



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

May 9, 1995

Pierre de St. Phalle, Esquire
Davis Polk & Wardwell
450 Lexington Avenue
New York, NY 10017

ACT ICA-40
SECTION 26(a)(2)
RULE —
PUBLIC
AVAILABILITY 05/09/95

Re: Unit Investment Trust Organizational Expenses

Dear Mr. de St. Phalle:

Per your request on behalf of the Defined Asset Funds,¹ we have considered the issue of whether the Investment Company Act of 1940 allows a unit investment trust ("UIT" or "Trust") to bear its own organizational expenses. Although you acknowledge that, historically, UIT sponsors have borne their Trusts' organizational expenses, you contend that nothing in the Investment Company Act prohibits the Trusts themselves from bearing those expenses.

You propose that a Trust be permitted to bear the cost of preparing and printing its registration statement, trust indenture, and other documents; registering its securities with the Commission and the states; and the initial audit of the Trust. The sponsor would bear the Trust's other expenses, including all distribution costs such as advertising and printing and distributing prospectuses and sales material to prospective investors. The trust indenture would specify how organizational and other expenses will be allocated. The Trust's prospectus would prominently disclose that investors will bear organizational expenses.²

Under your proposal, the trustee of the Trust would be responsible for paying the Trust's organizational expenses, although on rare occasion the sponsor may do so. In either case, the payor would be entitled to receive reimbursement from the Trust equal to actual out-of-pocket expenses.

For the reasons set forth below, we agree that the Investment Company Act does not prohibit a UIT from bearing its own organizational expenses. First, the express language of section 26(a)(2) of the Investment Company Act appears to permit this practice. Second, the proposed expense allocation would not lead to any of the abuses that the Investment Company Act was designed to prevent, provided the allocation is adequately disclosed to trust investors. Finally, open-end and closed-end management investment companies currently bear their own organizational expenses, and we see no reason to impose a different standard on UITs.

¹ The Defined Asset Funds are a family of unit investment trusts jointly sponsored by Merrill Lynch, Pierce, Fenner & Smith Inc., Smith Barney Inc., PaineWebber Inc., Prudential Securities Inc., and Dean Witter Reynolds Inc.

² In particular, the Trust's fee table would contain a separate line item for organizational expenses, and the Trust's prospectus would inform investors that although historically the Trust's sponsors have paid all the costs of establishing UITs, this Trust will bear some or all of its organizational expenses.

Section 26 of the Investment Company Act regulates certain key aspects of a UIT's operation. Section 26(a)(2) was designed to preserve a UIT's assets by requiring that a UIT's trust indenture or custodian agreement limit the expenses that can be paid out of those assets.³ Paragraph (A) of section 26(a)(2) limits payments to the UIT's trustee and custodian to compensation for services and reimbursement for expenses that are specified in the trust indenture or custodian agreement. Paragraph (B) further limits payments to the UIT's trustee and custodian to payments for services actually performed and to reimbursement for expenses actually incurred. Paragraph (C) prohibits, with one exception not relevant here, payments to the UIT's depositor⁴ or principal underwriter. Finally, paragraph (D) of section 26(a)(2) requires that the trustee or custodian maintain possession of all UIT assets and hold them in trust, subject only to the charges and collections allowed under paragraphs (A), (B), and (C).

The proposed expense allocation is consistent with paragraph (A) of section 26(a)(2). The trust indenture would specifically authorize the trustee to pay organizational expenses and to reimburse itself out of Trust assets. Just as audit fees, annual report printing costs, and other charges are appropriate expenses of a UIT if the indenture so provides, we believe that the ordinary and necessary expenses of organizing and registering a UIT are similarly

³ Section 26(a)(2) provides as follows:

(a) No principal underwriter for or depositor of a registered unit investment trust shall sell, except by surrender to the trustee for redemption, any security of which such trust is the issuer (other than short-term paper), unless the trust indenture, agreement of custodianship, or other instrument pursuant to which such security is issued--

(1) * * *

(2) provides, in substance,

- (A) that during the life of the trust the trustee or custodian, if not otherwise remunerated, may charge against and collect from the income of the trust, and from the corpus thereof if no income is available, such fees for its services and such reimbursement for its expenses as are provided for in such instrument;
- (B) that no such charge or collection shall be made except for services theretofore performed or expenses theretofore incurred;
- (C) that no payment to the depositor of or a principal underwriter for such trust, 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 performing bookkeeping and other administrative services, of a character normally performed by the trustee or custodian itself); and
- (D) that the trustee or custodian shall have possession of all securities and other property in which the funds of the trust are invested, all funds held for such investment, all equalization, redemption, and other special funds of the trust, and all income upon, accretions to, and proceeds of such property and funds, and shall segregate and hold the same in trust (subject only to the charges and collections allowed under clauses (A), (B), and (C)) until distribution thereof to the security holders of the trust.

⁴ The depositor of a UIT includes the sponsor. See General Instructions to Form N-8B-2 (definition of "depositor").

appropriate for a UIT to bear, provided those expenses are authorized in the indenture. The proposed expense allocation also is consistent with paragraph (B) of section 26(a)(2) because reimbursement would be limited to actual out-of-pocket expenses incurred by the trustee.

The proposed expense allocation is consistent with paragraph (C) of section 26(a)(2). By its terms, paragraph (C) prohibits payments to a UIT's sponsor (or to an affiliate or agent of the sponsor), but the staff has interpreted paragraph (C) also to prohibit payments to third parties if such payments directly benefit the sponsor.⁵ Under your proposal, a Trust in most cases would pay parties other than its sponsor for their services in organizing the Trust. These payments to third parties would not directly benefit the sponsor.⁶ On rare occasion, a sponsor may advance funds to pay an organizational expense to an unaffiliated third party and receive reimbursement directly from the Trust. In light of the purposes underlying section 26(a)(2) and the legislative history of that section, discussed below, we do not believe that paragraph (C)'s prohibition on payments to a UIT's sponsor applies to a Trust's at-cost reimbursement of its sponsor.⁷

Finally, paragraph (D) of section 26(a)(2) provides, in effect, that the trustee or custodian of a UIT may use trust assets to pay only those expenses authorized by paragraph (A) of the section and not otherwise prohibited by paragraphs (B) and (C). Because we believe, for the reasons set forth above, that the Trust may reimburse the trustee for its payment of organizational expenses under paragraphs (A), (B), and (C), the proposed expense allocation is consistent with paragraph (D).

We believe that our statutory interpretation is consistent with the policies and purposes of section 26(a)(2), as expressed by Congress and the Commission. In the legislative history of section 26, Congress noted that, "[e]xcept under special circumstances, the [sponsor] or underwriter must be prohibited from deriving any *fees* from the trust other than the original sales load for distributing the shares."⁸ Here, the Sponsors would not receive any "fees" by virtue of the proposed expense allocation. Although the Sponsors may occasionally receive reimbursement at cost for their payment of a *bona fide* organizational

⁵ In assessing whether a payment benefits the sponsor, the staff has considered whether the payment is for a service typically provided by a UIT sponsor. The staff has refused, for example, to allow UIT sponsors to shift the expense of maintaining a secondary market in a UIT's securities to the UIT itself. Kemper Sales Co. (pub. avail. Jan. 3, 1985); E.F. Hutton Tax Exempt Fund (pub. avail. April 11, 1979).

⁶ Under your proposal, a Trust would pay the legal, accounting, registration, and other fees necessary to organize and establish the Trust, but would not pay any expenses that directly benefit the sponsor, such as those related to distributing, or maintaining a secondary market for, the Trust's securities. Of course, a UIT's sponsor benefits *indirectly* any time the trust bears an expense that the sponsor otherwise would have to bear. However, we do not interpret section 26(a)(2)(C) to prohibit the trust from paying any expense that might indirectly benefit the sponsor. Under that standard, UIT sponsors would be responsible for paying trustee and custodian fees, even though section 26(a)(2)(A) expressly authorizes the trust to make those payments. In our view, organizational expenses owed to third parties are analogous to trustee and custodian fees because they are legitimate business expenses paid to parties unaffiliated with the trust's sponsor for services that are necessary to the operation of the trust and that do not directly benefit the sponsor.

⁷ See note 9 *infra* and accompanying text.

⁸ S. Rep. No. 1775, 76th Cong., 3d Sess. (1940), at 18; H.R. Rep. No. 2639, 76th Cong., 3d Sess., at 22 (1940) (emphasis added).

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expense, we do not believe that such reimbursement constitutes payment of a "fee" in contravention of section 26(a)(2).⁹ Moreover, there is no evidence in the legislative history that Congress intended to prohibit a UIT from bearing its own organizational expenses. The restrictions and limitations contained in section 26(a)(2) were designed to prevent or mitigate certain abuses identified by the Commission in a 1940 report on UITs,¹⁰ particularly the "hidden charges" assessed against UITs by their sponsors.¹¹ Significantly, none of the hidden charges cited in the report related in any way to a UIT's organizational expenses.

Based on the legislative history of section 26(a)(2), the Commission has stated that section 26(a)(2) 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. . . . The purpose of [section 26(a)(2)] is to prohibit the depositor from 'reaping hidden profits' through purported administrative fees."¹² Under your proposal, a Trust's payment of organizational expenses would not be hidden, but would be prominently disclosed in its prospectus.¹³ On those rare occasions (if ever) when the proposed expense allocation results in a payment from a Trust to its sponsor, payment would be limited to reimbursement for out-of-pocket expenses. Thus, the sponsor would not receive any "additional remuneration" or "profit" as a result of the proposed expense allocation.

Finally, we note that open-end and closed-end management companies routinely pay their own organizational expenses. We have not identified any policy reason for allowing the sponsors of management companies to allocate organizational expenses to their funds, while prohibiting UIT sponsors from allocating the same expenses to their trusts.

For the reasons set forth above, we believe that your proposal that a UIT bear its own organizational expenses, either directly or through reimbursement of its sponsor, is

⁹ The Commission recognized the distinction between at-cost reimbursement and payment of a "fee" when it promulgated rule 26a-1 under the Investment Company Act. Rule 26a-1 permits a UIT to pay its sponsor for bookkeeping and other administrative services if payment is in an amount not greater than the actual cost of the services provided. The Commission considered the "at cost" standard of rule 26a-1 to be consistent with the policies underlying section 26(a)(2). See Investment Company Act Release Nos. 13705 (Jan. 9, 1984) (proposing rule 26a-1) and 14066 (July 27, 1984) (adopting rule 26a-1).

¹⁰ Securities and Exchange Commission, Investment Trusts and Investment Companies: Fixed and Semifixed Investment Trusts, H. Doc. No. 567, 76th Cong., 3d Sess. (1940). This report was one of a series of Commission reports about the investment management industry that led to the enactment of the Investment Company Act of 1940.

¹¹ These charges included, among other things: buying securities for a Trust at the (lower) bid price and selling them to the Trust at the (higher) asking price; charging the Trust odd-lot brokerage commissions even when the sponsor purchased the portfolio securities in round lots; including brokerage commissions on portfolio securities in the figure on which the load was calculated; adjusting the offering price of the Trust's securities to the next highest eighth of a dollar; and retaining the interest earned on the Trust's cash. Fixed and Semifixed Investment Trusts, *supra* note 10, at 165-189 (Chapter X, "Costs to Investors and Profits to Sponsors").

¹² Investment Company Act Release No. 13705, *supra* note 9.

¹³ See *supra* note 2.

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consistent with the provisions of the Investment Company Act and the policies and purposes underlying the Act.¹⁴

Sincerely,



Barry A. Mendelson
Senior Counsel

¹⁴ The position we announce today appears to conflict with an exemptive order issued by the Commission in 1979. In Third Generation Tax-Exempt Bond Trust, Series 1, Investment Company Act Release Nos. 10819 (Aug. 7, 1979) (notice) and 10857 (Sept. 5, 1979) (order), the Commission granted an exemption from section 26(a)(2) to permit a UIT to bear its own organizational expenses, implying that this practice would be prohibited without exemptive relief. The staff no longer believes that a UIT requires an exemptive order to bear its own organizational expenses, and has apprised the Commission of its position on this issue.