

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

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Request for Comments on Reform of the Regulation of Investment Companies

AGENCY: SECURITIES AND EXCHANGE COMMISSION

ACTION: Request for Comments

SUMMARY: The Commission is soliciting comments on reform of the regulation of investment companies under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934.

Developments in the financial markets require reexamination of how pooled investment vehicles are regulated, particularly since the laws governing investment companies have not been amended significantly since 1970. Accordingly, the Commission is requesting comment from investors, investment companies, investment advisers, the financial services industry generally, regulators, and the public generally on a number of specific issues summarized in this release and on any other issues that commenters believe relevant.

DATES: Comments are to be received on or before September 4, 1990.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C.

20549. All comment letters should refer to File No. S7-11-90. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: With respect to the study generally, Matthew A. Chambers, Assistant Director, or Nancy M. Morris, Associate Chief Counsel, at (202) 272-2048. With respect to the following specific topics: Internationalization of the Securities Markets -- Regina Hamilton, Attorney; Alternative Pooled Investment Structures -- Paul Goldman, Branch Chief, Diane Blizzard, Special Counsel, or Stuart Horwich, Senior Attorney; Asset-Backed Arrangements under the Investment Company Act -- Rochelle Kauffman, Senior Attorney; Distribution of Open-End Companies -- Karen L. Skidmore, Assistant Director; Closed-End Companies and Repurchases of Shares -- Stuart Horwich; Transactions in Options and Futures Contracts -- Karen L. Skidmore; Securities Act Issues -- Diane Blizzard or Ann Glickman, Special Counsel; Insurance Products under the Federal Securities Laws -- Wendell Faria, Attorney; and Bank Involvement with Investment Companies - - Ann Glickman (all at (202) 272-2048.)

SUPPLEMENTARY INFORMATION:

I. INTRODUCTION

The Commission is reexamining the regulation of investment companies under the Investment Company Act of 1940 (“Investment Company Act”) [15 U.S.C. 80a-1 et seq.], the Investment Advisers Act of 1940 (“Advisers Act”) [15 U.S.C. 80b-1 et seq.], the Securities Act of 1933 (“Securities Act”) [15 U.S.C. 77a-1 et seq.], and the Securities Exchange Act of 1934 (“Exchange Act”) [15 U.S.C. 78a-1 et seq.], in light of the significant changes in the securities markets in recent years. As a part of this reexamination, the Commission requests comments on whether or how investment company regulation should be amended, either by legislation or rulemaking.

This release begins by summarizing the existing regulatory framework for investment companies. Commenters are urged to address the overall regulatory structure for investment companies. The release also discusses briefly a number of specific topics on which the Commission is seeking comment. The topic discussions are summary and are intended to serve as starting points. In addition to addressing the specific topics, commenters are urged to address any other topics or issues relating to investment company regulation that they believe merit examination. Where possible, commenters are asked to provide specific statutory or rulemaking language to implement their recommendations.

II. THE EXISTING REGULATORY STRUCTURE

In section 30 of the Public Utility Holding Company Act of 1935 [15 U.S.C. 79z-4], Congress directed the Commission to study the unregulated investment company industry and report its findings. The Commission's multi-volume report on investment trusts and investment companies¹ laid the foundation for the Investment Company Act of 1940, which imposes significant substantive requirements on the formation, financial affairs, and operation of investment companies and requires investment companies to disclose information about their activities.

At the time the Investment Company Act was enacted, there were only 68 investment companies with assets of \$448 million. By 1970, the industry had grown to 400 investment companies with about \$40 billion in assets. In the last two decades, the industry has grown dramatically, in part due to the introduction of money market funds. Today there are over 3,500

¹ SEC, The Nature, Classification, and Origins of Investment Trusts and Investment Companies, H.R. Doc. No. 707, 75th Cong., 2d Sess. (1938); SEC, Statistical Survey of Investment Trusts and Investment Companies, H.R. Doc. No. 70, 76th Cong., 1st Sess. (1939); SEC, Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies, H.R. Doc. No. 279, 76th Cong., 1st Sess. (1939) [hereinafter cited as "Investment Trusts and Investment Companies"].

investment companies with over \$1.2 trillion in assets. Investment companies are fast becoming the primary investment and savings vehicle for a significant portion of the investing public, many of whom invest in investment companies not only directly but also indirectly through their employers' retirement plans. The growth of investment company industry assets has created a major national financial intermediary, giving the investment company industry parity with banks, savings and loan associations, brokerage houses, and insurance companies.

The Investment Company Act generally defines investment companies as issuers primarily engaged in the business of investing in, holding, or trading securities.² There are three types of investment companies: face-amount certificate companies,³ unit investment trusts ("UITs"),⁴ and management investment companies.⁵ By definition, the terms are mutually exclusive. The Commission requests comment on whether it continues to make sense to divide investment companies into three types, or whether different typologies would make more sense, or whether all investment companies should be treated more or less the same.

² Investment Company Act § 3(a) [15 U.S.C. 80a-3(a)].

³ A face-amount certificate company issues debt securities which investors purchase by periodic installments or by a lump sum payment. Investment Company Act § 4(1) [15 U.S.C. 80a-4(1)].

⁴ A UIT is a company organized under a trust indenture or similar instrument that invests in a largely fixed portfolio of securities, does not have a board of directors, and issues redeemable securities. Investment Company Act § 4(2) [15 U.S.C. 80a-4(2)]. UITs typically offer units in successive "series," each representing interests in a separate portfolio of securities.

⁵ A management investment company is any investment company that is not a face-amount certificate company or a unit investment trust. Investment Company Act § 4(3) [15 U.S.C. 80a-4(3)]. The distinguishing feature of a management investment company is that its investment portfolio is "managed," usually by an external investment adviser who is paid a fee based on a percentage of the company's assets.

Depending on the type of investment company, the Investment Company Act imposes requirements regarding, among other things, composition and election of boards of directors, exchange offers, pyramiding, investment policies and types of investments, investment advisory and underwriting contracts, transactions with affiliates, capital structure, custodial arrangements, portfolio evaluation, fidelity bonds, codes of ethics, disclosure of the source of dividends and distributions, proxies, loans, sales and redemptions, repurchases, use of fund assets for distribution, reorganizations, reports to shareholders and the Commission, books and records, and accountants and auditors.⁶ Underlying each of these Investment Company Act requirements are basic policy objectives. For example, section 12(d)(1) [15 U.S.C. 80a-12(d)(1)] was designed to prevent, among other things, a multiplicity of costs and fees from being imposed on shareholders through the practice of pyramiding the ownership and control of investment companies. Section 17 [15 U.S.C. 80a-17] was intended to protect investment company shareholders from loss in the value of their shares as a result of self-dealing by investment companies' insiders. Section 18(f) [15 U.S.C. 80a-18(f)] addressed the dilution of shareholder value through excessive leveraging. The Commission requests comment as to the current validity of these and other policy objectives underlying the Act's provisions. If the policies remain valid, can any of them be implemented in an alternative manner? Would a different overall regulatory structure be appropriate? Are there additional policies or requirements that the Commission should consider?

⁶ The Commission is empowered to adopt rules under the Investment Company Act, Investment Company Act § 38(a) [15 U.S.C. 80a-37(a)], and to enforce compliance by investment companies and their associated persons. Investment Company Act §§ 9(b), 36(a), 41 [15 U.S.C. 80a-9(b), -35(a), -40]. In order to determine compliance, the Commission conducts periodic inspections of investment companies, examining books and records. Investment Company Act § 31(b) [15 U.S.C. 80a-30(b)].

At the time of enactment, Congress and the Commission believed that most companies not appropriately subject to the Investment Company Act would be excepted from its provisions or otherwise excluded from the definition of investment company. However, to protect against the possibility that some companies would inadvertently be subject to its provisions, the Investment Company Act provides a procedure for a company to demonstrate that it is primarily engaged in a business other than that of being an investment company.⁷ Additional flexibility is provided by section 6(c) of the Investment Company Act [15 U.S.C. 80a-6(c)], which authorizes the Commission by rule or order to exempt persons conditionally or unconditionally from any or all provisions of the Act if the exemption is “in the public interest” and “consistent with the protection of investors” and the Act’s purposes. The Commission requests comment on whether additional flexibility is needed, whether further or different exemptive procedures are needed,⁸ and whether more specific exemptive standards are needed.

Investment companies are required to register with the Commission under the Investment Company Act unless otherwise exempt.⁹ The vast majority of investment companies registered

⁷ Investment Company Act § 3(b)(2) [15 U.S.C. 80a-3(b)(2)].

⁸ For example, in 1984, the Task Group on Regulation of Financial Services recommended amendments to the exemptive procedures.

The process of granting exemptions under the Investment Company Act should be streamlined to remove the requirement for public notice and comment in every case. Most exemptions are not controversial and are amply supported by precedent. Publication of notice seldom elicits any responses. Removing the notice requirements would eliminate unnecessary delays in the regulatory process and reduce paperwork burdens.

Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services 115-16 (1984).

⁹ Section 6(a) [15 U.S.C. 80a-6(a)] exempts certain investment companies from all provisions of the Investment Company Act, including the registration requirement.

with the Commission are management investment companies. The more common type of management investment company is the open-end company. Open-end companies, known as mutual funds, issue redeemable securities and generally offer their shares to the public on a continuous basis. In recent years, however, the number of closed-end management investment companies registered with the Commission has increased dramatically. Unlike open-end companies, closed-end companies do not issue redeemable securities and in most cases do not offer their shares to the public on a continuous basis. Rather, a closed-end company issues, in a traditional underwritten offering, a fixed number of shares that are subsequently traded on a securities exchange or in the over-the-counter market.

The sale of investment company shares is subject to the Securities Act. Certain other investment company activities, such as proxy solicitations, are subject to the Exchange Act and the rules thereunder. Investment advisers to investment companies are subject to the Investment Advisers Act, the companion statute to the Investment Company Act. Investment companies also must comply with state securities laws in those states in which they sell their shares. Finally, investment companies that wish to take advantage of favorable tax treatment afforded certain kinds of investment companies are subject to various provisions of the Internal Revenue Code of 1986 [26 U.S.C. 1 et seq.], in particular those of subchapter M [26 U.S.C. 851-855].

III. SPECIFIC TOPICS TO BE ADDRESSED

A. Internationalization of the Securities Markets

The globalization of securities markets has resulted in increased interest in marketing United States investment company services abroad and in opening United States markets to foreign investment company services. Twenty-four hour worldwide trading and growing

investor demand for pooled investment opportunities demonstrate the need to address barriers to cross-border sales of investment company services.¹⁰

This section of the release seeks comments on how best to facilitate competition between United States investment companies and advisers and foreign investment companies and advisers, both domestically and abroad. First, it summarizes barriers to sales of investment company services abroad by United States investment companies and advisers. Second, it discusses barriers to sales of investment company services in the United States by foreign entities. Third, it reviews recent developments to promote the growth of international markets in investment company services. Fourth, it sets forth several issues on which the Commission seeks comment.

United States investment companies encounter a number of legal impediments in marketing their products overseas. In order to reach a sufficiently large market abroad, they must comply with the varied requirements of several countries. Moreover, many countries impose greater restrictions on foreign investment companies than on domestic companies. Also, some countries have imposed currency and other restrictions that provide a disincentive to foreign securities investments by citizens of those countries.

Even when foreign host laws seemingly place the marketing of United States securities on a par with domestic securities, practical problems may arise. For instance, a host country may require both domestic and foreign securities to be sold only by the host country's banks or

¹⁰ As of December 31, 1985, 68 United States investment companies invested primarily in foreign securities, with total assets of about \$11.9 billion. As of December 31, 1989, the number of United States investment companies investing primarily in foreign securities had increased to 193, with total assets of about \$27 billion. Of these companies, 149 were open-end companies with total assets of about \$17.8 billion and 44 were closed-end companies with total assets of about \$9 billion. Also, 50 other open-end companies had at least 25% of their portfolios invested in securities traded outside of the United States, with total assets of about \$15.1 billion.

licensed broker-dealers. Yet, in such a case, it may be difficult for foreign investment companies to get “shelf space” for their securities because the host country’s banks or broker-dealers have their own competing products to sell.

United States tax law may also impede cross-border sales of the securities of United States investment companies. Certain distribution requirements and differing withholding standards provide an incentive for foreign investors to invest in foreign funds rather than in United States investment companies.¹¹

Under subchapter M of the Internal Revenue Code, in order to avoid federal taxation at the investment company level, a United States registered investment company must, among other things, distribute to its shareholders at least 90% of its gross income derived from sources such as dividends and interest. Subchapter M also imposes a tax on an investment company’s undistributed taxable income, and Internal Revenue Code section 4982 imposes an additional excise tax on an investment company if the investment company does not distribute to its shareholders 98% of its ordinary income and capital gains.¹² Thus, under subchapter M, if an investment company owning a portfolio of securities distributes all of its income to its shareholders, United States shareholders receive the same tax treatment as if they owned their proportionate share of that same portfolio of securities directly.

Foreign investors, however, may not receive the same tax treatment under the Internal Revenue Code for owning shares directly as for owning shares of a United States investment company holding those same securities. Foreign investors, when paid the distributions from an

¹¹ See, e.g., Hearings before the House Comm. on Ways and Means, 101st Cong., 2d Sess. (Jan. 30, 1990) (statement of D. Silver on behalf of the Investment Company Institute, “The Implications of ‘Europe 1992’ for the U.S. Mutual Fund Industry”) (unpublished).

¹² These provisions treat investment companies as conduits of income and tax them only on their undistributed income. See S. Rep. No. 1622, 83d Cong., 2d Sess. 59 (1954).

investment company effectively mandated by subchapter M, have 15% to 30% of the amount of ordinary income and short-term capital gains withheld from the distributions they receive.¹³

Under certain circumstances, if foreign investors owned the underlying securities directly, short-term capital gains and certain portfolio debt investment interest would not be subject to this withholding tax.¹⁴ Thus, foreign investors may incur a smaller United States federal tax liability by investing in securities directly rather than by investing in a United States investment company. Moreover, unlike the United States, many foreign jurisdictions do not require current distributions of earnings by investment companies and do not tax these earnings at the investment company level. Consequently, the overall effect of subchapter M and the foreign withholding tax provisions may be to discourage foreign investment in United States investment companies.

United States investment advisers conducting business abroad may be subject to more restrictive regulation than they encounter in the United States. For example, unlike the United States, foreign jurisdictions may require investment advisers to meet certain capital standards.¹⁵

Foreign regulators may also have greater discretion than United States regulators to determine whether to permit investment advisers to enter their respective markets. For example, under the minimum standards provided in the European Community (“EC”) Council Directive of 20th December 1985 on the Co-ordination of Laws, Regulations and Administrative Provisions

¹³ I.R.C. §§ 871(a), 881(a). This tax is often referred to as a “withholding tax.”

¹⁴ I.R.C. § 871(a)(2) imposes a withholding tax on capital gains of aliens only if they are present in the United States for 183 days or more during the taxable year. I.R.C. § 871(h) exempts from the withholding tax certain portfolio debt investment interest.

¹⁵ See, e.g., the Financial Resources Requirements set forth in the Investment Management Regulatory Organization’s Financial Resources Rules, Rule 4.01 and app. 6 (United Kingdom).

Relating to Undertakings for Collective Investment in Transferable Securities (“UCITS Directive”),¹⁶ the laws of EC member states (“Member States”) may give regulators greater latitude than the Commission to prevent advisers from entering the investment company business. To qualify as a UCITS manager in a Member State, the Member State must determine that the manager is of “good repute” and has the experience required to perform its duties.

United States law may inhibit cross-border sales of shares of foreign investment companies. An investment company not organized under United States law is prohibited by section 7(d) of the Investment Company Act [15 U.S.C. 80a-7(d)] from publicly offering its securities in the United States unless the Commission by order finds that “it is both legally and practically feasible effectively to enforce the provisions of [the Investment Company Act] against such company.” In effect, the Commission is required by section 7(d) to determine that investors in foreign investment companies have the same protections as investors in domestic investment companies. Although the Commission has granted exemptions for funds organized in certain common law countries, and, in the case of Canadian investment companies, has adopted rule 7d-1 [17 CFR 270.7d-1] to facilitate their registration, section 7(d) continues to present difficulties for foreign investment companies, especially those organized in civil law countries.

In 1984, the Commission recommended amending section 7(d) to make it easier for foreign investment companies to register with the Commission.¹⁷ The amendment would have authorized the Commission to exempt certain foreign investment companies from any provision

¹⁶ For a discussion of the UCITS Directive, see infra notes 25-28 and accompanying text.

¹⁷ See Letter from John S.R. Shad, Chairman, SEC, to the Honorable Thomas P. O’Neill, Jr., Speaker, United States House of Representatives (Jan. 31, 1984) (transmitting proposed Foreign Investment Company Amendments Act of 1984 and Memorandum of the SEC in Support of the Foreign Investment Company Amendments Act of 1984).

of the Investment Company Act if it found that compliance with the provision would be unduly burdensome and either that the foreign law under which the company operated would provide comparable investor protections or the company would agree to conditions providing those protections.¹⁸ The proposal was never introduced in Congress.¹⁹

A foreign investment company may also be required to register its proposed public offering under the securities or “blue sky” laws of one or more states.²⁰ In some states, those laws require a merit review of the offering, giving state regulators discretionary authority to reject offerings as too speculative.²¹

¹⁸ In addition, the Commission would have been required to find that the exemption would be consistent with the protection of investors and the purposes intended by the policy of the Investment Company Act, and that the foreign company would not be operated for the purpose of evading the provisions of that Act. The Commission also would have been required to find that it was both legally and practically feasible effectively to enforce against the company those provisions of the Investment Company Act from which exemptions were not granted.

¹⁹ Some foreign investment companies have avoided section 7(d) by forming “mirror funds.” A mirror fund invests in virtually the same securities as an existing foreign investment company, but is organized under United States law and registered under the Investment Company Act. See Investment Company Act Release No. 13691 (Dec. 23, 1983).

²⁰ Some public offerings of closed-end companies are exempt from many blue sky laws because their shares are listed on national securities exchanges registered with the Commission. Offerings of open-end investment companies and unit investment trusts generally must be registered in accordance with state blue sky laws, although seven states currently have “blue chip” investment company exemptions. See, e.g., N.J. Rev. Stat. § 49:3-50(a)(12) (1987).

²¹ Many states currently provide for registration by “coordination” to reduce the regulatory burden of this dual structure. An issuer can “coordinate” its blue sky filing with its required filing under the Securities Act by filing with the state the registration statement provided to the Commission and certain documents specified by the state. Coordination simplifies the state review process and can result in concurrent effectiveness on both regulatory levels.

A foreign investment adviser may register with the Commission under the Advisers Act merely by filing an application and paying a \$150 fee. While a foreign investment adviser need not maintain an office or staff in the United States, a non-resident adviser must furnish a consent to service of process with the Commission and undertake to furnish books and records to the Commission upon request.²² The Division of Investment Management takes the view that, once registered, a foreign adviser is subject to all of the provisions of the Advisers Act with respect to both its United States clients and its foreign clients.

To avoid Advisers Act regulation with respect to foreign clients, many foreign advisers create a separate and independent United States registered subsidiary or affiliate to service United States clients. In determining whether a domestically registered advisory subsidiary or affiliate of a foreign adviser operates as a separate independent entity, one of the factors the Division of Investment Management considers is whether the registered subsidiary or affiliate shares advisory personnel with the foreign entity. If they share personnel, the Division may “look through” the registered entity and apply the provisions of the Advisers Act to the foreign entity.²³

Commenters have suggested that the Division’s position may affect adversely the ability of advisory organizations to conduct international advisory activities. For example, it may force

²² See rules 0-2 and 204-2 under the Advisers Act (17 CFR 275.0-2, 275.204-2].

²³ See Richard Ellis, Inc. (pub. avail. Sept. 17, 1981) (an advisory subsidiary is viewed as having a separate, independent existence and to be functioning independently if it: (1) is adequately capitalized; (2) has a buffer, such as a board of directors a majority of whose members are independent of the parent, between the subsidiary’s personnel and the parent; (3) has employees, officers, and directors, who, if engaged in providing advice in the day-to-day business of the subsidiary entity, are not otherwise engaged in an investment advisory business of the parent; (4) makes the decisions as to what investment advice is to be communicated to, or is to be used on behalf of, its clients and has and uses sources of investment information not limited to its parent; and (5) keeps its investment advice confidential until communicated to its clients).

investment advisory firms to create separate United States subsidiaries or affiliates with distinct personnel to service only United States clients. This may divide scarce advisory personnel with expertise in specialized markets and reduce capital resources available to each entity, thus diminishing services to both United States and foreign advisory clients.

Moreover, foreign governments may perceive application of the Advisers Act to their investment advisers' activities with respect to non-United States clients as contrary to principles of international comity and might react by reciprocating the treatment. Thus, United States investment advisers might find their overseas operations subject to increased restrictions and their United States operations subject to the laws and regulations of foreign host countries.

In addition to meeting Advisers Act requirements, foreign investment advisers may have to register with state securities regulators. A majority of states require an investment adviser to secure a license by furnishing satisfactory evidence of its trustworthiness and competency to engage in the advisory business. Most states exclude or exempt investment advisers that are broker-dealers registered in the particular state, or have no office located in the state and advise only a de minimis number of clients or institutional clients.²⁴

Access by United States investment companies and advisers to European markets may improve with the recent implementation of the UCITS Directive. The Directive prescribes a common denominator approach to investor protection designed to coordinate laws and regulations governing collective investment undertakings in EC Member States.²⁵ A qualifying

²⁴ See, e.g., N.J. Rev. Stat. §§ 49:3-49(g), -56(c) (1987).

²⁵ Not all investment companies are covered by the UCITS Directive. Qualifying UCITS are similar to open-end management investment companies that invest in exchange-listed securities. Closed-end investment companies generally do not qualify as UCITS; companies investing in money market instruments in Member States in which the instruments are not regarded as having the characteristic of transferable securities would also not qualify as UCITS.

UCITS from one Member State may sell its shares in any other Member State, subject only to the host country's marketing, advertising, and tax laws.²⁶ Each Member State must adopt domestic legislation to implement the UCITS Directive, but each is free to choose a form and method of implementation consistent with its legal system. The Directive generally permits a Member State to impose more stringent requirements on its own UCITS than on UCITS from other EC Member States being sold within its borders.²⁷ While a Member State is free to apply stricter marketing regulations to its own UCITS than those applied to foreign UCITS, the Directive prohibits the use of marketing regulations to discriminate against UCITS originating in other Member States.

Compared with United States regulation of investment companies, the UCITS Directive may be more or less restrictive on any given issue. For example, the Directive requires regulators in a home country to approve not only an investment company's manager, but also the investment company's rules, and its choice of a depository. On the other hand, the Directive does not directly address other concerns such as affiliated transactions, pricing, and the use of fund assets for distribution.²⁸

²⁶ Because the UCITS Directive does not offer a unitary system of marketing, advertising, or taxation, it may not eliminate all potential disincentives for investment in UCITS of other Member States.

²⁷ For example, a Member State may define "transferable securities" to be held by UCITS it authorizes, or it may retain the general definition provided in the UCITS Directive.

²⁸ Other differences between UCITS and investment companies under the United States securities laws include voting and disclosure requirements. Unlike the Investment Company Act, the UCITS Directive does not provide for voting by shareholders and directors on any matter, but authorizes the home Member State to approve the choice and replacement of a UCITS' management company and depository (which, like a custodian, holds a UCITS's assets) and to adopt and amend a UCITS' rules or organizational documents. Similarly, although UCITS must provide some disclosure, the requirements under the Securities Act and the Investment Company Act are more extensive.

Japan has taken a step toward permitting foreign entities limited participation in its investment company market. Only investment trust management companies licensed by the Japanese Ministry of Finance (“MOF”) may manage Japanese investment trusts. Fewer than twenty of these licenses have ever been issued, all to Japanese entities. Last December, the MOF announced new guidelines for the licensing of investment trust management companies, which apply to both foreign and domestic applicants.²⁹ One commenter has suggested that, while the new application guidelines purport to improve the ability of foreign money managers to compete in Japan, it is unclear whether foreign firms will be able to comply with the guidelines to compete effectively in the Japanese investment company market.³⁰

²⁹ Pozen, For Foreign Funds, Japan Barely Opens Door, Pensions & Investments, Mar. 19, 1990, at 14.

³⁰ Id.

Efforts by government agencies³¹ and industry self-regulatory organizations,³² among others, are underway to identify and eliminate barriers to cross-border sales of investment company services. While each effort represents a further step toward the internationalization of investment company services, it also underscores the problems that must be addressed.

The Commission requests that commenters address how best to permit cross-border sales of investment company and adviser services, consistent with investor protection. Commenters are requested to identify unnecessary barriers to effective competition among United States investment companies and advisers and foreign investment companies and advisers, both in the United States and abroad, that are created by domestic or foreign securities, tax, or other laws, and any other significant barriers. In this regard, commenters are asked to assess the effect of the Investment Company Act and the Advisers Act, and of existing interpretations, on the ability of investment companies and investment advisory organizations to conduct international activities. Commenters are also asked to recommend, as specifically as possible, the most effective way to

³¹ For example, under the Financial Reports Act of 1988 [22 U.S.C. 5352], the Commission, the Departments of Treasury and State, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency are required to submit to Congress an updated version of the 1986 edition of The National Treatment Study. Like earlier editions, the updated study, due December 1, 1990, will examine the extent to which foreign countries deny United States commercial banking and securities organizations equality of competitive opportunity with domestic institutions in similar circumstances. It will also describe specific examples of discrimination by foreign countries against United States financial firms.

³² In June 1989, the United Kingdom's Investment Management Regulatory Organization Limited ("IMRO"), a self-regulatory organization, completed the first stage of a comparative study of the regulation of investment management in the United Kingdom and the United States. Commission staff prepared a similar study and received detailed comments from IMRO. Last September, IMRO proposed that, because United States registered advisers and IMRO members are required to submit very similar information, the two countries might agree to mutually recognize registration under the Advisers Act and membership in IMRO. However, IMRO noted that, because of differing regulatory standards, registration with the Commission and IMRO membership should not be automatically interchangeable.

eliminate unnecessary barriers to effective competition, including amending or reinterpreting domestic law, entering into multi-national or bilateral treaties, harmonizing conflicting regulation, or applying concepts of comity and mutual recognition. Commenters should address how any proposal to eliminate unnecessary barriers to effective competition would affect the Commission's enforcement efforts.

B. Alternative Pooled Vehicles

In 1982, the Commission requested comment on the advisability of a legislative proposal advanced by industry observers to create an alternative type of open-end investment company -- a unitary investment fund ("UIF").³³ As summarized in the Commission's release, a UIF would have had neither voting shareholders nor a board of directors; rather, a UIF would have been sponsored and managed by an investment manager.³⁴ The investment manager, including a bank acting in that capacity, would have been required to register under the Advisers Act.³⁵ A management contract between the investment manager and the UIF would have set forth, among other things, the UIF's investment objectives, management fees, and shareholder account

³³ Investment Company Act Release No. 12888 (Dec. 10, 1982) ("Release 12888"), 47 FR 56509 (Dec. 17, 1982). The UIF concept had been proposed as a way of streamlining and reducing operating costs of open-end companies. See generally speech by Stephen K. West, General Meeting of the Investment Company Institute (May 1, 1980) [hereinafter cited as "West Speech"].

³⁴ Both shareholder voting and boards of directors are currently required under the Investment Company Act for open-end investment companies. Investment companies in EC Member States and Japan generally do not have boards of directors or shareholder voting.

³⁵ The Commission has proposed that bank advisers to investment companies be subject to the Advisers Act. See infra notes 126-127 and accompanying text.

charges.³⁶ The investment manager could not have amended these provisions during an initial start-up period (suggested to be five years) unless the Commission had approved an application for an order permitting the amendment. After the initial period, the provisions could be changed at any time upon adequate notice to shareholders. Under the proposal, a UIF investment manager would not have had a fiduciary duty regarding the receipt of compensation by the manager and its affiliates.

The UIF proposal envisioned the Commission taking an active role regarding UIFs. For example, a UIF's registration statement under both the Securities Act and the Investment Company Act would have had to have been declared effective by the Commission before shares could have been sold, thereby giving the Commission the opportunity to review the management contract as well as proposed prospectus disclosure.³⁷

Commenters generally opposed the UIF concept when it was proposed in 1982. Numerous changes have occurred in the investment company industry since that time, however, that may make alternative pooled vehicles such as the UIF more attractive and practical. Most significantly, securities markets have become increasingly global, and investment companies are seeking opportunities to expand into foreign markets where an alternative structure may enhance

³⁶ The management fee would be calculated as a percentage of net assets, excluding expenses incurred for brokerage, interest, taxes, and extraordinary items. Shareholder accounts would be separately charged for sales or redemption fees, if any, and for shareholder servicing and transfer agent fees.

³⁷ Currently, a domestic investment company is automatically registered under the Investment Company Act upon filing a notification of registration on Form N-8A. Investment Company Act § 8(a) [15 U.S.C. 80a-8(a)]. Typically, a Securities Act registration statement for shares of an investment company includes a delaying amendment and is declared effective by the Commission only after review and comment by the staff. If, however, a Securities Act registration statement were filed without a delaying amendment, it would become effective automatically in twenty days. Securities Act § 8(a) [15 U.S.C. 77h(a)] and rule 473 thereunder [17 CFR 230.473].

competitiveness. In addition, some states now permit investment companies to forego annual shareholder meetings.³⁸ Also, fee structures and methods of paying for distribution have grown increasingly complex.³⁹ A UIF-type structure may be more attractive to investors because it would operate under a relatively simple fee structure.

Commenters are asked to consider whether these and other developments in the investment company industry, including anticipated future trends, create the need for alternative pooled vehicles, including, but not limited to, a UIF-type vehicle. Commenters should refer to Release 12888 for a more detailed discussion of issues raised in connection with the UIF proposal. Commenters who previously responded to Release 12888 are invited to update their responses.

Comment is also invited on the feasibility of other alternatives. For example, some commenters have suggested altering the UIT vehicle to provide the sponsor with greater latitude to manage its portfolio or to issue securities that are not redeemable. Others have suggested that

³⁸ In 1986, the Division of Investment Management took the position that section 16(a) of the Investment Company Act [15 U.S.C. 80a-16(a)] does not require investment companies to hold shareholders' meetings to elect directors (or those persons holding equivalent positions) on an annual basis. The Division concluded that, aside from two situations set forth in section 16(a) (*i.e.*, electing the initial board of directors and electing directors to fill existing vacancies on the board in the event that less than a majority of directors are elected by shareholders), applicable state law governs the timing of shareholders' meetings to elect investment company directors. John Nuveen & Co. Incorporated (pub. avail. Nov. 18, 1986). Subsequently, Maryland amended its state corporation law to remove the requirement that investment companies hold annual meetings. Md. Code Ann. § 2-501(B) (1987). Many investment companies operating in corporate form are Maryland corporations, and, consistent with state law, they have acted to dispense with annual shareholders' meetings. See also Minn. Stat. § 302A.431 (1986) (regular meetings of shareholders need not be held unless required by the corporation's articles or bylaws or by demand of shareholders.) In addition, under Massachusetts law, investment companies organized as Massachusetts business trusts are not required to hold annual meetings.

³⁹ For a discussion of current distribution arrangements, see infra notes 61-72 and accompanying text.

closed-end investment companies be allowed to provide a redemption-like mechanism and to use company assets to finance distribution costs.⁴⁰

Would an investment company's ability to avail itself of an alternative structure, such as a UIF, significantly improve the competitiveness of United States investment companies both at home and abroad? Would an alternative pooled vehicle initiative complement international initiatives to regulate similar pooled investment vehicles under a common set of principles?⁴¹

A significant issue involved in evaluating alternative structures is the extent to which operating expenses would be reduced. For example, investment companies may incur significant costs to solicit proxies and to pay directors' fees and expenses. Commenters are asked to furnish information both with respect to costs presently incurred in complying with the Investment Company Act and costs which would be incurred under an alternative structure. Specifically, how much less would it cost an average investment company to operate in UIF or alternative forms compared to present forms, and how would the cost savings be created?

As noted in the 1982 release, the UIF concept is premised, in part, on an assumption that, in the open-end management investment company context, voting shareholders and directors are "redundant."⁴² Some, however, have asserted that directors are sensitive to their responsibilities

⁴⁰ See infra notes 73-82 and accompanying text.

⁴¹ For a discussion of some of these initiatives, see supra notes 25-32 and accompanying text.

⁴² Release 12888 quoting West Speech, supra note 33, at 10.

as board members⁴³ and that voting rights benefit shareholders in a number of ways.⁴⁴ With this in mind, comment is sought on what, if any, investor protection concerns are raised by a management investment company that does not have shareholder voting or a board of directors? Are these concerns reduced for some types of investment companies? For example, it has been suggested that money market funds would be prime candidates for a UIF structure.⁴⁵ If management could take action without shareholder approval, what provision should be made to inform shareholders of management actions? Should shareholders be provided with a procedure to challenge such actions?

A number of provisions of the Investment Company Act and the rules thereunder rely on boards of directors to safeguard investor interests.⁴⁶ Some require directors to evaluate the reasonableness of a number of different and, in some cases, overlapping fees and charges for investment advice, distribution, administration, and shareholder services. Others permit various types of transactions and activities to take place without prior Commission review of individual

⁴³ Phillips, Deregulation Under the Investment Company Act -- A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors, 37 Bus. Law. 903, 910-11 (1982).

⁴⁴ For example, the availability of voting rights may deter management from acting in a manner contrary to shareholder interests. See Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. (1962); see also Release 12888.

⁴⁵ Both the West Speech and Release 12888 made this suggestion, based, in part, on the belief that money market funds may be the fund type most likely to be the subject of comparison shopping by investors. It has been noted that investors perceive the money market fund to be a relatively homogeneous product for which yield is a major purchase criterion and that the level of fund expenses is a major determinant of yield. Phillips, supra note 43, at 913.

⁴⁶ See, e.g., Investment Company Act §§ 2(a)(41), 15(c) [15 U.S.C. 80a-2(a)(41), -15(c)], rules 2a-7, 10f-3, 12b-1, 17a-7, 17a-8, 17d-1(d)(7), 17e-1, 17f-5 [17 CFR 270.2a-7, 270.10f-3, 270.12b-1, 270.17a-7, 270.17a-8, 270.17d-1(d)(7), 270.17e-1, 270.17f-5].

applications, which otherwise would be required. These provisions and rules contemplate that the board of directors of an investment company will establish, oversee, and monitor procedures designed to protect investor interests. Often, the disinterested directors are required to determine that an action will be in the best interests of the company and its shareholders. Commenters are asked to consider whether these provisions or rules should be modified to allow UIFs or other alternative vehicles to rely on them. If so, what mechanism, if any, would be needed in place of the directors' review? Would new types of sanctions be needed for an investment manager of a UIF or other vehicle who violated these provisions or rules?

The UIF concept relies on the idea that competition and consumer choice are adequate substitutes for director oversight and shareholder voting, particularly in controlling the ability of an investment company sponsor/manager to set fees that could be regarded as excessive. The ability of the market to regulate investment company fees may depend, however, on the extent to which investors make active purchase and redemption decisions, give significant consideration to cost in making those decisions, and are able easily to compare the total cost of investing in alternative funds. With this in mind, should a UIF or other alternative pooled vehicle be permitted to impose front-end sales charges, contingent deferred sales charges, redemption fees, or rule 12b-1 fees? What conditions or limitations should be imposed on charges? Should selling costs be imposed only on a shareholder's account and not on fund assets? Should shareholder account charges be limited to a front-end sales charge?

Comment is also requested on whether the need for a board of directors to stand as an intermediary between shareholders and the investment company in evaluating the reasonableness of multiple fees could be obviated by a single, all-inclusive fee to be charged for all costs

incurred in selling and operating an alternative pooled vehicle.⁴⁷ If all expenses and charges were included in a single fee, would investors be in a better position to compare total costs to be incurred by investing in different vehicles? Should a single fee also include agency transaction costs? If not, would the investment manager of an alternative pooled vehicle have an incentive to use “soft dollars” to pay for as many fund expenses as possible?

Finally, in the context of an alternative pooled structure like the UIF, should all service contracts between the investment company and affiliated persons be exempt from the requirements of rule 17d-1 under the Investment Company Act?⁴⁸ Should section 36(b)⁴⁹ be amended to provide that the investment manager of a UIF-type vehicle does not have a fiduciary duty regarding the receipt of compensation by the manager and its affiliates? Are alternative management fee controls, such as a statutory maximum fee, warranted?

C. Asset-Backed Arrangements Under the Investment Company Act

A structure financing or asset-backed arrangement (“ABA”) typically consists of a limited purpose entity whose primary business activity is acquiring and holding financial assets and issuing non-redeemable debt obligations or equity interests. The principal and interest payments on the pledged assets are used to make payment on the securities issued by the ABA,

⁴⁷ This approach would require the investment manager to set its fee at a rate high enough to compensate for all costs incurred in selling and operating an alternative pooled vehicle, whether services are performed “in house” or by outside contractors. The fee would include all distribution-related expenses, investment advice, shareholder accounting, transfer agent and shareholder costs, administration, professional fees (such as legal, accounting, and pricing services), and insurance.

⁴⁸ In brief, rule 17d-1 prohibits joint transactions among investment companies and their affiliated persons or principal underwriters, or any affiliated person of an affiliated person or principal underwriter, without a Commission order.

⁴⁹ Section 36(b) imposes a fiduciary duty regarding compensation paid by an investment company to its investment adviser and affiliated persons of the adviser.

which usually are rated not lower than AA by one or two nationally recognized statistical rating organizations.⁵⁰ Issuers that have more assets or collateral than needed to make full payment on their debt securities may sell equity or “residual” interests in the residual cash flow or value of the collateral.

The structured finance market is huge, global, and still evolving. In 1989, the volume of new issues was \$158 billion; in 1990, volume is projected to be \$175.5 billion.⁵¹ The most prevalent ABA to date is the collateralized mortgage obligation (“CMO”). A CMO is a debt obligation collateralized by various types of mortgage loans or by mortgage-backed securities usually issued or guaranteed by the Government National Mortgage Association, Federal National Mortgage Association (“FNMA”), or Federal Home Loan Mortgage Corporation (“FHLMC”).⁵² The CMO structure allows the cash flows on the underlying mortgage pool to be carved up into separate, marketable securities. CMOs are issued in a series of classes, each of a specified coupon and stated maturity. Scheduled payments and prepayments from the collateral

⁵⁰ The ratings are based solely upon each rating agency’s assessment of the likelihood of timely distribution of principal and interest. Highly rated structures usually have some type of credit enhancement, e.g., reserve funds, subordinated classes, insurance, letters of credit, or overcollateralization.

Certain trends may have increased credit risk; in fact, \$4.6 billion of structured finance securities was downgraded during 1989. Most notably, heightened competition among transaction participants may have increased the pressure on credit standards. The average credit quality of structured securities is expected to continue to decline in 1990. Structured Finance, Annual Report: 1989 Review and 1990 Outlook 3-6, Moody’s Structured Finance Research & Commentary (Jan. 1990) [hereinafter cited as “Moody’s Annual Report”].

⁵¹ See Moody’s Annual Report, supra note 50, at 3.

⁵² In the 1970s, approximately \$100 billion in mortgage-backed securities was issued; in 1989 alone, over \$94.5 billion in CMOs was issued. In 1989, there was a dramatic shift from private issuer CMOs to FNMA and FHLMC issuance, with agency CMOs accounting for 85% of the market, up from 34% in 1988. Moody’s Annual Report, supra note 50, at 3, 7.

are prioritized to retire the earliest class of CMOs before retiring later classes in the order of stated maturities.

More recently, other types of ABAs have been issued, including collateralized bond obligations, using corporate bonds as collateral; consumer loan-backed securities, including so-called “plastic bonds” collateralized by credit card receivables; securities collateralized by pools of federal agency loans; and securities issued by “bad banks,” which are entities chartered as banks that usually hold only non-performing assets and issue debt much like a CMO issuer.⁵³

ABAs generally are investment companies under section 3(a) of the Investment Company Act because they issue securities to the public (typically in the form of bonds or equity interests), and invest in, own, hold or trade securities within the meaning of the Act (e.g., open accounts receivable, mortgage notes, mortgage-backed securities, government loans). Most ABAs, however, would have great difficulty operating under the Act’s requirements. For example, many ABAs have complicated multiclass structures that would be prohibited under section 18, which makes it unlawful for any registered investment company to have more than one class of senior security outstanding and requires certain levels of asset coverage.

Some ABAs have avoided regulation under the Investment Company Act by relying on one of the three statutory exceptions to the definition of an investment company in section 3(c)(5) [15 U.S.C. 80a-3(c)(5)]. The exceptions are available only to issuers that are not issuing

⁵³ See Mayer, Slicing the Mellon: Behind the Good Bank/Bad Bank Scheme, Barron’s, Aug. 15, 1988, at 11.

“redeemable” securities.⁵⁴ First, section 3(c)(5)(A) [15 U.S.C. 80a-3(c)(5)(A)] excepts issuers primarily engaged in “acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services.” Second, section 3(c)(5)(B) [15 U.S.C. 80a-3(c)(5)(B)] excepts issuers primarily engaged in “making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of specified merchandise, insurance, and services.” Finally, section 3(c)(5)(C) [15 U.S.C. 80a-3(c)(5)(C)] excepts issuers primarily engaged in “acquiring mortgages and other liens on and interests in real estate.” Most CMO issuers have relied on this exception.

Some ABA issuers unable to rely on section 3(c)(5) have organized outside the United States and offered their securities publicly only outside the United States to foreign investors. Others have offered their securities in private placements to not more than one hundred investors, relying on the exception in section 3(c)(1) of the Investment Company Act [15 U.S.C. 80a-3(c)(1)].⁵⁵ Finally, a number of CMO issuers and a few government loan pools that were

⁵⁴ Issues important to the availability of any of the three exceptions under section 3(c) are the interpretation of the terms “redeemable securities” and “primarily engaged,” which have been analyzed by the Division of Investment Management in a variety of contexts. See, e.g., Prudential Mortgage Bankers & Investment Corp. (pub. avail. Dec. 14, 1977); Salomon Brothers, Inc. (pub. avail. June 17, 1985); California Dentists’ Guild Real Estate Mortgage Fund II (pub. avail. Jan 4, 1990). The redeemable securities prohibition was added by amendments to the Investment Company Act in 1970 and was intended to reach certain entities such as real estate investment trusts that attempted to capitalize on the popularity of open-end investment company securities. See S. Rep. No. 184, 91st Cong., 1st Sess. 37 (1970); H.R. Rep. No. 1382, 91st Cong., 2nd Sess. 17 (1970).

⁵⁵ Section 3(c)(1) of the Investment Company Act [15 U.S.C. 80a-3(c)(1)] is somewhat analogous to the private offering exemption in section 4(2) of the Securities Act [15 U.S.C. 77d(2)]. Section 3(c)(1) provides an exception for any issuer “whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.” See infra note 128 and accompanying text for a discussion of possible amendments to this exception.

unable to rely on a statutory exception have sought and received individual exemptions from some or all provisions of the Investment Company Act.⁵⁶

Given the emergence of ABAs, which developed subsequent to the enactment of the section 3(c)(5) exceptions and arguably were not specifically envisioned by Congress in 1940,⁵⁷ it may be appropriate to reevaluate the treatment of ABAs under the Investment Company Act. The Commission requests comments on the subject of ABAs generally and on the following specific issues and questions:

Should all ABAs, regardless of the assets being collateralized, be given the same regulatory treatment or do the different assets collateralizing the securities require or justify different regulatory treatment for each type of structured financing?⁵⁸ Similarly, should ABAs

⁵⁶ See, e.g., Trident Mortgage Securities Company, Investment Company Act Release Nos. 16228 (Jan. 15, 1988), 53 FR 1874 (Jan. 22, 1988) (notice) and 16268 (Feb. 11, 1988) (order); Community Program Loan Trust No. 1987 A, Investment Company Act Release Nos. 15900 (July 29, 1987), 52 FR 28628 (July 31, 1987) (notice) and 15948 (Aug. 24, 1987) (order); College and University Facility Loan Trust One, Investment Company Act Release Nos. 15903 (July 31, 1987), 52 FR 28890 (Aug. 4, 1987) (notice) and 15990 (Sept. 18, 1987) (order). With both CMOs and government loan sales, the legislative history of related legislation indicates a congressional expectation that such issuers be exempted. See The Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, Section 7005, 100 Stat. 1874 (1986); 132 Cong. Rec. 33303 (1986); 4 Hearings on the Concurrent Resolution on the Budget for Fiscal Year 1988 before the Senate Comm. on the Budget, 100th Cong., 1st Sess. 99 (1987) (statement of John S.R. Shad, Chairman, SEC); The Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (1984); S. Rep. No. 293, 98th Cong., 2d Sess. 9 (1983).

⁵⁷ See Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 181-82 (1940) (statement of David Schenker, Chief Counsel, SEC investment trusts study) (companies engaged in purchasing mortgages or automobile paper and refrigerator paper excepted). See also T. Frankel, 1 The Regulation of Money Managers 442-449 (1978).

⁵⁸ See Letter from the Investment Company Institute to Richard C. Breeden, Chairman, SEC (Feb. 2, 1990) (arguing that passive credit card receivables should not be deemed exempt under section 3(c)(5)). But see Letter from Thomas C. Smith, Jr., on behalf of a group of securities firms, to Kathryn B. McGrath, Director, Division of Investment Management, SEC (Feb. 27, 1990).

that are sold to accredited or institutional investors be given different regulatory treatment from those sold to other investors? Should all ABAs be excepted from the Act? Should an exception be conditional or unconditional? If a conditional exception is appropriate, what types of conditions would be necessary? That is, are structured financings susceptible to abuse and what conditions would address those abuses? Should distinctions be drawn based upon the level of structural complexity or credit risk of the ABA, or upon the types of securities the ABA issues? What is the appropriate role, if any, of the rating agencies in the regulatory framework?⁵⁹

Proponents of regulation of ABAs have argued that the Investment Company Act was designed for complex financial structures, like ABAs, where, in the proponents' view, investor protection concerns cannot adequately be resolved by disclosure alone.⁶⁰ If regulation under the Investment Company Act is appropriate, what provisions should apply to ABAs? For example, should ABAs be subject to section 17 [15 U.S.C. 80a-17], which restricts transactions with affiliated persons? What alternatives to the requirements of section 17 would be available to deal with potential conflicts of interest? Are the restrictions of section 18 [15 U.S.C. 80a-18] on leverage appropriate for ABAs, or can the policy concerns underlying this section be addressed in an alternative manner? Should ABAs be regulated under a statute or rule designed for this specific type of pooled investment vehicle, much as business development companies and flexible premium variable life insurance have been accommodated under the Act? Should changes be made in the Investment Company Act, the rules thereunder, or interpretive positions?

⁵⁹ Generally, the CMO and government loan sales offerings exempted by the Commission have been conditioned, in part, on the publicly-offered securities' being rated in the top two investment grades.

⁶⁰ See, e.g., Letter from Tamar Frankel, Professor of Law, Boston University, to Kathryn B. McGrath, Director, Division of Investment Management, SEC (Jan. 26, 1990).

D. Distribution of Open-End Companies

The methods by which open-end investment companies have financed the distribution of their shares have changed a great deal in the last ten years, with many companies now using arrangements that did not exist when the Investment Company Act was enacted. Traditionally, most open-end companies financed the expenses associated with the sale of shares by passing these costs on to investors in the form of a sales charge or “sales load” paid at the time of purchase. All investors typically paid the same sales load when buying a company’s shares because section 22(d) of the Investment Company Act [15 U.S.C. 80a-22(d)] prohibits retail negotiation of sales loads.⁶¹ Other open-end companies sold their shares to the public without a sales load, with the distribution costs being paid by the companies’ investment advisers or principal underwriters out of their own resources.

Under section 22(b) of the Investment Company Act [15 U.S.C. 80a-22(b)], the National Association of Securities Dealers, Inc. (“NASD”) may prescribe rules governing sales loads that allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors. The NASD has adopted a rule that generally permits a maximum front-end sales charge of not more than 8.5% of the share’s offering price.⁶² Although many open-end companies continue to use front-end sales loads, a large number now use them coupled with other distribution arrangements. In addition, investors in an investment company no longer necessarily pay the same sales load. Under rule 22d-1 [17 CFR 270.22d-1],

⁶¹ Under section 22(d), investment companies, their principal underwriters, and dealers in their shares may sell the company’s redeemable securities only “at a current public offering price described in the prospectus.” For a discussion of the legislative and administrative history of section 22(d), see Investment Company Act Release No. 13183 (Apr. 22, 1983), 27 SEC Docket 1353 (May 10, 1983) at the appendix (proposing rule 22d-6, which was later adopted as revised rule 22d-1).

⁶² See Article III, section 26(d) of the NASD’s Rules of Fair Practice.

investment companies may offer scheduled variations in, or the elimination of, a front-end sales load to specified classes of shareholders or in connection with specified classes of transactions, provided that the variation is applied uniformly to all investors in the class and certain disclosure requirements are met.⁶³ Negotiation of sales loads, however, continues to be prohibited by statute.

In 1980, after many years of debate, the Commission adopted rule 12b-1 under the Investment Company Act [17 CFR 270.12b-1].⁶⁴ The rule permits an open-end investment company to use company assets under a distribution plan (“12b-1 plan”) to pay sales and promotional expenses associated with the sale of its shares. The rule places the principal responsibility for making decisions relating to the use of company assets for distribution in the hands of the company directors, particularly those directors who are not interested persons of the company.

Since the adoption of rule 12b-1, more than half of all open-end companies have enacted 12b-1 plans. Many of these companies use 12b-1 fees either alone or with sales loads as the primary means of financing distribution.

⁶³ Investment Company Act Release No. 14390 (Feb. 22, 1985), 50 FR 7909 (Feb. 27, 1985) (adopting revised rule 22d-1). The rule superseded more limited rules previously adopted by the Commission in this area.

⁶⁴ Investment Company Act Release No. 11414 (Oct. 28, 1980), 45 FR 73898 (Nov. 7, 1980). Before the adoption of rule 12b-1, the Commission opposed the use of company assets to pay for the distribution of company shares. Since the adviser’s compensation is typically based on the size of the company, the Commission believed that the adviser might be inclined to spend excessive amounts on the distribution of shares in an effort to increase company assets and its own compensation. See Investment Company Act Release No. 16431 (June 13, 1988), 53 FR 23258 (June 21, 1988) (“Release 16431”) (discussing earlier Commission positions).

In 1988, the Commission proposed amendments to the rule.⁶⁵ The proposed amendments would, among other things, require that payments under a 12b-1 plan be made on a current basis and for specific distribution services actually provided to the plan, clarify the duties of directors in adopting and continuing 12b-1 plans, define payments made under a 12b-1 plan as “asset-based sales loads,” and prohibit investment companies that adopt or continue distribution plans from being held out to the public as “no-load” or from being otherwise offered in a misleading manner using similar terminology.

In response to the proposal, the Commission has received over 1,900 letters from individual investors, 40 letters from individuals affiliated with the financial services industry (such as financial planners), and 40 letters from entities affiliated with the investment company industry. Virtually all individual investors and a large majority of the individuals from the financial services industry favor the proposed amendments or support changes to rule 12b-1. Many of the letters from individuals urge that 12b-1 fees be abolished. Most industry commenters, however, strongly oppose the proposed amendments, with many arguing that they are unnecessary and would curtail or eliminate 12b-1 plans as an alternative method of financing distribution.

On April 16, 1990, the NASD published for comment an amendment to its sales charge rule that, if adopted, would subject 12b-1 fees to the rule.⁶⁶ The proposed amendment is intended to ensure, to the extent possible, that a majority of shareholders that own shares of

⁶⁵ Release 16431, supra note 64.

⁶⁶ NASD Notice to Members No. 90-26 (Apr. 16, 1990).

companies with 12b-1 plans pay no more for distribution expenses than is permitted by the provisions of the current rule.⁶⁷

A number of open-end companies now also assess deferred sales loads. In 1981, the Commission first issued an exemptive order permitting the deduction of contingent deferred sales loads (“CDSLs”) upon redemption of company shares.⁶⁸ Since then, the Commission has received and granted numerous applications for exemptions permitting CDSLs. To pay for distribution expenses, many open-end companies use CDSLs in conjunction with 12b-1 plans in lieu of charging investors front-end sales loads.

In 1988, the Commission proposed for comment rule 6c-10.⁶⁹ The proposed rule would permit open-end companies and certain related persons to impose deferred sales loads, both contingent and non-contingent, subject to specified conditions. The proposed rule generally would codify the standards that the Commission has developed in issuing exemptive orders concerning the use of CDSLs and also would permit for the first time other types of deferred sales loads, such as sales loads deducted in installments.

⁶⁷ Under the proposal, however, some long-term shareholders of these companies may still pay more than the economic equivalent of a maximum front-end sales charge. To address this, the proposed amendment also would require that this fact be disclosed adjacent to the fee table in the front section of the prospectus.

⁶⁸ E.F. Hutton Investment Series, Inc., Investment Company Act Release Nos. 12079 (Dec. 4, 1981), 46 FR 60703 (Dec. 11, 1981) (notice) and 12135 (Jan. 4, 1982) (order). The NASD has taken the position that its sales load rule applies to deferred sales loads.

⁶⁹ Investment Company Act Release No. 16619 (Nov. 2, 1988), 53 FR 45275 (Nov. 9, 1988). The Commission had previously adopted rules 6c-8 [17 CFR 270.6c-8] and 6e-3(T) [17 CFR 270.6e-3(T)] which permit certain investment company separate accounts to impose deferred sales loads. See Investment Company Act Release Nos. 13406 (July 28, 1983), 48 FR 36097 (Aug. 9, 1983) (adopting rule 6c-8); 14234 (Nov. 14, 1984), 49 FR 47208 (Dec. 3, 1984) (adopting rule 6e-3(T)); and 15651 (Mar. 30, 1987), 52 FR 11187 (Apr. 8, 1987) (adopting amendments to rule 6e-3(T)).

Commenters on the proposed rule generally support codifying the exemptive orders permitting CDSLs. Commenters' reactions are mixed, however, on whether the Commission should expand these exemptions to permit the use of deferred sales loads not subject to a contingency. Commenters opposing the expansion, many of whom are affiliated with the investment company industry, are particularly concerned about deferred sales loads payable in installments. Some of these commenters argue that investment companies would not be interested in using installment sales loads because of the costs and operational difficulties that would be incurred in implementing such a load structure.

Finally, the Commission has issued a number of exemptive orders permitting the issuance of multiple classes of securities representing interests in a single portfolio of investments where the classes are subject to different distribution arrangements.⁷⁰ The orders contain a number of conditions to address concerns regarding the complexity of the arrangement, including a condition that an independent expert render an initial and annual report on the allocation of expenses between the two classes and the accounting for the expenses.

⁷⁰ See, e.g., Merrill Lynch California Municipal Bond Trust, Investment Company Act Release Nos. 16503 (July 28, 1988), 53 FR 29294 (Aug. 3, 1988) (notice), and 16535 (Aug. 23, 1988) (order) (investors given the option of purchasing shares either with a front-end sales load, or subject to a CDSL and a rule 12b-1 fee); Prudential-Bache California Municipal Fund, Investment Company Act Release Nos. 17277 (Dec. 20, 1989), 54 FR 53414 (Dec. 28, 1989) (notice), and 17308 (Jan. 18, 1990) (order) (investors given the option of purchasing shares either with a front-end sales load and a low 12b-1 fee, or with a CDSL and a higher 12b-1 fee). See also Alliance Short-Term Multi-Market Trust, Inc., Investment Company Act Release Nos. 17295 (Jan. 8, 1990), 55 FR 1300 (Jan. 12, 1990) (notice), and 17330 (Feb. 2, 1990) (order) (arrangement similar to Prudential-Bache's, *supra*, except that, after a specified time, the shares of the class with the higher 12b-1 fee would convert into the other class of shares without payment of any additional load, thereby limiting payments borne by each investor and placing a ceiling on the underwriter's compensation).

The Commission requests comment on whether the present regulatory approach to financing distribution costs should be revisited.⁷¹ Commenters are encouraged to consider any alternative approaches, including distribution arrangements used by other pooled investment vehicles, both in the United States and abroad, such as commodity pools and real estate partnerships. One area of comparison may be with possible fee structures for UIFs.⁷² Another may be with UCITS. The Commission understands that the UCITS Directive would not prohibit price competition among brokers and dealers or the use of assets to finance distribution with appropriate disclosure. Host Member States, however, may impose restrictions on the use of assets to finance distribution. Commenters are requested to address specific changes in the Investment Company Act, the rules thereunder, and any interpretive positions.

The Commission requests comments on how open-end investment companies should be allowed to finance distribution. Should the use of company assets to finance distribution be permitted, and if so, subject to what, if any, conditions? Should there be limits on the amounts that may be expended for such purposes? Should the limits be expressed as percentages of net assets or as percentages of the offering price? Should distribution be financed only on a shareholder account basis by means of front-end sales loads or other fees? What types of sales loads should be permitted? Would direct retail price negotiation between brokers and dealers or the existence of a secondary market in investment company shares increase price competition, reducing the need for regulatory limitations? Would price competition adversely affect

⁷¹ The Commission's reconsideration of the present regulatory approach is not an indication of a change in the Commission's views regarding the proposed amendments to rule 12b-1 or proposed rule 6c-10, both of which remain pending. Comments already received regarding these proposals will be considered as part of the general reexamination of the regulation of investment companies under the Investment Company Act.

⁷² See supra notes 47-49 and accompanying text.

investment companies? Should retail price negotiation be permitted for distribution fees taken out of company assets? That is, should customers be able to negotiate for rebates of distribution fees from sales personnel?

In commenting on whether the present regulatory approach should be changed, commenters should address the potential for investor confusion resulting from a variety of distribution arrangements, the operational ability of the investment company industry to implement various types of financing arrangements, the conflicts of interest inherent when company assets are used to finance distribution and the role, if any, that directors should have in monitoring those conflicts, the amount shareholders should be required to pay and whether such amounts should be capped, and the competitive effects any regulatory revisions would have.

E. Closed-end Funds and Repurchases of Shares

As noted earlier, closed-end companies typically do not issue redeemable securities or continuously offer their shares to the public.⁷³ Investors in closed-end companies must instead trade their shares on a securities exchange or in the over-the-counter market at a price determined by the market, which is typically lower than the shares' net asset value.

A study by the Commission's Office of Economic Analysis demonstrated that a substantial decrease in the value of closed-end fund shares often occurs shortly after the initial public offering.⁷⁴ While some of the decrease is attributable to sales loads, there appears to be a further reduction in share value below net asset value that cannot be explained by the sales load.

⁷³ A redeemable security is "any security * * * under the terms of which the holder, upon its presentation * * * is entitled * * * to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." Investment Company Act § 2(a)(32) [15 U.S.C. 80a-2(a)(32)].

⁷⁴ Office of Economic Analysis of the Securities and Exchange Commission, The Post-Offering Price Performance of Closed-end Funds (July 21, 1989).

It has been observed that the practical effect of this “discount phenomenon” is that a shareholder who purchases shares of a closed-end fund at the initial public offering and subsequently sells those shares in the open market incurs two separate and substantial costs. At the time of the initial public offering, the investor pays a premium over the fund’s initial net asset value to cover underwriting expenses.⁷⁵ Upon the sale of these securities, the shareholder also absorbs the discount at which the fund shares may trade in the open market.

One reason for the existence of the discount may be that brokers have a greater financial incentive to sell shares of closed-end investment companies in the initial public offering than in the secondary market, because broker compensation for sales made during the initial public offering is higher than commission rates for secondary market transactions.⁷⁶ In addition, few analysts choose to follow closed-end funds after the initial offering has been completed. Some observers have suggested that it might be appropriate for closed-end companies to use fund assets to attempt to address the problem of discounts.⁷⁷ For example, a closed-end fund could provide brokers with additional compensation for secondary market transactions in fund shares. Alternatively, closed-end companies could provide analysts with reports and other information in order to increase the number of analysts that follow them and stimulate retail interest.

⁷⁵ The Commission proposed amendments to Form N-2, the registration form for closed-end investment companies, that would change the caption on the fee table from the present term “underwriting discount” to “sales load.” Investment Company Act Release No. 17091 (July 28, 1989), 54 FR 32993 (Aug. 11, 1989) (“Release 17091”).

⁷⁶ See, e.g., id. (separate statement of Commissioner Grundfest); B. Malkiel, The Valuation of Closed-end Investment Company Shares, 32 J. Fin. 847, 857-58 (June 1977).

⁷⁷ At present, closed-end investment companies do not use fund assets to pay for distribution of their shares. Rule 17d-3 [17 CFR 270.17d-3], which exempts certain distribution arrangements between affiliates of open-end investment companies, is not applicable to closed-end funds. Rule 12b-1, which permits open-end management investment companies to use their assets to finance distribution-related activities under certain circumstances, does not apply to closed-end investment companies.

A number of funds have sought to minimize the discount at which their shares trade by employing a variety of other methods, including guaranteeing minimum distributions and reinvesting shareholder dividends in additional fund shares. Other closed-end investment companies have considered either conversion to open-end status or liquidating fund assets.

Perhaps most significantly, a number of closed-end companies have repurchased their shares in the secondary market in reliance on section 23(c)(1) of the Investment Company Act [15 U.S.C. 80a-23(c)(1)], which allows repurchases on an exchange, or have made tender offers for their shares at prices approximating net asset value. A closed-end company, however, cannot give shareholders an unlimited right to have their shares repurchased by the fund at a price approximating net asset value. Under rule 23c-2 [17 CFR 270.23c-2], a closed-end company may call or redeem any securities of which it is the issuer, in accordance with the terms of the securities, but the Division of Investment Management has interpreted the rule to require that the calls or redemptions be at the option of the issuer and not the shareholder.⁷⁸ The Division also has interpreted the Act to limit the ability of closed-end companies to state their intention to make future tender offers at definite times or intervals.⁷⁹

If the shareholders of a closed-end company were given the option to redeem their shares at a price approximating net asset value, the closed-end company would become functionally

⁷⁸ Dimensional Fund Advisors, Inc. (pub. avail. Nov. 21, 1988); J. & W. Seligman & Co. (pub. avail. Nov. 13, 1989).

⁷⁹ In the staff guidelines accompanying Release 17091, supra note 75, the Division stated that a closed-end company may agree to consider periodically whether to make a tender offer, but that the board of directors may breach its fiduciary duty by affirmatively stating that the fund will make tender offers at definite times or intervals in the future. Id. at app. C. Accordingly, the Division cautioned that a registrant contemplating repurchasing shares on a regular or frequent basis should neither state nor imply in its prospectus that the repurchase will be automatic.

similar to an open-end company.⁸⁰ Closed-end companies, however, are not subject to all of the provisions that govern the operation of open-end companies.⁸¹ For example, section 22 of the Investment Company Act [15 U.S.C. 80a-22], which applies only to open-end companies, imposes certain requirements on the sale and redemption of securities. Also, under section 18, closed-end companies, unlike open-end companies, may issue separate classes of senior securities that leverage the company's other securities. This leverage may confuse shareholders as to the value of the securities that are periodically redeemable. It also may make a company's net asset value more sensitive to market movements and, in a declining market, make redemptions of the company's securities more difficult or impossible. In addition, shareholders may become confused as to the limited availability of redemptions and may believe that they have the right to redeem their shares at any time.

The Commission invites comments regarding possible amendments to the Investment Company Act, the rules thereunder, or any interpretive positions that would give closed-end investment companies additional means to attempt to reduce the discount associated with their shares, or provide shareholders with additional flexibility in selling their shares, consistent with investor protection. Commenters are requested to address whether closed-end companies should

⁸⁰ The legislative history of the Investment Company Act and early Commission action indicates that the drafters of the Act regarded the redeemability of shares for open-end companies as the distinction between closed-end and open-end investment companies. Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 56 (1940) (statement of Robert C. Healy, Commissioner, SEC); Wisconsin Investment Company, 10 S.E.C. 555, 557 (1941). Depending on the nature of the redemption rights offered to the shareholders of a closed-end company, the company might be issuing "redeemable securities" and therefore fall within the definition of an open-end company.

⁸¹ See Wisconsin Investment Company, supra note 80, at 557 (Commission granted exemption allowing closed-end investment company to redeem its securities, but required the company to comply with Investment Company Act sections dealing with open-end investment companies).

be permitted to use their assets to pay for activities designed to lower the share price discount from net asset value, as well as the relative costs and benefits to shareholders from such activities, the conflicts of interest inherent when company assets are used to pay sales-related expenses, and whether only closed-end companies engaged in a continuous public offering should be permitted to use their assets for sales-related expenses.

Commenters are also requested to address whether closed-end companies should be permitted to issue securities that offer holders limited rights of redemption and what safeguards would be necessary to prevent any possible investor confusion between this type of company and open-end companies, such as requiring this type of closed-end company's advertising and name to indicate that the company is offering only limited redemption rights. Commenters also may wish to consider whether closed-end companies should be allowed to make periodic redemptions at a price approximating net asset value, or whether closed-end companies should be allowed to redeem their shares after a certain number of days' notice given to the companies by shareholders.⁸² Commenters are also requested to address what safeguards, if any, would be necessary to protect both those shareholders choosing to redeem their shares and those shareholders choosing to retain their shares. Finally, what effect, if any, would periodic redemptions of closed-end funds have on the market generally, and what, if anything, should be done to lessen that effect?

F. Transactions in Options and Futures Contracts

Investment company transactions in futures contracts, options on futures, and options on stock and stock indices continue to increase. Because the Investment Company Act was written

⁸² Commenters should address whether closed-end companies may redeem or repurchase for an amount slightly less than net asset value to reflect the brokerage and other costs associated with the transaction.

long before futures contracts and options gained widespread acceptance, the Act does not address expressly investment company transactions in these instruments. These transactions, however, may raise a number of concerns under the Act. For example, the Division of Investment Management believes that entering into options and futures commitments may result in the leveraging of investment company assets. Section 18 places limitations on the leveraging of investment companies by limiting the amount of “senior securities” an investment company may issue.⁸³ Section 18 is designed, in part, to protect junior security holders from the speculative effects of leveraging.⁸⁴ Under section 18(f), open-end investment companies may not issue senior securities except that they may borrow from banks if they have asset coverage of at least 300%. Section 18(a) allows closed-end investment companies to issue senior securities, including debt, provided that borrowing companies have asset coverage of at least 300%.⁸⁵ The Division of Investment Management has taken the position that, unless a fund that engages in options and futures transactions meets certain segregation requirements or “covers” positions to eliminate any potential leveraging, those transactions may constitute the issuances of senior securities.⁸⁶

⁸³ Section 18(g) [15 U.S.C. 80a-18(g)] defines “senior security” to mean “any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividend.”

⁸⁴ See Investment Company Act § 1(b)(7); Investment Trusts and Investment Companies, *supra* note 1, at 1708.

⁸⁵ With respect to the issuance of preferred stock, section 18(a)(2)(A) requires asset coverage of only 200%.

⁸⁶ See, e.g., Dreyfus Strategic Investing (pub. avail. June 22, 1987); Putnam Option Income Trust II (pub. avail. Aug. 23, 1985).

Commenters are requested to address whether the Investment Company Act should be amended to facilitate the use of options and futures contracts by investment companies for hedging purposes and, if so, what limitations or requirements should be placed on those transactions. Alternatively, should the Commission consider rulemaking or interpretive positions? How should the status of entities that invest in both securities and futures contracts be analyzed under the Act? Do any liquidity or other concerns arise from the use of fund portfolio holdings to cover option positions?

G. Securities Act Issues

An investment company that continuously offers new shares to the public is generally regarded to be engaged in a continuous distribution subject to the registration and prospectus delivery requirements of section 5 of the Securities Act [15 U.S.C. 77e], unless an exemption from registration is available. As a result, these investment companies (as well as the underwriters, brokers, and dealers that distribute their shares) are limited in their ability to advertise.⁸⁷ Because an investment company rarely, if ever, advertises except in connection with the sale of its shares (typically its only “product”), an investment company advertisement generally is deemed to be a prospectus that must comply with statutory requirements. In addition, the investment company must maintain an updated or “evergreen” prospectus that must

⁸⁷ Section 5(b)(1) of the Securities Act makes it unlawful to use jurisdictional means to transmit or carry any “prospectus” relating to any security with respect to which a registration statement has been filed unless the prospectus complies with section 10 of the Securities Act [15 U.S.C. 77j]. A written communication or advertisement designed to procure orders for a security could, unless a safe harbor is available, be a “prospectus” as that term is broadly defined in section 2(10) of the Securities Act [15 U.S.C. 77b(10)]. See In the Matter of Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 848 (1950). As such, the advertisement or written communication must comply with section 10 or be preceded or accompanied by a full statutory prospectus that meets the requirements of section 10(a).

precede or accompany delivery of the securities under section 5(b)(2) of the Securities Act, both for sales by the issuer or by a dealer.⁸⁸

1. Rule 482 Advertisements as “Omitting Prospectuses”

The Commission in 1979 adopted a rule permitting investment companies to publish advertisements containing any information the substance of which is included in the full statutory prospectus.⁸⁹ Rule 482 was adopted under the rulemaking authority contained in section 10(b) of the Securities Act, which permits the use of a prospectus for purposes of section 5(b)(1) that omits in part or summarizes information in the prospectus specified in section 10(a). Thus, rule 482 advertisements are styled “omitting prospectuses.”⁹⁰ Some have suggested that the requirement that the substance of the information in a rule 482 ad be included in the prospectus is awkward and lengthens the prospectus with information that may not be of interest to the individual investor.

Comment is requested on whether the Securities Act or the Investment Company Act should be amended to deal specifically with investment company advertisements and, if so, how

⁸⁸ Section 24(d) of the Investment Company Act [15 U.S.C. 80a-24(d)] effectively eliminates the so-called “dealer exception” in section 4(3) of the Securities Act [15 U.S.C. 77d(3)] with respect to the sale of investment company securities of the type continuously offered to the public. See infra notes 96-99 and accompanying text.

⁸⁹ See Securities Act Release No. 6116 (Aug. 31, 1979), 44 FR 52816 (Sept. 10, 1979) (adopting rule 434(d), later renumbered as rule 482 [17 CFR 230.482]). In contrast, rule 134 under the Securities Act [17 CFR 230.134] limits so-called “tombstone” advertisements to the specific types of information set forth in the rule (e.g., the name of the issuer, the title of the security, the amount being offered). Prior to adoption of rule 482, rule 134 was amended several times to permit investment company tombstones to include a broader range of information than can be included in the tombstones of other issuers. See, e.g., Securities Act Release No. 5536 (Nov. 4, 1974), 39 FR 39868 (Nov. 12, 1974) (adopting amendments to rule 134).

⁹⁰ An “omitting” prospectus may be used prior to delivery of the full statutory prospectus that must precede or accompany delivery of the security or confirmation of the sale.

it should be amended. For example, section 10(b) of the Securities Act could be amended to permit certain types of investment company advertisements, including advertisements containing performance information, under such requirements as the Commission may prescribe, but not require that the substance of the information be contained in the prospectus of the investment company.⁹¹ Of course, if the amendment were added to section 10(b), the advertisements would continue to carry prospectus liability for false or misleading statements of material fact.⁹² However, comment is requested on whether investment company advertisements should continue to carry prospectus liability.

Another approach would be to amend rule 482 to allow investors to purchase fund shares directly from an advertisement, by completing an application form included in the ad, similar to the so-called “off the page” advertisements permitted in the United Kingdom.⁹³ Rule 482 currently prohibits this practice. Commenters should consider whether rule 482 should be amended, or another rule adopted, to permit investment company advertisements to include an application or order form to purchase fund shares, and if so, whether the ad should be required to contain certain information (e.g., fund policies, risks, charges).

⁹¹ Commenters should consider whether it would be necessary to amend section 10(b) because, as earlier noted, section 10(b) currently only authorizes the Commission to adopt rules permitting the use of a prospectus for purposes of section 5(b)(1) that “omits in part” or “summarizes” information in the full statutory prospectus.

⁹² Although section 10(b) specifically states that a prospectus permitted under that subsection is not deemed part of the registration statement for purposes of section 11 of the Securities Act [15 U.S.C. 77k], civil liability would attach under section 12(2) of that Act.

⁹³ See Securities and Investments Board (United Kingdom), the Financial Services (Conduct of Business) Rules 1987, rule 7.25.

Finally, commenters are requested to provide information on how other countries regulate investment company advertising and to consider whether some comparable regulatory approach should be adopted, in whole or in part, in the United States.

2. UIT Secondary Market Sales

Sponsors of UITs, although not required to do so, generally maintain a secondary market in trust units as an alternative to the UITs' having to redeem shares. Maintenance of a secondary market benefits unit holders because it increases liquidity and may prevent the premature liquidation of the trust.⁹⁴

The registration statement of each series of a UIT for which the sponsor maintains a secondary market must be kept current because the sponsor, as the trust's depositor, is an "issuer" under section 2(4) of the Securities Act [15 U.S.C. 77b(4)]. Although secondary market sales of registered securities are usually not subject to the Securities Act once the offering has "come to rest," all securities offered or sold by an issuer, (i.e., the sponsor) unless otherwise exempt, are subject to the registration requirements of the Securities Act, notwithstanding the fact that the securities may have been sold previously under an effective registration statement.⁹⁵ As a result, sponsors maintaining a secondary market are required to file annual post-effective amendments for each UIT series and comply with filing and fee requirements under section 24(f) of the Investment Company Act [15 U.S.C. 80a-24(f)]. In addition, a prospectus generally must be delivered to investors in connection with each secondary market sale, including sales by

⁹⁴ Redeeming shares might require the UIT to sell off a portion of its underlying portfolio and, eventually, liquidate.

⁹⁵ See First Multifund for Daily Income v. United States, 602 F.2d 332 (Ct. Cl. 1979), cert. denied 445 U.S. 916 (1980); SEC v. Stanwood Oil Corp., 516 F. Supp. 1181 (W.D. Pa. 1981). See also Securities Act Release No. 5817 (Mar. 15, 1977), 42 FR 15922 (Mar. 24, 1977) (proposing Investment Company Act rule 24e-2).

dealers who are not sponsors, because section 24(d) of the Investment Company Act eliminates the “dealer exception” in section 4(3) of the Securities Act.⁹⁶

Commenters are asked to consider whether the requirement that sponsors and third party dealers deliver a prospectus in connection with secondary market sales of UITs should be eliminated, and if so, how best to accomplish that objective. Commenters should specifically address whether UITs should be treated differently in this regard from other issuers.⁹⁷ If the prospectus delivery requirement were eliminated, how would secondary market purchasers of UITs be able to obtain adequate information about their investment? Should sponsors and third party dealers be required to deliver the most recent annual report of the UIT’s trustee or a similar document in connection with secondary market sales of UITs?

One option would be to revise section 2(4) of the Securities Act so that the depositor (sponsor) of a UIT is not an “issuer,”⁹⁸ or is only an “issuer” until the initial public offering of the series is completed. Thereafter, the depositor could be deemed to be a dealer with respect to

⁹⁶ Section 24(d) provides, in pertinent part:

The exemption provided by * * * section 4(3) of the Securities Act of 1933, as amended, shall not apply to any transaction in a security issued by a * * * unit investment trust, if any other security of the same class is currently being offered or sold by the issuer or by or through an underwriter in a distribution which is not exempted from section 5 of said Act, except to such extent and subject to such terms and conditions as the Commission, having due regard for the public interest and the protection of investors, may prescribe by rules or regulations with respect to any class of persons, securities, or transactions.

⁹⁷ Section 24(d) of the Investment Company Act was amended in 1954 to eliminate the dealer’s exception with respect to securities issued by mutual funds and UITs on the theory that, because those issuers continuously offered their securities to the public, all dealers should be compelled to use the statutory prospectus. H.R. Rep. No. 1542, 83d Cong., 2d Sess. 29-30 (1954).

⁹⁸ Of course, any depositor who also acts as an underwriter of trust units would be subject to liability for its underwriting activities under the Securities Act.

secondary market sales. If section 2(4) were so amended, section 24(d) of the Investment Company Act would no longer apply, and section 4(3) would then operate to exempt most dealer sales in the secondary market from the prospectus delivery requirements. Commenters should address whether means exist to make such changes through the rulemaking process rather than by statutory amendment. Commenters should also address whether dealers should be required to deliver prospectuses for secondary market sales under other circumstances, such as, for example, trades occurring any time before the initial public offering of the series is completed.⁹⁹

3. Delivery of Prospectuses of Open-End Companies Prior to Sale

Open-end management investment companies are subject to the same prospectus delivery requirements as other issuers. A full statutory prospectus must be delivered to purchasers no later than delivery of the security or receipt of confirmation of the sale.¹⁰⁰ The circumstances of the sale of open-end company shares differs from that of other issuers, however, because a full statutory prospectus is typically available beforehand.¹⁰¹ In addition, mutual fund shares may be sold on the basis of fairly extensive advertising (*i.e.*, rule 482 advertisements), whereas non-investment company issuers are limited to tombstone advertisements.

⁹⁹ Under section 4(3), dealers must deliver a prospectus in connection with original sales by the dealer of securities obtained from or through an underwriter, and resales by the dealer occurring prior to 40 days (90 days for first-time issuers) after the effective date of the registration statement (or, under certain circumstances, a different date). See also rule 174 under the Securities Act [17 CFR 230.174], which provides an exception from the requirement in section 4(3) that a prospectus be delivered prior to the expiration of the applicable 40-day or 90-day period.

¹⁰⁰ Thus, investors may see the prospectus for the first time with receipt of the confirmation or the security itself.

¹⁰¹ Preliminary prospectuses are not often used for sales of mutual fund securities because the fund usually does not commence marketing until its registration statement is effective, and, thereafter, uses its final prospectus.

Rule 482 advertisements must state from whom a prospectus may be obtained and that investors should read the prospectus before investing. However, in the case of dealer sales of securities issued by open-end companies, it may be unrealistic to assume that potential investors will take the time to request and review a prospectus before investing. Rather, investors may be purchasing based not on the prospectus, but solely on the basis of an advertisement or oral representation of the salesperson.

Commenters are requested to address whether section 5(b)(2) of the Securities Act or section 24 of the Investment Company Act should be revised to require the delivery of mutual fund prospectuses prior to sale. In 1941, the Commission proposed amending the Securities Act to require delivery of a form of prospectus to all investors (not just mutual fund investors) a reasonable time before purchase, but the proposal was not adopted.¹⁰² This proposal was followed by numerous efforts to improve dissemination of prospectuses to investors, including the development and formalizing of preliminary prospectus procedures as well as certain types of summary prospectuses.¹⁰³ Because open-end companies do not widely distribute a preliminary prospectus prior to sale, and because full statutory prospectuses for open-end companies are almost always available, it may be appropriate to require delivery of prospectuses before sale.

¹⁰² SEC Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, H.R. Comm. Print, Comm. on Interstate and Foreign Commerce, 77th Cong., 1st Sess. 9-12 (1941). See also Hearings on Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934 Before the House Comm. on Interstate and Foreign Commerce, 77th Cong., 1st Sess. 320 (1942) (statement of Ganson Purcell, Commissioner, SEC).

¹⁰³ See Report of the Securities and Exchange Commission, Disclosure to Investors (1969) 106-11. See also Rule 431 under the Securities Act [17 CFR 230.431] governing summary prospectuses.

H. Insurance Products Under the Federal Securities Laws

In the 1950s, insurance companies began to offer insurance contracts that blurred the distinction between traditional insurance and securities and raised questions under federal securities laws. In SEC v. Variable Annuity Life Insurance Co., 359 U.S. 65 (1959), the Supreme Court held that the first of these new contracts, the variable annuity,¹⁰⁴ was a security not entitled to the exemption in section 3(a)(8) of the Securities Act [15 U.S.C. 77c(a)(8)].¹⁰⁵ The Court's decision placed primary emphasis on the notion that all of the investment risk was on the contractholder, rather than on the issuer.¹⁰⁶ The Court also held that an issuer of variable annuity contracts was an investment company not entitled to the exception in the Investment Company Act for insurance companies.¹⁰⁷

After protracted administrative proceedings, the Commission determined that another new type of contract, variable life insurance,¹⁰⁸ was a security required to be registered under the

¹⁰⁴ A variable annuity generally is any accumulation or annuity contract, the value of which varies with the investment experience of an insurance company separate account.

¹⁰⁵ Section 3(a)(8) of the Securities Act exempts from that Act any insurance or endowment policy or annuity contract issued by a corporation subject to the supervision of state insurance regulators.

¹⁰⁶ Justice Brennan, in his concurring opinion, examined the differences between state and federal law that Congress set up in 1933 to see whether variable annuity contracts were the type of investment that Congress was willing to leave exclusively to state insurance commissioners. Justice Brennan concluded that state insurance regulation, which was concerned with such matters as contract terms, reserves, and solvency, was not relevant where people entrusted their money to others to be invested on an equity basis. SEC v. Variable Annuity Life Ins. Co., 359 U.S. at 78-79 (Brennan, J. concurring).

¹⁰⁷ Section 3(c)(3) of the Investment Company Act [15 U.S.C. 80a-3(c)(3)] excepts insurance companies from the definition of investment company.

¹⁰⁸ A variable life insurance contract may be described generally as a contract that guarantees a minimum death benefit, but also provides a variable death benefit and variable cash value that reflects the investment experience of an insurance company separate account.

Securities Act. The Commission pointed to the variable death benefit and cash value features of the variable life contract, and concluded that variable life insurance contractholders would assume a substantial investment risk. The Commission also concluded that a variable life insurance separate account¹⁰⁹ that funds such contracts would be an investment company, but said that “this [was] a close question.”¹¹⁰

In addition to variable insurance contracts, insurance companies also began to offer through their general account a type of interest-sensitive product called a guaranteed investment contract (“GIC”).¹¹¹ The Commission took the position that some of these contracts were

¹⁰⁹ “Separate account” is defined in section 2(a)(37) of the Investment Company Act [15 U.S.C. 80a-2(a)(37)] as “an account established and maintained by an insurance company * * * under which income, gains and losses, whether or not realized, from assets allocated to such account, are * * * credited to or charged against such account without regard to other income, gains, or losses of the insurance company.”

The Court of Appeals for the Third Circuit had previously held that a separate account used to fund the reserves under a variable annuity contract was separable from the insurance company and required to register under the Investment Company Act. Prudential Ins. Co. v. SEC, 326 F.2d 383 (3d Cir.), cert. denied, 377 U.S. 953 (1964).

¹¹⁰ The Commission then adopted rule 3c-4, which exempted from the Investment Company Act certain separate accounts established to fund variable life insurance contracts. The Commission’s decision to adopt rule 3c-4 was based, in part, on the expectation that the states would develop regulations with respect to variable life insurance that would provide protections to purchasers substantially equivalent to those afforded by the Investment Company Act. The Commission indicated that it would monitor the development of state law, and that, if regulatory deficiencies were not remedied, it would consider modifying or rescinding the rule. Investment Company Act Release No. 7644 (Jan. 31, 1973), 38 FR 4315 (Feb. 13, 1973). The Commission subsequently rescinded rule 3c-4 because it “would not assure the necessary investor protections.” Investment Company Act Release No. 8826 (June 18, 1975), 40 FR 27644 (July 1, 1975).

¹¹¹ A GIC is a type of annuity contract under which the purchaser agrees to pay money to an insurer and the insurer promises to pay interest at some guaranteed rate for the life of the contract, and, in some contracts, the insurer may periodically pay discretionary excess interest over and above the guaranteed rate. In addition, all of these contracts generally allow the purchaser to buy an annuity with the monies accumulated under the contract. See Securities Act Release No. 5838 (June 22, 1977), 42 FR 32861 (June 28, 1977) (“Release 5838”) for a more detailed discussion of GICs.

securities required to be registered under the Securities Act. In order to provide assistance in determining the status of these contracts under the Securities Act, the Commission issued a number of interpretive releases. Most recently, the Commission issued rule 151 [17 CFR 230.151], which provides a safe harbor for GICs meeting the requirements of the rule.¹¹²

1. Variable Insurance Contracts

As an initial matter, commenters are asked to consider whether variable insurance contracts should continue to be regulated as securities under the Securities Act, or whether the statute should be amended to exempt such contracts, in whole or in part, from the requirements of that Act. In considering this question generally, commenters are asked to consider whether Securities Act regulation of variable insurance contracts is appropriate, and whether the differences between variable life insurance and variable annuities warrant differing treatment for these two types of contracts under that Act.¹¹³

Assuming variable insurance contracts should continue to be registered under the Securities Act, should the separate accounts that fund them be excluded from the definition of investment company in the Investment Company Act? Is the basis for Investment Company Act regulation of separate accounts still valid? In determining whether an insurance company itself should be required to register under the Investment Company Act, how should the Commission

¹¹² Securities Act Release No. 6645 (May 29, 1986), 51 FR 20254 (June 4, 1986) (“Release 6645”). Rule 151 is discussed infra notes 120-121 and accompanying text.

¹¹³ Commenters have suggested that the Commission should adopt a “predominance test” for all insurance products with an investment component, including variable life insurance. Under this test, consideration is given to the significant mortality component under the contracts. See, e.g., Kroll & Cohen, The Insurance-Security Identity Crisis, 46 Geo. Wash. L. Rev. 790 (1978).

interpret the company's "primary and predominant business activity?"¹¹⁴ Should the Commission consider the assets held by separate accounts and the assets held by the general account that are attributable to GICs that are required to be registered under Securities Act?

Because variable insurance contracts have both insurance and investment features, neither they nor the separate accounts that fund them fit comfortably under investment company regulation. The interplay between the insurance and investment elements of variable insurance products has required several Commission rules providing extensive exemptions from various provisions of the Investment Company Act.¹¹⁵ Assuming variable products should continue to be regulated under the federal securities laws, commenters are asked to consider whether a separate statute for variable insurance products would result in a more efficient regulatory framework, or whether the existing framework should be retained but amended, through rulemaking or interpretation.

If a new statutory approach is preferable, should it be premised on Securities Act-type disclosure principles, Investment Company Act-type regulatory requirements, or some

¹¹⁴ Section 2(a)(17) of the Investment Company Act [15 U.S.C. 80a-2(a)(17)] defines "insurance company" as "a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State * * *."

¹¹⁵ See, e.g., rules 0-1(e), 6e-2, 6e-3(T) [17 CFR 270.0-1(e), 270.6e-2, 270.6e-3(T)].

combination of both?¹¹⁶ What “security” should be registered? In the case of variable annuities, should it be the contract, or only the accumulation and annuity units representing payments allocated to the separate account? Similarly, what should be deemed to be the “security” registered by the issuer of variable life insurance contracts? Who should be considered the “issuer” of variable insurance contracts: the insurance company sponsoring the separate account, or the separate account itself? When should a sale be deemed to occur for a variable insurance contract that requires the remittance of periodic payments over its life?¹¹⁷ Do the differences between variable life insurance and variable annuities warrant different regulatory approaches? In addition to considering whether variable annuities and variable life insurance warrant different treatment, commenters also should consider whether section 3(a)(2) of the Securities Act and section 3(c)(11) of the Investment Company Act and rules 22d-1 and 22d-2 thereunder adequately take account of the different regulatory issues that arise in the context of group insurance contracts.¹¹⁸

¹¹⁶ One observer has urged, in the context of variable life insurance, that any attempt at drafting a statute be premised on the principle of disclosure, at least with respect to selling practices and limits on charges currently provided for in the Investment Company Act and the rules thereunder. See Latto, A Proposed Federal Variable Contracts Act of 1990?, ALI-ABA Conference on Life Insurance Company Products (Nov. 1989). It may be difficult, however, to implement controls over some charges (e.g., some or all investment-related charges) and not others (e.g., imposing a disclosure standard for insurance-related charges). A system structured on both disclosure and regulatory principles might present opportunities for an insurer to shift excessive amounts of a regulated charge (i.e., amounts in excess of some regulatory ceiling) to a charge that is not so regulated.

¹¹⁷ Should the sale be deemed to occur at the time of initial purchase only or each time a payment is made (scheduled or unscheduled) under the contract?

¹¹⁸ See generally Mason & Roth, SEC Regulation of Life Ins. Products - On the Brink of the Universal, 15 Conn. L. Rev. 505, 522-25 (1983); see also Frankel, 4 The Regulation of Money Managers 356-58 (1980).

On the other hand, if the existing regulatory framework should be retained, but amended, what are the specific regulatory provisions that should be amended, and how should they be amended? Commenters are asked, in particular, to address the topics discussed below.

First, variable contracts are subject to the limitations imposed by section 27 [15 U.S.C. 80a-27], which was designed for periodic payment plans. Section 27 regulates the sales charges and administrative expenses under variable insurance contracts, requires the contracts to be redeemable, and prescribes certain refund and withdrawal rights depending on the sales load design. Although the Commission has exercised its rulemaking authority to accommodate the insurance element of variable contracts, issues continue to arise in this area.¹¹⁹ Commenters are asked to comment on whether section 27 imposes unnecessary or burdensome constraints on the design of variable contracts, and if so, to suggest alternative approaches consistent with investor protection.

Second, the Commission regulates the level of administrative charges under variable insurance contracts through the application of section 26 and section 27(c)(2) of the Investment Company Act [15 U.S.C. 80a-26, -27(c)(2)], which were designed to regulate the expenses of UITs and periodic payment plans. For the most part, these sections limit deductions for administrative expenses to the costs incurred in providing such services. Comments are requested on whether this is an appropriate standard.

Third, commenters may also wish to address problems associated with the unique disclosure issues raised by variable insurance products. For example, should variable life

¹¹⁹ For example, the guideline annual premium concept was introduced to permit issuers of flexible premium variable life insurance to comply with sales loads limitations given the flexibility in premium payments, the indeterminate length of the contracts, and the desire of issuers to impose sales loads in excess of nine percent in the early years of the contract. Rule 6a-3(T)(b)(13)(i).

insurance prospectuses include a fee table, and if so, how might it present the unique aspects of life insurance charges? Should contractholders be presented with information on the rate of return on the savings component of variable life insurance contracts? How may illustrations be standardized to enhance comparability among competing products? Should illustrations be used by issuers of variable annuities?

2. Guaranteed Investment Contracts

As noted above, a GIC cannot always be readily characterized as “insurance” or as a “security” for purposes of section 3(a)(8) of the Securities Act. To provide greater certainty regarding the availability of section 3(a)(8), the Commission adopted rule 151, which provides a non-exclusive safe harbor for GICs that satisfy all of the rule’s conditions.¹²⁰ Significantly, rule 151 dispenses with the requirement that a GIC contain a mortality component, although this remains a factor in a section 3(a)(8) analysis.¹²¹

¹²⁰ Under rule 151, an annuity contract will be deemed to fall within section 3(a)(8) if it is issued by an insurer subject to the supervision of a state insurance commissioner, the insurer assumes the investment risk under the contract, and the contract is not marketed primarily as an investment. To assume the investment risk, the insurer must guarantee the principal amount of purchase payments and interest credited thereto, credit a minimum specified rate of interest, and guarantee that any excess interest (above the required minimum) will not be modified more often than annually.

¹²¹ Release 6645, supra note 112.

Comments are requested generally on whether investor protection concerns suggest that GICs should be subject to the federal securities laws.¹²² In the absence of actuarial considerations (the pooling mechanism), should an insurance company's guarantee under a GIC be treated differently from a guarantee provided by any other person?

I. Bank Involvement with Investment Companies

The Commission has previously recommended that if banks are permitted to sponsor, distribute, and underwrite investment companies, the Investment Company Act and the Advisers Act should be amended.¹²³ Because the two Acts were drafted in the context of the separation between banking and securities mandated by the Glass-Steagall Act,¹²⁴ they do not adequately address the conflicts of interest and other investor protection concerns presented by bank involvement in the investment company business. Although banks generally are not allowed to underwrite investment company securities, they now engage in a wide range of investment

¹²² In this regard, what significance should be accorded mortality risks in analyzing the status of GICs under Section 3(a)(8)? The Commission determined not to include a mortality risk assumption requirement as a separate element of rule 151. The Commission noted that when Congress created the insurance exclusion under the Securities Act, there were certain "traditional" annuity contracts in effect that involved no assumption of mortality or longevity risks by the insurer. However, the Commission concluded that the presence or absence of a mortality risk assumption may be an appropriate factor to consider in a section 3(a)(8) analysis of annuity contracts outside the "safe harbor." Release 6645, *supra* note 112. For an argument that the *sine qua non* of insurance is the pooling of mortality risks, *see* Kroll and Cohen, *supra* note 113, at 799. For a criticism of the current regulation of GICs, *see* Neuenschwander, The Inadequacy of Current Regulation of Financial Products: The Case of the Single-Premium Deferred Annuity, 26 Am. Bus. L. J. 183, 217 (1988).

¹²³ See, e.g., Hearings for the Reform of the Nation's Banking and Financial System Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs 540-41, 100th Cong., 1st Sess. (1987) (statement of David S. Ruder, Chairman, SEC).

¹²⁴ The Banking Act of 1933, commonly referred to as the Glass-Steagall Act, 48 Stat. 162, is codified at various sections of Title 12 of the United States Code, as amended. 12 U.S.C. 24, 78, 278, 377.

company activities, including advising investment companies and selling investment company shares as agent. In addition, the Office of the Comptroller of the Currency has proposed to amend its regulation of common trust funds to eliminate, among other things, the prohibition on common trust fund advertising.¹²⁵ These activities raise many of the concerns that would be created by repeal of the Glass-Steagall Act. Accordingly, the Commission requests comment on the regulatory changes necessitated by bank entry into the investment company industry.

In 1988, in response to legislative proposals to allow greater bank securities activities, the Commission proposed several amendments to the Investment Company Act and the Advisers Act.¹²⁶ Commenters are asked to comment on those proposals, as well as any other matters that they believe should be addressed. The Commission's 1988 proposals are briefly summarized below.

First, the Commission recommended amending the Investment Company Act to clarify and strengthen the Commission's authority to regulate how banks may serve as custodians of affiliated management investment companies and as trustees of affiliated UITs.¹²⁷ Second, to avoid the potential abuse of overreaching by a bank affiliate in a loan transaction with an investment company, the Commission recommended amending the Investment Company Act to

¹²⁵ Notice of Proposed Rulemaking, Fiduciary Powers of National Banks and Collective Investment Funds, 55 FR 4184 (Feb. 7, 1990).

¹²⁶ Memorandum of the SEC to the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce concerning Financial Services Deregulation and Repeal of the Glass-Steagall Act (Apr. 11, 1988). The Commission also proposed amendments to the Exchange Act, including amending the definitions of "broker" and "dealer" to include banks that engage in certain activities. Those amendments are not discussed here because they do not relate solely to investment company regulation.

¹²⁷ The Commission said it should be given explicit rulemaking authority to prescribe appropriate requirements for investor protection where a bank affiliated with a management investment company seeks to act as its custodian or where a bank affiliated with a UIT seeks to serve as its trustee. Id.

prohibit a bank-affiliated investment company from borrowing from its affiliated bank or banks, except in accordance with Commission rules. Third, the Commission recommended amending the Advisers Act to remove the current exclusion from the definition of “investment adviser” for those banks that serve as advisers to registered investment companies. Fourth, the Commission recommended amending the Investment Company Act to regulate potential conflicts of interest arising from the relationships between banks and their borrowers, such as where a bank-affiliated investment company might invest in a corporation to further the bank’s interest as a creditor of the corporation. Fifth, the Commission recommended amending the Investment Company Act to provide that no registered investment company may have a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank holding company or any company affiliated with it, and amending the definition of “interested person” in section 2(a)(19) of the Investment Company Act [15 U.S.C. 80a-2(a)(19)] to include persons with significant relationships to a bank affiliated with an investment company. Sixth, the Commission recommended amending section 35(d) of the Investment Company Act [15 U.S.C. 80a-34(d)] to prevent investor confusion between bank deposit instruments and investment company securities, by giving the Commission additional authority to require disclosure that the securities of a bank-affiliated investment company are not backed by federal deposit insurance.

J. Miscellaneous

1. Institutional Funds

The Investment Company Act does not distinguish between investment companies that are sold to retail investors and those that are sold to institutional investors, with a limited exception. Section 3(c)(1) of the Investment Company Act provides an exception for “private” investment companies, but, to qualify for that exception, a company can have no more than 100

shareholders. Commenters are asked to discuss whether the exception should be expanded to include entities that sell their securities to an unlimited number of institutional investors.¹²⁸ Alternatively, should investment companies with more than 100 institutional shareholders be required to register under the Investment Company Act, but be exempted from some of its provisions, either by statute or by rule? From what provisions should such entities be exempted? Finally, if an expanded exemption is appropriate, should it be available to entities that sell their securities publicly overseas, but sell their securities in the United States only to institutional investors?

2. Regulation of Series Companies

The Investment Company Act allows investment companies to issue series of stock each representing interests in distinct portfolios of securities. Many investment companies have chosen to organize in this fashion because the series structure may result in certain economies. Because the Investment Company Act generally does not specify the provisions for which a series should be deemed a separate investment company, a number of questions exist concerning the application of many of the Act's provisions.¹²⁹ Commenters are asked to address the appropriate resolution of these questions. In addition, the use of one prospectus by an investment company with a number of different portfolios may result in a long, confusing prospectus. Should the number of series of any one investment company, or the number of series described in one prospectus, be limited?

¹²⁸ Such an exception might also have significance for the treatment of asset-backed securities under the Investment Company Act. See supra notes 50-60 and accompanying text.

¹²⁹ For a detailed discussion of these questions, see Fleming, Regulation of Series Investment Companies Under the Investment Company Act of 1940, 44 Bus. Law. 1179 (1989).

3. Fund Complexes

Since the passage of the Investment Company Act, the industry has developed to consist primarily of various money manager organizations each offering a number of different types of open-end companies. Many of these so-called “complexes” are large with some consisting of as many as 100 open-end investment companies sharing a common adviser and underwriter, with liberal exchange privileges among the companies. The Investment Company Act, however, focuses on individual investment companies. Commenters should address whether and how the Act and the Commission’s rules should be amended to focus on issues raised under the Act by investment company complexes. For example, should prospectuses for funds in a complex also contain summary information for the other funds offered by that complex?

4. Transactions with Affiliated Persons

Section 17(a) of the Investment Company Act prohibits affiliated persons, promoters of, and principal underwriters for registered investment companies, and affiliated persons of such persons, from engaging in certain principal transactions with the investment companies without first seeking an order of the Commission. Rule 17d-1, adopted under section 17(d) of the Investment Company Act, prohibits certain joint enterprises among registered investment companies and their affiliated persons and principal underwriters or affiliated persons of such persons or underwriters absent an order of the Commission approving such enterprises. Sections

17(a) and 17(d) were designed to protect investment companies from self-dealing and overreaching by insiders.¹³⁰

Commenters have suggested that section 17(a) and rule 17d-1 provide unduly cumbersome procedures for approval of transactions involving investment companies and their affiliates.¹³¹ Others have criticized rule 17d-1 as being unclear and inconsistent with the purpose of section 17(d).¹³²

The Commission seeks comment on whether section 17(a) and rule 17d-1 should be amended to permit increased transactions involving investment companies and their affiliates. Are there classes of transactions now subject to either the section or the rule that do not present the dangers of overreaching? Are there classes of affiliated persons that should not be subject to either the section or the rule? Should the definition of “affiliated person” in section 2(a)(3) of the Investment Company Act [15 U.S.C. 80a-2(a)(3)] be revised?

Should transactions with affiliates generally be permitted, subject to the review of the independent directors? If so, should such transactions be subject to section 36(b)?¹³³

¹³⁰ In addition, section 10(f) of the Investment Company Act prohibits an investment company from knowingly purchasing or otherwise acquiring during the existence of any underwriting or selling syndicate any security a principal underwriter of which is an officer, director, member of an advisory board, investment adviser, or employee of the investment company or any person of which such officer, director, member of an advisory board, investment adviser, or employee is an affiliated person.

¹³¹ See, e.g., Rosenblat and Lybecker, Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project, 124 U. Pa. L. Rev. 587, 639, 649 (1976).

¹³² See, e.g., Bartlett & Dowd, Section 17 of the Investment Company Act -- An Example of Regulation by Exemption, 8 Del. J. Corp. L. 449 (1983).

¹³³ Section 36(b)(4) provides that the provisions of section 36(b) shall not apply to compensation in connection with transactions subject to section 17.

How may the scope of rule 17d-1 best be clarified? Should rule 17d-1 be amended to prohibit only those joint transactions where an investment company participates on a different or less advantageous basis or otherwise involves overreaching? If so, how should overreaching be defined?

5. Size of Investment Companies

Section 14(a)(1) of the Investment Company Act generally requires an investment company to have a net worth of at least \$100,000 before commencing a public offering of its securities. The legislative history of the section indicates that Congress imposed a minimum net worth requirement for registered investment companies to prevent organizers from forming and later abandoning the company to the detriment of investors.¹³⁴ While the \$100,000 minimum net worth requirement may have been adequate in 1940 to ensure that a minimum risk capital was committed to the investment company's operations, the requirement now appears to be low. Comment is requested on whether the net worth requirement in section 14(a)(1) should be increased and by what amount. Should provision be made to adjust automatically the minimum net capital requirement, and, if so, what criteria should govern any readjustment?

IV. ADMINISTRATIVE POLICY DURING THE PERIOD OF REEXAMINATION

The underlying reason for reexamination of the regulation of investment companies and other pooled investment vehicles at this time is the extent of developments in the financial markets during the fifty years since enactment of the Investment Company Act and the Advisers Act and particularly during the twenty years since the last significant amendments of the laws governing investment companies other than business development companies. Many of the

¹³⁴ See Investment Trusts and Investment Companies: Hearings on H.R. No. 10065 Before a Subcomm. of the Comm. on Interstate and Foreign Commerce, 76th Cong. 3rd Sess. 116 (1940).

specific topics on which the Commission seeks comments in Section III of this release arise as a result of the proliferation of new vehicles, the development of new markets, and the creation of new financial interests which, by virtue of the scope and expansiveness of the operative phrases “primarily in the business of investing, reinvesting, or trading in securities,” and in “the business of investing, reinvesting, owning, holding, or trading in securities,” are within the reach of the Investment Company Act. Many of the vehicles and interests, and the markets in which they are traded, are adapted only with great difficulty to regulation under the Investment Company Act; some appear as a practical matter to be prohibited under that regulatory pattern. In many instances, the vehicles and interests implicate only to a minor extent certain of the core problems to which various provisions of the Investment Company Act are addressed.

Congress bestowed upon the Commission a broad power to exempt persons, securities, and transactions from any provision or provisions of the Investment Company Act “if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act].”¹³⁵ That exemptive power has been historically exercised by the Commission “with circumspection and with full regard to the public interest and the purposes of the Act * * *.”¹³⁶ Over the decades, the Commission has granted exemptions in situations where the Investment Company Act by its terms clearly applied, and has rejected the argument that simply because a provision prohibited certain conduct any exemption from that provision was contrary to the intent of the Act.

¹³⁵ Investment Company Act § 6(c).

¹³⁶ Great American Life Underwriters, Inc., 41 S.E.C. 15 (1960).

The Commission is aware that section 6(c) is analogous to section 3(d) of the Public Utility Holding Company Act of 1935 [15 U.S.C. 79c(d)] and the Commission is sensitive to the constitutional dimension inherent in any interpretation of exemptive authority that seeks to justify such a delegation in the absence of standards for the exercise of the authority delegated. During the pendency of the review of comments elicited by this release, and while awaiting adoption of such legislative or administrative amendments as may result therefrom, the Commission intends to follow the interpretation of its section 6(c) authority evidenced in its prior exemptive orders. The Commission believes that the tripartite test set forth in section 6(c) provides the Commission with standards that, applied with circumspection, allow it to exempt particular vehicles and particular interests from those provisions of the Investment Company Act that inhibit competitive development of new products and new markets offered and sold in or from the United States.

V. CONCLUSION

In reexamining the regulation of investment companies, the Commission is seeking comment on a number of specific regulatory issues. Commenters are encouraged, however, to address any other matters that they believe merit reexamination.

By the Commission,

Jonathan G. Katz
Secretary

Dated: June 15, 1990