

ACT ICA
SECTION 26(a)(2)(C)
RULE 26a-1
PUBLIC AVAILABILITY 12/23/98

PUBLIC

December 23, 1998
Our Ref. No. 98-694-CC
Defined Asset Funds
File No. 811-1777

**RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT**

Your letter of November 30, 1998 requests our agreement with your view that Section 26(a)(2)(C) of the Investment Company Act of 1940 (the "Act") does not prohibit the Defined Asset Funds (the "Trusts"), a family of unit investment trusts ("UITs"), from paying the costs of updating their registration statements as described in your letter.

Facts

The Trusts are organized as UITs and jointly sponsored by Merrill Lynch, Pierce, Fenner & Smith, Inc., Salomon Smith Barney Inc., Dean Witter Reynolds, Inc., and PaineWebber Inc. (the "Sponsors"). The Trusts currently pay the costs of preparing and filing their initial registration statements. The Sponsors currently pay the costs of updating the Trusts' registration statements. The Sponsors also currently maintain, and pay the costs associated with maintaining, a secondary market for units of the Trusts.

You propose that in the future, the Trusts, rather than the Sponsors, would pay the expenses incurred in connection with updating the Trusts' registration statements. These expenses consist of legal fees, typesetting fees, electronic filing expenses and regulatory filing fees. Under your proposal, the Sponsors would continue to pay all direct distribution expenses of the Trusts (including the costs of maintaining the secondary market for the Trusts), such as printing and distributing prospectuses, and preparing, printing and distributing any advertisements or sales literature. The trust indentures for the Trusts would provide that expenses for updating the Trusts' registration statements will be paid by the Trusts. The Trusts' prospectuses and annual reports would disclose that the expenses of updating the Trusts' registration statements will be paid by the Trusts and, for at least one year from the date that the Trusts' prospectuses first disclose that the Trusts will pay the expenses, also disclose that these expenses historically have been paid by UITs' sponsors. Any payments made to reimburse the Sponsors for updating registration statements would not exceed the costs incurred by the Sponsors for that purpose.

Analysis

1. Requirement to Deliver a Current Prospectus

Section 4(2) of the Act, in relevant part, defines a UIT as an investment company that is organized under a trust indenture

or, similar instrument, does not have a board of directors, and issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities. UITs typically are created by a sponsor that accumulates a fixed portfolio of securities and deposits the securities with a trustee under the terms of a trust indenture.¹ The UIT then issues units of participation in the portfolio and offers these units to the public at an offering price that is based upon the value of the underlying securities, plus a sales charge.²

After completing its initial offering, a UIT no longer offers units to the public.³ In almost all cases, however, the sponsor establishes and maintains a secondary market in units issued by the UIT. In the secondary market, the sponsor purchases units tendered for redemption by UIT unitholders and resells the units to new investors at an offering price that is based upon the value of the underlying securities, plus a sales load.⁴

The Securities Act of 1933 ("Securities Act") requires that securities publicly offered by an issuer be accompanied or preceded by the delivery of a current prospectus.⁵ The

¹ The same entity usually is the sponsor and the depositor of a UIT. See definition of "depositor" in the General Instructions to Form N-8B-2, the registration statement under the Act for UITs.

² For background on the nature and structure of UITs, see Form N-7 for Registration of Unit Investment Trusts Under the Securities Act of 1933 and the Investment Company Act of 1940, Investment Company Act Release Nos. 14513 at nn. 8-14 and accompanying text (May 14, 1985) ("Release 14513") and 15612 (Mar. 9, 1987) ("Release 15612") (releases proposing and repropounding a unified form to register UITs under both the Act and the Securities Act of 1933).

³ See generally Rule Proposal for Unit Investment Trust Start-Up Exemptions and Proposed Revision of Rule Regarding Pricing of Investment Company Shares Generally, Investment Company Act Release No. 10545 (Jan. 8, 1979) (describing UITs and the operation of secondary markets by UIT sponsors).

⁴ The existence of a secondary market enhances the liquidity of a UIT. In the absence of a secondary market, a UIT might have to sell portfolio securities to meet redemption requests. If redemptions were significantly high, the terms of a UIT's trust indenture may require the trustee to terminate the UIT.

⁵ Section 5 of the Securities Act prohibits the use of the U.S. mails or interstate commerce to sell a security unless accompanied or preceded by a prospectus that meets the requirements of Section 10(a) of the Securities Act. Section

prospectus delivery requirement applies both to initial sales of UIT units and to resales of UIT units by a sponsor in the secondary market.⁶ Thus, the continued operation of a UIT depends, in part, on maintaining a current registration statement because the UIT's units cannot be offered for sale unless the underwriter or sponsor can deliver a current prospectus to offerees or purchasers.

2. UIT Expenses

Section 26(a)(2) of the Act indirectly limits the expenses that may be paid out of a UIT's assets by prohibiting a depositor or principal underwriter from selling interests in a UIT unless the UIT's trust indenture, or similar instrument, specifically includes the payment limitations in Section 26(a)(2). Paragraph (C) of Section 26(a)(2) provides:

that no payment to the depositor of or a principal underwriter for [a UIT], or to any affiliated person or agent of such depositor or underwriter, shall be allowed the trustee or custodian as an expense (except that provision may be made for the payment to any such person of a fee, not exceeding such reasonable amount as the Commission may prescribe as compensation for bookkeeping and other administrative services, of a character normally performed by the trustee or custodian itself).

Paragraph (D) requires a UIT's trustee or custodian to hold all assets of the UIT in trust, subject only to the charges allowed by Section 26(a)(2), until the assets are distributed to the UIT's unitholders.⁷ Rule 26a-1 under the Act, in relevant part,

10(a)(3) of the Securities Act requires that information contained in a prospectus be current.

⁶ Secondary market transactions in most securities are not subject to the prospectus delivery requirements. UIT depositors, however, are considered "issuers" under Section 2(4) of the Securities Act, and are therefore subject to the prospectus delivery requirement. See Release 15612 *supra* note 2 at n.2 and accompanying text; Release 14513, *supra* note 2 at n.14 and accompanying text. See also M.L. Stern & Co. Inc. (pub. avail. Nov. 18, 1988) (explaining when the prospectus delivery requirements of the Securities Act apply to resales of UIT units in a secondary market).

⁷ Paragraph (A) of Section 26(a)(2) limits payments to a UIT's trustee or custodian to fees for services, or reimbursements for expenses, as are set forth in the UIT's trust indenture or similar instrument. Paragraph (B) limits payments under paragraph (A) to payments for services previously performed or to reimbursement for expenses previously incurred.

provides that any payments made under Section 26(a)(2)(C) may not exceed the cost of the services rendered.

You represent that your proposal is consistent with paragraph (C) of Section 26(a)(2). You acknowledge that the staff, in E. F. Hutton Tax Exempt Fund (pub. avail. Apr. 11, 1979) ("Hutton"), previously took the position that Section 26(a)(2) prohibits the payment by a UIT's trustee from the UIT's assets to its sponsor of any expenses related to the maintenance of a secondary market for units of a UIT. In Hutton, the staff stated that secondary market expenses include the costs of keeping a UIT's registration statement current. The staff also stated in Hutton that an alternate proposal to have the UIT itself bear the expenses of maintaining a secondary market would seem to be an attempt to circumvent Section 26(a)(2)(C) of the Act, and would therefore violate Section 48(a) of the Act.⁸ In your view, however, your proposal is consistent with more recent staff interpretations of Section 26(a)(2)(C). You state that the positions taken by the staff in Kemper Sales Company (pub. avail. Jan. 3, 1985) ("Kemper") and Unit Investment Trust Organizational Expenses (pub. avail. May 9, 1995) ("Organizational Expenses Letter") provide support for your position.

In Kemper, the staff agreed not to recommend enforcement action to the Commission under Section 26(a)(2)(C) of the Act if UITs were to bear the expenses of preparing audited financial statements for the purpose of maintaining current registration statements for the UITs. The staff's position was limited to two circumstances: (1) the audit was required by the terms of a UIT's trust indenture; or (2) the UIT's trustee determined that an audit would be in the best interests of the UIT's unitholders.

In the Organizational Expenses Letter, the staff stated that Section 26(a)(2) does not prohibit a UIT from bearing its own organizational and initial registration expenses even though those expenses historically had been paid by a UIT's sponsor. The staff reasoned that: (1) the express language of Section 26(a)(2) did not prohibit the practice; and (2) the proposed expense allocation would not lead to the abuses that Section 26(a)(2) of the Act was intended to prevent,⁹ particularly the

⁸ Section 48(a) makes it "unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of [the Act] or any rule, regulation, or order thereunder."

⁹ The legislative history of the Act demonstrates that the restrictions and limitations contained in Section 26(a)(2) were intended by Congress to prevent or mitigate abuses in the investment company industry that were identified by the Commission in a series of reports. S. Rep. No. 1775, 76th Cong., 3d Sess. 8, 18 (1940); H.R. Rep. No. 2639, 76th Cong., 3d Sess. 22 (1940). Some of the abuses described in the Commission's

assessment of "hidden charges" against UITs by their sponsors, provided that the allocation was adequately disclosed to investors. The staff concluded that a UIT's payment of its own organizational and initial registration expenses is consistent with paragraph (C) of Section 26(a)(2) because the expenses are legitimate business expenses paid to parties unaffiliated with the UIT's sponsor for services that are necessary to the operation of the UIT and that do not directly benefit the sponsor.¹⁰ As a result, the sponsor would not receive any hidden fees, even when directly reimbursed for organizational expenses, because (1) the sponsor would be reimbursed only for its costs and (2) the UIT's payment of its organizational expenses would be prominently disclosed to investors.

We believe that Section 26(a)(2)(C) does not prohibit a UIT from paying the expenses of updating its registration statement, including payments to reimburse the UIT's sponsor for its costs incurred in providing updating services.¹¹ The Commission has stated that Section 26(a)(2)(C) was designed "to preserve trust assets and prevent securityholders from being subjected to purported 'administrative' fees which, instead of compensating the depositor for administrative services actually rendered, in fact provide additional remuneration to the depositor."¹² The Commission also has stated that "[t]he purpose of [Section 26(a)(2)] is to prohibit the depositor from 'reaping hidden profits' through purported administrative fees."¹³

A UIT's payment of the expenses of updating its registration statement, similar to its payment of its own organizational and

reports included examples of UIT sponsors reaping hidden profits through practices such as: buying securities for the UIT at the (lower) bid price and selling them to the UIT at the (higher) asking price; charging the UIT odd-lot brokerage commissions even when the sponsor purchased the portfolio securities in round lots; adding brokerage commissions to the base price of units and calculating the sales load on the increased amount; adjusting the offering price to the next highest eighth of a dollar; and retaining the interest earned on the UIT's cash. Securities and Exchange Commission, *Investment Trusts and Investment Companies, Fixed and Semifixed Investment Trusts*, Ch. 10 (1940), reprinted as H.R. Doc. No. 567, 76th Cong., 3d Sess. (1940).

¹⁰ Organizational Expenses Letter at n.6.

¹¹ To the extent that this position is inconsistent with Hutton, Hutton is superseded.

¹² Payment of Administrative Fees to the Depositor or Principal Underwriter of a Unit Investment Trust, Investment Company Act Release No. 13705 at n.5 (Jan. 9, 1984) (proposing Rule 26a-1).

¹³ *Id.* at text accompanying n.3.

auditing expenses, would not provide the kind of direct remuneration to the sponsor that Section 26(a)(2)(C) was intended to prevent. Updating expenses, like organizational and auditing expenses, are legitimate business expenses that are necessary to the operation of the Trusts and do not directly benefit the Sponsors. While the payments of updating expenses by the Trusts indirectly benefit the Sponsors because the Sponsors otherwise would bear the expenses, we believe that these expenses are not the type of charges that directly benefit UIT sponsors in the manner deemed abusive by Congress in enacting Section 26(a)(2).¹⁴

We believe that the Trusts' payment of updating expenses, as described in your letter, would not constitute hidden profits to the Sponsors. The Trusts will fully disclose the expenses in their prospectuses and annual reports and, for at least one year from the date that the Trusts' prospectuses first disclose the expenses, the prospectuses also will disclose that these expenses historically have been paid by UITs' sponsors. Nor are updating expenses the kind of "hidden charges" about which Congress was concerned.¹⁵ To the extent that updating expenses are paid directly to the Sponsors, the payments will be limited to the Sponsors' costs, as required by Rule 26a-1.

This position is based on the facts and circumstances set forth in your letter. Any different facts or circumstances may require a different conclusion.



Wendy Finck Friedlander
Senior Counsel

¹⁴ See *supra* note 9.

¹⁵ *Id.*

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Investment Company Act
Section 26(a)(2)(C)

November 30, 1998

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Attention: Douglas Scheidt, Esq.
Chief Counsel
Division of Investment Management

Re: Allocation of Expenses Incurred to
Update UIT Registration Statements

Dear Mr. Scheidt:

By letter dated May 9, 1995, the Staff of the Securities and Exchange Commission (the "Staff") advised us that it would not recommend enforcement action if a unit investment trust bears its own organizational expenses. *Unit Trust Organizational Expenses* (available 5/9/95). On behalf of Merrill Lynch, Pierce, Fenner & Smith Incorporated, Agent for the Sponsors¹ (the "Sponsors") of the Defined Asset Funds family of unit investment trusts ("UITs"), we hereby request similar confirmation from the Staff with respect to the permissibility of individual UITs to bear expenses related to

¹The other sponsors are currently Salomon Smith Barney Inc., Dean Witter Reynolds, Inc. and PaineWebber Incorporated.

updating trust registration statements pursuant to the Securities Act of 1933 (the "1933 Act").

I. The Proposal

Historically, the Sponsors have paid all the costs of maintaining a secondary market in trust units and reoffering units acquired in the secondary market, including the costs of annually updating a trust's 1933 Act registration statement.² The Sponsors propose that, in the future, certain expenses related to the preparation and filing of post-effective amendments would be borne by the trusts themselves. These expenses consist of the annual legal expenses for the preparation of post-effective amendments to the trusts' registration statements, the associated typesetting, electronic filing and related charges of a financial printer and regulatory filing fees, if any. The Sponsors will continue to bear all costs of printing and distributing prospectuses and of preparing, printing and distributing any advertising and promotional material. The updating expenses to be borne by a trust under the proposal would be immaterial on a per unit basis. The legal fees and printing expenses associated with the annual amendment to trust registration statements total \$3,700 per trust, per year. The weighted average cost is estimated to be \$0.21 per year on a unit of about \$1000. This level of expense would have only a minimal impact of approximately 0.024% on an investor's return.

We submit that this proposal is consistent with the way mutual funds that have not adopted distribution plans pursuant to Rule 12b-1 allocate expenses of annual prospectus updates and with the provisions of the Investment Company Act of 1940 (the "1940 Act"), as discussed below. Furthermore, except in limited circumstances when the Sponsors prepay third party expenses (in which case the charge will not exceed the amount of the payments made), the expenses borne by the trusts will involve payments by the trustee to third parties, in particular regulators, lawyers and printers -- not to the Sponsors.

²Since 1978, the cost of an annual audit of a trust's financial statements has, as provided in the indenture, been borne by the trust. This practice was approved in *Kemper Sales Company*, avail 1/3/85.

II. Legal Analysis

Section 26 of the 1940 Act requires inclusion of certain provisions in the indenture establishing a trust. The purpose of Section 26(a)(2) is to preserve the assets of registered investment companies and to prevent unitholders from bearing "administrative" fees which, instead of compensating the custodian for its services, actually provide additional profit to the sponsors. See, e.g., *Unit Investment Trust Organizational Expenses*.

We believe that this proposal is not inconsistent with Section 26(a)(2)(C). Section 26(a)(2)(C) was designed to ensure that sponsors and depositors could not receive hidden profits by charging excessive fees to the trusts. *Municipal Investment Trust Fund* (avail. 6/14/82). While *E.F. Hutton Tax Exempt Fund* (avail. 4/11/79), an early Staff pronouncement, cited Section 26(a)(2)(C) as authority for the proposition that trusts could not bear the "expenses of maintaining a secondary market," more recent no-action letters express a less restrictive view by the Staff. *Kemper Sales Company* (avail. 1/3/85), for example, found that trusts could bear the costs of obtaining annual audited financial statements despite the use of these statements by the sponsors in updating the trusts' registration statements, which would in turn allow the sponsors to maintain a secondary market in units. Similarly, the Staff's response in *Unit Investment Trust Organizational Expenses*, citing the practice of mutual funds generally to bear their own organizational expenses, agreed that a unit trust also could bear these expenses, including legal fees and "the cost of preparing and printing its registration statement."

Rule 12b-1(a)(2), applicable only to mutual funds, defines distribution as "any activity which is primarily intended to result in the sale of shares." Although Rule 12b-1 is not applicable to unit trusts, our proposal is consistent with the interpretation of distribution-related expenses prescribed by Rule 12b-1. We propose that the trust would pay only for expenses to prepare and file annual amendments to its registration statement which, like an annual audit, is not an "activity primarily intended to result in the sale of shares." Under this proposal, the sponsors of a trust will continue to bear all expenses related to maintaining a secondary market in units and all marketing and distribution expenses.

Furthermore, virtually all other issuers which compete with unit investment trusts pay their own update expenses. The principal other types of funds regulated by the 1940

Act -- mutual funds and closed-end funds -- routinely bear the annual legal fees for the preparation of post-effective amendments to their registration statements, the associated typesetting, electronic filing and related expenses of a financial printer and annual regulatory filing fees if any.³ Therefore, issuers of securities that compete with unit investment trusts and are subject to periodic filing requirements -- packaged products such as mutual funds and closed-end funds -- pay their own update expenses. Consequently, our proposal to charge legal and printing expenses associated with updating trust registration statements is designed to level the playing field on which UITs compete with mutual funds and closed-end funds.

Since the annual expense to update a trust's registration statement is *de minimus* on a per unit basis, we believe that existing trusts which have not previously disclosed this expense may amend their prospectuses and henceforth bear the update expense, as was permitted with respect to audit fees in *Kemper Sales Company*. We specifically agree that for at least a year following implementation of these changes, the fee table section of the prospectus will include disclosure that historically these updating expenses have been borne by the Sponsors.

In sum, our proposal is reasonable, fair and consistent with both the specific mandate and overall purpose of Section 26(a)(2)(C) and the protection of investors. It has been pointed out repeatedly in no-action letters and exemptive orders that the purpose of Section 26(a)(2)(C) is to preserve the assets of registered investment companies and to prevent unitholders from bearing fees which actually provide additional profit to the sponsors. Our proposal involves no payments to the Sponsors (except to reimburse them for prepayments of permissible third party expenses). Payments to third parties for actual expenses incurred in updating a trust's registration statement, as contemplated by this proposal, hardly constitute profit to the sponsors. This proposal merely equalizes the treatment of UITs and competing investment products.

³Neither Section 12(b) (applicable to open-end management companies) nor Section 23 of the Act (applicable to closed-end companies) prohibits mutual funds and closed-end funds from bearing the type of update expenses proposed here.

Douglas Scheidt, Esq.

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November 30, 1998

Please call me at (212) 450-4525 (or Gary Granik at (212) 450-4721 or Ken Chase at (212) 450-4731 in my absence) with any questions or comments you may have.

Very truly yours,


Pierre de Saint Phalle

cc: Mercer Bullard, Esq.
Wendy Friedlander, Esq.