.

#### III. Cost/Benefit Analysis

The rule and form changes adopted today are intended to improve the reporting of investment company expenses and the ability of investors to compare investment company expenses and yield. While these amendments may increase the cost to funds of preparing financial statements and registration materials, the Commission believes that any such cost increases would, at most, be minimal. A fund that has brokerage/service or expense offset arrangements is required to add two captions and a footnote to its statement

<sup>37</sup> The financial highlights table in fund prospectuses presents financial data for each of the last ten fiscal years. The amendments do not require funds to reflect total expenses in the expense ratio of the financial highlights table for fiscal years ending before the effective date.

<sup>38</sup> This requirement is consistent with the Commission's proposal. See Proposing Release, *supra* note 3, at n.30.

of operations and replace the net expense figures currently disclosed in its fee table and financial highlights table with total expense figures. Funds generally should be readily able to determine these figures. Commenters on the proposal stated that funds should also be readily able to estimate expenses paid with brokerage commissions for purposes of yield calculations. Thus, the Commission believes that the costs of the amendments will not be significant and will be substantially outweighed by the benefits to investors of receiving more accurate and useful financial information about funds.

#### IV. Regulatory Flexibility Analysis

A summary of the Initial Regulatory Flexibility Analysis, prepared in accordance with 5 U.S.C. 603, was published in the Proposing Release. No comments were received on this analysis. The Commission has prepared a final Regulatory Flexibility Analysis, a copy of which may be obtained by contacting Karen J. Garnett, Office of Disclosure and Investment Adviser Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 20549.

#### V. Statutory Authority

The Commission is amending rule 6-07 of Regulation S-X and the various fund registration forms under the authority of section 7 of the 1933 Act [15 U.S.C. 77g] and sections 8 and 38(a) of the 1940 Act [15 U.S.C. 80a-8, 80a-37(a)]. The authority citations for the rule and form amendments precede the text of the amendments.

#### Text of Rule and Form Amendments

##### List of Subjects

##### 17 CFR Part 210

Accounting, Reporting and recordkeeping requirements, Securities.

##### 17 CFR Parts 239 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Chapter II, Title 17 of the Code of Federal Regulations is amended as follows:

#### PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for part 210 continues to read as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77aa(25), 77aa(26), 78l, 78m, 78n, 78o(d), 78w(a), 78ll(d), 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37a, unless otherwise noted.

2. By adding paragraph 2.(g) to the Statements of Operations § 210.6-07 to read as follows:

**§ 210.6-07 Statements of operations.**

\* \* \* \* \*

2. *Expenses.* \* \* \*

(g)(1) *Brokerage/Service Arrangements.* If a broker-dealer or an affiliate of the broker-dealer has, in connection with directing the person's brokerage transactions to the broker-dealer, provided, agreed to provide, paid for, or agreed to pay for, in whole or in part, services provided to the person (other than brokerage and research services as those terms are used in section 28(e) of the Securities Exchange Act of 1934 [15 U.S.C. 78bb(e)]), include in the expense items set forth under this caption the amount that would have been incurred by the person for the services had it paid for the services directly in an arms-length transaction.

(2) *Expense Offset Arrangements.* If the person has entered into an agreement with any other person pursuant to which such other person reduces, or pays a third party which reduces, by a specified or reasonably ascertainable amount, its fees for services provided to the person in exchange for use of the person's assets, include in the expense items set forth under this caption the amount of fees that would have been incurred by the person if the person had not entered into the agreement.

(3) *Financial Statement Presentation.* Show the total amount by which expenses are increased pursuant to paragraphs (1) and (2) of this paragraph 2.(g) as a corresponding reduction in total expenses under this caption. In a note to the financial statements, state separately the total amounts by which expenses are increased pursuant to paragraphs (1) and (2) of this paragraph 2.(g), and list each category of expense that is increased by an amount equal to at least 5 percent of total expenses. If applicable, the note should state that the person could have employed the assets used by another person to produce income if it had not entered into an arrangement described in paragraph 2.(g)(2) of this section.

\* \* \* \* \*

**PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933**

**PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940**

3. The authority citation for Part 239 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78w(a), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-8, 80a-29, 80a-30 and 80a-37, unless otherwise noted.

\* \* \* \* \*

4. The authority citation for Part 274 continues to read as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, and 80a-29, unless otherwise noted.

**Note:** The text of Form N-1A does not and the amendments will not appear in the Code of Federal Regulations.

5. By revising the introductory text of Instruction 10 to Item 2(a)(i) in Part A of Form N-1A (referenced in §§ 239.15A and 274.11A) to read as follows:

**Form N-1A**

\* \* \* \* \*

**Part A—Information Required in a Prospectus**

\* \* \* \* \*

**Item 2. Synopsis**

(a)(i) \* \* \*

*Instructions:* \* \* \*

10. "Other Expenses" includes all expenses (except nonrecurring account fees and expenses reported in other items of the table) that are deducted from fund assets or charged to all shareholder accounts. The amounts of expenses deducted from fund assets are the amounts shown as expenses in the Registrant's statement of operations (including increases resulting from complying with paragraph 2(g) of Rule 6-07 [17 CFR 210.6-07] of Regulation S-X).

\* \* \* \* \*

6. By amending Item 3(a) in Part A of Form N-1A (referenced in §§ 239.15A and 274.11A) by adding the phrase "Average Commission Rate Paid" below "Portfolio Turnover Rate", by redesignating Instructions 13 and 14 as Instructions 14 and 15, and adding Instructions 13, 16, and 17 to read as follows:

**Form N-1A**

\* \* \* \* \*

**Part A—Information Required in a Prospectus**

\* \* \* \* \*

**Item 3. Condensed Financial Information**

(a) \* \* \*

*Instructions:*

\* \* \* \* \*

*Ratios/Supplemental Data*

\* \* \* \* \*

13. Compute the "ratio of expenses to average net assets" using the amount of expenses shown in the Registrant's statement of operations for the relevant fiscal year, including increases resulting from complying with paragraph 2(g) of Rule 6-07 [17 CFR 210.6-07] of Regulation S-X, and including reductions resulting from complying with paragraphs 2(a) and (f) of Rule 6-07 regarding fee waivers and reimbursements. If a change in the methodology for determining the ratio of expenses to average net assets results from applying paragraph 2(g) of Rule 6-07, explain in a note that the ratio reflects fees paid with brokerage commissions and fees reduced in connection with specific agreements only for fiscal years ending after September 1, 1995.

\* \* \* \* \*

*Average Commission Rate Paid*

16. A Registrant that invests not more than ten percent of the value of its average net assets in equity securities on which commissions are charged on trades may omit "average commission rate paid." Compute average net assets based on amounts invested at the end of each fiscal quarter.

17. Compute the "average commission rate paid" as follows: (A) divide the total dollar amount of commissions paid during the fiscal year by (B) the total number of shares purchased and sold during the fiscal year for which commissions were charged. Carry the amount of the average commission rate paid to no fewer than four decimal places. Convert commissions paid in foreign currency into U.S. dollars and cents per share using consistently either the prevailing exchange rate on the date of the transaction or average exchange rate over such period as related transactions took place. Do not include mark-ups, mark-downs, or spreads paid on shares traded on a principal basis unless such mark-ups, mark-downs, or spreads are disclosed on confirmations prepared in accordance with rule 10b-10 under the 1934 Act [17 CFR 240.10b-10].

\* \* \* \* \*

7. By redesignating Instructions 7 and 8 to Item 22(b)(ii) as Instructions 8 and 9, and adding Instruction 7 to Item 22(b)(ii) in Part B of Form N-1A

(referenced in §§ 239.15A and 274.11A) to read as follows:

**Form N-1A**

\* \* \* \* \*

**Part B—Information Required in a Statement of Additional Information**

\* \* \* \* \*

**Item 22. Calculation of Performance Data**

\* \* \* \* \*

(b) *Other Registrants* \* \* \*

(ii) *Yield*. \* \* \*

*Instructions:* \* \* \*

7. If a broker-dealer or an affiliate (as defined in paragraph (b) of Rule 1-02 [17 CFR 210.1-02(b)] of Regulation S-X) of the broker-dealer has, in connection with directing the Registrant's brokerage transactions to the broker-dealer, provided, agreed to provide, paid for, or agreed to pay for, in whole or in part, services provided to the Registrant (other than brokerage and research services as those terms are used in Section 28(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(e))), add to expenses accrued for the period an estimate of additional amounts that would have been accrued for the period if the Registrant had paid for the services directly in an arms-length transaction.

\* \* \* \* \*

**Note:** The text of Form N-2 does not and the amendments will not appear in the Code of Federal Regulations.

8. By revising Instruction 9 to Item 3.1 in Part A of Form N-2 (referenced in §§ 239.14 and 274.11a-1) to read as follows:

**Form N-2**

\* \* \* \* \*

**Part A—Information Required in a Prospectus**

\* \* \* \* \*

**Item 3. Fee Table and Synopsis**

1. \* \* \*

*Instructions* \* \* \*

9. "Other Expenses" includes all expenses (except fees and expenses reported in other items in the table) that are deducted from the Registrant's assets and will be reflected as expenses in the Registrant's statement of operations (including increases resulting from complying with paragraph 2(g) of Rule 6-07 [17 CFR 210.6-07] of Regulation S-X).

\* \* \* \* \*

9. By amending Item 4.1 in Part A of Form N-2 (referenced in §§ 239.14 and 274.11a-1) by adding "l. Average Commission Rate Paid" below "k.

Portfolio Turnover Rate", by redesignating Instruction 16 as Instruction 17, and adding Instructions 16, 18 and 19 to read as follows:

**Form N-2**

\* \* \* \* \*

**Part A—Information Required in a Prospectus**

\* \* \* \* \*

**Item 4. Financial Highlights**

1. *General* \* \* \*

*Instructions* \* \* \*

*Ratios and Supplemental Data* \* \* \*

16. Compute the "ratio of expenses to average net assets" using the amount of expenses shown in the Registrant's statement of operations for the relevant fiscal year, including increases resulting from complying with paragraph 2(g) of Rule 6-07 [17 CFR 210.6-07] of Regulation S-X, and including reductions resulting from complying with paragraphs 2(a) and (f) of Rule 6-07 regarding fee waivers and reimbursements. If a change in the methodology for determining the ratio of expenses to average net assets results from applying paragraph 2(g) of Rule 6-07, explain in a note that the ratio reflects fees paid with brokerage commissions and fees reduced in connection with specific agreements only for fiscal years ending after September 1, 1995.

\* \* \* \* \*

*Average Commission Rate Paid*

18. A Registrant that invests not more than ten percent of the value of its average net assets in equity securities on which commissions are charged on trades may omit "average commission rate paid." Compute average net assets based on amounts invested at the end of each fiscal quarter.

19. Compute the "average commission rate paid" as follows: (A) divide the total dollar amount of commissions paid during the fiscal year by (B) the total number of shares purchased and sold during the fiscal year for which commissions were charged. Carry the amount of the average commission rate paid to no fewer than four decimal places. Convert commissions paid in foreign currency into U.S. dollars and cents per share using consistently either the prevailing exchange rate on the date of the transaction or average exchange rate over such period as related transactions took place. Do not include mark-ups, mark-downs, or spreads paid on shares traded on a principal basis unless such mark-ups, mark-downs, or spreads are disclosed on confirmations prepared in accordance with rule 10b-

10 under the 1934 Act [17 CFR 240.10b-10].

\* \* \* \* \*

**Note:** The text of Form N-3 does not and the amendments will not appear in the Code of Federal Regulations.

10. By revising the introductory text of Instruction 15 to Item 3(a) in Part A of Form N-3 (referenced in §§ 239.17a and 274.11b) to read as follows:

**Form N-3**

\* \* \* \* \*

**Part A—Information Required in a Prospectus**

\* \* \* \* \*

**Item 3. Synopsis**

(a) \* \* \*

*Instructions:* \* \* \*

15. "Other Expenses" includes all expenses (except fees and expenses reported in other items in the table) that are deducted from separate account assets and will be reflected as expenses in the Registrant's statement of operations (including increases resulting from complying with paragraph 2(g) of Rule 6-07 [17 CFR 210.6-07] of Regulation S-X).

\* \* \* \* \*

11. By redesignating Instruction 7 to Item 25(b)(ii) as Instruction 8, and adding Instruction 7 to Item 25(b)(ii) in Part B of Form N-3 (referenced in §§ 239.17a and 274.11b) to read as follows:

**Form N-3**

\* \* \* \* \*

**Part B—Information Required in a Statement of Additional Information**

\* \* \* \* \*

**Item 25. Calculation of Performance Data**

\* \* \* \* \*

(b) *Other Accounts* \* \* \*

(ii) *Yield*. \* \* \*

*Instructions:* \* \* \*

7. If a broker-dealer or an affiliate (as defined in paragraph (b) of Rule 1-02 [17 CFR 210.1-02(b)] of Regulation S-X) of the broker-dealer has, in connection with directing the Registrant's brokerage transactions to the broker-dealer, provided, agreed to provide, paid for, or agreed to pay for, in whole or in part, services provided to the Registrant (other than brokerage and research services as those terms are used in Section 28(e) of the Securities Exchange Act of 1934 [15 U.S.C. 78bb(e)]), add to expenses accrued for the period an estimate of additional amounts that would have been accrued for the period if the Registrant had paid for the

services directly in an arms-length transaction.

\* \* \* \* \*

Note: The text of Form N-4 does not and the amendments will not appear in the Code of Federal Regulations.

12. By revising the introductory text of Instruction 17 to Item 3(a) in Part A of Form N-4 (referenced in §§ 239.17b and 274.11c) to read as follows:

Form N-4

\* \* \* \* \*

Part A—Information Required in a Prospectus

\* \* \* \* \*

Item 3. Synopsis

(a) \* \* \*

Instructions: \* \* \*

17. "Other Expenses" includes all expenses (except management fees) that are deducted from portfolio company assets. The amounts of expenses are the amounts shown as expenses in the portfolio company's statement of

operations (including increases resulting from complying with paragraph 2(g) of Rule 6-07 [17 CFR 210.6-07] of Regulation S-X).

\* \* \* \* \*

13. By redesignating Instructions 2 and 3 to Item 21(b)(ii) as Instructions 3 and 4, and adding Instruction 2 to Item 21(b)(ii) in Part B of Form N-4 (referenced in §§ 239.17b and 274.11c) to read as follows:

Form N-4

\* \* \* \* \*

Part B—Information Required in a Statement of Additional Information

\* \* \* \* \*

Item 21. Calculation of Performance Data

\* \* \* \* \*

(b) Other Sub-Accounts \* \* \*

(ii) Yield. \* \* \*

Instructions: \* \* \*

2. If a broker-dealer or an affiliate (as defined in paragraph (b) of Rule 1-02

[17 CFR 210.1-02(b)] of Regulation S-X) of the broker-dealer has, in connection with directing the portfolio company's brokerage transactions to the broker-dealer, provided, agreed to provide, paid for, or agreed to pay for, in whole or in part, services provided to the portfolio company (other than brokerage and research services as those terms are used in Section 28(e) of the Securities Exchange Act of 1934 [15 U.S.C. 78bb(e)]), add to expenses accrued for the period an estimate of additional amounts that would have been accrued for the period if the portfolio company had paid for the services directly in an arms-length transaction.

\* \* \* \* \*

Dated: July 21, 1995.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 95-18472 Filed 7-27-95; 8:45 am]

BILLING CODE 8010-01-P